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2009 Annual Report

Banca d'Italia/Central Bank of Italy

BANCA D'ITALIA
EUROSISTEMA

Annual Report
Abridged Version

Ordinary Meeting of Shareholders
Rome, 31 May 2010

116th FINANCIAL YEAR

2009

Financial Year 116th

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2009 - 116th 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

World output contracted by 0.6 per cent in 2009, as the sharp fall of 3.2 per cent in the advanced economies was not quite offset by the gain of 2.4 per cent, modest by comparison with the pre-recession years, recorded by the emerging and developing countries. The latter's share of world GDP, at purchasing power parity, is now nearly 50 per cent, 10 percentage points more than in 2000.

The data available for the first few months of 2010 indicate considerable diversity of national economic trends. Robust growth in the emerging economies, actually higher in Asia than before the recession, contrasts with slower growth in the United States and Japan and hesitant recovery in the United Kingdom and the euro area. The leading international institutions forecast that this situation will continue for the rest of this year. While for the emerging economies the main risk is a resurgence of pressure on the prices of goods and financial and real assets, for the advanced economies the main concerns are persistent high unemployment and the mounting public debt.

The recession affected virtually all the advanced countries. After contracting in the first six months of 2009, economic activity returned to expansion in the second half, benefiting from the support of monetary and fiscal policies and the gradual improvement of conditions in the financial markets, which was assisted by official intervention on behalf of the segments and intermediaries worst hit by the crisis.

The emerging and developing countries responded to the crisis in diverse ways. In the countries of central and eastern Europe, including the new non-euro EU members, economic activity followed the same pattern as in the advanced economies, a first-half contraction followed by modest recovery in the latter part of the year. In the emerging countries of Asia, led by China and India, which the recession had affected chiefly through the reduction in foreign demand, recovery began sooner than in the rest of the world, with a return to rapid GDP growth as early as the spring, thanks above all to massive fiscal stimulus and the easing of monetary conditions. In Brazil, with its relatively sound financial system and diversified productive economy, domestic demand held up and the contraction in output was short-lived, while in Russia economic activity collapsed owing to the dominance of the energy sector and the drying-up of foreign finance.

In 2009 and the early months of this year, the advanced countries maintained strongly expansionary monetary policy stances. Reference rates remained unchanged at very low levels. The Federal Reserve, the Bank of England and, more recently, the Bank of Japan took unconventional measures to hold long-term rates low. By contrast the emerging and developing countries, where the pace of the economic expansion has regained or surpassed the potential growth rate, as in China, India and Brazil, began to take a less accommodating monetary policy stance in the first few months of 2010.

Fiscal policies gave strong impetus to growth in 2009 and continue to do so this year. In the G20 economies, crisis-related discretionary fiscal stimulus amounted to about 2 percentage points of GDP in 2009 and 1.9 points this year, according to the latest IMF estimates. In the advanced economies general government net borrowing swelled, reflecting not only discretionary countercyclical measures but also the working of built-in stabilizers and a deterioration in structural balances (see the box "The public finances in selected advanced countries", *Economic Bulletin,* No. 56, April 2010). The abrupt deterioration in the public finances has fuelled uncertainty over their sustainability, as is shown by the strains in the government securities markets in some euro-area countries in the early months of this year. To avert the risk, a number of countries have set adjustment strategies to correct the cyclically adjusted primary balance beginning in 2011. According to the IMF the correction will involve mainly the advanced economies and should amount to about 3.5 percentage points of potential GDP from 2010 through 2015.

Fiscal policy support was substantial in the emerging countries as well, especially China, but the worsening of the public finances has not been a source of concern, thanks both to sounder budgetary situations than in the past and to these countries' swift return to rapid economic growth.

The United States

Output in the United States fell by 2.4 per cent in 2009, the worst performance in sixty years (Table 1.1). The contraction in activity was concentrated in the first half of the year and was due chiefly to sharp declines in non-residential fixed investment, exports and inventories. The economy returned to growth in the months following, assisted by the inventory cycle and the recovery in investment in machinery and software.

Household consumption expanded moderately during the year, recouping only part of the steep fall registered in the second half of 2008. The upswing in the saving rate that had marked 2008 came to an end, owing among other things to the low level of interest rates. Their impact more than counterbalanced that of the tightening of the supply of consumer credit and the modest recovery in household net wealth, whose ratio to disposable personal income rose by 15 percentage points during the year – thanks above all to the stock market recovery – following the plunge of about 130 points in 2008.

Non-residential fixed investment diminished by nearly 18 per cent. Presumably one cause was the bank credit tightening that lasted throughout the year. This had a stronger effect on investment by small firms which, unlike the larger corporations, were unable to turn to the capital markets.

Residential investment declined by more than one fifth in 2009, year on year, but it turned upwards in the second half after more than three years of contraction.

Table 1.1

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

	2007	2008	2009	2009				2010
				Q1	Q2	Q3	Q4	Q1
United States								
GDP (1)	2.1	0.4	-2.4	-6.4	-0.7	2.2	5.6	3.2
Domestic demand (1)	1.4	-0.7	-3.4	-8.6	-2.3	3.0	5.2	3.8
Inflation (2)	2.9	3.8	-0.4	..	-1.2	-1.6	1.4	2.4
Japan								
GDP (1)	2.4	-1.2	-5.2	-15.9	7.4	0.5	4.2	4.9
Domestic demand (1)	1.3	-1.3	-4.0	-13.2	-0.2	-1.0	1.7	2.3
Inflation (2)	0.1	1.4	-1.4	-0.1	-1.0	-2.2	-2.0	-1.2
European Union								
GDP (1)	2.9	0.7	-4.2	-9.4	-1.0	1.1	0.4	0.7
Domestic demand (1)	2.9	0.7	-4.0	-9.7	-3.2	1.5	-0.1	....
Inflation (2)	2.4	3.7	1.0	1.6	0.9	0.4	1.0	1.7
United Kingdom								
GDP (1)	2.6	0.5	-4.9	-10.0	-2.7	-1.1	1.8	0.8
Domestic demand (1)	3.0	0.1	-5.3	-9.3	-3.9	-0.3	3.1	....
Inflation (2)	2.3	3.6	2.2	3.0	2.1	1.5	2.1	3.3
Canada								
GDP (1)	2.5	0.4	-2.6	-7.0	-3.5	0.9	5.0	....
Domestic demand (1)	4.1	2.6	-1.7	-7.4	0.3	5.6	4.6	....
Inflation (2)	2.1	2.4	0.3	1.2	0.1	-0.9	0.8	1.6
Advanced economies								
GDP (4)	2.8	0.5	-3.2	....	....	....	....	....
Memorandum item:								
World output (4)	5.2	3.0	-0.6	....	....	....	....	....

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.

Non-farm payroll employment fell by over 4.7 million during the year, and by the end of the year the unemployment rate had reached 10 per cent (from 7.4 per cent twelve months earlier). The rise in unemployment was most pronounced among the less well-educated segments of the working-age population. The long-term unemployed – those out of work for at least 27 weeks – made up 40 per cent of the total, some 20 points more than at the end of 2008.

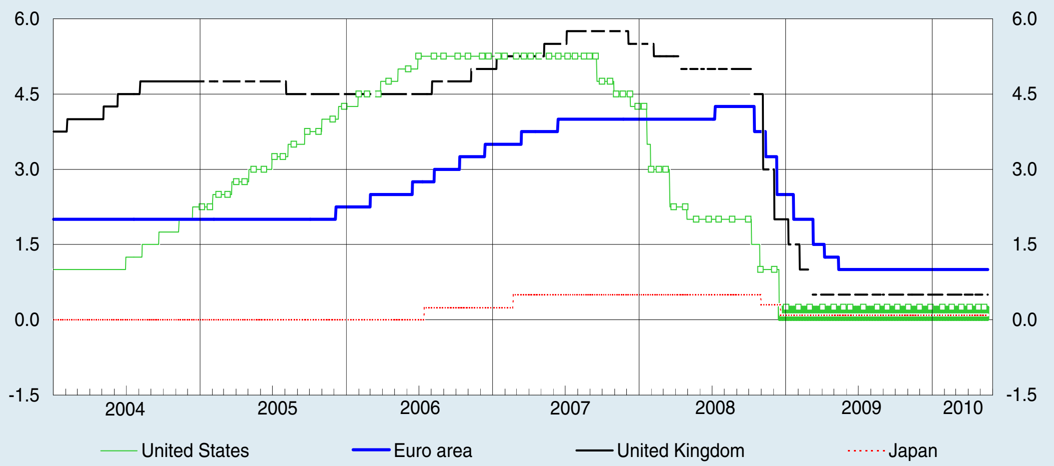
According to preliminary data, in the first quarter of 2010 GDP grew at an annual rate of 3.2 per cent, continuing to benefit from the rebuilding of inventories and the resumption of investment in machinery and software. Private consumption accelerated to growth of 3.6 per cent, while the saving rate fell to 3.1 per cent (from 3.9 per cent in the fourth quarter). In the first four months of the year non-farm payroll employment improved markedly, adding 570,000 jobs by comparison with the end of 2009.

Core inflation, net of energy and food products, fell from 1.7 per cent in January 2009 to 0.9 per cent in April 2010. A contributing factor was housing costs, whose twelve-month variation swung from 1.8 per cent to minus 0.7 per cent. Disinflation was fostered by a decline in the unit labour costs of non-farm businesses, which fell by 5 per cent between the fourth quarter of 2008 and the first quarter of 2010, thanks to the sharp rise in labour productivity and the weakness of earnings increases.

The Federal Reserve kept the federal funds target rate unchanged throughout 2009 and the first few months of 2010 at between 0 and 0.25 per cent (Figure 1.1). It also sought to stabilize interest rate expectations by reaffirming, at every Federal Open Market Committee meeting, its intention to hold rates at exceptionally low levels for an extended period. On 20 May the markets were assuming essentially unchanged monetary policy rates for the rest of the year. Also during 2009, the Fed redefined the unconventional measures it had adopted against the financial crisis. With the interbank and money markets' return to normal, the Fed progressively scaled back the support it offered those markets through liquidity programmes and direct lending to issuers of commercial paper. In its effort to lower long-term mortgage lending rates, between September 2008 and March 2010 the Fed made outright purchases of $175 billion worth of federal agency debt securities and $1.25 trillion worth of mortgage-backed securities guaranteed by federal agencies (Fannie Mae, Freddie Mac, and Ginnie Mae). It also purchased medium-to-long-term Treasury securities worth $300 billion. At the start of May, in response to the resurgence of stress in the short-term dollar funding markets in Europe, the Fed restored dollar swap lines with the European Central Bank, the Bank of England and the Swiss National Bank.

Figure 1.1

Official interest rates (1)
(daily data; percentages)



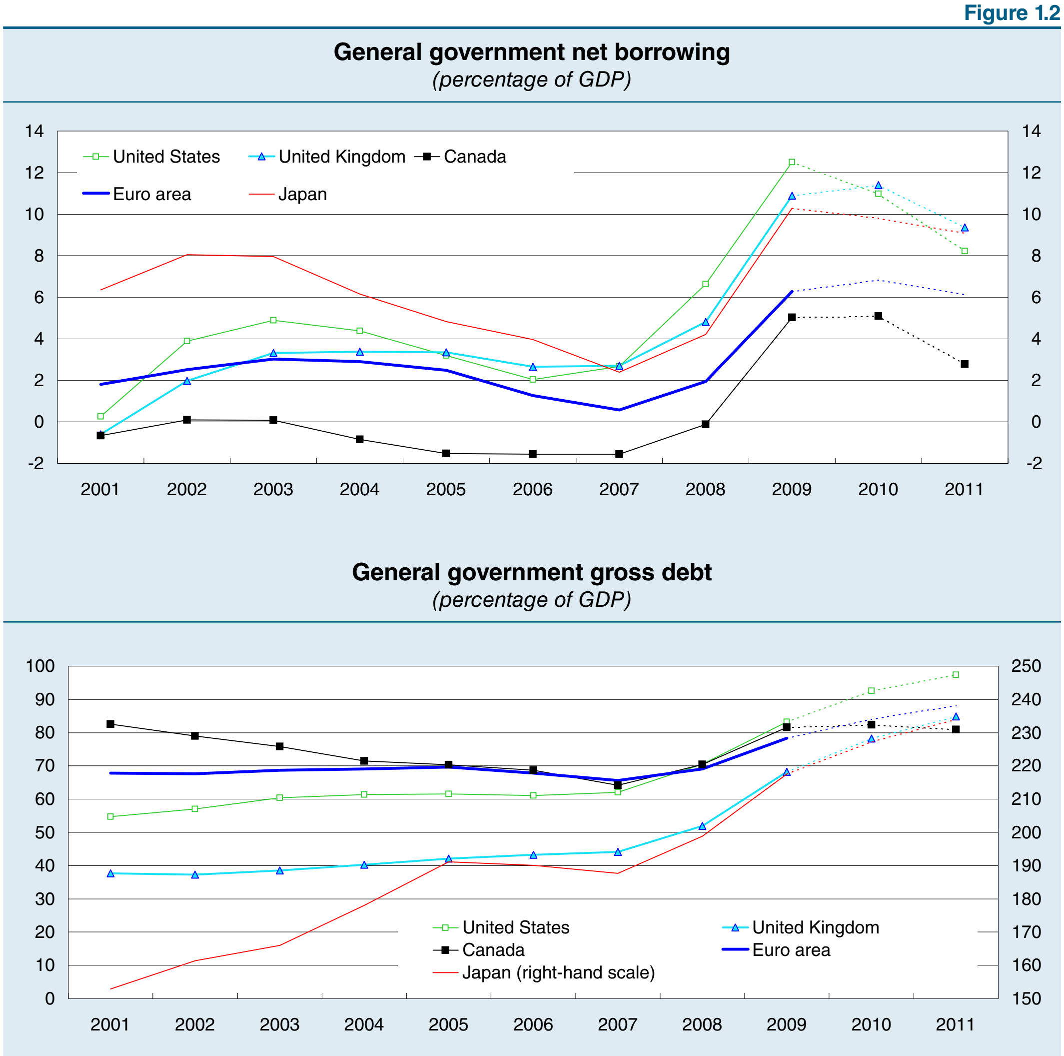
Sources: ECB and national statistics.
(1) For the United States, federal funds target rate; for Japan, uncollateralized overnight call target rate; for the euro area, interest rate on main refinancing operations; for the United Kingdom, interest rate on commercial banks' reserves with the Bank of England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

As part of its effort to make its policy choices more transparent in order to keep inflation expectations stable in the face of unconventional measures, the Federal Reserve has announced an explicit exit strategy. According to the Philadelphia Fed's Survey of Professional Forecasters, long-term inflation expectations held basically unchanged throughout 2009 and in early 2010 at between 2.3 and 2.5 per cent.

In the 2009 fiscal year ending last September, the federal budget deficit increased to 9.9 per cent of GDP (compared with 3.2 per cent in 2008). A number of factors were at work: the pronounced worsening of the structural balance, the operation of built-in stabilizers, the American Recovery and Reinvestment Act (see the box "The anti-crisis fiscal measures in the main advanced and emerging countries", *Economic Bulletin,* No. 52, January 2009), and action to support the financial system. According to the Congressional Budget Office, the Recovery and Reinvestment Act in particular increased the deficit by about 1.4 percentage points of GDP in 2009 and should increase it by 2.8 points in 2010.

In February the Administration presented a budget plan that according to the CBO represents a partial deficit adjustment. The federal deficit is projected to decline from 10.3 per cent of GDP in 2010 to 4.1 per cent in 2014, then stabilize at between 4 and 5.6 per cent for the rest of the decade (see the box "The public finances in selected advanced countries", *Economic Bulletin,* No. 56, April 2010). The IMF projects a rise in US general government gross debt from 83.2 per cent of GDP at the end of 2009 to 97.4 per cent at the end of 2011 (Figure 1.2).

Figure 1.2



Source: IMF, *World Economic Outlook*, April 2010.

The real estate market crisis. – The US housing market showed signs of stabilizing in 2009 and early 2010. Between December 2008 and February 2010 the Case-Shiller index covering the ten largest metropolitan areas fell by 3 per cent, compared with the 28 per cent drop between mid-2006 and the end of 2008. Case-Shiller index futures currently indicate that prices will stagnate for the rest of the year.

The Federal Reserve and the Treasury have continued their resolute action to counter the market crisis. The Fed, through purchases of mortgage-backed securities guaranteed by government-sponsored entities, has helped to stabilize the rate on conventional 30-year mortgage loans at around 5 per cent, progressively narrowing the spread over 30-year Treasury bonds to exceptionally low levels. The Treasury has eased its standards for access to refinancing, enabling some 4 million debtors to refinance their debt at lower interest rates. It has also promoted the renegotiation of mortgages deemed to be at risk of default. Even so, of the original objective of 4 million mortgages (about 8 per cent of all those outstanding), by April 2010 only 295,000 had undergone permanent contractual modifications, and another 640,000 were being renegotiated.

The commercial real estate crisis has worsened. The Moody's price index for four types of commercial property (office, apartment buildings larger than four units, industrial, retail) plunged by about 30 per cent in 2009. The continuing rise in the commercial property vacancy rate signals that demand is still falling.

The volume of bank credit available to this market continued to contract throughout 2009. In order to ease the funding difficulties of the sector – whose liabilities amounted to some $3.5 trillion at the end of the year, equivalent to two thirds of the value of households' home mortgages – the Federal Reserve extended to investors in commercial mortgage-backed securities the possibility of access to the Term Asset-Backed Securities Loan Facility that it had introduced at the end of 2008.

Japan

Gross domestic product diminished by 5.2 per cent last year (Table 1.1). All of the contraction occurred in the first quarter, when output fell at a 15.9 per cent annual rate. Economic activity began to grow again in the last three quarters, led by a strong gain in exports. Exports to Asia, which account for more than half of total Japanese exports, increased by nearly 50 per cent at current prices between the first and the fourth quarter and thus recouped a good part of the loss recorded between the first half of 2008 and the first quarter of 2009. Consumer spending, stimulated by incentives for the purchase of durable goods, also contributed. According to preliminary estimates, economic activity maintained its robust expansion in the first quarter of 2010 (at a 4.9 per cent annual rate), continuing to rely mainly on the vigorous growth of exports of goods and services (30.5 per cent).

The economic recovery has produced a slight improvement in labour market conditions. The unemployment rate, which had risen to 5.6 per cent in July, came back down to 5 per cent in March 2010 but is still about 1 percentage point higher than it was during the first half of 2008.

Deflationary tendencies have reappeared. The twelve-month rate of change in consumer prices net of energy and food products turned negative in January 2009 and continued to fall throughout the year, to a low of minus 1.2 per cent in December. In the first few months of 2010 it has steadied at around minus 1 per cent. The Bank of Japan responded by maintaining its strongly expansionary monetary policy stance, leaving its reference rate unchanged at 0.1 per cent. Also, in December 2009 it began providing three-month financing at a fixed rate of 0.1 per cent, with a view to bringing long-term rates down; this facility was reinforced in March and will eventually total ¥20 trillion, about 4 per cent of Japan's GDP. Finally, the Bank recently announced a facility for twelve-month financing at a fixed rate equal to the reference rate; details on the facility have yet to be finalized.

According to the latest IMF estimate, Japanese general government net borrowing rose to 10.3 per cent of GDP in fiscal 2009. In 2010 and 2011 it should come down very slightly (Figure 1.2). General government gross debt, by this estimate, will come to more than 230 per cent of GDP at the end of 2011.

The European Union

The United Kingdom. – Economic activity contracted by nearly 5 per cent last year, stabilizing only in the fourth quarter. Consumption diminished by 3.2 per cent, playing a greater role than in other advanced economies in the fall in GDP. Business investment continued to decline throughout the year, suffering from difficulty in obtaining bank credit that was only partly offset by recourse to the capital market. The fall in residential investment, under way for nearly three years now, accounted for about 0.6 percentage points of the decline in economic activity. There have been signs of stabilization in the real estate market, with a recovery in house prices (which rose 11 per cent in the twelve months to April 2010) and an easing in the supply of secured credit to households. The inflation rate – responding among other things to the temporary reduction in VAT between December 2008 and December 2009 – fluctuated widely during the year and early in 2010. In April it stood at 3.7 per cent.

During the year the Bank of England made its monetary policy stance still more expansionary, supplementing the decision to hold the policy rate at 0.5 per cent with a quantitative target for purchases of medium/long-term securities financed by creation of central bank reserves. The Bank steadily raised this target from £75 billion in March to £200 billion in November (equivalent to 14 per cent of GDP). The target was met in January. Unlike the Federal Reserve, the Bank of England bought almost exclusively Treasury gilts.

In the 2009-2010 fiscal year, ended on 5 April, the public sector borrowing requirement, excluding the temporary effects of financial interventions, rose to 11.8 per cent of GDP (from 6.7 per cent in 2008-09). The Treasury reports a serious deterioration in the structural requirement, as a consequence of a permanent reduction of about 5 percentage points in potential GDP and a reduction in tax receipts both from the financial industry and from the real estate sector.

The new European Union members. – In the eight new EU member countries not part of the euro area, GDP contracted by 3.4 per cent in 2009, compared with growth of 3.9 per cent in 2008 (Table 1.2). In the first half of the year the tightening of the terms for external financing, the decline in consumer confidence and the diminishing growth prospects resulted in a sharp decline in domestic demand, which was accompanied by a fall in exports. In the second half GDP returned to growth in nearly all these countries, fuelled by the recovery in exports and the gradual improvement in domestic demand.

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)
	2008	2009	2008	2009	2008	2009	2009	2008	2009	2009
Bulgaria	6.0	-5.0	12.0	2.5	-24.0	-9.4	116.5	1.8	-3.9	14.8
Czech Republic	2.5	-4.2	6.3	0.6	-0.7	-1.1	45.1	-2.7	-5.9	35.4
Estonia	-3.6	-14.1	10.6	0.2	-9.4	4.6	130.9	-2.7	-1.7	7.2
Hungary	0.6	-6.3	6.0	4.0	-7.0	0.2	172.8	-3.8	-4.0	78.3
Latvia	-4.6	-18.0	15.2	3.3	-13.0	9.4	159.6	-4.1	-9.0	36.1
Lithuania	2.8	-14.8	11.1	4.2	-11.9	3.8	88.6	-3.3	-8.9	29.3
Poland	5.0	1.7	4.2	4.0	-5.1	-1.6	64.3	-3.7	-7.1	51.0
Romania	7.3	-7.1	7.9	5.6	-11.6	-4.5	71.8	-5.4	-8.3	23.7
Total	**3.9**	**-3.4**	**6.6**	**3.7**	**....**	**....**	**82.2**	**-3.6**	**-6.6**	**45.2**

Sources: Based on data from Eurostat and Joint BIS-IMF-OECD-WB External Debt Hub.
(1) Harmonized Index of Consumer Prices. – (2) As a percentage of GDP. – (3) Gross.

The weakness of economic activity and the fall in food and energy prices helped to curb inflationary pressures, and annual inflation came down from 6.6 to 3.7 per cent. The lower inflation and the appreciation of currencies against the euro starting in March enabled the central banks of the countries with inflation targets (Czech Republic, Hungary, Poland, and Romania) to relax monetary conditions with successive reductions in their policy rates.

The public finances worsened in all these countries except Estonia, which cut its deficit from 2.7 to 1.7 per cent of GDP. In Hungary adjustment measures as part of the country's undertakings with international financial institutions succeeded in stabilizing the deficit. The worsening Polish and Czech deficits reflected governmental decisions to allow built-in stabilizers to operate.

Owing to the steep decline in domestic demand, the balance-of-payments deficit on current account diminished appreciably in all the countries except the Czech Republic, where it was nevertheless relatively small.

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

China. – Economic activity again expanded rapidly last year, at a pace of 8.7 per cent (Table 1.3), somewhat below the average for the decade (10.3 per cent). After losing speed in late 2008, the economy regained vigour as early as the spring of 2009, thanks to powerful fiscal and monetary stimulus.

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 (2)	
	2008	2009	2008	2009	2008	2009	2008	2009
China	9.6	8.7	5.9	-0.7	9.4	5.8	-0.4	-3.0
India	7.4	6.4	8.4	10.9	-2.2	-2.1	-7.9	-10.5
Brazil	5.1	-0.2	5.7	4.9	-1.7	-1.5	-1.4	-3.3
Russia	5.6	-7.9	14.1	11.7	6.2	3.9	4.3	-6.2

Sources: IMF and national statistics.
(1) As a percentage of GDP. – (2) Consolidated public sector, balance as a percentage of GDP in the relevant fiscal year.

On average for the year the contribution of net exports was negative for the first time since 1995, reducing GDP growth by 4.1 percentage points, while investment continued to be the main driver of growth (8.2 points), thanks in part to the plan of major public infrastructural works. Consumption grew by 9.3 per cent, faster than the average for the decade, fuelled by government incentives for the purchase of durable goods and by income support measures. Car sales in particular rose by 60 per cent, compared with 25 per cent in 2008.

The rapid growth of the Chinese economy in the last decade has been powered mainly by capital formation and exports. In 2008 consumption accounted for just over 35 per cent of GDP, about 10 points less than in 2000. This reflected both the diminishing ratio of households' disposable income to GDP (from 64 per cent in 2000 to 59 per cent in 2007) and their high and rising savings (22.2 per cent of GDP, compared with 17.5 per cent in 2000).

A number of factors are behind the rise in the household saving rate. In urban areas real disposable income has doubled in a decade, permitting households, especially the more affluent, to set more resources aside. Second, the proportion of people of working age in the population has increased (from 70 per cent in 2000 to 73 per cent in 2008). Going forward, in the absence of corrective public action the lack of public services and adequate social safety nets will keep the saving rate high. Urban households, whose number will continue to rise, are obliged to save against the growing costs of housing, education, health insurance and retirement provision. Only a significant increase in social expenditure (which now amounts to scarcely 5 per cent of GDP) and the development of the financial and insurance markets can create the conditions for a decline in the saving rate.

Consumer price trends reflect international energy and foodstuff prices. On average for the year consumer prices declined by 0.7 per cent, after a rise of 5.9 per cent in 2008. The upturn in the latter part of 2009 and the first few months of 2010 has been due to higher food prices. Core inflation has returned to positive territory (0.7 per cent in April).

Unlike the other emerging countries, China registered an appreciable acceleration in credit. The largest banks, which are still state-controlled, were called on to expand credit to finance the infrastructure projects envisaged by the fiscal stimulus plan. Bank lending grew by 31.7 per cent in 2009, bring the outstanding stock to 127 per cent of GDP. Abundant low-cost funds also spilled over into the real estate market, generating a sharp rise in house prices.

The People's Bank of China abandoned its expansionary monetary policy stance last summer, first setting stricter guidelines for commercial bank lending, then stepping up its action to sterilize foreign currency reserves, and finally, at the start of 2010, raising the compulsory reserve ratio several times by a total of 1.5 percentage points to 17 per cent for large banks.

The enlarged public sector deficit came to 3 per cent of GDP in 2009, whereas in previous years the budget had been broadly in balance. According to the recent budget plan, which calls for the reallocation of public spending towards greater support for household consumption and incomes, the deficit should hold at around 3 per cent this year as well.

GDP growth accelerated in the first quarter of 2010 to 11.9 per cent with respect to the year-earlier quarter, regaining the pace recorded in 2007. Consumption made a large contribution (6.2 percentage points), though still slightly less than investment (6.9 points). The negative contribution of the external sector moderated to 1.2 points, thanks to the gradual recovery in exports.

India. – GDP grew by 6.4 per cent in 2009, 1 point less than in 2008. The slowdown came in the first quarter and mainly involved manufacturing and ICT services, the sectors most dependent on foreign demand. Economic activity picked up sharply from the second quarter on, fuelled by the government plan for infrastructure construction. Household spending and business investment also returned to growth, with gains of 3.9 and 5.8 per cent respectively for the year as a whole.

Consumer inflation rose from 8.4 to 10.9 per cent on average for the year, and in January 2010 reached a peak of 16.1 per cent, owing in part to sharply rising food prices.

From the fourth quarter onwards the Reserve Bank of India altered its expansionary monetary policy stance. First, portfolio constraints on banks were tightened and then, in the first few months of 2010, the reference rate was raised repeatedly by a total of 50 basis points and the reserve ratio by 100 points.

Fiscal policy was directed last year to supporting demand with increased public works spending, the reduction of indirect taxes, and other measures on behalf of the rural poor. The consolidated public sector deficit thus widened from 7.9 to 10.5 per cent of GDP, and the public debt reached 73.2 per cent of GDP, high by comparison with the other main emerging countries.

Brazil. – After five years of rapid growth, the Brazilian economy registered a recession in 2009, albeit a brief and mild one. GDP slipped by 0.2 per cent. While investment fell by 10 per cent in response to the drop in international demand and a temporary outflow of foreign capital, consumption continued to rise (by 4 per cent), driven by public support measures.

In the second quarter, with the return of financial inflows and the rise in the prices of raw materials, of which Brazil is a net exporter, economic activity began to expand again. However, the rapid reduction of idle capacity fuelled inflationary pressures, and in April 2010 consumer price inflation stood at 5.3 per cent, well above the 4.5 per cent mid-point of the Central Bank of Brazil's target range. After rapidly lowering the monetary policy reference rate in the first half of 2009 by a total of 5 percentage points to 8.75 per cent in July (the lowest level since 1996), the Central Bank then changed its stance. At the start of 2010 it increased the reserve ratio and at the end of April the reference rate as well (by 0.75 percentage points).

Russia. – The Russian economy was hit hard by the global crisis. GDP contracted by 7.9 per cent in 2009, compared with average growth of 7 per cent in the previous five years. The collapse of oil export earnings at the depth of the crisis abruptly shrank the main source of public revenue. The halt in foreign financing to the private banking system was a factor in the rapid contraction of credit and business investment.

Investment fell by 18.2 per cent and private consumer spending by 5.4 per cent, owing to the drastic deterioration in the labour market, with the unemployment rate rising from 6.4 to 8.5 per cent. Inflationary pressures eased, the twelve-month increase in the consumer price index falling from 14 per cent at the start of 2009 to 6.4 per cent in March of this year. The first signs of a recovery in economic activity came towards the end of the year, in response to the firming up of energy prices and the improvement in financial conditions.

The severe liquidity crisis triggered by the sudden outflow of capital between October 2008 and February 2009 led the Central Bank of Russia to inject massive quantities of money into the banking system. With demand still very slack and inflationary pressures sharply reduced, the reference rate was lowered from 13 per cent in April 2009 to 8 per cent last month. The drastic decline in tax revenues and the demand stimulus measures produced a public deficit of 6.2 per cent of GDP after the substantial surpluses of the previous years.

2. THE FINANCIAL AND FOREIGN EXCHANGE MARKETS

The negative spiral between the financial markets and productive activity that marked all of 2008 and the first few months of 2009 ended in the spring of last year, thanks to strongly expansionary economic policies and measures to support the financial system. Financial market conditions eased progressively, anticipating and at the same time fostering the recovery of world economic activity. The international banking system also improved in 2009 and the interbank markets began to function normally once again. International portfolio investment started to flow back into the emerging economies more rapidly than had been expected, attracted by good growth prospects and wide interest rate spreads compared with the advanced economies. Bank lending to the private sector, which had slowed considerably in all the leading economies except China, gave signs of recovery towards the end of the year. In some markets, including China and Brazil, the rapid recovery of the prices of financial and real assets fuelled fears of possible speculative bubbles.

For some months, there has been strong pressure on government securities in some European countries, in particular Greece, as a consequence of the marked deterioration in the public finances. These intensified between the end of April and the beginning of May, causing an abrupt increase in risk aversion on international markets. To address the crisis in Greece, on 2 May the authorities of the European Union and the governments of the euro-area countries agreed a three-year financial support plan, with IMF participation, for a total of €110 billion. Tensions eased moderately only after a decision of the European Council, announced on 10 May, to create a mechanism for further support to EU member countries, if necessary, for a total of up to €500 billion; the IMF would also participate in any such interventions, as in the case of Greece. To foster market stability, on the same day the ECB decided to launch a plan to purchase euro-area countries' government securities.

The financial and foreign exchange markets in the industrial countries

Very great uncertainty and exceptionally volatile conditions still prevailed in the international financial markets in the first few months of 2009, following the crisis of confidence sparked by the collapse of Lehman Brothers and other major financial institutions. The contribution of public capital and guarantees on assets and liabilities in the banking system, while stabilizing the balance sheets of the most highly exposed banks and averting the paralysis of the financial system, had only partly tempered fears of further collapses, which continued to be reflected in high premiums for default risk on the interbank markets and on credit default swaps (CDSs) for the major international banks. Share prices continued to fall, while risk premiums on corporate bonds remained close to the maximum values reached at the end of 2008; the "flight to quality" – investors' desire to hold assets considered safer and more liquid – kept yields on government securities at very low levels and facilitated an appreciation of the dollar.

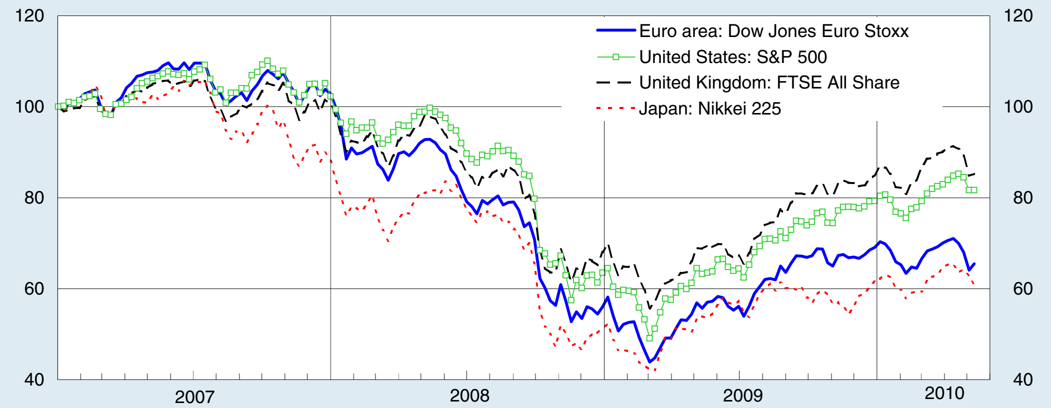
Since the spring of 2009, with the gradual strengthening of world economic activity, conditions on the financial markets began to ease, benefiting from the abundant liquidity injected into the system by central banks and from the measures taken by the authorities in direct support of the worst-hit markets in the most acute phase of the crisis.

Compared with the lows of March 2009, in mid-April 2010, the main share indices had gained almost 80 per cent in the United States and between 60 and 70 per cent in the other economies, though they were still significantly below the levels of summer 2007 (Figure 2.1). In particular, the shares of financial companies, despite much greater increases, had recouped only half of the losses accumulated during the crisis.

Figure 2.1

Stock market indices (1)

(average weekly data; first week of January 2007=100)



Source: Thomson Reuters Datastream.
(1) Up to the week ending on 14 May 2010.

Between March 2009 and mid-April 2010 risk premiums on corporate bonds fell significantly in all risk categories: the yield spreads between the shares of non-financial companies with a high credit rating (BBB) and 10-year government securities fell from 6.2 to 1.7 percentage points for the dollar and from 4.7 to 1.5 points for the euro; those for high-yield bonds declined, respectively, from 18.7 to 5.6 percentage points and from 22.1 to 5.9 points.

Last year, firms made ample recourse to the bond market, issuing securities in the United States, in the euro area, and in the United Kingdom for a total equivalent value of $350 billion, an unprecedented amount that was able to compensate, at least in part, for difficulties in accessing bank credit, the supply of which continued to be limited by banks' deleveraging.

Conditions also improved during 2009 for the international banking system: the major groups' profits turned positive, albeit at levels less than half those in the two-year period prior to the crisis. Between March 2009 and mid-April 2010, the median premium on CDSs in relation to the main international banks fell from 230 to about 80 basis points, nevertheless significantly greater than before the crisis.

The interbank markets returned to normal. The interest rate spreads between unsecured three-month interbank deposits and three-month overnight index swaps – a measure of counterparty and liquidity risks – gradually narrowed to levels close to or only slightly greater than those observed in the first half of 2007 (less than 10 basis points for the dollar and around 20 points for the euro and for sterling). In recent months, easing on the money markets has led the Federal Reserve to discontinue almost all the liquidity facilities introduced during the crisis. The only one still active, the Term Asset-Backed Securities Loan Facility, is limited to loans guaranteed by newly issued commercial mortgage-backed securities and will expire at the end of June.

The improvement in financial market conditions and the economic recovery were accompanied, especially in the first half of 2009, by a rise in long-term interest rates. Yields on ten-year government securities in the United States and the United Kingdom reached their lowest point in late 2008 and early 2009 at 2.1 and 2.9 per cent respectively, then rising to 4 per cent by the first half of April 2010; these increases may have been curbed by government securities purchases by the Federal Reserve and the Bank of England as part of unconventional monetary policy operations. Yields in the euro area, after rising from 2.9 to 3.7 per cent in the first half of 2009, fell back to just over 3 per cent in mid-April 2010, reflecting the weakness of the recovery in Europe.

At the end of 2009, strong pressures emerged on the government bond markets of some European countries, in particular in Greece, as a result of the emergence of serious problems in the public finances and the lowering of the country's credit rating by the major agencies. The Greek authorities had faced growing difficulty in refinancing the public debt as it matured; premiums on five-year CDSs on government securities jumped from just over 100 basis points last September to more than 800 points towards the end of April. Tensions spread with particular intensity to Portugal: the premiums on CDSs on Portuguese government securities rose from 50 basis points in September to 360 in April. More limited but still significant increases in risk premiums were observed, especially in the second half of April, in relation to the debt of other European countries; this indicates the concerns arising from the deterioration of the public finances in the advanced economies and the risk that pressures on one country could spread to others. On 2 May, to address the crisis in Greece, the EU authorities and euro-area member countries agreed a plan of financial support under which they would grant bilateral loans for a total of €80 billion over three years; the IMF is also participating in the programme, allocating €30 billion. With this support, the Greek government has pledged to bring the ratio of the budget deficit to GDP permanently below 3 per cent by 2014, from its present level of more than 13 per cent.

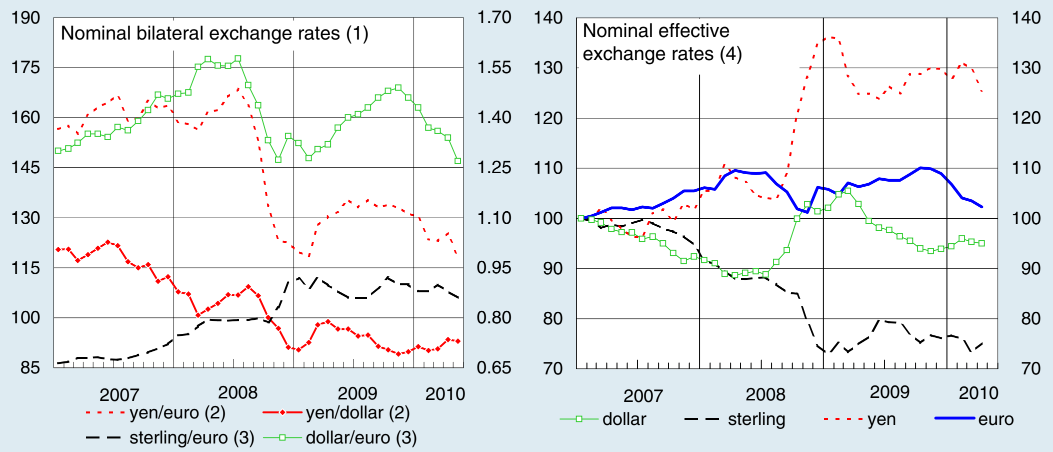
Despite this agreement, in the following days tensions worsened further, accompanied by sharp falls in share prices and government bond yields in the countries considered less risky; rates on ten-year securities in the United States fell to 3.4 per cent, while those in the euro area fell to a low of 2.7 per cent. The uncertainty was also reflected in a sharp increase in premiums on the major banks'

CDSs, which rose to 180 basis points. In order to safeguard financial stability in Europe, on 10 May the Finance Ministers of the EU countries decided to create a mechanism under which member countries in severe economic or financial difficulties due to exceptional circumstances beyond their control will be eligible for a loan or a line of credit under terms similar to those applied by the IMF; the resources available for this safety net would, if necessary, reach €500 billion, of which €60 billion disbursed by the EU itself and €440 billion in the form of loans granted by a special vehicle and guaranteed by the euro-area governments. The IMF has declared its readiness to participate in any interventions by providing extra funding in proportion to the amount given by Europe, as in the plan for Greece. Furthermore, to re-establish the orderly working of the worst-hit markets, the ECB announced a series of extraordinary measures, including a plan to purchase government securities and corporate bonds of countries in the euro area. Following these decisions, in mid-May the tensions were attenuated, although there were still high levels of uncertainty and volatility in the markets.

In early 2009, on the foreign exchange markets the strong demand on the part of financial agents for liquidity in dollars and the flight to quality continued to facilitate the appreciation of the dollar against the euro and sterling. Since then, the foreign exchange markets have undergone two distinct phases (Figure 2.2): between March and November 2009 the dollar fell by 14 per cent against the yen and about 17 per cent against the euro and sterling, reflecting expectations of an expansionary US monetary policy stance for an extended period and no structural reduction in global payments imbalances. Later, although the dollar fell by 4 per cent against the yen, it began to appreciate against the other two currencies: between early December and 20 May, it regained 23 per cent against the euro and 15 per cent against sterling. This strengthening seems connected with the improvement in the economic picture and the prospect for an earlier tightening of monetary policy in the United States; in more recent weeks, however, the climate of great uncertainty unleashed by the crisis in Greece has been the main contributor to the weakness of the euro.

Figure 2.2

Exchange rates of the main currencies
(average monthly data)



Sources: Bank of Italy and ECB.
(1) Units of the first currency per unit of the second; the data for May 2010 are based only on the first 20 days of the month. – (2) Right-hand scale. – (3) Left-hand scale. – (4) Indices, January 2007=100.

The financial and foreign exchange markets in the emerging countries and new EU member countries not part of the euro area

Since spring 2009, the abatement of risk aversion worldwide and the low level of interest rates in the advanced economies have encouraged a rapid recovery of international flows of capital to the emerging countries. Stock market indices turned upwards again, spreads on the yields of sovereign debts were reduced and the currencies of the countries with more flexible exchange regimes strengthened.

In the first few months of 2010 the financial conditions of the emerging countries continued to improve. The sharp increase in tensions on the international capital markets in late April and early May – unleashed by the serious situation of the public finances in Greece – led to general deterioration. Against a background of heightening volatility, the share indices recorded losses: at 20 May, for the emerging countries as a whole, the level was 8 per cent lower than at end-2009. From the minimum reached at the end of March, spreads on the yields of sovereign debt rose to an average of 330 basis points by 20 May, higher than at the end of 2009. The major currencies have weakened against the dollar.

The resumption of private capital flows to the emerging countries in 2009 mainly involved share and bond portfolio investment; net flows of bank credit remained weak, continuing to record disinvestment from central and eastern European markets and from Russia. In some emerging economies, the rapid increase in financial asset prices drove the authorities to adopt, or to announce the possibility of adopting, extraordinary measures to control capital movements.

The contraction of financial leverage by the international banking system, together with lower demand for credit on the part of the domestic private sector, contributed to a significant slowdown of internal credit during 2009 in the main emerging areas. The only important exception is China, where the strong acceleration in lending reflected the need to fund a substantial public investment programme. But at the end of 2009 the trend in lending did show signs of recovery in Asia and of stabilization in Latin America and central and eastern Europe.

In the new EU member countries not belonging to the euro area there was an easing of financial tensions, which had been most acute in the first few months of 2009; the currencies of Poland, the Czech Republic and Hungary began to appreciate again, although they did not reach their pre-crisis levels. In some of the more vulnerable economies episodes of financial tension continued until the summer.

At the end of 2009, premiums on these emerging economies' CDSs had fallen to values between 230 and 550 basis points. Only in Estonia had premiums fallen below 200 basis points, a value in line with those of September 2008, mainly due to the effective consolidation of the public deficit on the part of the authorities and the consequent improvement in prospects for adopting the euro as of 2011.

3. WORLD TRADE AND PAYMENTS BALANCES

Last year, world trade in goods and services shrank by 10.7 per cent, the most severe contraction since the Second World War. From the spring onwards there were signs of a gradual recovery.

The main raw materials prices reflected trends in the economic cycle. After falling sharply in the second half of 2008, in early 2009 prices began to recover rapidly, driven by strengthening demand from emerging Asian economies, in particular China.

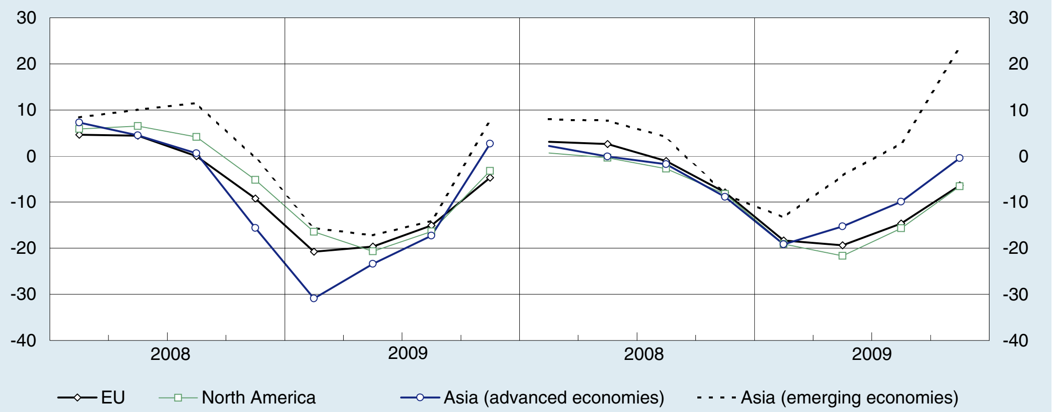
Current account imbalances narrowed in all the main areas, primarily for cyclical reasons, such as the weakness of demand and the prices of raw materials and energy.

World trade

In 2009 the contraction in trade affected both goods (down 11.8 per cent in volume terms and nearly 23 per cent in value terms), and services (down 12 per cent in value terms). Concentrated between the end of 2008 and early 2009, the decline in the volume of trade occurred simultaneously in all the main economies (Figure 3.1).

Figure 3.1

World trade in goods: main geographical areas (1) (2)
(percentage changes; volume)



Sources: Based on national statistics and Eurostat data.
(1) Growth rates are calculated on the corresponding period of the previous year. – (2) North America: Canada and the United States; European Union countries; Asia (advanced economies): Japan, South Korea, Singapore and Taiwan; Asia (emerging economies): China, Indonesia and Thailand.

Between the peak in the second quarter of 2008 and the low in the first quarter of 2009, the global volume of merchandise exports fell by almost 20 per cent. Those of the advanced Asian economies declined most markedly (by around 30 per cent), in part owing to these countries' specialization in durable goods sectors, which tend to be more exposed to cyclical fluctuations.

The subsequent recovery in world trade was driven above all by that of imports in the emerging Asian economies, especially China. In the fourth quarter of 2009, the volume of merchandise imports in the main advanced areas was significantly down on the peaks recorded in 2008 (by around 16 per cent in Europe, 14 per cent in North America and 10 per cent in Asia), while in the emerging Asian economies they had more than recouped the previous losses and were estimated to be up by about 10 per cent. The recovery, which began in the second half of 2009, continued into early 2010, albeit at a slower pace; current world trade levels remain about 7 per cent below the peak recorded in the first quarter of 2008.

The severity of the world recession had raised fears of an intensification of protectionist pressures. According to the latest estimates of the World Trade Organization, relatively few defensive trade protection measures were adopted in 2009 and they became less and less frequent as the year came to a close.

The Doha Round multilateral negotiations on trade liberalization failed to make any significant progress. As a result, its hoped-for conclusion by the end of 2010 now appears very unlikely. The stalling of the multilateral talks strengthened incentives to draw up free trade agreements at regional level. This trend intensified sharply in Asia, where there is a need to promote the further development of the international production chains that are typical of the region's manufacturing industry.

Commodity prices

In 2009 oil and non-fuel commodity prices quoted in dollars fell by 34.8 and 16.7 per cent respectively, compared with a drop of 6.9 per cent for manufactured goods. Starting in early 2009, with the recovery of economic activity in the emerging Asian economies, prices began to rise rapidly, despite remaining generally lower than the highs recorded in the early part of 2008.

In line with previous episodes of synchronized global economic developments, the highest volatility was recorded in the prices of oil and the main metals. In 2009 demand for oil shrank by 1.4 per cent, the sharpest contraction since the beginning of the 1980s. The downturn occurred in the first half of the year; consumption then expanded rapidly, boosted by strong growth in the emerging countries. In China crude oil consumption rose by almost 8 per cent, accounting for about two thirds of the overall increase in the non-OECD countries. At the end of 2009 global demand for oil had returned to levels close to those recorded before the crisis.

Since October the price of oil (average for the three main grades) mostly stayed within a range of $70 to $80 a barrel, except for temporary increases of up to $85 a barrel in April. Price volatility was generally limited, however, and the markets expect only gradual increases in the quarters to come (WTI futures prices indicate an increase of up to $84.8 a barrel over the next twelve months). The ample spare capacity in OPEC countries, around 6 million barrels a day or 7.4 per cent of forecast global demand for 2010, should help to curb upward pressure on prices.

Balance-of-payments disequilibria

In 2009 the US current account deficit fell sharply, from 4.9 per cent of GDP in 2008 to 2.9 per cent (Table 3.1). The absolute value, $420 billion, is about half the peak registered in 2006. This improvement is wholly attributable to the narrowing of the trade deficit, which fell by 40 per cent compared with 2008, from $840 billion to $517 billion, above all following the sharp decline in expenditure on net imports of energy products and, to a lesser degree, the drop in the volume of imported goods. However, the trade deficit had already ceased to narrow in the second half of 2009, and in the first quarter of 2010 it was over 20 per cent wider with respect to the previous year, mainly as a result of the rise in oil prices.

In 2009, non-resident capital inflows to the United States were meagre by historical standards, totalling $435 billion, even less than the already modest $534 billion of the previous year. While the inflows attributable to foreign authorities held up ($448 billion), owing to the continued build-up of international dollar reserves, private capital flows recorded a net outflow for the first time in the last forty years. Turning to the breakdown of the flows, the *Other investment* category, primarily of banking origin, recorded a net outflow of $209 billion. Foreign direct investment halved, falling to $152 billion, the lowest level since 2005; by contrast, portfolio investment returned to growth and rose to $492 billion, reflecting the recovery of the financial markets in the second half of the year.

The ratio of the US net debtor position to GDP is not expected to have increased significantly from the 27.7 per cent registered at the end of 2008. The effects of changes in the dollar values of foreign financial assets and liabilities, which in 2008 had made a significant contribution to the deterioration of no less than 17 percentage points in the net debtor position, appear to have turned positive (thanks to the depreciation of the dollar and the recovery of international stock markets), offsetting at least part of the deterioration caused by the deficit on current account.

After peaking in 2008, the current account surplus of the main oil-exporting countries narrowed by almost 70 per cent in 2009, to $197 billion, primarily as a result of lower crude oil prices. The surplus recorded an especially marked fall in the OPEC countries, from 19.3 to 5.1 per cent of GDP, but contracted less in Russia (from 6.2 to 4 per cent).

The overall surplus of the main Asian economies (excluding India) narrowed to $648 billion, from $712 billion in 2008. Performances were rather uneven, however: while the surplus of the newly-industrialized countries and the ASEAN-4 increased sharply, Japan's narrowed slightly and China's fell by almost one third, to $297 billion or 6.1 per cent of GDP. The result in China was influenced by the sharp decline in exports compared with the more modest one in imports, sustained by fiscal stimulus measures; in the first three months of 2010 the reduction in the trade surplus did not appear to have come to a halt.

Following the slowdown in 2008, the build-up of foreign exchange reserves by emerging economies gathered pace again; at the end of February stocks had reached over $5.5 trillion, a 9 per cent increase on the peak recorded in August 2008. Since the end of 1995, before the Asian crisis struck, the stock of emerging countries' reserves

Table 3.1

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

	Current account balance (1)						Reserves		
	2007		2008		2009		2007	2008	2009 (2)
	billion dollars	% of GDP	billion dollars	% of GDP	billion dollars	% of GDP	billion dollars	billion dollars	billion dollars
United States	**-726.6**	**-5.2**	**-706.1**	**-4.9**	**-419.9**	**-2.9**	**4.7**	**7.1**	**53.1**
Euro area	**18.8**	**0.1**	**-226.6**	**-1.7**	**-73.6**	**-0.6**	**18.2**	**3.3**	**64.8**
Japan	**211.0**	**4.8**	**157.1**	**3.2**	**141.7**	**2.8**	**73.1**	**56.6**	**12.9**
United Kingdom	**-75.1**	**-2.7**	**-39.8**	**-1.5**	**-28.7**	**-1.3**	**8.3**	**-4.6**	**11.4**
Canada	**14.6**	**1.0**	**9.2**	**0.5**	**-36.4**	**-2.7**	**6.0**	**2.8**	**10.5**
Latin America	**14.8**	**0.4**	**-26.7**	**-0.6**	**-18.6**	**-0.5**	**134.9**	**52.6**	**51.1**
Asia	**537.7**	**7.4**	**523.6**	**6.1**	**474.7**	**5.3**	**694.5**	**412.0**	**733.7**
Newly-industrialized Asian economies	111.5	6.1	84.6	4.9	137.7	8.6	73.6	1.5	212.2
Hong Kong	*25.5*	*12.3*	*29.3*	*13.6*	*18.4*	*8.7*	*19.5*	*29.8*	*73.3*
Singapore	*47.1*	*27.5*	*35.9*	*19.1*	*34.1*	*19.2*	*26.7*	*11.2*	*13.6*
South Korea	*5.9*	*0.6*	*-5.8*	*-0.6*	*42.7*	*5.1*	*23.3*	*-61.0*	*68.8*
Taiwan	*33.0*	*8.4*	*25.1*	*6.2*	*42.6*	*11.2*	*4.2*	*21.4*	*56.5*
ASEAN-4	62.5	6.2	44.0	3.8	71.5	6.2	62.9	11.2	50.7
Indonesia	*10.5*	*2.4*	*0.1*	*..*	*10.6*	*2.0*	*13.9*	*-5.4*	*14.0*
Malaysia	*29.2*	*15.7*	*38.6*	*17.4*	*32.1*	*16.8*	*18.9*	*-9.9*	*4.3*
Philippines	*7.1*	*4.9*	*3.6*	*2.2*	*8.6*	*5.3*	*10.2*	*3.0*	*5.6*
Thailand	*15.7*	*6.3*	*1.6*	*0.6*	*20.3*	*7.7*	*19.9*	*23.4*	*26.8*
India	-8.1	-0.7	-31.1	-2.6	-31.6	-2.6	96.3	-19.6	17.8
China	371.8	11.0	426.1	9.4	297.1	6.1	461.8	419.0	453.1
Central and Eastern Europe	**-132.6**	**-8.0**	**-152.1**	**-7.8**	**-37.9**	**-2.3**	**60.6**	**-0.5**	**44.9**
Main oil-exporting countries	**464.9**	**10.4**	**608.0**	**11.1**	**197.1**	**4.4**	**383.6**	**99.3**	**-17.4**
OPEC (3)	340.9	19.3	436.4	19.3	100.4	5.1	197.5	156.2	-24.7
Algeria	*30.6*	*22.8*	*34.5*	*20.2*	*0.5*	*0.3*	*32.4*	*32.9*	*5.8*
Angola	*9.4*	*15.9*	*6.4*	*7.5*	*-2.2*	*-3.3*	*2.6*	*6.7*	*-4.2*
Ecuador	*1.7*	*3.6*	*1.2*	*2.2*	*-0.6*	*-1.1*	*1.3*	*0.9*	*-0.9*
Iran	*34.1*	*11.9*	*24.0*	*7.2*	*7.9*	*2.4*	*....*	*....*	*....*
Kuwait	*50.0*	*44.7*	*64.5*	*40.8*	*28.7*	*25.8*	*4.1*	*0.5*	*3.2*
Libya	*29.1*	*40.7*	*36.6*	*40.7*	*10.2*	*16.9*	*20.1*	*12.9*	*6.7*
Nigeria	*31.2*	*18.8*	*42.3*	*20.4*	*20.1*	*11.6*	*9.0*	*1.7*	*-13.1*
Qatar	*21.8*	*30.7*	*33.1*	*33.0*	*13.8*	*16.4*	*4.0*	*0.2*	*8.7*
Saudi Arabia	*93.5*	*24.3*	*132.5*	*27.9*	*20.5*	*5.5*	*79.5*	*137.0*	*-32.6*
United Arab Emirates	*19.5*	*9.4*	*22.2*	*8.5*	*-7.0*	*-3.1*	*49.6*	*-45.5*	*5.7*
Venezuela	*20.0*	*8.8*	*39.2*	*12.3*	*8.6*	*2.5*	*-5.2*	*8.9*	*-11.4*
Mexico	-8.4	-0.8	-15.9	-1.5	-5.2	-0.6	10.8	8.0	4.5
Norway	54.7	14.1	83.8	18.6	52.9	13.8	4.0	-9.9	-2.1
Russia	77.8	6.0	103.7	6.2	49.0	4.0	171.2	-55.0	4.9

Sources: IMF and national statistics.
(1) Due to errors, omissions and differences in international statistics, the world current account balance, instead of being nil, is now positive (according to IMF estimates, by $310.3 billion in 2007, $180.4 billion in 2008 and $174.4 billion in 2009). – (2) For the United Arab Emirates, first eleven months; for Nigeria, first ten months. – (3) The OPEC aggregate does not include Iraq; the flow of foreign exchange reserves does not include Iran.

has risen tenfold; their share of global reserves has increased to 65 per cent (from 37 per cent at the end of 1999).

Among the group of economies with a structural surplus on current account, reserves grew most markedly in China (to around $2.4 trillion at the end of 2009, an increase of $453 billion compared with a year earlier), the newly-industrialized countries of Asia, and Thailand. Reserves declined in the main oil-exporting countries belonging to OPEC, while in Russia they returned to growth, after falling sharply in 2008.

4. THE G20 AND INTERNATIONAL ECONOMIC COOPERATION

The G20 countries have continued to give powerful impetus to the reform of the international financial system. At the summits in London and Pittsburgh (April and September 2009) it was decided to significantly increase the resources of the international financial institutions, revise their lending instruments, improve cooperation in the field of economic policy, and strengthen the international financial system. The main initiatives approved concern: a) a multilateral exercise for the coordination of member countries' economic policies, with the aim of creating a framework for strong, sustainable and balanced growth; b) the definition of regulatory policies for finance that will prevent a repetition of the excesses that led to the crisis; and c) reform of the governance of the international financial institutions.

Increase in the international financial institutions' resources and reform of their lending instruments

Increase in the IMF's resources. – At the London summit the G20 countries undertook to triple the resources of the IMF to $750 billion, from $250 billion before the crisis, by expanding the New Arrangements to Borrow (NAB). The announcement of this decision contributed to the reduction in the spreads on emerging countries' sovereign debt, which had started in the early months of 2009 after they had peaked in the most acute phase of the crisis.

The reform of the NAB was approved by the IMF's Executive Board in April 2010: the number of participant countries rose from 26 to 39, the resources available rose from $52 billion to $588 billion ($88 billion more than the original objective), and more flexible procedures were introduced for the IMF to use these resources.

In the meantime some members of the G20 and some other European countries have provided the IMF with new resources on a bilateral and temporary basis through bilateral loan agreements or purchases of IMF credit notes for a total of about $250 billion. These resources will be incorporated into the NAB at a later stage.

At the behest of the G20 the IMF approved a new general allocation of SDRs amounting to $250 billion, of which $100 billion in favour of emerging and developing countries. At the same time the Fourth Amendment of the Articles of Agreement was approved, with provision for a one-time allocation of SDRs amounting to $33 billion. With these decisions the stock of SDRs was increased from 21 billion to 204 billion.

IMF lending. – The recession led numerous countries to turn to the IMF for financial assistance. Between the second half of 2008 and April of this year the IMF approved 24 new credit lines for a total of SDR 105 billion ($160 billion).

Overhaul of the Fund's lending instruments. – The IMF has undertaken a far-reaching overhaul of its financial assistance instruments. The main reforms concerned: a) the creation of a new window known as the Flexible Credit Line (FCL); b) the granting of large loans through ordinary credit instruments (Stand-By Arrangements; SBA); and c) the resources devoted to concessional credit and the related lending facilities.

Unlike the Stand-By Arrangements, the Flexible Credit Line is based on the prior satisfaction of some conditions and does not require the achievement of objectives agreed with the borrower country. This instrument, which can be renewed and is without predetermined limits, is reserved to member countries with very strong fundamentals, policies, and track record of policy implementation; the credit line can be of a purely precautionary nature and can last for six or twelve months.

As regards the IMF's ordinary credit facilities, the reform has doubled the normal lending limits, taking the annual limit to 200 per cent of a country's quota and that on a cumulative basis to 600 per cent. In addition, the procedure for granting precautionary credit above the normal limits under the SBA (High-Access Precautionary Arrangements, HAPAs) has been set out more clearly and simplified. HAPAs have the same financial conditions as the SBA, can be requested in the absence of actual balance-of-payments need and resources can be frontloaded.

In January a thorough revision of the IMF's concessional lending facilities for low-income countries was completed; it was also decided to increase the resources available and to make additional facilitations of a temporary nature available to borrower countries.

The reform provides for the resources to be channelled into a single fund, the Poverty Reduction and Growth Trust (PRGT). In addition, three new credit facilities have been established, with different loan maturities and conditionality: the Extended Credit Facility (ECF), reserved to countries with protracted balance-of-payments needs; the Stand-By Credit Facility (SCF), which provides short-term financial assistance for episodic balance-of-payments needs and those of a potential nature (in which case the instrument can be used on a precautionary basis); and the Rapid Credit Facility (RCF), which guarantees a small volume of resources with limited conditionality when there is an urgent need to raise funds.

Lastly, measures were approved to reduce the debt servicing costs incurred by countries that use the Poverty Reduction and Growth Trust.

Increase in the resources of the Multilateral Development Banks. – The global economic crisis will have a lasting effect on the achievement of the Millennium Development Goals for 2015.

The loans granted by the Multilateral Development Banks (MDBs) were increased considerably to mitigate the adverse effects of the crisis on the poorest strata of the population. In 2009 alone the three largest MDBs (the World Bank, the Inter-American Development Bank and the Asian Development Bank) approved new loans amounting to $62 billion, about twice the average for the two years 2007-08 ($33.5 billion); more than two thirds of the additional $28 billion came from the World Bank. A large proportion of the new loans served to provide direct support to the beneficiary countries' public finances, thus allowing measures to assist the part of the population hardest hit by the crisis to be financed and permitting faster disbursement of funds.

In response to the increase in lending, all the major MDBs took action to boost their resources. Capital increases were approved by the Asian Development Bank in April 2009, the Inter-American Development Bank in March 2010, the World Bank (IBRD) in April 2010, the African Development Bank in May 2010, and the European Bank for Reconstruction and Development in May 2010.

These capital increases added more than $340 billion to the resources available to the major MDBs; the amount that member countries will actually be required to pay in during the coming years is equal to about $15 billion (Table 4.1).

Table 4.1

Capital increases by Multilateral Development Banks
(in billions of dollars, except as indicated)

	IBRD	Asian DB	IADB	African DB	EBRD (1)
Subscribed capital before the increase	190	55	101	36	20
Subscribed capital after the increase	276.2	165	171	98	30
Change	86.2	110	70	62	10 (2)
of which: *instalments to be paid*	5.1	4.4	1.7	3.7	1 (2)

(1) In billions of euros. – (2) The agreement provides for the cancellation of the uncalled part, equal to €9 billion, if it is not used by 2015. All the paid-in part will be transferred from the Bank's reserves.

Strengthening of international cooperation and reform of the financial system

Coordination of economic policies. – At the Pittsburgh summit in September 2009 the G20 countries decided to undertake a multilateral exercise for the coordination of their economic policies, with the aim of creating a framework for strong, sustainable and balanced growth. In this context the G20 finance ministers were charged with: a) agreeing on shared economic policy objectives; b) setting out a medium-term policy framework and working together to assess the collective implications of national policy frameworks for the level and pattern of global growth and identify potential risks to financial stability; and c) considering corrective actions. The technical activity of carrying out analyses and putting forward proposals has been entrusted to the IMF for the examination of mutual consistency of economic policies and to the World Bank for the assessment of the impact on development and poverty reduction.

Using the information provided by the G20 countries, the IMF has drawn up a baseline scenario for their growth in the period 2010-14. The next step involves the drawing up of alternative scenarios on the basis of a series of principles agreed by the finance ministers and central bank governors. The results of these exercises will provide indications for the orientation of economic policies to be submitted to the heads of state and government for them to take the appropriate decisions.

Strengthening of financial regulation and supervision. – In April 2009 the G20 decided to expand and institutionalize the Financial Stability Forum and changed its name to Financial Stability Board. Membership of the Board was broadened to include all the G20 countries, Spain and the European Commission. Among other things, the Board is collaborating with the IMF on early-warning exercises aimed at increasing awareness of the systemic implications of macroeconomic and financial policies and is calling for appropriate corrective measures.

Reform of the IMF's mandate. – The recent financial crisis has stimulated a wide-ranging debate on the possible revision of the IMF's mandate, with special reference to its surveillance function and the strengthening of its credit facilities. A broad consensus has already emerged on the need to strengthen financial sector surveillance. In addition, the IMF has put forward proposals aimed at improving multilateral and bilateral surveillance. Lastly, consideration is also being given to the possibility of strengthening the IMF's precautionary financial instruments, such as the Flexible Credit Line, or introducing new instruments aimed at discouraging member countries' accumulation of official reserves for precautionary purposes.

Reform of the structure of representation and governance of the IMF and the World Bank. – The Pittsburgh summit established some essential aspects of a reform of countries' representation within the IMF. Consideration is also being given to the possibility of altering the functions and composition of the Executive Board and involving the IMF Governors in the more strategic issues. The measures to reform the IMF's structure of representation and governance must be completed by January 2011.

As for the World Bank, the reform just approved has brought an increase of 4.6 percentage points in the emerging and developing countries' voting power, which is now equal to 47.2 per cent of the total. The redistribution was made principally on the basis of member countries' economic importance and to a lesser extent their financial contribution to the International Development Association, which offers grants and interest-free credits to the poorest countries. The increase was made possible by the reduction in the voting power of the major European countries, Japan and the United States and by China's forgoing part of the increase to which it was theoretically entitled. The reallocation of voting power will be implemented through a capital increase of $27.8 billion, reserved in large part to the countries benefiting from the reform.

With a view to the next revision of voting power – scheduled for 2015 – the plan is to adopt a new formula that will ensure an equitable distribution of representation within the World Bank and maintain the voting power of the smallest poor countries.

Other initiatives. – The international community has agreed on two other initiatives aimed at facilitating international transfer of migrants' remittances and improving the access of the poorest to financial services. As regards the first objective, during the Italian presidency the G8 set the goal of reducing the average cost of transfers to developing countries, currently equal to 10 per cent, by five percentage points over five years. As for the second objective, the G20 is discussing measures to improve the access of poor people to retail banking and financial services, including through innovative channels, and encourage lending to small and medium-sized enterprises.

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

5. MACROECONOMIC DEVELOPMENTS

In 2009 the GDP of the euro area suffered its most severe contraction since the Second World War. After the sharp drop in output recorded in the first half of the year, all the major countries showed a modest recovery in the second, except for Spain, hit by the sharp downturn in the construction sector.

In the area as a whole, the pickup in growth drew most of its strength from the increase in exports, which were boosted by the recovery in international trade, and the turn in the inventory cycle. The decline in domestic demand came to a halt, aided by the incentives adopted by governments. The pace of euro-area growth remained below that recorded in the United States, Japan and the main emerging economies.

The recovery continued into the first quarter of 2010 and, based on the latest data, in recent months. In the spring, the €-coin indicator computed by the Bank of Italy, which measures euro-area growth adjusted for short-term fluctuations, settled at levels compatible with a further recovery in economic activity.

Uncertainty dogs the strength of the recovery. The rise in production risks being held back by the gradual phasing out of the expansionary economic policies, the end of the inventory replenishment cycle, and the deterioration in labour market conditions, which could affect consumption.

Growth prospects for the euro area could also be dampened by the financial strains connected with the Greek crisis and by the need to correct the external imbalances that have built up in several countries in the last ten years, despite the broadly balanced position of the area as a whole. The indispensable adjustment of European economies with large external deficits should be accompanied by structural measures to stimulate domestic demand in countries running a surplus. Within this group, the removal of obstacles to domestic investment, through measures designed to heighten competition in service sectors that are not exposed to international competition, would support productive activity and employment, thereby boosting household expenditure and purchases of goods from countries with a deficit.

The risk of deflation did not materialize in 2009. Last year's slowdown in the growth of consumer prices, to 0.3 per cent on average from 3.3 per cent in 2008, was mostly the result of the steep drop in the prices of imported raw materials. Core inflation, though slowing slightly, amounted to just under 1.5 per cent. For 2010 and 2011 analysts predict broadly similar average rates.

The euro area

In 2009 euro-area GDP shrank by 4.1 per cent in real terms, owing to the contraction recorded in the first half of the year (Table 5.1). In the second half output began to grow again, albeit at a slow pace (gaining 0.4 per cent on the previous period), and unevenly across sectors. The improved performance of industry, where the rise in value added offset only a small part of the contraction suffered during the recession, contrasted with stagnation in services and a further decline in construction.

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)

	2007	2008	2009	2009			
	Year	Year	Year	Q1	Q2	Q3	Q4
				GDP			
Germany	2.5	1.3	-4.9	-3.5	0.4	0.7	0.2
France	2.4	0.2	-2.6	-1.4	0.2	0.3	0.5
Italy (2)	1.5	-1.3	-5.0	-2.9	-0.3	0.4	-0.1
Spain	3.6	0.9	….	-1.7	-1.0	-0.3	-0.1
Euro area (2) (3)	2.8	0.6	-4.1	-2.5	-0.1	0.4	..
				Imports			
Germany	4.8	4.3	-9.5	-6.1	-4.8	4.7	-1.6
France	5.6	0.6	-10.7	-6.0	-3.0	0.2	2.6
Italy	3.8	-4.3	-14.5	-9.7	-2.5	1.6	3.2
Spain	8.0	-4.9	….	-10.8	-2.3	1.7	2.1
Euro area (3)	5.5	1.1	-11.5	-7.6	-2.8	2.9	1.3
				Exports			
Germany	7.5	2.9	-14.5	-10.2	-1.0	3.2	2.3
France	2.5	-0.5	-12.4	-7.7	0.2	1.7	0.4
Italy	4.6	-3.9	-19.1	-11.3	-2.8	2.6	0.1
Spain	6.6	-1.0	….	-8.4	0.7	2.1	3.0
Euro area (3)	6.3	1.0	-12.9	-8.0	-1.1	2.9	1.9
				Household consumption (4)			
Germany	-0.3	0.4	-0.1	0.4	0.8	-1.3	-0.2
France	2.6	0.5	0.6	..	0.3	0.3	0.9
Italy	1.1	-0.8	-1.7	-1.3	0.3	0.6	-0.1
Spain	3.6	-0.6	….	-2.4	-1.3	..	0.3
Euro area (3)	1.6	0.4	-1.1	-0.5	0.1	-0.1	..
				Gross fixed investment			
Germany	5.0	3.1	-9.0	-7.8	0.7	0.8	-1.0
France	6.0	0.5	-7.1	-2.6	-1.3	-1.4	-1.1
Italy	1.7	-4.0	-12.1	-3.9	-2.7	..	-1.0
Spain	4.6	-4.4	….	-6.0	-4.1	-2.4	-1.0
Euro area (3)	4.8	-0.6	-10.8	-5.2	-1.6	-0.9	-1.3
				National demand (5)			
Germany	1.1	1.8	-2.2	-1.6	-1.1	1.3	-1.5
France	3.3	0.5	-2.4	-1.2	-0.5	-0.1	1.4
Italy	1.3	-1.5	-3.8	-2.4	-0.5	0.3	0.5
Spain	4.2	-0.5	….	-2.7	-1.7	-0.3	-0.3
Euro area (3)	2.4	0.6	-3.4	-2.3	-0.8	0.4	-0.2

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 aggregate for the euro area relates to 16 countries. – (4) Consumption of resident households and non-profit institutions serving households. – (5) Includes changes in stocks and valuables.

Spurred by the revival in international trade, euro-area exports of goods and services began to expand again in the summer, gaining 3.3 per cent in volume terms in the second quarter compared with the first and interrupting the downward trend under way since the spring of 2008. For the year as a whole the decline was 12.9 per cent. Among the main economies, Germany's exports increased markedly, by 3.8 per cent in the second half of 2009 compared with the first, helped by the greater presence of German businesses in more dynamic markets (such as China and the other emerging Asian economies) and in the sectors where worldwide trade had recovered most. In France and Italy the increase between the first half and the second was more modest (2 per cent and 1.2 per cent, respectively). One contributory factor was the loss of price competitiveness in the last decade. In the second half of 2009, the strengthening of demand also helped to sustain euro-area imports of goods and services, which nonetheless expanded at a slower pace than exports.

With production levels still very low, there was a decline in capital goods investment, which became progressively less steep during the year. Only in Germany and Italy did signs of an increase in purchases of machinery, equipment and means of transport appear in the second half of the year. Expenditure of this kind was held back by the low rates of plant capacity utilization, the uncertainty of the expectations about the strength of the recovery and the strains in the credit market.

The cyclical downturn in the construction sector continued. Last year investment fell by an average of 7.3 per cent in real terms, mostly reflecting the contraction of 9.5 per cent in the residential component. The slowdown in housing construction was exceptionally severe in Spain (24.5 per cent), where this sector had been a mainstay of GDP growth in the last decade.

The fall in household consumption of 1.1 per cent in real terms contributed to weak demand within the euro area and curbed the already slow growth recorded since the turn of the century. The fall derived both from the stagnation of real disposable income, notwithstanding moderate inflation, and from the increase in the propensity to save (from 13.9 per cent in 2008 to 15.4 per cent, gross of variations in pension fund reserves) in response to concern about labour market prospects. Among the main countries, the propensity to save grew most markedly in Spain (from 12.9 to 18.8 per cent) and remained high in Germany (17.2 per cent), where the increase in the last decade reflected the uncertainty that had arisen in connection with the reform of the social security system. In France too, despite the favourable performance of disposable income, households' spending decisions were marked by caution, with an increase in the saving rate of almost one percentage point, to 16.1 per cent.

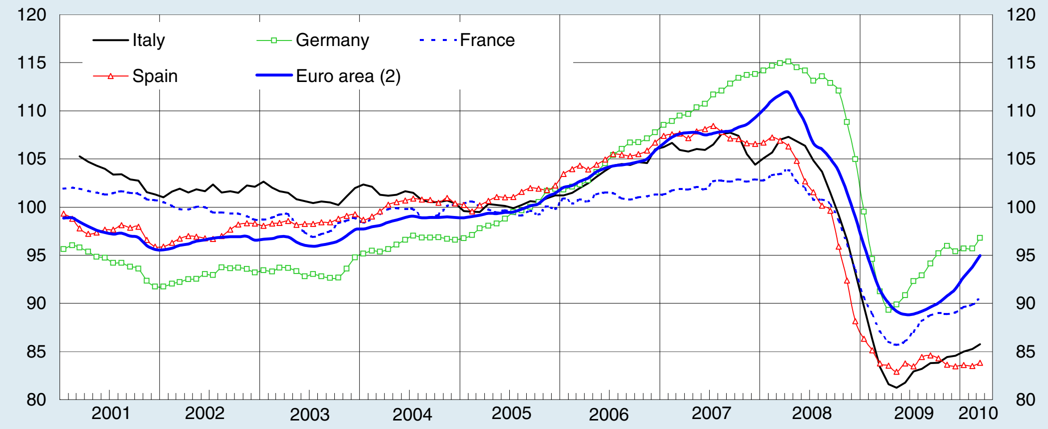
The indications of a brighter economic outlook recorded in the second half of 2009 continued into the early months of 2010. The rise in the purchasing managers index, the improvement in the climate of business and, despite some uncertainty, household confidence pointed to the gradual spread of more optimistic views on the current cyclical phase. In May, however, qualitative surveys reflected concern over the effects of the recent financial tensions stemming from the Greek crisis.

The quantitative indicators have yet to show an equally robust improvement. The pace of the recovery in industrial production is slow compared with the sharpness of the earlier decline (Figure 5.1): in the first quarter of 2010, manufacturing volumes were around 15 percentage points below the peak registered in early 2008 in Germany, France and the euro area as a whole and about 20 percentage points lower in Italy. In Spain, production continued to stagnate.

According to preliminary data, in the first quarter of 2010 GDP grew by 0.2 per cent on the previous period in the euro area as a whole and in Germany. The pace was faster in Italy (0.5 per cent) and barely positive in France and Spain.

Figure 5.1

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

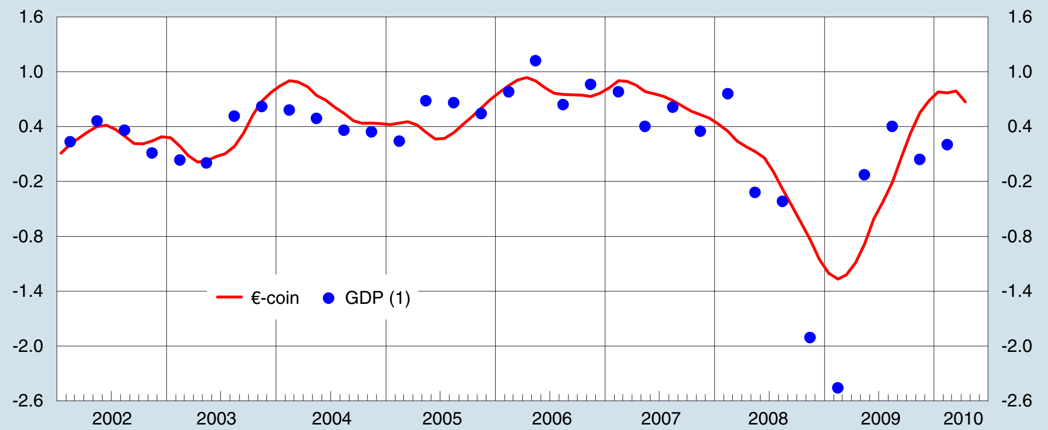


Sources: Based on Istat and Eurostat data.
(1) Indices, 2005=100; seasonally adjusted data. — (2) The aggregate for the euro area relates to 16 countries.

The latest economic data suggest the recovery will continue. After accurately signalling the turning point of the economic cycle early in 2009, the €-coin indicator increased sharply; in the first part of 2010, despite falling slightly, it remained at a relatively high level (Figure 5.2).

Figure 5.2

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



Sources: Bank of Italy and Eurostat. For more details on the €-coin indicator: see http://eurocoin.bancaditalia.it.
(1) The aggregate for the euro area relates to 16 countries.

Prices and costs

Consumer prices. – After reaching the highest level since the launch of the third phase of monetary union (3.3 per cent), annual consumer price inflation in the euro area fell to 0.3 per cent (Table 5.2). The drop mainly reflected the decline in food and, above all, energy prices, caused by the fall in the international prices of the corresponding raw materials.

Table 5.2

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

	Italy			Germany			France			Spain (3)			Euro area (4)		
	2007	2008	2009	2007	2008	2009	2007	2008	2009	2007	2008	2009	2007	2008	2009
Consumer prices (1)															
General index	2.0	3.5	0.8	2.3	2.8	0.2	1.6	3.2	0.1	2.8	4.1	-0.2	2.1	3.3	0.3
Index excluding food and energy products	1.8	2.2	1.6	1.9	1.3	1.3	1.6	1.8	1.4	2.5	2.4	0.9	1.9	1.8	1.4
of which:goods	*1.5*	*1.7*	*1.3*	*1.3*	*0.6*	*1.2*	*0.5*	*0.9*	*0.5*	*0.7*	*0.4*	*-0.9*	*1.0*	*0.8*	*0.6*
services	*2.0*	*2.7*	*1.8*	*2.2*	*1.7*	*1.5*	*2.5*	*2.4*	*2.2*	*3.9*	*3.9*	*2.2*	*2.5*	*2.6*	*2.0*
Food products	3.0	5.2	1.9	3.0	4.3	-0.3	1.5	4.8	0.5	4.1	5.7	0.2	2.8	5.1	0.7
of which:processed	*2.8*	*6.1*	*1.9*	*3.2*	*5.0*	*-0.1*	*1.0*	*5.6*	*0.8*	*3.9*	*7.4*	*1.0*	*2.8*	*6.1*	*1.1*
unprocessed	*3.2*	*3.8*	*1.9*	*2.4*	*2.6*	*-0.7*	*2.2*	*3.7*	*-0.1*	*4.3*	*3.9*	*-0.7*	*3.0*	*3.5*	*0.2*
Energy products	1.5	10.1	-8.9	3.8	9.4	-5.4	1.8	10.8	-11.2	1.7	11.9	-9.0	2.6	10.3	-8.1
Producer prices (2)	**3.3**	**5.8**	**-5.4**	**1.3**	**5.4**	**-4.0**	**2.8**	**5.6**	**-6.4**	**3.6**	**6.5**	**-3.4**	**2.7**	**6.1**	**-5.1**
GDP price deflator	**2.6**	**2.8**	**2.1**	**1.9**	**1.5**	**1.5**	**2.5**	**2.5**	**0.8**	**3.3**	**2.5**	**0.2**	**2.4**	**2.2**	**1.1**

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 2009 the GDP deflator is calculated on the basis of the quarterly national accounts. – (4) The aggregate for the euro area relates to 16 countries.

During the year, the rise in consumer prices slowed progressively, turning negative in the summer months (down 0.4 per cent on the year-earlier period). This trend reflected significant base effects due to the comparison with the same period in 2008, when prices had surged. Since last autumn, in relation to the rise in oil prices, inflation has turned positive again (Figure 5.3).

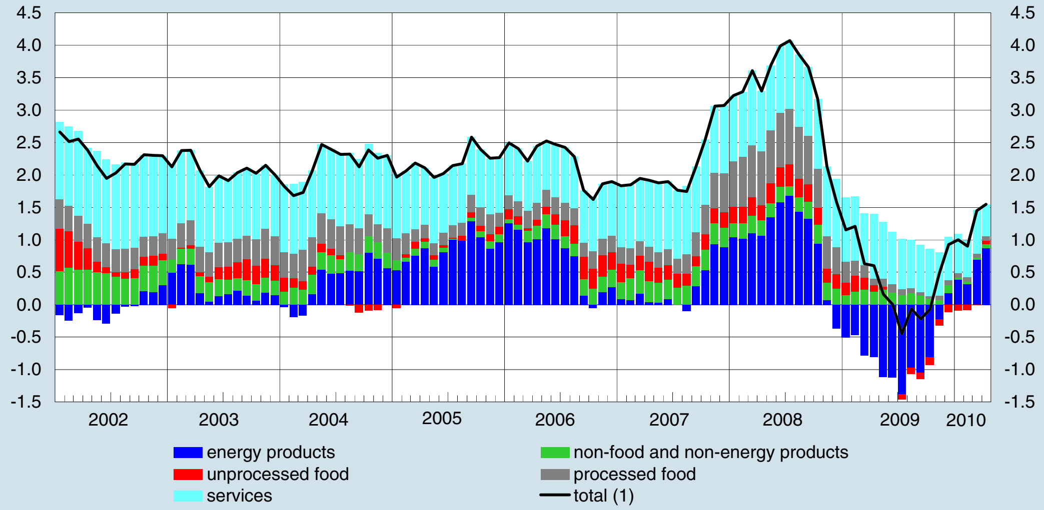
Wage moderation and the fall in firms' profits also led to a decline in inflation excluding food and energy (core inflation), which for the year as a whole stood at 1.4 per cent, down from 1.8 per cent in 2008. As regards the individual components, services prices decelerated from 2.6 per cent to 2 per cent, driven by the fall in air transport prices and the slowdown in those of recreational and restaurant services. The rise in the prices of non-food and non-energy products declined to a lesser extent, from 0.8 per cent to 0.6 per cent.

Among the most volatile components of the general index, in 2009 the rise in the prices of food products declined to 0.7 per cent from 5.1 per cent in 2008, recording slightly negative values in the second half of the year; the slowdown in processed food prices was especially large, from 6.1 to 1.1 per cent. Energy prices fell by 8.1 per cent in 2009, compared with an increase of 10.3 per cent in 2008.

Early in 2010, the twelve-month increase in the harmonized index of consumer prices rose progressively, reaching 1.5 per cent in April, driven by the acceleration of energy prices (9.1 per cent). Core inflation stayed at around 1 per cent.

Figure 5.3

Contributions to inflation in the euro area
(percentage points)



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

Producer prices, costs and profit margins. – After rising by 6.1 per cent in 2008, last year the producer prices of products sold in the domestic market declined by 5.1 per cent. The fall reflected those recorded by the energy, intermediate goods and food components (11.5, 5.3 and 4.5 per cent respectively), which were more directly affected by the sharp contraction in raw material prices. By contrast, the prices of non-food final consumption goods remained unchanged from the previous year, compared with an increase of 0.9 per cent in 2008.

The decline in producer prices slowed between late 2009 and early 2010 in response to the growing pressures linked to increases in input costs. In March, for the first time in over a year, the twelve-month increase turned positive and rose to 0.9 per cent.

Following the depreciation of the euro, the producer prices of non-energy industrial goods sold outside the euro area fell less than those for such goods sold on the domestic market (by 1 and 2.8 per cent, respectively). Early in 2010, the fall in export prices came to a halt, as the international economic outlook brightened.

Last year unit labour costs in the economy as a whole grew at a rate close to 4 per cent, compared with 3.1 per cent in 2008 (Table 5.3). The rise reflected the cyclical decline of 1.2 per cent in hourly output, which was especially pronounced in industry (6.3 per cent), where the fall in value added was associated with measures to support employment based on reducing the number of hours worked, above all in Italy and Germany.

According to national accounts data, the share of profits in value added in the euro area as a whole declined by about 6 percentage points with respect to 2008; the contraction was smaller in the service sector, where the effects of the fall in world demand were less pronounced.

Table 5.3

Unit labour costs, costs per employee, productivity and its components in the major euro-area countries
(percentage changes on previous year)

	Labour costs per employee (1)		Hourly productivity						Unit labour costs	
					Value added (2)		Hours worked (1)			
	2008	2009	2008	2009	2008	2009	2008	2009	2008	2009
					Industry excluding construction (3)					
Germany	2.6	5.1	-0.4	-8.5	0.2	-17.2	0.6	-9.5	3.1	14.9
France	2.9	3.7	-1.0	-4.6	-2.0	-10.3	-1.0	-6.1	3.9	8.7
Italy	3.4	5.4	-2.3	-5.5	-3.6	-15.1	-1.3	-10.2	5.8	11.5
Spain	5.3	3.6	-0.5	-2.7	-1.5	-13.7	-1.0	-11.3	5.8	6.5
Euro area (4)	4.1	3.1	0.2	-6.3	-0.7	-13.3	-0.9	-7.5	3.9	10.0
					Services (5)					
Germany	2.1	3.5	0.0	-0.5	1.7	-1.7	1.7	-1.1	2.1	4.1
France	2.0	2.5	-0.4	0.3	0.9	-1.2	1.3	-1.4	2.4	2.2
Italy	2.5	1.8	-1.0	-0.9	-0.4	-2.6	0.6	-1.8	3.5	2.6
Spain	5.9	3.3	0.6	1.8	2.2	-1.0	1.6	-2.7	5.3	1.5
Euro area (4)	3.0	2.6	0.0	-0.2	1.4	-1.6	1.3	-1.5	3.0	2.8
					Total economy					
Germany	2.2	3.3	0.1	-2.9	1.4	-5.6	1.3	-2.8	2.1	6.3
France	2.1	2.5	-0.3	-0.6	0.5	-2.5	0.9	-2.0	2.4	3.1
Italy	2.7	2.8	-1.1	-1.9	-1.2	-5.5	-0.1	-3.6	3.9	4.8
Spain	6.1	3.7	1.7	3.1	1.1	-3.8	-0.6	-6.7	4.3	0.6
Euro area (4)	3.4	2.8	0.2	-1.2	0.8	-4.2	0.6	-3.0	3.1	4.1

Source: Based on Eurostat data.
(1) On the basis of the number of hours worked; for Spain, standard labour units. – (2) Chain-linked volumes. – (3) Manufacturing, mining and quarrying, and electricity generation and distribution. – (4) The aggregate for the euro area relates to 16 countries. – (5) Comprises "wholesale and retail trade, transport and communications", "financial and real-estate services" and "other services".

Inflation expectations. – In the early months of 2010 the professional forecasters surveyed by Consensus Economics expected average consumer price inflation to rise slightly above 1 per cent for the year, revised upwards in May to 1.3 per cent, in response to the effects of the increases in oil prices and the depreciation of the euro; forecasts for 2011 are also for a modest rise, to 1.4 per cent (Table 5.4). These assessments are in line with those published by the main international organizations.

Longer-term expectations and those that can be inferred from the financial markets point to basically stationary levels of inflation consistent with the price-stability objective.

Table 5.4

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

	2010	2011
Italy	1.5	1.8
France	1.5	1.5
Germany	1.0	1.3
Spain	1.5	1.6
Euro area (2)	1.3	1.4

Source: Consensus Economics.
(1) May 2010. – (2) The aggregate for the euro area relates to 16 countries.

Employment

According to national accounts data, in 2009 euro-area employment fell by 1.9 per cent (over two million less people in employment), with a marked decline in the early part of the year.

Among those in the 15-64 age group the employment rate fell by around one percentage point compared with 2008, to 64.8 per cent; there was a sharp reduction for men, from 73.4 to 71.2 per cent, especially those aged between 15 and 39, from 70.6 to 67.2 per cent; the female participation rate remained largely unchanged at 58.4 per cent.

In 2009 the unemployment rate continued to rise, to an average of 9.4 per cent for the year (up 1.8 percentage points on 2008); in March of this year it stood at 10 per cent, the highest level since 1998.

The impact of the global crisis on the labour market was felt worldwide but its effect on the number of those in employment and on hours worked was distributed unevenly. In Germany, widespread recourse to measures to support employment helped curb job losses; the slump in economic activity was reflected above all in a reduction in hours worked. The unemployment rate increased only slightly, averaging 7.5 per cent for the year; unlike in the other major countries, the employment rate showed a small year-on-year increase, from 70.3 per cent to 70.8 per cent.

In Spain, total employment fell by 6.7 per cent, driven down by the heavy job losses in the construction sector, characterized by a high labour intensity and large numbers of workers on temporary contracts. The workers hit hardest by the unprecedented job losses were those in the 15-39 age group, where the employment rate fell from 65.2 to 58.4 per cent. The unemployment rate rose by around 7 percentage points compared with 2008, averaging 18 per cent for the year; in the last quarter it reached 19 per cent.

In France, the number of workers in employment declined by about half a million in the year as a whole; the unemployment rate moved broadly in line with the euro-area average (rising to 9.5 per cent).

The balance of payments

In 2009 the euro-area current account recorded a deficit of €55.8 billion (0.6 per cent of GDP), €98 billion less than in 2008 (Table 5.5). Contributions to the improvement came from trade in goods (€58.6 billion) and the income account (€38.6). Net inflows on the financial account declined from €163.2 billion to €45.4 billion. Errors and omissions amounted to just €2.4 billion, following the adoption of a new methodology which, by adjusting a number of items in the financial account at aggregate level, has notably reduced the statistical discrepancies with the current account.

Following the sharp contraction in merchandise trade between the end of 2008 and the beginning of 2009, area-wide exports recovered more rapidly than imports, which were also affected by the fall in oil prices. The surplus on services narrowed for the second consecutive year, from €41.4 billion to €31.4 billion, reflecting the deterioration in the economic outlook. Trade was again concentrated with the UK and the United States. The negative balance on the income account narrowed from €76.6 billion to €38 billion, owing to a larger reduction in outward payments than in receipts.

Table 5.5

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

	2005	2006	2007	2008	2009
Current account	**11.7**	**-10.2**	**13.5**	**-153.8**	**-55.8**
Goods	43.7	10.7	48.0	-19.1	39.5
Services	38.7	41.6	49.6	41.4	31.4
Income	2.7	17.3	2.9	-76.6	-38.0
Transfers	-73.3	-79.8	-87.0	-99.5	-88.7
Capital account	**11.7**	**9.1**	**5.0**	**9.8**	**8.0**
Financial account	**-37.6**	**-9.4**	**-10.7**	**163.2**	**45.4**
Direct investment	-206.0	-160.2	-73.7	-198.7	-95.7
Portfolio investment	108.3	188.7	151.5	344.1	317.9
Financial derivatives	-17.3	-0.6	-63.7	-62.5	39.9
Other investment	59.4	-36.0	-19.6	83.7	-221.2
of which: monetary financial institutions (2)	*87.0*	*-38.4*	*78.4*	*-130.5*	*60.1*
Change in official reserves (3)	18.0	-1.3	-5.1	-3.4	4.5
Errors and omissions	**14.1**	**10.5**	**-7.8**	**-19.2**	**2.4**

Source: ECB.
(1) The aggregate for the euro area relates to 16 countries. – (2) Excluding the Eurosystem. – (3) A minus sign indicates an increase in reserves.

Euro-area external trade was basically in balance but several countries showed large and persistent imbalances (Table 5.6). The current account deficits of Greece, Portugal and Spain have widened progressively in the last decade, reaching record highs in 2008 (around 15, 12, and 10 per cent of GDP, respectively). From 1999 to 2009, net foreign liabilities grew from 33.1 to 111.7 per cent of GDP for Portugal, from 32.1 to 93.6 per cent for Spain, and from 34.3 to 83.1 per cent for Greece.

The situation in Ireland is different. The recent current account deficit has been accompanied by exceptionally large amounts of foreign assets and liabilities (around 14 times GDP), the result of intensive financial integration pursued through deregulation and tax incentives. The net foreign position has deteriorated sharply, swinging from a net credit position of 50.5 per cent of GDP in 1999 to a net debit position of 67 per cent of GDP in 2009.

By contrast, Germany, the Netherlands and Belgium are the only euro-area countries to record both a positive current account balance and a net foreign credit position in the last decade. Germany, in particular, has a net credit position of almost €900 billion (equal to 37.2 per cent of GDP), half of which is attributable to the banking sector.

The lower net inflows in the euro-area financial account are largely attributable to deposits and loans. There were exceptionally high levels of disinvestment both on the asset side and, to an even greater extent, on the liability side. One contributory factor has been intermediaries' post-crisis deleveraging.

Net inflows of direct and portfolio invstement rose from €145.4 billion in 2008 to €222.2 billion in 2009, primarily owing to increased direct investment in the euro area by non-residents (€218.6 billion of net inflows). Foreign direct investment by euro-area residents stayed close to its 2008 level.

Table 5.6

Current account balances and net foreign position of the euro area and selected member countries
(percentage of GDP; for the net foreign position, end-of-year stocks)

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
					Balance of payments - current account						
Euro area	-0.5	-1.5	-0.4	0.6	0.3	0.8	0.1	-0.1	0.2	-1.7	-0.6
Belgium	5.1	4.0	3.4	4.5	3.4	3.2	2.0	1.9	1.6	-2.9	0.5
France	3.1	1.7	2.0	1.4	0.8	0.6	-0.4	-0.5	-1.0	-2.3	-2.2
Germany	-1.3	-1.7	0.0	2.0	1.9	4.7	5.1	6.5	7.6	6.7	5.0
Greece	-5.5	-7.8	-7.2	-6.6	-6.5	-5.8	-7.5	-11.3	-14.4	-14.6	-11.3
Ireland	0.3	-0.4	-0.7	-1.0	..	-0.6	-3.5	-3.6	-5.3	-5.2	-2.9
Italy	0.7	-0.5	-0.1	-0.8	-1.3	-0.9	-1.7	-2.6	-2.4	-3.6	-3.2
Netherlands	3.8	1.9	2.4	2.5	5.5	7.5	7.3	9.3	8.7	4.8	5.4
Portugal	-8.5	-10.6	-9.9	-7.8	-5.9	-7.2	-9.2	-8.5	-9.3	-12.4	-9.3
Spain	-2.9	-4.0	-3.9	-3.3	-3.5	-5.3	-7.4	-9.0	-10.0	-9.7	-5.4
					Net foreign position (1)						
Euro area	-6.1	-7.3	-5.4	-9.5	-10.2	-10.9	-8.8	-11.9	-13.9	-17.6	-16.3
Belgium	60.5	60.6	51.8	37.1	36.7	28.4	33.6	28.7	29.2	33.2	….
France	-8.0	-7.6	-2.0	3.0	-4.2	-4.7	-3.9	-7.0	-7.6	-14.2	….
Germany	4.5	3.2	8.7	5.1	6.6	11.2	21.5	28.0	26.1	26.8	37.2
Greece	-34.3	-39.0	-46.5	-52.9	-58.9	-66.8	-76.4	-84.7	-94.7	-74.9	-83.1
Ireland	50.5	-8.0	-15.3	-18.0	-20.1	-18.0	-24.7	-5.3	-19.5	-58.4	-67.0
Italy	-13.4	-13.2	-9.9	-13.8	-15.1	-16.3	-15.7	-20.6	-21.5	-21.5	-19.2
Netherlands	-8.2	-15.2	-13.4	-24.3	-1.7	3.7	-2.6	3.2	5.5	11.0	18.7
Portugal	-33.1	-41.1	-48.6	-57.1	-59.0	-63.8	-70.0	-81.1	-92.4	-99.3	-111.7
Spain	-32.1	-32.0	-35.6	-41.6	-45.2	-51.9	-55.6	-65.9	-77.6	-81.0	-93.6

Sources: Based on Bank of Italy, ECB, BIS, Eurostat and Istat data and national statistics.
(1) Difference between the stock of financial assets and liabilities (all the institutional sectors are considered).

After a period of preference for secure and liquid assets, investors' appetite for equities gradually returned, thanks to improved conditions in the financial markets and lower risk aversion. There were net share purchases, both outward and inward, albeit at lower levels than those recorded from 2005 to 2007.

The renewed interest in equities was reflected in a reduction in net portfolio investment in debt securities, which fell to €224.6 billion compared with the peak of €347.3 billion recorded in 2008. On the liability side, the sharp contraction in net purchases of securities issued in the area (from €441 billion to €252.2 billion) also involved money market instruments. On the asset side, residents remained cautious, with a further drop in net outflows.

At the end of 2009, the international investment position of the euro area showed a debit balance of €1,467.3 billion (16.3 per cent of GDP compared with 17.6 per cent in 2008). Faced with an increase in net liabilities in the financial account, the improvement reflects the positive contribution of value adjustments.

6. BUDGETARY POLICIES

The public finances of the euro-area countries deteriorated very sharply in 2009 as a result of the crisis and of the discretionary counter-measures adopted by the various governments. The situation became particularly acute in Greece, while difficulties also emerged in Ireland, Spain and Portugal. As the recovery gets under way, budgetary policies will need to aim at securing a rapid reduction in the deficits and restoring conditions for sustainable public finances.

Budgetary policies and performance in 2009. – Area-wide general government net borrowing more than tripled with respect to 2008, rising from 2 to 6.3 per cent of GDP (Table 6.1). About 1.3 percentage points of the increase can be ascribed to the reaction of budgetary policies to the crisis, which proved stronger in the countries which had had a lower than average debt-to-GDP ratio in 2007 (Table 6.2 and Figure 6.1).

Table 6.1

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

	Net borrowing				Debt			
	2008	2009	2010 (1)	2011 (1)	2008	2009	2010 (1)	2011 (1)
Germany	0.0	3.3	5.0	4.7	66.0	73.2	78.8	81.6
France	3.3	7.5	8.0	7.4	67.5	77.6	83.6	88.6
Italy	2.7	5.3	5.3	5.0	106.1	115.8	118.2	118.9
Spain	4.1	11.2	9.8	8.8	39.7	53.2	64.9	72.5
Netherlands	-0.7	5.3	6.3	5.1	58.2	60.9	66.3	69.6
Belgium	1.2	6.0	5.0	5.0	89.8	96.7	99.0	100.9
Austria	0.4	3.4	4.7	4.6	62.6	66.5	70.2	72.9
Greece	7.7	13.6	9.3	9.9	99.2	115.1	124.9	133.9
Finland	-4.2	2.2	3.8	2.9	34.2	44.0	50.5	54.9
Portugal	2.8	9.4	8.5	7.9	66.3	76.8	85.8	91.1
Ireland	7.3	14.3	11.7	12.1	43.9	64.0	77.3	87.3
Slovakia	2.3	6.8	6.0	5.4	27.7	35.7	40.8	44.0
Luxembourg	-2.9	0.7	3.5	3.9	13.7	14.5	19.0	23.6
Slovenia	1.7	5.5	6.1	5.2	22.6	35.9	41.6	45.4
Cyprus	-0.9	6.1	7.1	7.7	48.4	56.2	62.3	67.6
Malta	4.5	3.8	4.3	3.6	63.7	69.1	71.5	72.5
Euro area (1)								
European Commission	*2.0*	*6.3*	*6.6*	*6.1*	*69.4*	*78.7*	*84.7*	*88.5*
Stability programmes	–	*6.3*	*6.7*	*5.2*	–	*78.7*	*83.9*	*86.5*
IMF	–	*6.3*	*6.8*	*6.1*	–	*78.3*	*84.1*	*88.1*

Sources: For data on the individual countries, European Commission (*Spring Forecast*, May 2010). For euro-area averages, European Commission (*Spring Forecast*, May 2010); based on the updates to national stability programmes; IMF (*World Economic Outlook*, April 2010).
(1) Forecasts.

Table 6.2

Responses to the crisis in the euro area: effects on public finances in 2009
(as a percentage of GDP)

	Support of the financial system		Support of the economy
	Impact on the deficit	Impact on the debt	Impact on the deficit
Germany	0.1	4.1	1.8
France	-0.1	0.3	1.1
Italy	0.0	0.3	0.0
Spain	-0.1	1.8	2.3
Netherlands	0.3	10.1	1.0
Belgium	0.1	6.2	0.5
Austria	0.0	2.0	1.5
Greece	0.0	0.0	1.3
Finland	0.0	0.0	2.0
Portugal	0.0	0.0	0.8
Ireland	2.3	3.2	0.7
Slovakia	0.0	0.0	0.0
Luxembourg	0.2	6.6	1.8
Slovenia	0.0	0.0	1.5
Cyprus	0.0	0.0	1.5
Malta	0.0	0.0	0.0
Euro area	**0.1**	**2.4**	**1.2**

Sources: For measures to support the financial system, Eurostat; for support of the economy, based on European Commission data (recommendations for Council opinion on updates to the national stability programmes).

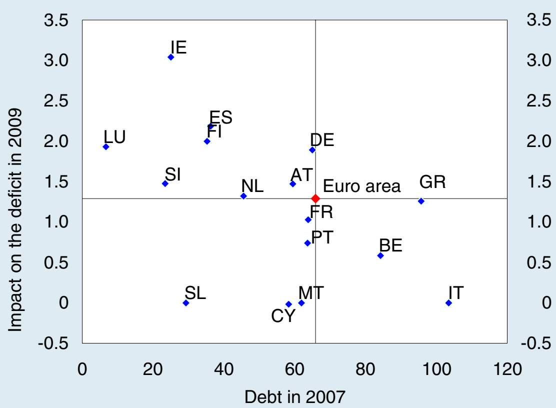
While interest expense declined slightly, the area-wide primary balance turned negative by 3.5 percentage points of GDP, against a surplus of 1 per cent in 2008. The deterioration was the result mainly of the 4.1 point rise in primary expenditure, to 47.9 per cent of GDP. The European Commission estimates that the area's structural deficit, i.e. adjusted for the effects of the business cycle and temporary measures, increased to 4.7 per cent of GDP, compared with 2.8 per cent in 2008.

In Spain the deficit widened from 4.1 per cent of GDP in 2008 to 11.2 per cent, in France it rose from 3.3 to 7.5 per cent, while in Germany, which had balanced its budget in 2008, the deficit was 3.3 per cent (Table 6.1). Economic stimulus packages contributed respectively 2.3, 1.1 and 1.8 percentage points.

Looking at the rest of the euro area, there was a large deterioration in the public finances in Ireland. General government net borrowing increased by around 7 percentage points of GDP for the second consecutive year, reaching 14.3 per cent, the highest level in the area. For the most part this was due to the severity of the recession, which saw GDP decline by about 10.1 per cent between 2007 and 2009 compared with an area-wide average of 3.5 per cent, but about a third can be ascribed to the measures to support the financial system. In Portugal,

Figure 6.1

Anti-crisis measures in the euro area
(as a percentage of GDP)



Sources: Based on Eurostat and European Commission data.

where net borrowing rose by nearly 7 points to 9.4 per cent of GDP, economic support measures contributed very little.

The situation of the public finances became extremely serious in Greece, where net borrowing rose by about 6 percentage points of GDP in 2009, with economic support measures contributing 1.3 points. The sharp deterioration did not become apparent for some time. In January 2009 the Greek Government estimated that net borrowing for the year would amount to 3.7 per cent of GDP; in October the new Government made substantial revisions to this figure, estimating a deficit of 12.5 per cent; finally, in April of this year, the deficit was reported to have been 13.6 per cent of GDP. Eurostat has expressed reservations, however, about the figure given by the Greek authorities; it has called for further investigation and suggested that additional adjustments may be necessary in the order of half a percentage point. The uncertain outlook for the public finances has caused yields on Greek government securities to rise sharply, particularly since the end of 2009.

In all the euro-area countries except Finland and Luxembourg, the deficit overshot the threshold of 3 per cent of GDP in 2009. The debt-to-GDP ratio rose on average by 9.3 points, to 78.7 per cent. The majority of countries do not comply with the reference threshold set in the EU Treaty.

The medium and long-term outlook. – In October 2009, when the first signs of recovery appeared, the Council of the European Union outlined an exit strategy from the expansionary fiscal measures and called on the member states to adopt timely, ambitious, medium to long-term consolidation measures. Compatibly with the improvement in the economic situation, the Council hoped that the following would be achieved: a) fiscal consolidation would start in 2011 at the latest; b) each year's structural adjustment would exceed 0.5 per cent of GDP; and c) the deficit-reduction plan would be accompanied by reforms aimed at reinforcing national budgetary frameworks and boosting economic growth in the long run.

The measures set out by governments in their stability programme updates differ from country to country. Some will continue to adopt expansionary fiscal measures in 2010, to be followed by determined consolidation efforts (Germany and France); others, like Spain, will begin consolidation already this year (See the box "The public finances in selected advanced countries", *Economic Bulletin,* No. 56, April 2010).

The updates to the stability programmes were examined by the European Commission between February and April 2010. It found the consolidation plans outlined by the leading euro-area countries to be in line with the strategy drawn up by the Council in October 2009. However, the objectives of the programmes are based on fairly optimistic forecasts of the economic situation, as well as on the adoption, starting in 2011, of substantial corrective measures that have yet to be set out in detail.

In May the European Commission updated its forecasts for 2010-11, indicating an increase in area-wide net borrowing of 0.3 points in 2010, in line with the stability programmes, of which 0.2 points due to the increase in interest expense. The debt is projected to widen by 6 percentage points, slightly more than indicated in official government documents. Assuming unchanged budgetary policies, the Commission estimates that the deficit will decline by 0.5 percentage points of GDP in 2011, despite a further 0.2 point growth in interest expense. The debt-to-GDP ratio is expected to rise by 3.8 percentage points.

The critical state of the public finances in Greece has prompted the country to begin consolidation this year. The Government has tried to ease tensions on the government securities market by introducing progressively tighter measures in recent months, which it is estimated will produce an overall adjustment of over 7 percentage points of GDP in 2010, a further 4 points in 2011 and 2 additional points a year until 2013. The consolidation of the public finances is the requirement imposed on Greece in order to access joint financial support from the other euro-area countries and the IMF.

The January update to the Greek stability programme outlined a consolidation based on an increase in revenue and, to a smaller extent, the containment of current expenditure, which was expected to cut the deficit by 4 percentage points of GDP in 2010 (see the box "The public finances in selected advanced countries", *Economic Bulletin,* No. 56, April 2010).

On 16 February the Council of the European Union drew up a list of the measures that Greece was required to adopt by the end of 2012. As a result, in February and March the Greek Government introduced a new package of restrictive measures, split equally between permanent increases in revenue and expenditure cuts.

As financial market tensions emerged again, on 25 March the Heads of State and Government of the euro-area countries designed a financing mechanism to be activated in the event of a member state experiencing a shortage of funds. On 11 April the Finance Ministers announced that in the case of Greece the financing programme would cover a period of three years; the member states would contribute €30 billion in the first year; the interest rate would be equal to the base rate plus a spread of 300 or 400 basis points according to the maturity of the loan; and a one-off fee of 50 basis points would be levied. On 23 April Greece made an official application for financial support from the IMF and the other euro-area countries.

On 2 May the Greek authorities agreed with the European Commission, the ECB and the IMF on a far-reaching consolidation and development programme that envisages a progressive adjustment of the public finances, from 2.5 percentage points of GDP in 2010 to 11 points in 2013. The document sets out a series of permanent measures, evenly distributed between expenditure cuts and increases in revenue, that are expected to bring the deficit back below the threshold of 3 per cent of GDP from 2014 (and reduce the debt ratio from 2013). The principal provisions will reduce salaries and new jobs in the public sector and cut pension expenditure, intermediate consumption and transfers to public enterprises, while on the revenue side they will raise VAT rates and excise duties. The implementation of the programme will be monitored quarterly by the IMF, the ECB and the European Commission. When the Greek Government submitted its consolidation plan, the Finance Ministers activated bilateral loans amounting to €80 billion over three years, €30 billion of which in the current year. These funds are in addition to the €30 billion provided by the IMF.

In order to prevent Greece's financial difficulties spreading to other member states and safeguard the overall soundness of markets in the euro area, on 10 May the Council of the European Union drew up a broad-based financial support plan. The measures approved will mobilize around €500 billion to be added to the loans already granted by the IMF. At the same time the ECB has begun to make purchases of government securities and private sector bonds of euro-area countries.

If investors are to regain confidence, the euro-area countries must give a clear and coordinated signal that they can restore order to their public finances. The consolidation strategy will only be effective and lasting if the most prominent role is given to measures to contain expenditure, which is now at its highest level in relation to GDP since the start of the Economic and Monetary Union.

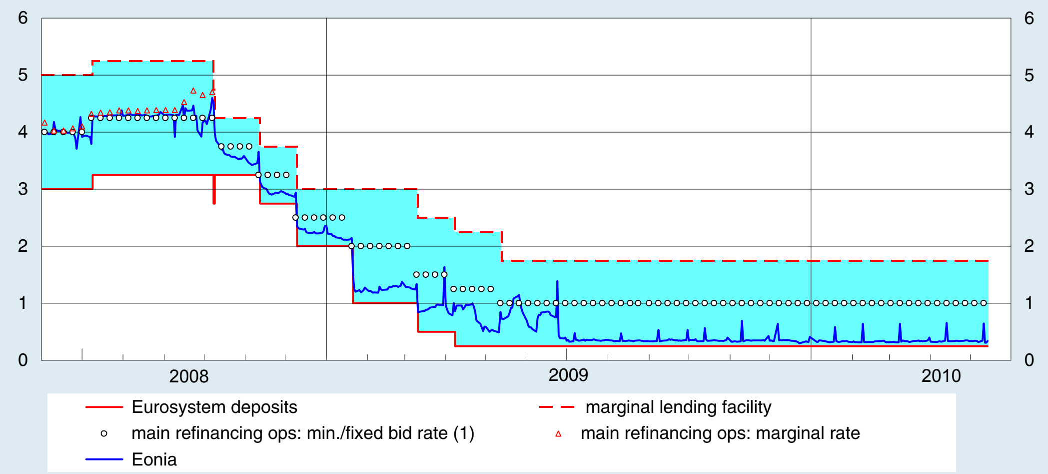
In a communication to the main European institutions issued on 12 May, the Commission illustrated a set of proposals designed to strengthen the mechanisms for the coordination of economic policies. The aim is to achieve more efficient multilateral surveillance of macroeconomic performance and to combine the discussion of stability and convergence programmes with the review of planned national reforms, to be undertaken prior to the drafting of national budgetary policies. The Commission has also drawn up proposals to reinforce the Stability and Growth Pact and the Excessive Deficit Procedure, including the introduction of an interest-bearing deposit requirement for countries not conducting prudent budgetary policies during a cyclical upswing and a tightening of rules on public debt. Member states are also invited to bring national budgetary rules and institutions closer into line with the system created at European level.

7. THE COMMON MONETARY POLICY

The Governing Council of the European Central Bank eased monetary conditions markedly in 2009 against the background of the deepest recession since the Second World War and the persistence of strains in the financial markets, which abated, however, in the second half of the year. Between January and May 2009 the interest rate on main financing operations, which had already been cut by 175 basis points in the final months of 2008, was reduced by a further 150 points to 1 per cent, the lowest level ever reached by official rates in euro-area member countries. The Eonia rate fell to 0.3 per cent (Figure 7.1).

Figure 7.1

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



Sources: ECB and Thomson Reuters Datastream.
(1) Up to 14 October 2008, minimum bid rate; subsequently, fixed rate.

In light of the persistence of serious problems in the functioning of the financial and credit markets, the Governing Council also introduced unconventional monetary policy measures intended to assist the transmission of the reductions in official rates to money market and bank rates and to sustain the flow of credit to households and firms. Eurosystem interventions guaranteed the availability of unlimited liquidity to banks against a wide range of collateral. The set of measures helped to keep the liquidity crisis from turning into a systemic crisis with dire consequences for the supply of credit to the economy.

In the second half of the year the Governing Council did not renew some of the exceptional measures, deeming them no longer necessary. However, it did maintain an abundant supply of financing, with the aim of avoiding distortions in markets while continuing to support the recovery and guarantee the necessary liquidity to the banking system.

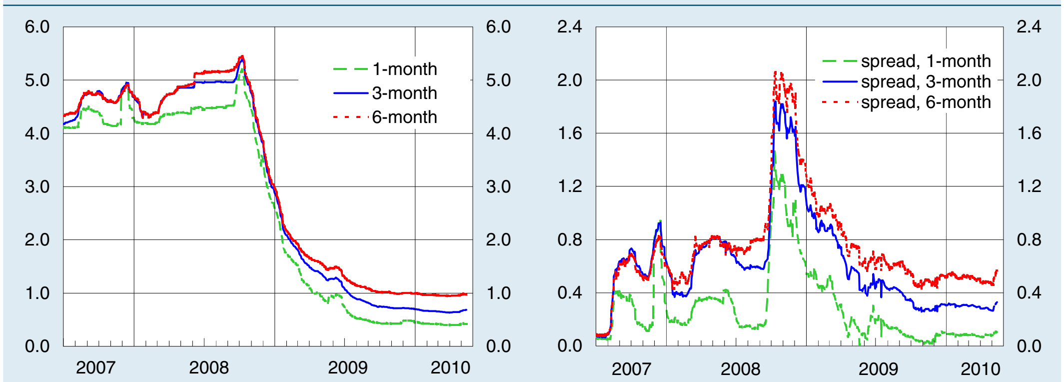
The closing months of 2009 and the first few months of 2010 saw mounting fears about the state of the public finances in Greece. The strains grew considerably worse in April and spread to other euro-area countries. In May, in concomitance with the decision of the Council of the European Union to adopt a set of measures to safeguard financial stability in Europe, the ECB Governing Council began a programme of purchases of euro-area public and private sector securities in order to support market segments particularly hard hit by the crisis. At the same time it resumed supplying unlimited liquidity in longer-term refinancing operations and, in concert with other central banks, reactivated operations in dollars.

Interest rates and the exchange rate of the euro

Short-term interest rates. – Money market rates fell between January and the summer of 2009, continuing the trend that had begun in October 2008 (Figure 7.2). The decline reflected both the reduction in official rates and the introduction of exceptional monetary policy measures to support liquidity, particularly the first, massive twelve-month operation at the end of June. Three-month Euribor reached 0.7 per cent at the end of September and subsequently stayed near that level. The spread between Euribor and the rates on secured interbank loans (Eurepo), which had widened markedly after the collapse of Lehman Brothers, signalling an abrupt increase in counterparty risk, gradually diminished in the course of 2009 (Figure 7.2). At the end of April 2010 the spread on the three-month maturity stood at 30 basis points, below the peak reached in October 2008 but still above the pre-crisis level. Some signs of stress in the interbank market reappeared in May in connection with the pressures on euro-area government securities.

Figure 7.2

Euribor rates and spreads with corresponding Eurepo rates
(daily data; percentage points)



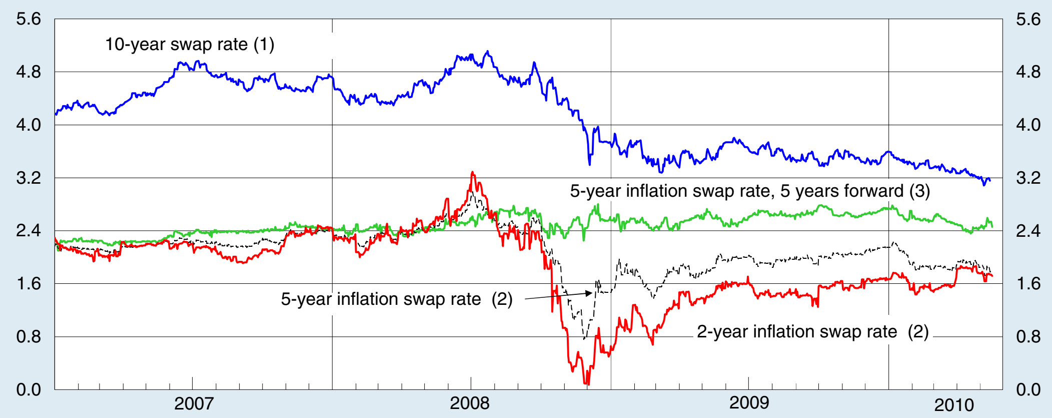
Source: Thomson Reuters Datastream.

Real short-term interest rates fell rapidly during 2009, turning negative in the last quarter. At the end of 2010 they stood at -0.5 per cent, the lowest level since the launch of the euro.

Long-term rates. – Measured on the basis of ten-year swap contracts in euros, long-term interest rates fluctuated moderately in 2009, averaging about 3.5 per cent for the year (Figure 7.3). The yield spreads between the government securities of many euro-area countries and German Bunds widened considerably in the early months of the year owing to portfolio reallocation in a "flight to quality"; subsequently they diminished, reflecting the improvement in the conditions on financial markets. Starting in December, however, the risk premiums on government securities rose rapidly amidst mounting concern about the sustainability of the public finances in Greece and other countries of the area. The strains grew rapidly worse between the end of April and the first week of May, after the further downgrade of Greek and Spanish securities by some international rating agencies, and then partly abated after the decisions taken by the EU Council and the ECB.

Figure 7.3

Nominal long-term yields and short, medium, and long-term inflation expectations
(daily data; per cent)



Sources: Based on Bloomberg and Thomson Reuters Datastream data.
(1) Yield on 10-year interest rate swaps. – (2) Yields on 2-year and 5-year euro-area inflation swaps. – (3) Yield implied by 10-year and 5-year euro-area inflation swaps.

Inflation expectations remain firmly anchored. After subsiding in the final part of 2008, short and medium-term inflation expectations rose in the first half of 2009 and then stabilized from the summer onwards (Figure 7.3). Inflation expectations on a horizon between five and ten years ahead, which are influenced to a lesser extent by the current behaviour of consumer prices, remained at levels which, net of the risk premiums, are consistent with the objective of price stability. The surveys conducted by Consensus Economics and the ECB's Survey of Professional Forecasters offer similar findings.

The exchange rate of the euro. – The euro strengthened significantly against the dollar between the spring and the autumn of last year. During that period the recovery of the financial markets and the fall in risk aversion sparked a reversal of the reallocation of international investors' portfolios towards dollar assets that had been recorded, as the financial crisis deepened, in late 2008 and the first few months of 2009. In November the euro began to depreciate again both against the dollar and in nominal effective terms, a trend that gained pace in May. Expectations of slower economic recovery in the euro area than in the United States, concern over the crisis in Greece and the sustainability of the public finances of other euro-area countries, and the fear that the necessary fiscal adjustment measures might further dim the outlook for growth contributed to the euro's deprecation. From the beginning of 2010 to 20 May the euro lost 14 per cent against the dollar and depreciated by 8 per cent in nominal effective terms.

Money and credit

Money. – The twelve-month rate of growth in the M3 monetary aggregate diminished steadily in 2009 and from the final part of the year was in negative territory for the first time since the launch of the third phase of European monetary union (-0.3 per cent in December and -0.1 per cent in March 2010, compared with 7.6 per cent at the end of 2008). The slowdown reflected reallocation from the less liquid monetary assets included in M3 (such as debt securities issued with maturity up to 2 years and money market fund units) towards long-term securities in a context characterized by a steep yield curve. At the same time, the fall in short-term interest rates fostered a shift within the money supply towards the more liquid components: in March 2010 the M1 monetary aggregate showed twelve-month growth of 10.9 per cent. Among the sectors holding monetary assets, households gradually reduced the rate at which they were accumulating deposits included in M3, while non-financial corporations began rebuilding reserves of liquidity from the second half onwards, in concomitance with the gradual improvement in the economic outlook.

Credit. – The year-on-year growth in bank lending was practically zero at the end of 2009, compared with 7.1 per cent in December 2008 after adjusting for the accounting effect of securitizations; it turned negative in the first few months of 2010. There was a fall in lending to non-financial corporations, whose twelve-month decline of 2.2 per cent at the end of the year (data not adjusted for securitizations) reflected the sharp contraction in short-term loans.

After falling uninterruptedly between the second half of 2006 and the first few months of 2009, lending to households grew at a slow pace (1.3 per cent at the end of 2009; data not adjusted for securitizations). The differences in developments across economic sectors could be consistent with the pattern seen in the past during cyclical inversions: lending to households tends to increase from the very outset of economic upturns, while lending to non-financial corporations typically displays a lag of several quarters. As of March 2010, however, there were still no signs of recovery in loans to firms, which probably indicates that supply constraints are still at work.

The growth in lending to the private sector was curbed by the weak demand for loans, reflecting the negative state of economic activity and the adverse outlook for the property market, as well as supply-side strains, albeit of diminishing intensity.

According to the responses provided by the euro-area banks participating in the Eurosystem Bank Lending Survey, a rapid tightening of supply conditions occurred at the start of 2009. Subsequently, in the course of the year and in the first quarter of 2010 the tightening of the standards for loans to firms moderated. Supply policies reportedly continued to be influenced, though decreasingly, by assessments of credit risk and the costs connected with banks' capital position, while the negative effects deriving from their liquidity position and the difficulty of access to financing on the markets faded away. The tightening of lending policies vis-à-vis households, for both loans for house purchases and for consumer credit, also reportedly eased in the course of 2009, reflecting less pessimistic assessments of the outlook for the property market and of borrowers' creditworthiness; however, a small increase in restrictiveness appears to have been recorded in the first quarter of 2010. Less optimistic indications than those provided by the banks participating in the Bank Lending Survey come from the business survey conducted by the ECB together with the European Commission, according to which conditions of access to credit continued to tighten in the second part of 2009, especially for small and medium-sized firms.

The cost of bank credit continued to diminish in 2009, reflecting the gradual passing on to customers of the ECB's reductions in reference rates and its policy of supporting liquidity. From the beginning of the reduction in official rates, in October 2008, the cost of new short-term loans to non-financial corporations and to households for house purchases has fallen by about three percentage points (to 3.4 and 2.6 per cent respectively in March). The cost of new long-term, fixed-rate financing has come down by more than two points for loans to firms and by more than one point for loans to households for house purchases (to 3.4 and 4.1 per cent respectively).

Unconventional monetary policy operations

The ECB reacted to the financial crisis by coupling the rapid reduction in official rates with unconventional monetary policy measures designed to support the liquidity of the markets and the banking system and thereby to avert a systemic crisis, ease the financial strains and foster the flow of financing to the economy. From October 2008 onwards, a primary role was played by the adoption of fixed-rate tenders with full allotment in all Eurosystem refinancing operations, the widening of the range of eligible assets to include assets with a rating as low as BBB- or Baa3, and the supplying of liquidity in foreign currency. In May 2009 the Governing Council strengthened these measures, introducing longer-term refinancing operations with a maturity of twelve months, likewise conducted at a 1 per cent fixed rate and full allotment, alongside the six-month operations initiated in 2008, with the aim of containing longer-term yields. It was also decided to launch a plan of outright purchases of covered bonds issued in the area.

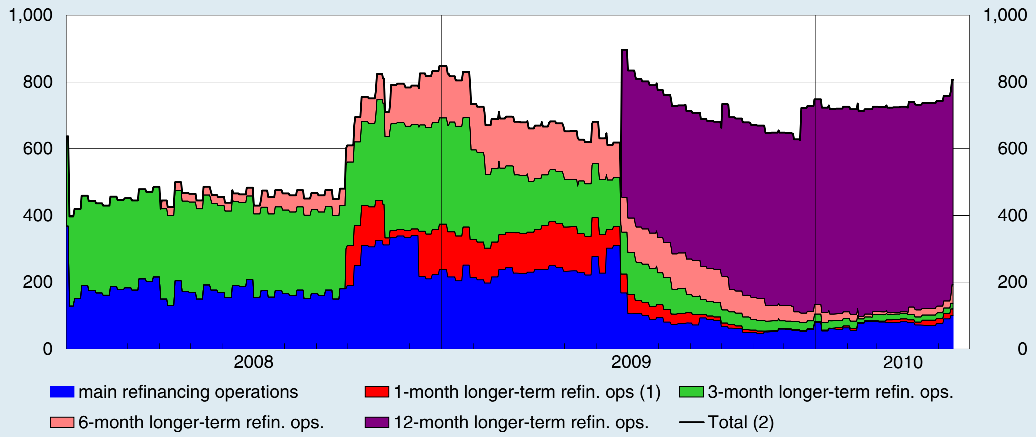
In the first twelve-month fixed-rate tender with full allotment, held at the end of June 2009, banks requested an exceptionally large volume of funds (some €440 billion; Figure 7.4). The abundance of liquidity, largely deposited with the Eurosystem (an average of about €120 billion in the reserve maintenance period ending in July) pushed the Eonia rate towards the lower limit of the official-rate corridor, set at 0.25 per cent. Consequently, the spread between the rate on main refinancing operations and Eonia widened, reaching 65 basis points and subsequently remaining close to that level (Figure 7.4 and Table 7.1).

The excess of liquidity in the banking system, partly due to the further allotment of €75 billion and €97 billion in the second and third twelve-month tenders at end-September and end-December, remained very considerable; the excess funds deposited by the banking system with the deposit facility reached an average of about €220 billion in the reserve maintenance period ending in mid-May 2010.

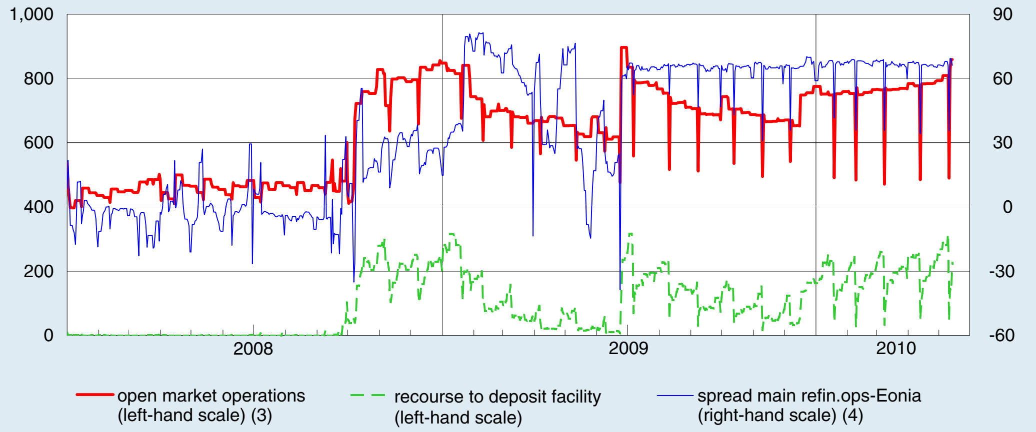
Figure 7.4

Open market operations, deposit facility and spread between rate on main refinancing operations and Eonia

(daily data; billions of euros)



(daily data; billions of euros; basis points)



Source: ECB.
(1) Operations with a special maturity equal to the length of each maintenance period. – (2) Does not include fine-tuning operations. – (3) Includes purchases of covered bonds. – (4) For main refinancing operations, up to 14 October 2008, minimum bid rate; subsequently, fixed rate.

In the light of the improvement in the conditions on financial markets, in its meeting at the beginning of December 2009 the ECB Governing Council did not renew some of the exceptional measures, no longer deeming them indispensable, but at the same time confirmed the Eurosystem's commitment to providing all the liquidity required by the banking system in the euro area. No twelve-month tenders were held in the first few months of 2010. However, the Governing Council also decided that both main refinancing operations and refinancing operations with a maturity equal to the length of each reserve maintenance period would continue to be conducted by fixed-rate tender and with full allotment of the amounts requested.

At the beginning of March the Governing Council decided that regular longer-term refinancing operations with a maturity of three months would revert to being held at variable rates, with a minimum bid rate of 1 per cent, starting with the tender scheduled for 28 April. The Governing Council set a large indicative amount for that tender and also reserved its right to increase the amount actually provided should this prove necessary to avoid increases in the allotment rates or liquidity strains.

Table 7.1

Money market indicators
(average data for the period shown)

	2008	2009 1 Jan.-24 June	2009 25 June-31 Dec.	2009 1 Jan.-11 May
Main refinancing operations (MROs)				
Volume (1)				
Euro area	202.5	236.3	75.1	73.1
Italy	11.9	8.4	4.2	1.9
Italy's share (2)	5.9	3.6	5.6	2.6
Spread MROs-Eonia (3)	3.9	48.1	64.1	65.1
Volatility of the Eonia spread (4)	15.2	26.0	5.3	7.1
Longer-term refinancing operations				
Volume (5)				
Euro area	336.7	458.8	643.2	656.0
Italy	8.0	24.2	23.9	24.9
Italy's share (2)	2.4	5.3	3.7	3.8
Standing facilities (6)				
Marginal lending facility				
Euro area	2.1	1.6	0.5	0.6
Italy	0.1	0.0	0.0	0.0
Deposit facility				
Euro area	37.9	110.5	119.8	182.0
Italy	1.4	3.1	2.1	3.3
Excess reserves (7)				
Euro area	0.51	0.49	0.48	0.56
Italy	0.24	0.19	0.21	0.23

(1) Daily average of funds disbursed to monetary financial institutions through main refinancing operations; billions of euros. – (2) Funds assigned to Italian counterparties as a percentage of the total allotted. – (3) Daily average of the spread between the minimum/fixed bid rate on main refinancing operations (minimum rate up to 14 October 2008; fixed rate thereafter) and Eonia; basis points. – (4) Standard deviation of the spread between the minimum/fixed bid rate on main refinancing operations and Eonia; basis points. – (5) Daily average stock of funds disbursed to monetary financial institutions through longer-term refinancing operations with a maturity of three, six or twelve months or equal to the length of each maintenance period; billions of euros. – (6) Daily average stock in the maintenance periods ending in the interval indicated; billions of euros. – (7) As a percentage of required reserves; average of daily data in the maintenance periods ending in the interval indicated.

In April 2010, with the resurgence of strains in the markets, the Governing Council decided to keep the minimum rating for assets eligible as collateral in refinancing operations with the Eurosystem at BBB- or Baa3 beyond the end of this year; it also confirmed the higher minimum for asset-backed securities and modified the haircuts on securities with lower credit ratings with effect from January 2011.

At the end of April the strains grew rapidly worse, spreading from Greek government securities to those of other euro-area countries and to other financial markets. Some market segments ceased working in an orderly fashion: liquidity dried up, transaction volumes fell and bid-ask spreads reached unprecedented levels. On 3 May, after the Council of the European Union decided to activate the financial support agreed by Greece with the European Commission, the ECB and the IMF, the Governing Council suspended the minimum rating requirements for eligible assets to securities issued or guaranteed by the Greek government.

On 10 May the Council of the European Union adopted a massive plan for the preservation of financial stability in Europe. The ECB Governing Council established the Securities Market Programme of purchases of euro-area public and private sector securities to support certain market segments hit particularly hard by the crisis, while providing for purchases to be sterilized through liquidity-draining operations so as to avert repercussions on the stance of monetary policy. In addition, the Governing Council reactivated fixed-rate tenders with full allotment for the regular three-month longer-term refinancing operations scheduled for the end of May and the end of June, and decided to conduct a six-month tender with the same procedure and at a fixed rate (equal to the average minimum bid rate on main refinancing operations during the life of the operation). In concert with other central banks, the ECB reintroduced refinancing facilities in dollars.

The objective of the Governing Council's decisions is to counter the exceptional strains in financial markets, ensure refinancing to intermediaries and guarantee the depth and liquidity of market segments that risk seizing up. In safeguarding the stability of the financial system and guaranteeing the functioning of the monetary policy transmission mechanisms, the Eurosystem is discharging its responsibility under the Treaty on European Union to maintain price stability over the medium term.

THE ITALIAN ECONOMY

8. DEMAND, SUPPLY AND PRICES

In 2009 GDP contracted by 5 per cent in Italy, the largest decrease since the Second World War. A moderate recovery got under way in the second half of the year, owing above all to a gradual improvement in exports fuelled by the expansion of world trade. In the same period, the industrial sector returned to growth, although recouping only a small part of the contraction recorded during the recession: in December output was more than 20 percentage points lower than at the cyclical peak in spring 2008. The decline in the service sector came to a halt, but that in the construction industry continued, albeit at a slower pace.

Domestic demand remained weak. Spending on capital goods, although picking up slightly in the second half of 2009 in response to the tax incentives for purchases of machinery and equipment, was dampened by the ample margins of spare capacity and uncertainty about the consolidation of growth. Investment in construction, especially residential building, continued to decline. Signs of an easing of the property market recession appeared towards the end of the year.

The decline in consumer spending worsened for the year as a whole, despite the measures introduced to support purchases of some durable goods. The prudent behaviour of households reflected not only their concerns about labour market developments but also a decline in real disposable income to the per capita levels of the mid-1990s.

Inflation fell to a historically low level of 0.8 per cent on average for the year, compared with 3.3 per cent in 2008, mainly due to the marked slowdown in prices of imported goods and services. Analysts expect consumer price inflation to remain moderate this year.

The cyclical improvement continued in the early months of 2010. Preliminary estimates released by Istat indicate that in the first quarter GDP grew by 0.5 per cent with respect to the previous quarter. In the surveys conducted in March and April of this year, firms expressed more favourable opinions regarding the general economic situation. The manufacturing order books increased, particularly export orders, to the benefit of industrial output, which staged a moderate recovery.

The transmission of the global recession to the Italian economy

The global recession has had severe repercussions in Italy, subtracting about 7 percentage points from GDP in 2008-09. The contraction was attenuated by the stimulus of economic policies, which are estimated to have contributed around 2 percentage points to GDP in the two years.

Empirical analyses using the Bank of Italy's quarterly econometric model indicate that the main recessionary impulse came from outside our economy. The collapse of world trade in late 2008 and early 2009 translated into a fall in Italian exports that was rapidly transmitted to domestic demand and to employment. Overall, it is estimated that in the two years almost 5 percentage points of the contraction in GDP were of imported origin.

A less substantial though not negligible negative contribution came from the tightening of borrowing conditions for households and firms. Italian banks were affected, albeit only indirectly, by the tensions on international financial markets, particularly following the collapse of Lehman Brothers; this was compounded by the downgrading of borrowers. The ensuing credit freeze, although relatively less severe in Italy than elsewhere, led to a reduction in investment spending, owing partly to the lack of financing instruments other than bank credit. It is estimated that the impact of the financial strains on GDP in 2008-09 was in the order of 1 percentage point.

The sharp deterioration in business and consumer confidence resulting from the exceptional surge of uncertainty about the outlook for demand and employment contributed to the reduction in capital formation and prompted households to adopt more prudent spending behaviour. According to our estimates, this caused a further half-point contraction in GDP.

The impact of these factors was attenuated by the response of economic policies and by automatic stabilizers. It is estimated that the reduction of policy rates by the European Central Bank stimulated GDP by about 1 percentage point; added to this was the hard to quantify but presumably very substantial effect of the ECB's unconventional monetary policy measures from October 2008. The automatic stabilizers are estimated to have further softened the impact of the crisis factors by roughly half a percentage point, while similar support came from the Government's stimulus measures, such as the car scrappage scheme, the reinforcement of family income support and the tax incentives for purchases of capital goods.

Household consumption

In 2009 Italian household consumption contracted significantly, by 1.8 per cent in volume, although less sharply than real disposable income (Table 8.1). This accentuated a decade of weak growth, and per capita spending fell back to the level of 1999.

All the main categories of consumption were affected. Purchases of durable goods declined by 3.7 per cent, pushing the cumulative decrease in the last two years over 10 per cent. Expenditure on non-durable goods fell for the third consecutive year, by 1.9 per cent. The downward trend in this category of spending is without precedent in the national accounts time series. The fall in purchases of semi-durable goods steepened to 5.5 per cent, while the demand for services fell by a relatively moderate 0.8 per cent.

Consumption was held back by the decrease in households' disposable income, of 2.5 per cent in real and 2.7 per cent in nominal terms (Table 8.2). However, taking into account expectations of a smaller erosion of the real value of financial assets, the decline becomes less marked, amounting to 0.6 per cent.

Table 8.1

Sources and uses of income in Italy

	As a percentage of GDP in 2009 (volumes at previous-year prices)	2008			2009		
		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	–	-1.3	2.8	–	-5.0	2.1	–
Imports of goods *fob* and services (1)	26.5	-4.3	6.8	1.3	-14.5	-6.1	4.3
of which: goods	*21.1*	*-5.4*	*8.5*	*1.3*	*-15.5*	*-7.7*	*3.7*
Uses							
National demand	101.9	-1.5	3.2	-1.5	-3.8	0.6	-3.8
Consumption of resident households	60.9	-0.8	3.2	-0.5	-1.8	-0.2	-1.0
Consumption of general government and non-profit institutions serving households	21.8	0.8	3.4	0.2	0.6	2.7	0.1
Gross fixed investment	19.2	-4.0	3.2	-0.8	-12.1	0.8	-2.5
machinery, equipment and transport equipment	*8.0*	*-4.7*	*3.0*	*-0.5*	*-16.6*	*0.5*	*-1.6*
intangible assets	*0.8*	*-1.0*	*1.7*	*..*	*-5.4*	*1.2*	*..*
construction	*10.4*	*-3.4*	*3.4*	*-0.4*	*-7.9*	*1.0*	*-0.8*
Change in stocks and valuables (2)	–	–	–	-0.3	–	–	-0.4
Exports of goods *fob* and services (3)	24.6	-3.9	5.1	-1.1	-19.1	-0.4	-5.5
of which: goods	*19.8*	*-4.0*	*5.4*	*-1.0*	*-20.4*	*-0.7*	*-4.8*
Net exports	–	–	–	0.1	–	–	-1.2

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

A major contributing factor in the decrease was net property income, which contracted by 14.2 per cent at current prices, mainly due to the decline of 43.4 per cent in households' net interest flow. Self-employment income, which accounts for a fifth of total disposable income, decreased for the second time running (2.4 per cent in nominal terms) owing to a reduction in the number of self-employed. Total wages and salaries decreased for the first time since 1999, by 0.8 per cent, as growth in per capita wages and a small reduction in social security contributions were more than offset by the drop in the number of full-time equivalent employees. Government measures to reduce current taxes and increase net social benefits instead provided a positive contribution to the growth in disposable income.

In the private sector as a whole, which comprises households and firms, disposable income decreased by 1.2 per cent in real terms; the decline was contained by the reduction in the dividends paid by firms.

Table 8.2

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

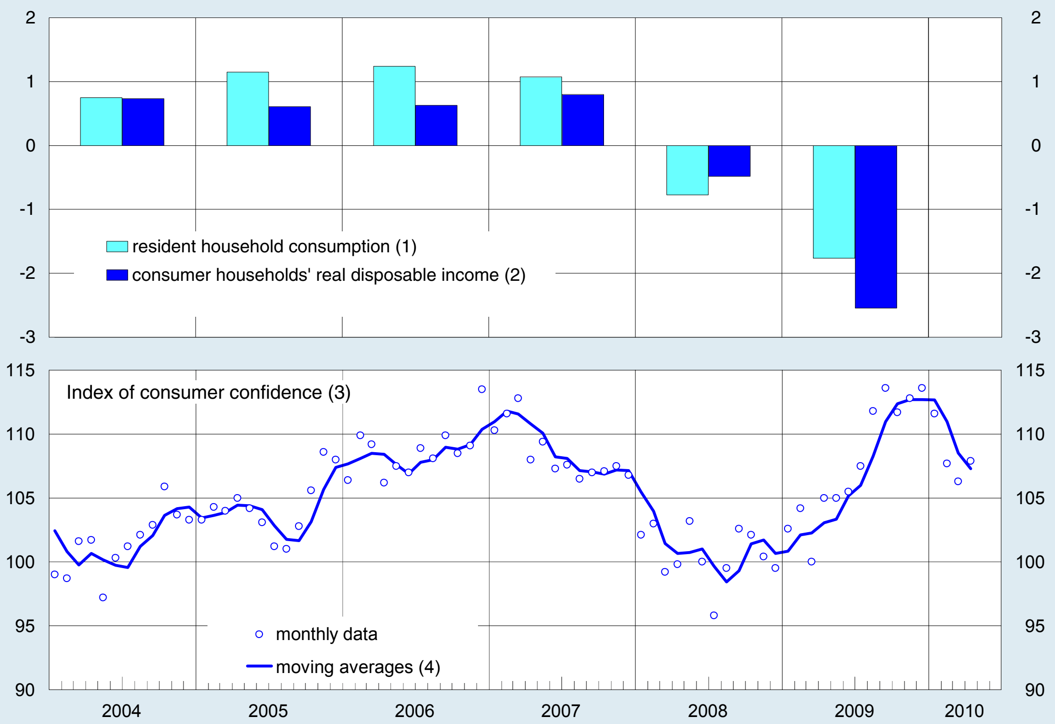
	As a percentage of households' gross disposable income in 2009	2007	2008	2009
		Percentage changes		
Earnings net of social contributions charged to workers	42.8	3.6	3.2	-0.8
Income from salaried employment per standard labour unit	–	*2.4*	*3.6*	*2.0*
Total social contributions (1)	–	*-0.3*	*-0.5*	*-0.2*
Standard employee labour units	–	*1.5*	*0.1*	*-2.7*
Income from self-employment net of social contributions (2)	20.9	0.2	-1.5	-2.4
Income from self-employment per standard labour unit	–	*1.8*	*0.7*	*0.2*
Total social contributions (1)	–	*-1.2*	*-0.7*	..
Standard self-employed labour units	–	*-0.4*	*-1.5*	*-2.6*
Net property income (3)	23.8	6.3	3.1	-14.2
Social benefits and other net transfers	30.6	5.1	4.7	5.2
of which: net social benefits	–	*4.8*	*4.9*	*4.9*
Current taxes on income and wealth (–)	18.1	7.4	5.1	-3.1
Households' gross disposable income (4)	**100.0**	**3.3**	**2.2**	**-2.7**
in real terms (5)	–	0.9	-0.9	-2.5
in real terms, adjusted for expected inflation (5) (6)	–	0.3	-1.1	-0.6
in real terms, adjusted for past inflation (5) (7)	–	0.7	-0.4	..
Private sector gross disposable income	–	**3.0**	**1.4**	**-1.4**
in real terms (5)	–	0.7	-1.8	-1.2
in real terms, adjusted for expected inflation (5) (6)	–	0.3	-1.8	0.2
in real terms, adjusted for past inflation (5) (7)	–	0.7	-1.2	0.6
		Percentages		
Households' average propensity to save (4) (8)	–	**11.6**	**11.5**	**10.8**
calculated on income adjusted for expected inflation	–	9.1	8.8	9.9
calculated on income adjusted for past inflation	–	8.9	9.2	10.8
Private sector average propensity to save (8)	–	**23.3**	**22.5**	**22.9**
calculated on income adjusted for expected inflation	–	23.8	23.0	23.1
calculated on income adjusted for past inflation	–	23.8	22.9	22.9

Sources: Based on Bank of Italy and Istat data.
(1) Contribution of social contributions to the change in net income, in percentage points; negative values indicate an increase in social contributions relative to income. – (2) Mixed income and income withdrawn by members of quasi-corporations. – (3) Gross operating profit (essentially imputed rents), net rents from land and intangible assets, actual net interest, dividends and other profits distributed by companies. – (4) Consumer households. – (5) Deflated using the resident household consumption deflator. – (6) Gross disposable income net of expected losses on net financial assets due to inflation (estimated on the basis of the Consensus Economics survey). – (7) Gross disposable income net of actual losses on net financial assets owing to inflation, calculated ex post. – (8) 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.

Households' prudence in spending partly reflected their concern over the impact of the recession on the labour market. According to ISAE surveys, the proportion of households expecting unemployment to rise peaked at 80 per cent in March and did not fall below 60 per cent at any time in 2009. Consumer confidence, which had strengthened somewhat once the acute phase of the crisis was over, began to slip again at the beginning of 2010, partly owing to uncertainties about the soundness of household finances and the strength of the recovery (Figure 8.1).

Figure 8.1

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



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

Given the reduction in disposable income, households' saving rate declined from 11.5 per cent in 2008 to 10.8 per cent last year, net of changes in households' net pension equity. Measured with reference to income adjusted for expected monetary erosion of financial assets, however, it increased by over 1 percentage point, to 9.9 per cent.

Savings in the private sector, which in the case of firms are virtually equal to income, rose to 18.3 per cent of gross national disposable income. For the economy as a whole, the saving rate decreased by around 2 percentage points, to 16.2 per cent, owing to the negative contribution of general government.

Investment

Gross fixed investment contracted by 12.1 per cent in 2009, the largest decline since Istat first published the national accounts time series in 1970 (Table 8.3). The contraction involved investment in construction, down by 7.9 per cent, as well as in machinery and equipment, transport equipment and intangible goods (16.6 per cent). The ratio of investment to GDP declined by 2 percentage points to 19.2 per cent, after stabilizing around an average of 21 per cent from the beginning of the decade. Net of depreciation, the slump in investment was exceptionally severe, close to 60 per cent, compared with a 19.8 per cent fall in 2008.

Table 8.3

Fixed investment in Italy
(chain-linked volumes, unless otherwise indicated; per cent and percentage changes)

	Percentage share in 2009 (1) (volumes at previous-year prices)	Percentage change			As a percentage of GDP (1) (volumes at previous-year prices)	
		2007	2008	2009	2000	2009
Construction	54.0	0.3	-3.4	-7.9	9.3	10.4
residential	*22.3*	*1.1*	*-1.7*	*-9.2*	*3.8*	*4.3*
other	*27.1*	*0.1*	*-3.4*	*-6.4*	*4.7*	*5.2*
property transfer costs	*4.6*	*-1.8*	*-10.2*	*-9.9*	*0.8*	*0.9*
Machinery and equipment	32.0	3.7	-5.6	-18.4	7.6	6.1
Transport equipment	9.6	0.8	-2.7	-15.2	2.3	1.8
Intangible assets	4.4	3.9	-1.0	-5.4	0.9	0.8
Total gross fixed investment	**100**	**1.7**	**-4.0**	**-12.1**	**20.1**	**19.2**
Total excluding residential buildings	–	1.9	-4.6	-12.9	16.4	14.9
Total excluding construction	–	3.1	-4.7	-16.6	10.8	8.8
Total net fixed investment (2)	**–**	**1.5**	**-19.8**	**-58.0**	**5.6**	**2.0**

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

The decline in gross investment was prompted by the sharp contraction in demand and the consequent increase in spare capacity. This was compounded by uncertainty regarding the timing and strength of the recovery, the deterioration in profitability and the persistent tensions affecting the availability of financing. In the second half of the year, purchases of capital goods showed signs of recovery, albeit discontinuous, in response to the partial replenishment of order books, particularly from abroad, and the tax incentives for purchases of machinery and equipment in force from 1 July 2009 to 30 June 2010 (Article 5 of Decree Law 78/2009, ratified by Law 102/2009, known as the *Tremonti-ter*).

The cut-back in investment in construction reflected the 9.2 per cent dip in the residential component, larger than the decreases recorded in past cyclical downswings. However, there were signs of an easing of the slump in the property market. House prices, which fell by 0.5 per cent in the first six months of 2009 after eleven years of growth, started to stabilize in the second half of the year. The improvement is borne out by the opinions of professionals in the sector.

The survey conducted in the months of March and April of this year by the branches of the Bank of Italy on a sample of 3,921 firms with 20 or more workers in industry excluding construction and in private non-financial services confirms that gross fixed investment contracted sharply in 2009, in line with the expectations reported in the previous year's survey (Table 8.4). The contraction was especially marked in industry, even though spending was slightly higher than planned. Expectations for 2010 are of a partial recovery (3.8 per cent), mostly thanks to service firms (6.6 per cent) and small industrial firms. Investment in manufacturing is predicted to dwindle further (0.9 per cent).

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 2009 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 2009	*-20,9*	*-21,3*	*-20,5*	*-18,2*	*-22,3*	*-14,2*	*-27,2*	*-14,9*	*-25,9*
realization rate (4)	*103,5*	*122,5*	*103,7*	*106,6*	*92,8*	*100,6*	*98,1*	*106,4*	*100,7*
plans for 2010	*-0,9*	*10,1*	*-5,8*	*-4,6*	*-1,8*	*-3,1*	*-4,8*	*2,1*	*-3,9*
Realized investment in 2009	-17,8	-20,4	-19,6	-14,6	-16,6	-9,7	-25,4	-12,3	-23,8
Realization rate (4)	103,0	119,8	103,6	105,9	96,0	102,1	97,3	105,2	100,2
Plans for 2010	1,0	10,1	-5,1	-1,1	1,5	-0,6	-1,3	4,0	-2,8
Services (5)									
Realized investment in 2009	-10,6	-12,7	-16,4	-11,4	-6,2	….	….	-6,5	-15,1
Plans for 2010	6,6	2,1	2,0	5,8	10,9	….	….	11,2	0,6
Total									
Realized investment in 2009	-14,5	-16,8	-18,1	-13,3	-11,6	-9,7	-25,4	-9,6	-19,8
Plans for 2010	3,8	5,9	-1,7	1,7	6,4	-0,6	-1,3	7,6	-1,1

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 2009. – (3) With reference only to industrial firms with 50 employees or more. – (4) Realized investment as a percentage of investment planned at the end of 2008 for 2009, both at current prices. – (5) Private sector non-financial services.

Exports and imports

Exports. – In 2009 the decline in exports of goods and services steepened to 19.1 per cent in volume and 20.4 per cent for goods alone. However, the contraction in the first half of the year was followed in the second by a modest upturn that provided support for the recovery in output.

According to foreign trade data, in 2009 the drop in the volume of merchandise exports was almost entirely ascribable to sales to Germany and the other European Union countries (Table 8.5). All sectors were affected: in the case of capital and intermediate goods, mechanical engineering and metal products were especially hard hit, while among consumer goods those that fared worst were traditional products, i.e. textiles and clothing, leather and footwear, furniture and wood products. The recovery in the second half of the year was limited to the chemical and pharmaceutical industries, basic metals and transport equipment.

Table 8.5

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

	Exports						Imports					
	2008			2009			2008			2009		
	% comp. of values	% change in AUVs	% change in volumes	% comp. of values	% change in AUVs	% change in volumes (2)	% comp. of values	% change in AUVs	% change in volumes	% comp. of values	% change in AUVs	% change in volumes (2)
EU-27 countries	**58.9**	**4.4**	**-6.3**	**57.4**	**-2.4**	**-21.2**	**54.6**	**2.5**	**-5.7**	**57.3**	**-2.9**	**-16.0**
of which: Euro-16	*44.3*	*4.7*	*-7.0*	*43.9*	*-2.7*	*-19.6*	*44.4*	*2.3*	*-5.9*	*46.2*	*-3.0*	*-16.6*
France	*11.2*	*4.3*	*-5.3*	*11.6*	*-0.5*	*-18.0*	*8.6*	*3.2*	*-6.7*	*8.9*	*-1.8*	*-18.4*
Germany	*12.8*	*3.1*	*-3.1*	*12.7*	*-0.6*	*-21.2*	*16.0*	*2.0*	*-6.1*	*16.8*	*-2.1*	*-16.7*
Spain	*6.5*	*7.0*	*-17.8*	*5.7*	*-9.4*	*-24.0*	*4.4*	*1.3*	*1.1*	*4.3*	*-3.6*	*-20.4*
UK	*5.2*	*2.3*	*-11.0*	*5.1*	*-0.4*	*-22.2*	*3.1*	*2.5*	*-7.7*	*3.2*	*-1.0*	*-19.9*
Non-EU-27 countries	**41.1**	**7.3**	**-0.6**	**42.6**	**0.9**	**-18.8**	**45.4**	**16.4**	**-5.7**	**42.7**	**-15.4**	**-13.8**
of which: China	*1.7*	*4.7*	*-1.9*	*2.3*	*6.4*	*-2.9*	*6.2*	*7.4*	*1.4*	*6.5*	*0.9*	*-19.1*
DAEs (3)	*2.7*	*3.2*	*-2.0*	*3.0*	*3.1*	*-16.3*	*2.1*	*2.3*	*-8.5*	*1.9*	*-6.3*	*-24.2*
Japan	*1.2*	*5.5*	*-6.7*	*1.3*	*5.8*	*-17.0*	*1.3*	*0.7*	*-6.8*	*1.3*	*8.1*	*-28.3*
Russia	*2.8*	*6.4*	*3.2*	*2.2*	*3.1*	*-39.8*	*4.2*	*30.3*	*-15.1*	*4.1*	*-22.8*	*-2.8*
US	*6.2*	*6.6*	*-10.8*	*5.9*	*2.9*	*-27.7*	*3.1*	*6.3*	*1.0*	*3.2*	*1.7*	*-20.2*
Total	**100.0**	**5.6**	**-4.0**	**100.0**	**-1.0**	**-20.3**	**100.0**	**9.0**	**-6.1**	**100.0**	**-9.2**	**-14.5**

Source: Based on Istat data.
(1) The values for EU countries and the total are calculated on the basis of data adjusted for the estimate of transactions measured annually and taking account, in view of past experience, of delays in submitting customs returns. (2) For EU countries and the total, changes in volumes for 2009 are calculated on the basis of data deflated for AUVs. – (3) Dynamic Asian economies: South Korea, Hong Kong, Malaysia, Singapore, Taiwan and Thailand.

The first quarter of the current year saw a sharp upturn in export volumes, which spread to the mechanical engineering industry and traditional products. In the opinion of firms the upswing will continue in the months to come.

Imports. – In 2009 imports of goods and services fell by 14.5 per cent in real terms, and goods alone by 15.5 per cent. This was mainly due to the slackening of investment, which, with exports, is the most import-intensive demand component. Imports returned to growth in the second half of the year driven by the cyclical upswing, expanding by almost 2 per cent with respect to the first six months. The improvement came mainly from transport equipment, following the car scrappage incentives, and from the chemical and electronics industries.

Supply

Value added declined in all sectors in 2009, sharply in industry excluding construction (15.1 per cent) and in construction (6.7 per cent), more moderately in agriculture and services (3.1 and 2.6 per cent respectively). In the service sector, the decline in value added in financial intermediation and tourism compounded that in trade, transport and communications already under way in 2008. Real-estate services instead recorded moderate growth.

In industry excluding construction the only branch in which value added increased was coke manufacture and oil refining. The largest reductions were recorded for capital and intermediate goods: the value added generated by the manufacturing of machinery and equipment, basic metals and metal products decreased by around a quarter with respect to 2008 and that of transport equipment (part of which is included in consumer durables) by about a fifth. In the traditional sectors, there was a large contraction in value added in textiles and leather and a more modest one in clothing.

Since last summer there have been signs of a cyclical turnaround in Italy, fostered by the global recovery. Albeit with some fluctuations, GDP resumed growth in the second half of the year, gaining 0.2 per cent on average with respect to the first half. The gradual recovery in industry excluding construction, notably in the chemical and transport equipment sectors, was the main contributory factor.

The economy continued to improve in the early months of 2010. Business surveys indicate more favourable views of the current and expected economic situation. The portfolio of manufacturing orders, particularly from abroad, expanded and the index of industrial production continued to rise, although it is still some 20 percentage points below the cyclical peak of spring 2008. According to Istat's preliminary estimates, GDP grew by 0.5 per cent in the first quarter of this year with respect to the last quarter of 2009, and the latest indicators suggest that this growth will continue.

Nonetheless, uncertainties about the progressive strength of the cyclical upturn persist and may be aggravated by the recent financial market turmoil. The ability of our economy to take full advantage of the recovery in world trade will prove crucial, given the expectations of continuing slack domestic demand. The government incentives introduced in April will probably provide only a temporary and limited boost to household consumption. A positive contribution to the growth in output could come from the gradual replenishment of inventories, as the de-stocking process seems to have come to a halt at the end of last year.

Prices and costs

Consumer prices. – Consumer price inflation in Italy, as measured by the index for the entire resident population, fell to 0.8 per cent in 2009, the slowest rate since the 1950s (Table 8.6). This mainly reflected the sharp drop in the prices of imported goods and services (6.1 per cent on the basis of the import deflator) caused by the fall in the dollar prices of raw materials. Domestic inflation – measured by the GDP deflator – slowed somewhat, from 2.8 to 2.1 per cent.

The twelve-month increase in the consumer price index was barely positive on average in the third quarter of 2009, but rose back to 0.7 per cent in the fourth quarter as the fall in energy prices slowed from 12.7 per cent in the summer to 6.5 per cent. Consumer price inflation continued to gain pace, reaching 1.5 per cent in April 2010 in response to the rise in oil prices (which have begun to subside in recent weeks) and to the gradual fading of the base effects of statistical comparison with the previous year.

Table 8.6

Consumer prices	Percentage changes on previous year		Percentage weights	Contributions to average inflation (percentage points)
	2008	2009	2009	2009
Index of consumer prices for the entire resident population	**3.3**	**0.8**	**100**	**0.8**
Unregulated goods and services	**3.5**	**0.7**	**81.6**	**0.57**
Unprocessed food	4.5	1.6	6.8	0.11
of which: milk	*9.4*	*..*	*0.7*	*..*
meat	*4.1*	*1.8*	*3.0*	*0.05*
eggs	*7.1*	*2.7*	*0.1*	*..*
vegetables and legumes	*3.3*	*2.3*	*1.2*	*0.03*
Processed food	5.9	2.1	10.8	0.23
of which: bread	*10.2*	*1.1*	*1.3*	*0.01*
pasta and rice	*18.4*	*4.3*	*0.8*	*0.03*
dairy products	*7.7*	*1.2*	*0.2*	*..*
Non-food and non-energy products	1.4	1.2	27.4	0.33
of which: motor vehicles	*1.4*	*1.4*	*3.8*	*0.05*
Services	3.3	1.7	32.7	0.56
of which: restaurants	*3.3*	*2.4*	*5.0*	*0.12*
hotels	*-0.1*	*-2.2*	*2.5*	*-0.06*
all-inclusive package holidays	*-0.8*	*-0.5*	*0.3*	*..*
air transport	*17.0*	*-13.0*	*0.8*	*-0.11*
financial services	*-0.2*	*2.5*	*0.9*	*0.02*
Energy products	10.6	-13.9	3.8	-0.53
Regulated goods and services	**2.5**	**1.4**	**18.4**	**0.26**
Public services and utilities	4.2	1.3	10.7	0.14
of which: gas	*9.7*	*-1.5*	*2.3*	*-0.03*
electricity	*9.7*	*-1.9*	*1.2*	*-0.02*
Overall index net of food and energy	**2.1**	**1.5**	**72.9**	**1.09**
Harmonized consumer price index	**3.5**	**0.8**	**–**	**–**

Source: Based on Istat data.

Core inflation, excluding food and energy products and goods with regulated prices, slowed to a twelve-month rate of 1.4 per cent on average, compared with 2.4 per cent in 2008, reflecting the decline in the costs of imported inputs and in domestic demand. The brusque slowdown in the prices of services, from 3.3 to 1.7 per cent, was largely due to the drop in air fares (13 per cent) and to the moderate rise of just 0.7 per cent in restaurant, hotel and package holiday prices. The annual rate of change in non-energy industrial products slowed from 1.4 per cent to 1.2 per cent. The growth in the prices of food products slowed from 5.3 per cent on average in 2008 to 1.9 per cent in 2009, in line with the relevant world food commodity prices.

The differential between harmonized consumer price inflation in Italy and in the euro area as a whole widened slightly in 2009, from 0.2 to 0.5 percentage points, reflecting the more moderate deceleration in the prices of food products in Italy. The gap in core inflation was reduced by half, to 0.2 percentage points.

Producer prices and costs. – In 2009 the producer price index for the domestic market fell by 5.4 per cent on average, compared with an increase of 5.8 per cent in the previous year. As in the other euro-area countries the fall in prices was driven by the components that react immediately to changes in raw material prices. In particular, the energy component contracted by almost 15 per cent, while food and intermediate products recorded more moderate decreases, of 3.9 and 5.6 per cent respectively. The producer prices of non-food consumer goods were unchanged over the year as a whole, after increasing by half a percentage point in 2008.

From the middle of 2009, the gradual acceleration in raw material prices and the fading of substantial base effects progressively attenuated the decline in producer prices. In February 2010, after more than a year, the index turned positive, gaining 0.5 per cent on the previous period. The Purchasing Managers Index for manufacturing indicates that firms' selling prices increased in April for the first time in 18 months, following the progressive rise in the prices of inputs.

The contraction in world trade prompted Italian producers to revise their export prices substantially downward as well; these decreased by 2.6 per cent overall in 2009, in contrast with an increase of 2.8 per cent in 2008.

Unit labour costs in the economy as a whole accelerated further in 2009, to 4.8 per cent from 3.9 per cent in 2008, due to the cyclical decline of 1.9 per cent in hourly productivity. In industry, where the decrease in value added was greater than that in actual hours worked, hourly productivity fell by 5.5 per cent. According to the national accounts, last year the mark-up in industry excluding construction, calculated as the ratio of the deflator of value added at factor cost to unit labour costs, decreased by 8.3 per cent.

Inflation expectations. – The analysts surveyed in May by Consensus Economics expect consumer prices to rise by 1.5 per cent on average in 2010 and by 1.8 per cent in 2011. According to the recent survey conducted by the Bank of Italy in collaboration with *Il Sole 24 Ore*, firms confirm their expectations of very moderate increases in selling prices in the next twelve months.

9. THE LABOUR MARKET

The effects of the crisis on the labour market became fully evident in 2009, both in Italy and in the other advanced countries. After peaking in April 2008, the number of resident workers in employment had fallen by 815,000 by March 2010, to the same level as in the early months of 2006; at the same time the number of job-seekers rose by around half a million. Cut-backs in hirings and, to a lesser extent, dismissals contributed. The unemployment rate, which had risen steadily from the first half of 2007, somewhat earlier than in the other main European countries, reached 8.8 per cent in March this year, the same level as in 2001; for young people aged 20 to 34 it rose by more than 2 percentage points. The rise in unemployment was curbed by a decrease in the participation rate in the job market, mainly due to discouragement. A broader measure of the underutilized labour supply, which includes discouraged workers and the equivalent hours of Wage Supplementation benefits, puts the unemployment rate at 10.6 per cent.

The decline in the number of persons in employment was compounded by a comparable drop in their average hours worked as a result of ample recourse to the Wage Supplementation Fund, which the Government had opened up to additional beneficiaries in the early stages of the crisis. The average annual decline in total hours worked, the largest since 1980 when the time series first appeared, was not as large as the drop in output, however, thus adding to the fall in hourly labour productivity recorded in 2008.

Although hourly earnings decelerated once the numerous wage contract renewals of 2008 had exhausted their effects, they nonetheless rose by 2.1 per cent in real terms owing to the slowdown in prices. Hourly labour costs rose by 2.3 per cent, and this, together with the sharp drop in hourly productivity, caused unit labour costs to accelerate further.

Labour market conditions are expected to continue to deteriorate throughout this year. The planned staff downsizings will mainly take the form of freezes on hiring and on renewals of expiring fixed-term employment contracts; the consequences will be most serious for the youngest cohorts, who will begin their working careers with considerable delay.

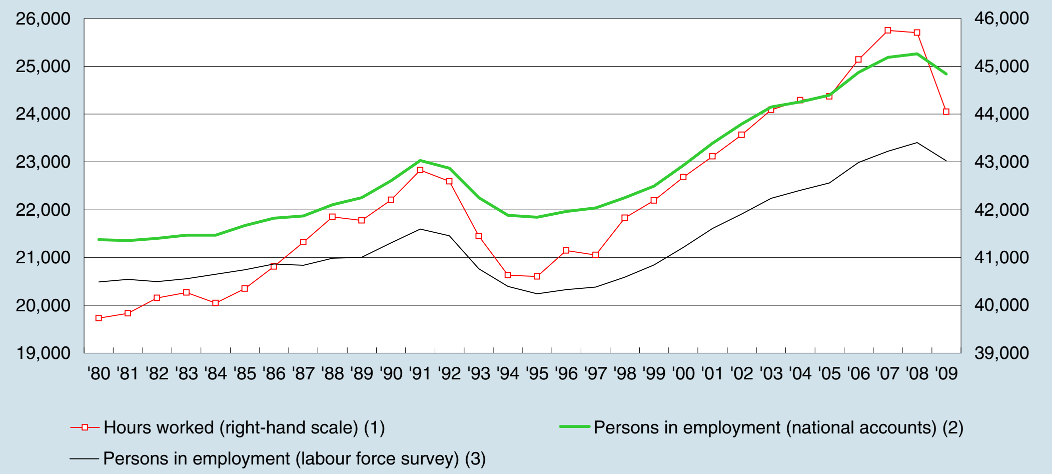
Employment and labour input during the crisis

As the effects of the crisis unfolded, in 2009 the decline in employment that had begun in the middle of the previous year steepened. At the end of the year, the number of persons employed, according to the national accounts definition, had fallen by 616,000, or 2.4 per cent, with respect to the peak recorded in the second quarter of 2008; year on year, the decrease in 2009 with respect to the previous year was 1.7 per cent (Figure 9.1). In the same period, total hours worked, a measure of the effective input of labour, declined twice as fast (4.7 per cent and 3.6 per cent on average in 2009) and more in line with the 6.4 per cent decrease in value added at constant prices.

Figure 9.1

Measures of employment

(thousands of persons and millions of hours)



Sources: Istat, national accounts and labour force survey.
(1) Hours worked by residents and non-residents, official and unreported, employed in resident firms (Source: Istat. national accounts). – (2) Number of residents and non-residents, official and unreported, employed in resident firms. – (3) Number of officially registered residents in employment (excluding those living permanently in institutions).

The sharp reduction in labour input was mainly achieved through a contraction in total hours worked per capita and a freeze on hiring. By reducing hours of work, firms were able to adjust labour input to the cyclical conditions and limit the loss of jobs; they were facilitated in this by ample recourse to the Wage Supplementation Fund, which the anti-crisis measures extended to ordinarily ineligible workers. In industry excluding construction, in the fourth quarter of 2009 Wage Supplementation benefit hours rose to around 12 per cent of total hours worked, more than twice the figure recorded during the 1992-93 recession (Figure 9.2).

In the industrial and non-financial service firms with over 20 employees surveyed by the Bank of Italy, labour turnover, defined as the sum of hirings and terminations as a percentage of average workforce, fell from 35.4 per cent in 2008 to 29.7 per cent last year, with a particularly sharp drop in industry. The main cause was the sharp cut-back in hiring, both of fixed-term and permanent workers, the decline in terminations being essentially the result of the reduction in the number of new fixed-term contracts. According to Istat's labour force survey, more than a quarter of the drop in employment occurred in firms with fewer than 20 employees, where dismissals rose more rapidly.

The fall in the number of persons employed concerned only the private sector and varied in manner and intensity from branch to branch. This reflected not only the sectoral impact of the crisis, but also differences in the scope for adjustment through recourse to social buffers and use of more flexible employment contracts. Non-construction industry, which is more sensitive cyclically, was hard hit, with labour demand down by 4.6 per cent in 2009, and especially the textiles, clothing and leather branches (7.9 per cent). The number of hours worked, already declining in 2008, fell by more than twice as much as employment (Table 9.1). In construction, the decrease in labour input, both number of workers and hours worked, was less marked, reflecting in part the smaller contraction in activity. In private services, where less recourse is made to the Wage Supplementation Fund and fixed-term contracts are more common, labour input was adjusted chiefly by reducing the number of persons employed (2 per cent) instead of per capita hours (0.9 per cent). In agriculture, the negative long-term trend in employment continued.

Given lower levels of output, employment is expected to continue to fall throughout the country in 2010, although firms in the service sector expect a slowing of the rate of decline.

Table 9.1

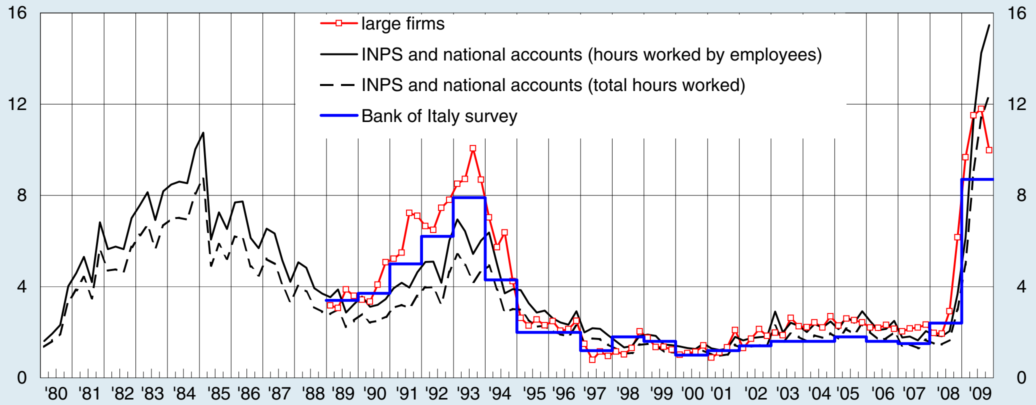
Labour input in the Italian economy by sector
(per cent and percentage changes)

	Total				Employees				Total hours worked			
	Per cent		Percentage change		Per cent		Percentage change		Per cent		Percentage change	
	1999	2009	2009/ 1999	2009/ 2008	1999	2009	2009/ 1999	2009/ 2008	1999	2009	2009/ 1999	2009/ 2008
Agriculture, forestry, fishing	**4.9**	**3.9**	**-12.1**	**-1.4**	**6.6**	**5.2**	**-15.7**	**-1.8**	**6.6**	**5.4**	**-15.0**	**-2.5**
Industry excl. construction	**23.2**	**20.0**	**-5.0**	**-4.6**	**22.2**	**18.9**	**-10.0**	**-8.1**	**22.1**	**18.4**	**-12.8**	**-10.2**
of which: manufacturing	*22.4*	*19.3*	*-4.7*	*-4.7*	*21.4*	*18.2*	*-10.0*	*-8.4*	….	….	….	….
Construction	**6.7**	**7.7**	**27.6**	**-1.1**	**6.8**	**8.1**	**25.3**	**-0.7**	**6.6**	**7.8**	**23.9**	**-3.7**
Services	**65.1**	**68.3**	**15.9**	**-0.9**	**64.5**	**67.8**	**11.0**	**-1.3**	**64.7**	**68.4**	**10.3**	**-1.8**
Wholesale/retail trade, hotels, transport, communications	24.4	24.4	10.3	-2.0	26.4	26.8	7.2	-2.2	29.1	29.0	4.1	-2.1
Wholesale/retail trade and repairs	*15.1*	*14.5*	*6.0*	*-1.7*	*14.7*	*14.2*	*2.3*	*-2.3*	….	….	….	….
Hotels and restaurants	*4.0*	*5.0*	*35.9*	*-2.1*	*5.2*	*5.9*	*19.4*	*-1.3*	….	….	….	….
Transport, storage and communications	*5.3*	*4.9*	*3.1*	*-2.8*	*6.5*	*6.7*	*8.6*	*-2.6*	….	….	….	….
Monetary and financial intermediation	12.3	14.9	34.4	-2.0	12.0	14.5	27.9	-1.6	11.7	14.4	29.1	-4.6
Monetary and financial intermediation	*2.6*	*2.6*	*7.9*	*-0.4*	*2.6*	*2.6*	*7.0*	*-0.8*	….	….	….	….
Business services (1)	*9.6*	*12.3*	*41.6*	*-2.4*	*9.4*	*11.9*	*33.6*	*-1.8*	….	….	….	….
Other service activities	28.5	29.1	12.6	0.7	26.1	26.5	7.1	-0.2	24.0	24.9	8.6	0.3
General government (2)	*6.5*	*5.4*	*-8.4*	*-1.0*	*6.3*	*5.4*	*-9.0*	*-1.0*	….	….	….	….
Education	*6.9*	*6.4*	*1.6*	*-2.2*	*6.7*	*6.4*	*0.3*	*-2.2*	….	….	….	….
Healthcare	*6.2*	*6.7*	*17.8*	*0.9*	*6.0*	*6.5*	*12.8*	*0.6*	….	….	….	….
Other public, social and personal services	*4.1*	*4.5*	*21.3*	*1.1*	*4.0*	*4.4*	*17.4*	*1.0*	….	….	….	….
Domestic services for households and live-in help	*4.8*	*6.2*	*42.7*	*5.0*	*3.1*	*3.8*	*29.8*	*1.5*	….	….	….	….
Total	**100.0**	**100.0**	**10.4**	**-1.7**	**100.0**	**100.0**	**5.5**	**-2.6**	**100.0**	**100.0**	**4.4**	**-3.6**

Source: Istat, national accounts.
(1) Includes real-estate services, leasing, IT, research and other professional and business services. – (2) Includes defence and compulsory social insurance.

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 and *Indagine sulle grandi imprese*; and Banca d'Italia, *Survey of Industrial and Service Firms*.

The composition of employment

Istat's labour force survey, which covers only registered Italian residents, signals that employment declined by 1.6 per cent on average in 2009, close to the rate recorded during the 1992-93 recession (Table 9.2 and Figure 9.1). More than half the contraction occurred in the South of Italy, with a fall of 3 per cent compared with 1.1 per cent in the Centre and North, where employment had already been falling in 2008. The geographical difference can be ascribed above all to the more negative trend in labour demand in industry, construction and wholesale and retail trade in the South.

The increase in the population of working age (15-64) accentuated the drop in the employment rate for persons aged 15 to 64, which fell to 57.5 per cent, the same as five years earlier (Table 9.3). The male and foreign components were hardest hit. All age groups below 55 were affected, especially young people aged 20 to 34, whose employment rate fell from 62 to 58.9 per cent, close to the levels prevailing in the second half of the 1990s.

Both payroll employment and self-employment declined, by 1 and 3.5 per cent respectively. In the case of the former, the decrease affected only employees on fixed-term contracts (7.3 per cent), following a trend already under way from the first half of 2008, and their share in total payroll employment fell by 0.8 percentage points to 12.5 per cent. As the crisis deepened, the negative trend spread to permanent payroll employment, which fell by 1.1 per cent between end-2008 and end-2009 (although average annual employment remained unchanged), breaking off a period of almost continuous growth of nearly 1.5 per cent a year since 1996.

The share of payroll employees working part-time was virtually unchanged, but the percentage wanting full-time positions increased, presumably to compensate for the deterioration in the household's general financial situation.

Although self-employment was down in all sectors except construction, two thirds of the decrease was concentrated in manufacturing (8.7 per cent), wholesale and retail trade (3.2 per cent) and professional and business services (4.6 per cent). The number of self-employed workers with collaboration contracts and providing occasional services shrank by 14.9 per cent, business owners and unpaid family workers by about 9 per cent, and self-employed workers with staff by 4.1 per cent.

Table 9.2

Structure of employment in Italy in 2009 (1)
(thousands of persons and percentages)

	Centre and North		South		Italy	
	Thousands of persons	Percentage change 2009-08	Thousands of persons	Percentage change 2009-08	Thousands of persons	Percentage change 2009-08
Employees	**12.649**	**-0.3**	**4.627**	**-2.9**	**17.277**	**-1.0**
Permanent	11.272	0.7	3.852	-2.0	15.124	..
full-time	*9.634*	*0.6*	*3.420*	*-2.5*	*13.053*	*-0.2*
part-time	*1.638*	*1.4*	*432*	*2.6*	*2.071*	*1.7*
Fixed-term and temporary	1.377	-7.5	775	-7.0	2.153	-7.3
full-time	*1.040*	*-8.7*	*598*	*-7.1*	*1.638*	*-8.1*
part-time	*337*	*-3.6*	*177*	*-6.7*	*514*	*-4.7*
Self-employed	**4.088**	**-3.6**	**1.660**	**-3.3**	**5.748**	**-3.5**
Entrepreneurs, professionals and own-account workers	3.497	-1.9	1.459	-2.1	4.956	-2.0
with employees	*1.146*	*-3.5*	*404*	*-5.7*	*1.549*	*-4.1*
without employees	*2.351*	*-1.2*	*1.056*	*-0.7*	*3.407*	*-1.0*
Family workers	270	-7.6	92	-16.2	363	-9.9
Cooperative members	23	-1.0	11	-2.5	34	-1.5
Collaborators	234	-18.7	73	-11.7	307	-17.2
Occasional workers	64	-10.6	25	7.1	89	-6.3
Full-time	3.567	-2.9	1.485	-1.9	5.052	-2.6
Part-time	521	-8.0	175	-14.0	696	-9.6
Total employment	**16.737**	**-1.1**	**6.288**	**-3.0**	**23.025**	**-1.6**

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

Unemployment and the labour supply

The average number of job-seekers increased by 15 per cent in 2009 or 253,000 persons, about a third of them foreigners (Table 9.3). The increase was over 20 per cent for men, who form a larger part of the workforce in the sectors hardest hit by the crisis, and for university graduates, reflecting the greater difficulties encountered by young people in finding work.

Table 9.3

Labour supply in Italy in 2009 (1)
(thousands of persons and per cent)

	Centre and North		South		Italy	
	Thousands of persons (2)	Percentage change 2009-08 (3)	Thousands of persons (2)	Percentage change 2009-08 (3)	Thousands of persons (2)	Percentage change 2009-08 (3)
Labour force	**17,783**	**0.3**	**7,187**	**-2.5**	**24,970**	**-0.5**
Women	7,622	0.5	2,558	-2.6	10,180	-0.3
Men	10,161	0.2	4,628	-2.4	14,790	-0.6
Italians	15,886	-0.9	6,946	-2.9	22,833	-1.5
Foreigners	1,897	11.8	240	11.5	2,137	11.7
Total employment	**16,737**	**-1.1**	**6,288**	**-3.0**	**23,025**	**-1.6**
Women	7,070	-0.8	2,166	-2.2	9,236	-1.1
Men	9,667	-1.3	4,122	-3.4	13,789	-2.0
Italians	15,057	-2.0	6,070	-3.4	21,127	-2.4
Foreigners	1,680	8.1	218	10.4	1,898	8.4
Job seekers	**1,046**	**29.9**	**899**	**1.4**	**1,945**	**15.0**
Women	552	20.1	393	-4.7	945	8.4
Men	494	42.8	506	6.7	1,000	21.9
Italians	829	25.3	877	1.0	1,706	11.5
Foreigners	217	51.0	22	22.8	239	47.9
Participation rate (ages 15-64)	**68.6**	**-0.3**	**51.1**	**-1.4**	**62.4**	**-0.6**
Women	59.4	-0.2	36.1	-1.0	51.1	-0.5
Men	77.7	-0.3	66.3	-1.7	73.7	-0.7
Italians	68.0	-0.3	50.7	-1.4	61.6	-0.7
Foreigners	73.9	-0.6	64.2	-0.4	72.7	-0.6
Employment rate (ages 15-64)	**64.5**	**-1.2**	**44.6**	**-1.4**	**57.5**	**-1.2**
Women	55.1	-0.9	30.6	-0.8	46.4	-0.8
Men	73.8	-1.4	59.0	-2.1	68.6	-1.6
Italians	64.4	-1.0	44.3	-1.5	56.9	-1.2
Foreigners	65.4	-2.8	58.3	-0.9	64.5	-2.5
Unemployment rate	**5.9**	**1.3**	**12.5**	**0.5**	**7.8**	**1.0**
Women	7.2	1.2	15.3	-0.3	9.3	0.7
Men	4.9	1.5	10.9	0.9	6.8	1.3
Italians	5.2	1.1	12.6	0.5	7.5	0.9
Foreigners	11.4	3.0	9.3	0.9	11.2	2.7
Youth unemployment rate	**20.1**	**5.6**	**36.0**	**2.4**	**25.4**	**4.2**
Women	23.1	5.6	40.9	1.7	28.7	4.0
Men	17.9	5.5	33.1	2.9	23.3	4.4
Italians	19.5	5.1	36.8	2.7	25.8	4.0
Foreigners	23.5	7.7	11.9	-7.8	22.4	6.1

Source: Based on Istat, labour force survey.
(1) With the survey for the first quarter of 2008, the minimum age for labour market participation was raised from 15 to 16. – (2) Participation, employment and unemployment rates are percentages. The unemployment rate is the number of job-seekers aged 16-74 as a percentage of the labour force aged 16 and over. The youth unemployment rate refers to the labour force in the 16-24 age-group. Rounding may cause discrepancies in the totals. – (3) For participation, employment and unemployment rates, changes in percentage points.

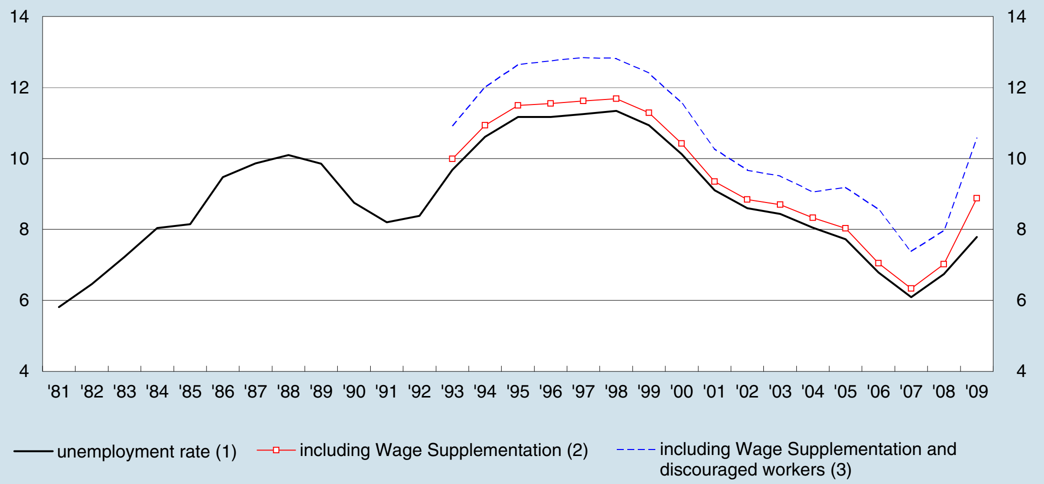
The unemployment rate, which had begun to climb in the first half of 2007, averaged 7.8 per cent in 2009, up from 6.8 per cent in 2008, and reached 8.8 per cent in March of this year. Almost all population groups were affected, in particular foreign workers. The growth in unemployment was worse among young people (over 2 percentage points in the 20-34 age group) owing to the delay in finding work, but it was also considerable among older workers, particularly in the North, and those with higher educational qualifications.

The rise in the unemployment rate was attenuated by the drop of 0.5 per cent, or 127,000 persons, in the labour force, similar to that recorded during the crisis of the 1990s. The participation rate for the working-age population fell from 62.3 to 61.6 per cent for Italian citizens and from 73.3 to 72.7 per cent for foreigners. The decline in the labour supply among Italians was limited to young people, largely owing to a discouragement effect.

The unemployment rate does not fully measure the extent of underutilization of the labour force because it does not count people who would be available immediately to work but are not actively job-hunting, or the non-contribution of employees on Wage Supplementation. Our estimates, which consider these two factors, indicate that the rate of unutilized potential labour supply rose from 7.7 per cent in 2008 to 9.5 per cent in 2009 if discouraged workers are included and from 8 to 10.6 per cent including also the equivalent Wage Supplementation hours (Figure 9.3; see the box "Estimates of unutilized available labour", *Economic Bulletin*, No. 55, January 2010).

Figure 9.3

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



Source: Based on data from Istat, labour force surveys.
(1) The unemployment rate is the number of job-seekers as a percentage of the labour force. – (2) The unemployment rate including Wage Supplementation is the number of job-seekers plus full-time equivalent workers receiving Wage Supplementation benefits as a percentage of the labour force. – (3) The unemployment rate including Wage Supplementation and discouraged workers is the number of job-seekers, full-time equivalent workers receiving Wage Supplementation benefits and discouraged workers as a percentage of the labour force plus discouraged workers.

The increase in the number of persons without employment led to a sharp rise in recourse to forms of income support, to which the Government's measures to extend benefits to previously ineligible persons contributed. According to the INPS annual report, some 4 million people received such benefits in 2009.

Earnings and labour costs

The growth in hourly earnings in the entire economy was virtually unchanged in 2009 at almost 3 per cent, close to the average for the decade (Table 9.4). It accelerated from 3.4 to 5.3 per cent in industry, where the decline in employment was steepest among workers on lower wages. The growth in hourly earnings in private services was similar to the previous year (1.8 against 1.6 per cent) but slowed in the public sector from 3.3 to 1.4 per cent; in both cases, the figures reflect one-off payments made in 2008 to compensate for delays in labour contract renewals.

Table 9.4

Labour costs and productivity in Italy
(annual percentage changes)

	Value added (1)	Total hours worked	Value added per hour of work (1)	Hourly compen-sation	Hourly labour costs (2)	Unit labour costs (2) (3)	Labour's share of value added (2) (4)	Real labour costs per hour of work (5)	Real earnings per hour of work (6)
				Industry excluding construction					
1996-2000	1.1	-0.3	1.4	3.3	2.4	1.0	66.1	0.3	0.9
2001-2005	-0.5	-0.7	0.2	3.3	3.3	3.0	66.1	1.3	0.8
2006-2009	-3.7	-2.2	-1.5	3.6	3.4	5.0	68.7	0.6	1.5
2006	3.1	1.5	1.6	2.8	2.1	0.5	67.0	0.9	0.7
2007	1.9	1.6	0.3	2.8	2.8	2.5	66.0	-1.1	1.0
2008	-3.6	-1.3	-2.3	3.4	3.4	5.8	68.2	0.9	..
2009	-15.1	-10.2	-5.5	5.3	5.4	11.5	73.6	2.0	4.5
				Construction					
1996-2000	1.0	1.4	-0.4	3.4	2.2	2.6	74.5	..	1.0
2001-2005	2.8	3.5	-0.7	2.6	2.8	3.5	71.0	-1.9	0.2
2006-2009	-1.8	0.6	-2.4	2.8	3.0	5.5	70.8	-1.5	0.8
2006	1.8	2.9	-1.1	0.5	0.3	1.4	69.5	-2.0	-1.6
2007	0.5	4.4	-3.7	1.5	2.1	6.0	70.6	-2.2	-0.3
2008	-2.4	-0.8	-1.6	3.3	3.7	5.4	70.5	-1.7	..
2009	-6.7	-3.7	-3.1	6.0	5.9	9.2	72.6	-0.2	5.2
				Private services (7) (8)					
1996-2000	3.1	2.1	1.0	2.9	1.7	0.7	77.0	-0.6	0.4
2001-2005	1.4	1.4	..	2.6	2.6	2.7	73.7	0.2	0.2
2006-2009	-0.3	0.3	-0.6	2.1	2.0	2.6	76.6	0.1	0.1
2006	2.4	1.9	0.5	2.1	1.7	1.2	76.6	2.8	..
2007	3.1	1.9	1.1	2.8	2.8	1.6	76.1	0.5	0.9
2008	-1.1	0.5	-1.7	1.6	1.8	3.5	76.5	-1.2	-1.6
2009	-5.4	-2.9	-2.5	1.8	1.8	4.4	77.1	-1.8	1.0
				Private sector (8)					
1996-2000	2.2	0.9	1.3	3.1	2.1	0.8	74.6	0.1	0.7
2001-2005	0.8	0.8	..	2.8	2.8	2.9	72.7	0.5	0.4
2006-2009	-1.5	-0.4	-1.1	2.7	2.5	3.6	75.4	0.2	0.6
2006	2.4	1.8	0.6	2.2	1.7	1.0	74.6	1.7	0.1
2007	2.4	1.8	0.6	2.8	2.8	2.2	74.1	-0.2	0.9
2008	-2.0	-0.3	-1.6	2.4	2.5	4.2	75.0	-0.4	-0.9
2009	-8.5	-4.9	-3.8	3.3	3.2	7.2	77.8	-0.2	2.5
				Total economy (8)					
1996-2000	1.9	1.0	0.9	3.0	2.2	1.3	76.5	-0.2	0.5
2001-2005	0.9	0.8	0.1	3.3	3.3	3.1	75.1	0.6	0.8
2006-2009	-1.0	-0.2	-0.8	2.6	2.5	3.3	77.4	0.2	0.6
2006	2.1	1.7	0.4	2.5	2.1	1.7	77.0	1.4	0.4
2007	2.0	1.3	0.7	2.4	2.4	1.7	76.3	-0.2	0.5
2008	-1.5	-0.1	-1.4	2.7	2.7	4.2	77.1	-0.4	-0.6
2009	-6.4	-3.6	-2.9	2.8	2.8	5.9	79.2	-0.2	2.0

Source: Based on Istat, national accounts.
(1) Value added at base prices, chain-linked volumes, reference year 2000. – (2) The introduction of the regional tax on productive activities and the simultaneous elimination of some employers' contributions in 1998 caused a break in the series. – (3) Hourly compensation as a percentage of value added per hour of work at base prices, chain-linked volumes, reference year 2000. – (4) Percentages; value added at base prices. – (5) Hourly labour income deflated by the value added deflator at base prices. – (6) Hourly compensation deflated by the consumer price index. – (7) Includes wholesale and retail trade, hotel and restaurant services, transport and communications, financial intermediation, real-estate and rental services and professional and business services. – (8) Net of rental of buildings.

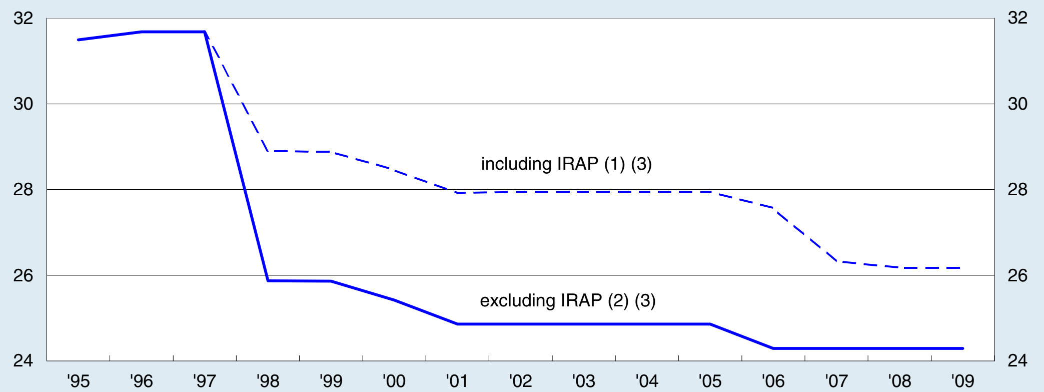
In the private sector, the index of contractual earnings as established in the industry-wide wage agreements, which does not take account of one-off payments or changes in the composition of employment, rose on average by 3 per cent in 2009, the same as in 2008.

Given the sharp slowdown in consumer prices, mainly due to the energy component, actual hourly earnings increased by 2 per cent in real terms, after falling in 2008. Considering prices net of energy products, the increase came to 1.3 per cent.

Between 1995 and 2009, average actual hourly earnings rose by 8.3 per cent in the private sector, that is by around 0.6 per cent a year, compared with an increase of 5.3 per cent overall in contractual pay. The gap is due partly to the increase in the level of education and seniority of the work force and partly to the existence of company-level bargaining, albeit on a modest scale. Over the same period the annual increase in labour costs, which includes employers' contributions, was only 0.2 per cent, due to the much slower growth in social contributions. Contributory factors were the introduction of IRAP (regional tax on productive activities) and the simultaneous abolition of some social contributions in 1998 and the successive adjustments to contribution rates, which reduced the weight of employers' contributions in labour costs from 31.5 per cent in 1995 to 24.3 per cent in 2009 (Figure 9.4). If labour costs are computed to include the portion of IRAP relating to labour, the decrease becomes less pronounced but remains nonetheless considerable (from 31.5 to 26.2 per cent). Despite these adjustments, the tax and contribution wedge in Italy remains high by international standards.

Figure 9.4

Incidence of tax wedge in firms' labour costs
(per cent)



Source: Based on data from Istat, national accounts.
(1) The tax wedge includes employers' social security contributions and from 1998 the portion of IRAP (regional tax on productive activities) relating to labour. The part of the tax wedge due to IRAP is calculated on the basis of the legislation in force in each year by applying the national average ordinary rate to labour costs alone. – (2) The tax wedge includes employers' social security contributions. – (3) Social security contributions are calculated by applying the rates currently in force to per capita gross earnings in the private sector; they do not include firms' allocations to severance pay provisions, which represent deferred compensation and not contributions. Figures for 2007-09 reflect the tax relief on labour costs granted under the 2007 Finance Law.

If workers' taxes and contributions are also taken into account, the difference between the cost of labour to the firm and the average take-home pay of private sector payroll employees narrowed from 50.4 per cent of labour costs in 1995 to 46.4 per cent in 2009 for a single worker and from 45.4 to 36.9 per cent for a worker with dependent spouse and two children (to 47.7 per cent and to 38.5 per cent, respectively, including IRAP).

Unit labour costs increased by 5.9 per cent, against 4.2 per cent in 2008, driven up by the 2.9 per cent decline in value added per hour worked. In industry excluding construction, where the increase in hourly labour costs (5.4 per cent) and the decline in productivity (5.5 per cent) were greatest, unit labour costs rose by 11.5 per cent. In private services, excluding rentals, the increase was 4.4 per cent.

Personal distribution of earnings and household income

According to the Bank of Italy's bi-annual *Survey of Household Income and Wealth*, between 2006 and 2008 the real per capita monthly take-home pay of employees fell by 3.2 per cent (Table 9.5). The hardest hit were women and workers in the South of Italy, where the decline was limited to the lowest-paid workers, while men in full-time employment were less seriously affected. The percentage of low-paid workers was unchanged overall, although it increased among women, particularly those working part-time, in the South and among workers under 30 or aged 41 to 50.

Table 9.5

Real net monthly earnings in Italy (1)

(in euros at 2008 prices; absolute values and per cent)

	1998	2000	2002	2004	2006	2008
			Total payroll employees			
Average earnings	1,358	1,377	1,406	1,434	1,454	1,408
Men	*1,473*	*1,503*	*1,525*	*1,555*	*1,584*	*1,553*
Women	*1,191*	*1,192*	*1,236*	*1,260*	*1,280*	*1,221*
Centre & North	*1,411*	*1,431*	*1,459*	*1,491*	*1,512*	*1,468*
South	*1,230*	*1,237*	*1,274*	*1,276*	*1,301*	*1,259*
Gini index (2)	0.241	0.24	0.251	0.242	0.233	0.237
Inter-decile ratio (3)	3.1	3.1	2.9	3.0	2.8	2.8
Percentage of low-paid workers (4)	18.3	16.9	17.8	18.1	16.3	16.5
Men	*13.0*	*11.2*	*10.6*	*12.0*	*10.0*	*9.2*
Women	*25.9*	*25.4*	*28.0*	*26.7*	*24.7*	*26.0*
Centre & North	*14.4*	*13.3*	*14.9*	*15.5*	*13.8*	*13.0*
South	*27.6*	*26.5*	*24.9*	*25.1*	*22.8*	*25.3*
			Full-time payroll employees			
Average earnings	1,427	1,448	1,482	1,496	1,527	1,494
Men	*1,513*	*1,533*	*1,556*	*1,575*	*1,607*	*1,584*
Women	*1,287*	*1,299*	*1,358*	*1,361*	*1,399*	*1,352*
Centre & North	*1,474*	*1,495*	*1,533*	*1,558*	*1,592*	*1,553*
South	*1,312*	*1,320*	*1,354*	*1,325*	*1,359*	*1,344*
Gini index (2)	0.216	0.217	0.228	0.225	0.212	0.212
Inter-decile ratio (3)	2.6	2.4	2.6	2.5	2.4	2.3
Percentage of low-paid workers (4)	12.2	10.6	11.3	12.7	10.0	9.0
Men	*9.8*	*9.0*	*8.0*	*10.4*	*8.2*	*6.7*
Women	*16.1*	*13.4*	*16.9*	*16.4*	*12.7*	*12.7*
Centre & North	*8.6*	*7.4*	*8.6*	*9.7*	*7.2*	*5.8*
South	*20.9*	*19.3*	*18.4*	*20.6*	*17.1*	*17.1*

Source: Banca d'Italia, *Survey on Household Income and Wealth*, historical archives (Version 6.0, February 2010).
(1) Main payroll employment (excluding second jobs). Earnings are deflated with the cost-of-living index and are net of taxes and social security and welfare contributions. Values in lire until 2000 are converted into euros at the exchange rate of 1936.27 lire to the euro. – (2) The Gini concentration index ranges from 0 (perfect equality) to 1 (maximum inequality). – (3) Ratio between the wage at the highest 9th decile and the wage at the lowest 1st decile. – (4) Percentages. The OECD defines "low wage" as a wage lower than two thirds of the median for full-time employees.

It is estimated that between 1991 and 2008 net real earnings, as reported in the Bank of Italy's Survey, declined by 2.1 per cent, while gross earnings rose by 3.1 per cent. This large gap was caused mainly by the fiscal drag. Between 1991 and 2009, the total tax wedge (i.e. the worker's share of taxes and social security contributions) for a single, employed worker with gross earnings equal to the average based on the national accounts increased from 24.7 to 29.8 per cent of salary as a result of fiscal drag alone. Taking account of intervening changes in the tax and contribution structure, the effective wedge in 2009 was 29.3 per cent. For an employed worker with the same salary but with spouse and two children, however, the tax wedge remained virtually unchanged, rising from 16.7 to 17 per cent. The effects of failing to compensate for the fiscal drag were almost entirely offset by the changes in tax credits for dependents and in family allowances.

Equivalent real disposable household income declined by 3.6 per cent between 2006 and 2008, and by 4.1 per cent in the South, wiping out the growth recorded in the previous two years (Table 9.6). The main cause was the sharp drop in self-employment and business income (20.3 per cent) compared with employee income (2.4 per cent). In the first case, this reflected above all the reduction in per capita income; in the second, the decrease in the number of earners. The drop in equivalent household income was sharpest for one-member households and those with four or more members (around 10 per cent).

Table 9.6

Equivalent real disposable income of households (1)
(values in euros at 2008 prices; absolute values)

(2)	1998	2000	2002	2004	2006	2008
Average equivalent income	17,863	18,078	18,501	19,314	20,064	19,342
Centre & North	*21,054*	*21,081*	*21,794*	*22,828*	*23,457*	*22,589*
South	*12,258*	*12,781*	*12,642*	*12,977*	*13,839*	*13,278*
Production worker, apprentice, clerk	*13,336*	*13,481*	*13,645*	*13,571*	*14,264*	*13,456*
Office worker, manager, teacher	*19,290*	*19,998*	*20,261*	*20,770*	*21,019*	*20,791*
Executive	*35,209*	*34,691*	*40,429*	*38,036*	*43,157*	*40,270*
Own-account worker	*24,092*	*22,244*	*23,161*	*27,018*	*28,283*	*25,341*
Retired worker	*16,510*	*17,215*	*17,158*	*17,398*	*18,296*	*19,286*
Non-employed non-pensioner	*7,113*	*7,262*	*6,621*	*9,902*	*7,802*	*7,084*
1-person household	*18,415*	*18,435*	*18,027*	*22,119*	*23,177*	*20,352*
2-person household	*20,649*	*20,695*	*21,028*	*22,037*	*22,250*	*22,115*
3-person household	*19,559*	*19,776*	*21,267*	*20,140*	*20,542*	*21,114*
4-person household	*16,655*	*16,905*	*17,229*	*18,406*	*18,960*	*17,866*
5-person household or larger	*13,846*	*13,943*	*13,520*	*13,102*	*15,653*	*13,215*
Home-owners	*19,782*	*19,909*	*20,303*	*21,362*	*22,174*	*21,559*
Tenants	*13,697*	*13,786*	*14,068*	*14,604*	*14,763*	*13,819*
Gini concentration index (3)	0.348	0.335	0.330	0.343	0.337	0.330
Centre & North	*0.314*	*0.293*	*0.292*	*0.306*	*0.305*	*0.295*
South	*0.350*	*0.357*	*0.329*	*0.334*	*0.324*	*0.326*
Inter-decile ratio (4)	4.8	4.6	4.4	4.5	4.4	4.5

Source: Banca d'Italia, *Survey on Household Income and Wealth*, historical archives (version 6.0, February 2010).
(1) Total household income (including imputed rent of owner-occupied homes) net of direct taxes, divided by the national accounts deflator of household consumption and rendered comparable using the OECD-modified equivalence scale (which assigns a value of 1 to the first adult member of the household, 0.5 to each additional members over the age of 13 and 0.3 to each member under 13). The values are weighted by the number of persons except in the case of low-income households, which are weighted by household. Values in lire until 2000 are converted into euros at the exchange rate of 1936.27 lire to the euro. – (2) Employment status of the head of the household, that is the person with the highest employment or pension income. – (3) The Gini concentration index ranges from 0 (perfect equality) to 1 (maximum inequality). – (4) Ratio of equivalent disposable income at the highest 9th decile to equivalent disposable income at the lowest 1st decile.

10. THE PRODUCTIVE STRUCTURE AND STRUCTURAL AND TERRITORIAL POLICIES

Hit by the slump in world trade and demand for durable goods, in 2009 the value added of Italian manufacturing declined by 15.8 per cent, over ten percentage points more than the fall in GDP and in line with the average for manufacturing in the euro area. The drop in value added was smaller in services (2.6 per cent). The crisis affected all parts of the country. The contraction in output was relatively steeper in the North but nonetheless also significant in the South, which though less involved in international trade flows is hampered by a fragile productive sector (see Banca d'Italia, *Mezzogiorno e politiche regionali*, Workshops and Conferences No. 2, 2009).

The crisis struck Italy after a decade in which the country had accumulated a large growth gap with respect to the European average and labour productivity had stagnated. Italy's productive structure, based mostly on small firms and concentrated in sectors facing limited growth opportunities, had shown signs of innovation only in the most recent years. The crisis accelerated the modification of the international division of labour, making a reallocation of resources towards sectors and firms with greater potential for expansion all the more necessary. The excessive regulation of some markets and deficiencies in the conditions for conducting business are obstacles to change. The poor quality of public services and the slowness of the justice system weigh on the productive economy.

Sectoral and territorial dynamics

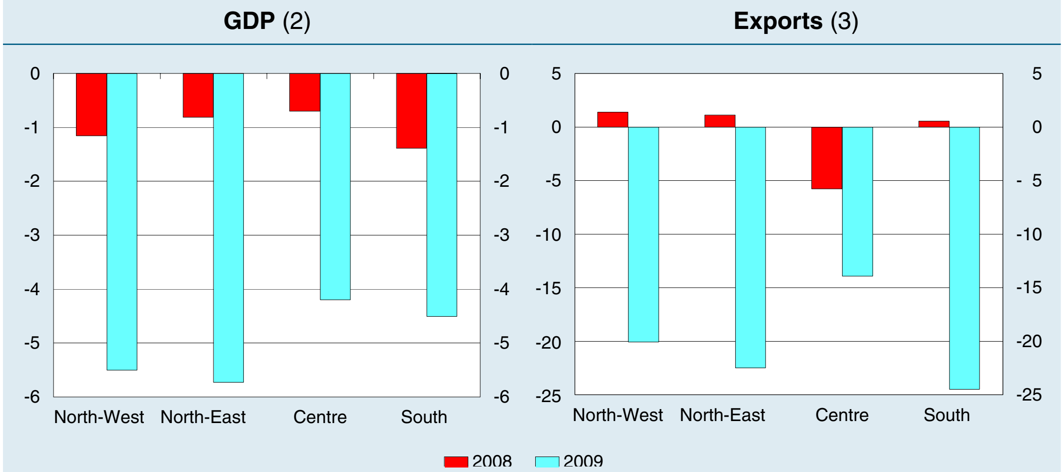
Productive activity, which had been falling sharply since the end of 2008, began to show signs of recovering during the summer. Year on year, value added diminished in 2009 in all the main sectors of activity. In manufacturing, the sector most exposed to the fall in world trade, it declined by 15.8 per cent and labour productivity fell by 8.1 per cent despite the decrease in hours worked.

The crisis had heavy repercussions on capital goods and durable consumer goods industries. Value added fell by an average of over 20 per cent in the basic metals and metal products, mechanical and electrical machinery and equipment, and transport equipment industries, which had recorded robust growth in the two years 2006-07. In the textiles and clothing sector, the decline was smaller (8.9 per cent), as the production of garments held up fairly well. Value added also decreased more than average in the construction sector (6.7 per cent), contributing in turn to a sharp drop in upstream industries, particularly non-metallic mineral products. In both sectors the contraction lasted until the second half of the year. In private services, value added fell by 2.6 per cent; the largest decreases were recorded in distribution (9.5 per cent), particularly wholesale trade, and business and household services (4.8 per cent excluding rental of buildings).

In 2009 the recession affected all parts of the country. According to Svimez estimates, the decline in GDP was sharpest in the North (5.5 per cent in the North-West and 5.7 per cent in the North-East, against 4.2 per cent in the Centre and 4.5 per cent in the South (Figure 10.1). The fall in employment, which similarly involved all parts of Italy, was smallest in the Centre and largest in the South. Exports of non-petroleum products fell in value by more than a fifth in the South, North-East and North-West, declining by 24.5, 22.5 and 20.1 per cent respectively; in the Centre, where exports had already contracted in 2008, the decrease came to 13.9 per cent.

Figure 10.1

Growth rates of GDP and exports (1)
(percentage changes)



Sources: For GDP in 2008, Istat, Conti economici territoriali; for GDP in 2009, Svimez estimates; for exports, Istat, *Le esportazioni delle regioni italiane*.
(1) Annual growth rates. – (2) Chain-linked prices. – (3) At current prices; excludes refined petroleum products and ship's stores.

Firms and anti-crisis policies

Calculations based on the data of the Bank of Italy's Survey of Industrial and Service Firms confirm the intensity of the crisis in manufacturing, where turnover fell by 12.5 per cent at constant prices (for the total sample, the decline was 8 per cent). Other characteristics being equal, the decline was greater for firms with high export shares and more moderate for those that in the period preceding the crisis had begun restructuring by substantially overhauling company strategy (some 50 per cent of the total). Overall, the recession appears to have had a significant impact on profitability: some 30 per cent of the firms surveyed reported making a loss in 2009, twice as many as in 2007. Corroborating the weak inversion of trend picked up by the indices of production, in the second half of last year firms revised their forecasts for real turnover growth in 2010 upwards to 1.9 per cent (1.4 per cent in industry and 2.3 per cent in services).

The recession led to an abrupt fall in business creation. According to Chamber of Commerce data, in 2009 the number of enterprises rose by barely 0.3 per cent, about one third of the annual average since the start of the decade. The downturn was due entirely to the decrease of 6.1 per cent in new registrations, while cessations remained broadly unchanged. Among companies formally still in business, however, there was a jump in new bankruptcy proceedings.

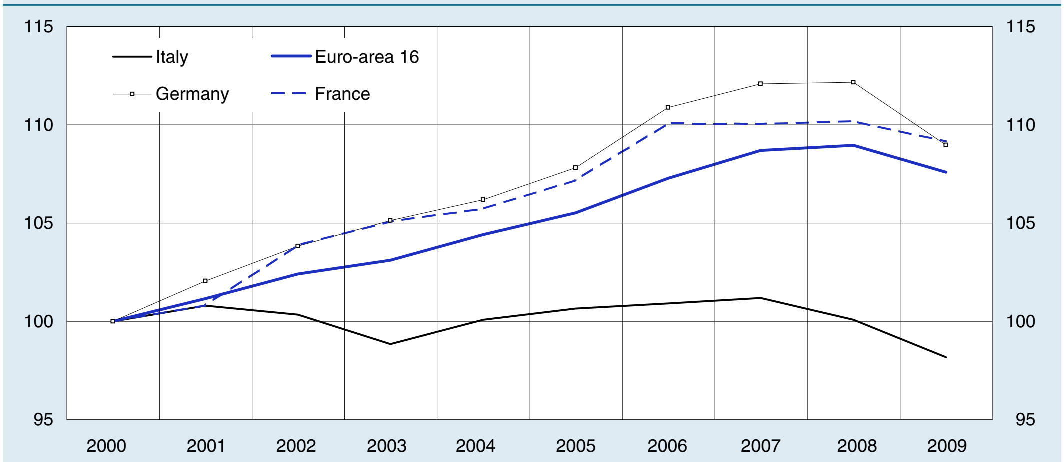
Like the other main European countries, in 2009 Italy took measures to support demand for some durable consumer and capital goods. The effects of these measures on Italy's GDP in 2009 can be estimated at 0.3 percentage points, part of which derived from the bringing forward of planned purchases.

The crisis and economic growth

The recession fell in the context of a decade of slow growth in Italy. In the period 2000-07 GDP grew by about 8 per cent in real terms, just over half the increase for the euro area. Hourly labour productivity grew by about 1 per cent, compared with 10 per cent in France, 12 per cent in Germany and 8.7 per cent on average in the euro area (Figure 10.2). In part this differential reflected more labour-intensive production, but it was largely due to the differential in total factor productivity, a measure of the degree of efficiency in the use of capital and labour inputs. According to OECD estimates, total factor productivity diminished by 0.4 per cent in Italy, while it grew at average rates of close to 1 per cent in France and Germany. These trends intensified in the two years 2008-09, when hourly productivity declined slightly in the euro area while in Italy it fell below its 2000 level.

Figure 10.2

Changes in labour productivity in selected European countries, 2000-09
(indices, 2000=100)



Source: Eurostat, 2010.

Contributing to these developments is a productive structure concentrated in activities with limited growth opportunities, fragmented and partly behind the curve in incorporating the new technological paradigms. In addition, the ownership structure of firms is highly concentrated and relatively closed to outside investment.

Regaining a standard of growth in line with those of the main European countries depends on further progress in restructuring the productive economy and reallocating resources towards sectors and firms with greater growth potential. Signals pointing in this direction have been evident since the middle of the decade.

The structure of supply depends on the endowment of productive factors such as human capital, the formation of which is necessarily gradual. However, effective resource allocation also depends on the regulatory framework and numerous environmental factors: a regulatory structure that promotes competition and fosters efficient conditions for the entry and exit of enterprises; the ability of public institutions to safeguard legality, protect property rights and guarantee the enforcement of contracts; and well-functioning and non-burdensome administrative action. According to international indicators, despite some progress in recent years, the gap between Italy and other developed countries in many of these fields remains considerable (Table 10.1).

Table 10.1

Regulatory framework and environmental factors: qualitative indicators for the main developed countries
(rank among the 30 OECD countries)

	Starting a business	Closing a business	Enforcing contracts	Protecting investors	Regulation of services	Control of corruption
	1	2	3	4	5	6
Italy	**22**	**20**	**30**	**15**	**26**	**26**
France	7	24	5	18	18	17
Germany	23	21	6	22	14	13
United Kingdom	6	8	15	5	1	14
United States	4	12	8	4	5	16

Sources: World Bank, *Doing Business 2010* (columns 1-4); OECD, *Indicators of Product Market Regulation 2010* (column 5); World Bank, *Governance Matters 2009* (column 6).

The regulatory framework

Liberalization and competition in the service sector. – The European Union's Services Directive (Directive 2006/123/EC) seeks to remove the obstacles to the freedom of establishment of service providers and to the free circulation of services among EU member countries; it could affect such sectors as distribution, tourism, craft industry and construction. Legislative Decree 59/2010 has initiated the transposition of the directive at central government and regional level. There is a general tendency of the regions, to which many of the relevant powers are assigned, to maintain authorization procedures on grounds of the general interest. Additional obstacles could stem from the disparities between jurisdictions due to insufficient coordination between regions.

In the field of local public services, rule changes have reaffirmed the pro-competitive approach, strengthening the principle that the competitive tender is the standard procedure for awarding service contracts (Decree Law 135/2009). The establishment of more competitive arrangements is impeded, however, by the weakness of second-level regulatory activity, due to the lack of independent regulators in many sectors.

In professional services, liberalization has not made progress and in some cases shows signs of regression. The parliamentary bill on the legal professions now under discussion restores many of the anti-competitive constraints abolished by Decree Law 223/2006 (the Bersani Decree), later ratified by Law 248/2006.

Bankruptcy law. – In recent years a series of wide-ranging legislative measures have been passed to encourage the prompt emergence of crisis situations and foster a more efficient management of them by simplifying the procedures and enlarging the scope for initiative of the parties involved. The growth in the number of compositions with creditors, by 37 per cent in 2008 and 69 per cent in 2009, demonstrates the success of the reform in offering better opportunities for restructuring companies in temporary difficulty. In connection with the greater recourse to this procedure, the share of firms still in business after two years is equal to about 80 per cent.

According to our calculations based on Chamber of Commerce data, the length of time required to close a composition with creditors has decreased from about twelve and a half months for procedures concluded in 2000 to six months for those concluded in 2009. The great lengthiness of bankruptcy procedures still precludes an assessment of the efficacy of the reform in this case. The reform should be completed with a revision of the provisions governing bankruptcy crimes consistent with the new overall design of bankruptcy law.

Company law. – Important changes concerning shareholders' rights and transactions subject to conflicts of interest have brought Italian legislation broadly into line with the prevailing international standards. This could lead to an opening up of ownership structures thanks to more extensive voting by institutional investors and the greater protection of minority shareholders against expropriation by controlling shareholders.

Public services and business activity

Reform of the public administration. – The three pillars of the reform effort under way to raise the standards of efficiency in the public administration are the fight against absenteeism, the introduction of external, including judicial, controls on the effectiveness and correctness of administrative action, and the strengthening of internal mechanisms. By contrast, no measures have yet been taken to reorganize the administrative structures and their operating practices.

Corruption undercuts the quality of administrative action and distorts the functioning of the markets. Measures to increase transparency in general government (Legislative Decree 150/2009, the anti-corruption bill approved by the Council of Ministers in March 2010) risk having limited impact, given a generally ineffective apparatus for enforcement and sanctions.

Legislative and administrative simplification. – Work has continued on the repeal of provisions deemed obsolete and no longer applicable, with the number of pieces of primary legislation in force slashed from about 50,000 in 2008 to 10,000 at present. Little has been done, instead, to reorganize and rationalize the primary and secondary legislation still in effect. Furthermore, new legislation is often opaque and unsystematic.

The administrative burden on firms has been reduced in some areas for which the central government has competence (labour and social security, fire prevention, cultural heritage) with measures to digitize procedures and simplify documentation. The contribution of local government bodies and the coordination between different levels of government, both of which are essential for the success of simplification policies, have been deficient up to now.

The justice system. – The duration of trials remains extremely long. Ordinary trials that concluded in 2008 lasted an average of nearly 1,000 days. The litigation rate is high; in 2008 some 2.8 million new civil actions were brought in the courts, 4.7 per 100 inhabitants, a high ratio by international standards. New instruments have been introduced to rationalize recourse to the civil justice system, but actual use of them could be limited by the lack of incentives for the actors involved. Glaring disparities can be found in the productivity of the courts and the workloads of individual magistrates.

11. ITALY'S ENERGY SYSTEM

Italy uses less energy per unit of output than most of the other industrial countries, but in the last twenty years this long-standing advantage has diminished. Italian energy consumption has increased at basically the same pace as GDP, while in other countries it has grown much more slowly than output. Italy's very heavy reliance on fossil fuels, practically all imported, makes energy costs for the economy especially sensitive to world oil prices. In relation to GDP, spending on energy has risen by an average of 0.8 percentage points in the last five years and in 2008 was equal to 3.8 per cent.

Energy prices to final users are higher than the EU average. The cost of electricity generation depends largely on the price of natural gas, which accounts for half of Italy's electricity output as against a quarter in the EU overall, and this price has risen sharply in the last decade. Despite liberalization, production and markets are still dominated by a very few corporations and limited by inadequate infrastructure, especially in the South. Energy taxes are among the highest in Europe. The ratio of taxation to total energy consumption is more than 40 per cent higher in Italy than in the EU overall.

To curb greenhouse gas emissions and improve energy security, early in 2009 the European Union approved a climate and energy package, which sets objectives for raising the share of renewable energy sources and reducing emissions by 2020. To work towards the objectives, incentives for renewable sources and energy efficiency have been adopted at national level and guidelines drafted for the resumption of nuclear power generation. By setting medium and long-term targets, the formulation of the National Energy Strategy will provide a framework for the coordination of local and national action and confer greater certainty on the planning of public and private investment.

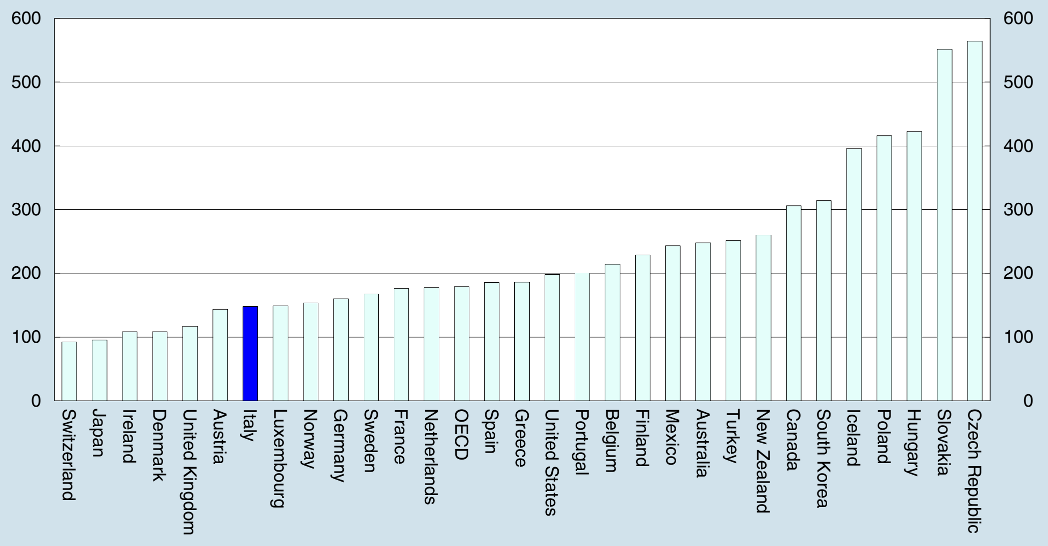
Energy supply and transformation

In 2008 gross inland energy consumption in Italy came to 191.3 million tons of oil equivalent (MTOE), with more than 86 per cent coming from fossil fuels (oil 41.4 per cent, natural gas 36.3 per cent, coal and other solid fuels 8.8 per cent). The rest came from renewable sources and electricity imports (8.9 and 4.6 per cent respectively). According to preliminary estimates, gross energy consumption decreased by about 6 per cent in 2009, owing chiefly to the decline in industrial demand as a consequence of the recession. Energy utilization per unit of output is still lower in Italy than in most of the OECD countries (Figure 11.1), but in the last fifteen years it has been reduced much less than in the other leading European countries.

Domestic production of crude oil covered 2.7 per cent of gross energy consumption in 2008, that of natural gas 4 per cent, and renewable sources 8.5 per cent. Imports provided the remaining 85 per cent or so. Italy's main suppliers of energy raw materials, except for solid fuels, are all outside the OECD.

Figure 11.1

Energy intensity of OECD countries, 2008
(TOE per million dollars of GDP at 2000 prices)



Source: International Energy Agency, *Energy Balances of OECD Countries* (2009 ed.), 2009.

By comparison with most other countries, Italian electricity generation depends heavily on natural gas. In 2008 gas-fired thermal generation accounted for 54.4 per cent of the country's total production of electricity, compared with 22 per cent for the OECD. In Europe, the figures were 4 per cent for France, 14 per cent for Germany and 46 per cent for the United Kingdom, which is a major gas producer.

Energy demand

Subtracting from gross energy consumption the amount dissipated in transformation, we get the amount of energy going to final users (141.1 MTOE in 2008).

Between 1990 and 2008 energy demand in industry (just over a quarter of the total) remained broadly unchanged, curbed both by more efficient use of resources as a result of price trends and stricter environmental regulations and by structural factors such as the decreasing incidence of heavy industry. In the service sector, however, which accounts for 11 per cent of final energy use, energy consumption rose at a much faster pace of over 3 per cent per year, despite a slowdown in recent years. Factors in the increase were stepped-up electricity use for air conditioning and the growth of large-scale retailing.

Based on Istat's survey of energy purchases by industrial enterprises, the census of industry, and the ASIA archive of firms, it is estimated that in 2007 the energy costs of industrial firms (excluding the energy sector) amounted to €21.3 billion, or about

€5,000 per employee. These costs increased by 22 per cent between 2000 and 2007, but their incidence on output value remained practically unchanged at just over 2 per cent. The energy cost per employee rose by an average 32 per cent and by 45 per cent in firms with fewer than 100 workers.

Household energy consumption (for heating, transport and electricity) accounts for more than 30 per cent of final energy use. In 2008 the energy intensity of consumer spending was 63 TOE per million euros at 2000 prices, compared with an average of 88 TOE in the 1970s.

According to Istat's household budget survey, spending for energy products came to almost €300 a month per household in 2008, and its share of total consumer expenditure, which had held practically constant at 11 per cent from 1997 through 2007, rose to almost 12 per cent. Half of this spending goes for transport fuel, nearly a third for heating and a fifth for electricity.

Final energy use for transport, about 40 per cent of which is estimated to be by households, accounts for 30 per cent of total final energy use; it has risen at an average annual rate of 1.5 per cent since 1990. Nearly 90 per cent of this energy goes for road transport of persons and goods. Italy has a very large number of vehicles per capita (598 per thousand inhabitants in 2007, compared with an EU average of 464) but comparatively low fuel consumption per vehicle (17.5 per cent less than the European average in 2007). Italy's fleet of industrial vehicles, by contrast, is relatively energy-inefficient and very large. Merchandise transport is overwhelmingly by road (86 per cent, against an EU average of 73 per cent), and the lorry fleet is older and uses less of its load capacity than in the other main European countries.

The prices of energy products

Italy's heavy reliance on oil and gas imports makes domestic energy prices dependent on world markets, and in particular on the price of crude oil, which has risen substantially over the past decade. As a consequence energy costs rose from 2.3 per cent of GDP in 2000-04 to 3.1 per cent in 2005-09. They peaked at 3.8 per cent in 2008, when oil went as high as $140 a barrel, before falling to 2.8 per cent in 2009.

The average level of energy prices to final users tends to be higher than in other European countries. According to our estimates, between January 2008 and June 2009, Italian firms paid about the same price for natural gas as their European competitors, but much more (31 per cent) for electricity. Households, by comparison, paid 16 per cent more for natural gas and 27 per cent more for electricity. Based on consumption in 2008, the average difference between Italian and European prices corresponds to an extra cost of €5.6 billion for industrial firms (0.51 per cent of the average value of industrial output) and €4.4 billion for households (0.47 per cent of total consumer spending).

These price differentials depend on the structure of energy supply, the degree of competition, the adequacy of infrastructure and the level of taxation. Given the predominance of natural gas in power generation, costs in this sector are largely determined by the variable component of fuel prices. Fuel accounts for 70 per cent of the total operating costs of gas-fired generating plants, against 28 per cent for coal-fired plants and 16 per cent for nuclear reactors. As a result, trends in electricity production costs are affected by the price of natural gas, which is generally purchased under long-term contracts indexed to the price of oil and has gone up particularly rapidly in the last decade.

The markets in petroleum products are competitive, but those in gas and electricity are conditioned by transport networks, which in some phases of the product chain constitute a natural monopoly. In the mid-1990s the European Community began a process of liberalization of potentially contestable activities (the purchase and sale of gas and electricity) and regulation of the others (network distribution).

The number of electricity producers in Italy has increased, and installed generating capacity expanded by more than 21 per cent between 2003 and 2009, thanks in part to incentives for the exploitation of renewable sources. The price of electricity, set at national level on the basis of an average of prices in different zones determined by trading on the electricity exchange, nevertheless suffers from a structural shortage of supply in some parts of the country, such as the South, owing to insufficient network interconnectivity.

The possibility of switching to the competitive market, introduced in 2003 for gas and 2007 for electricity, has been exploited by only a limited number of users. According to the third survey of the electricity and gas market, more than one fifth of Italian households are unaware of the liberalization of the markets and about half are uninformed about the offers available.

Taxation is higher than in most other EU countries. In 2007 energy taxes amounted to around €32 billion, equivalent to €170 per TOE. This was one of the highest figures in Europe, 42 per cent above the EU average of €121. Energy taxation serves both the need to generate revenue (in 2007 these taxes accounted for nearly 5 per cent of total tax and contribution revenue) and the need to send a price signal that can curb energy consumption. High taxation may have helped to moderate the energy intensity of the Italian economy. Energy taxation is also an environmental policy tool for correcting the negative externalities of energy use.

Energy policies to curb greenhouse gas emissions

The fourth report of the UN Intergovernmental Panel on Climate Change calculates that since the start of the twentieth century greenhouse gas emissions in connection with the production and consumption of energy have accounted for 0.7 degrees Celsius of the increase in the temperature of the Earth's surface. The International Energy Agency projects that in the next twenty years emissions will bring the concentration of greenhouse gases to a level consistent with a temperature increase of more than 6 degrees.

The European Union's Emissions Trading System (EU ETS), launched in 2005, puts a cap on the total emissions of some 12,000 energy-intensive plants in the energy production and manufacturing sectors. The participants in the System are given an initial endowment of emissions permits, which they can then buy or sell on a regulated exchange, depending on whether their current emissions are over or under the cap. By ratifying the Kyoto Treaty (with Law 120/2002), Italy is committed to lowering its average greenhouse gas emissions in 2008-12 by 6.5 per cent compared to 1990. Under its EU commitments, by 2020 the emissions of the most energy-intensive sectors (those subject to the ETS caps) have to be cut by 21 per cent compared with 2005, those of other sectors by 13 per cent.

By international standards Italy has a low level of CO_2 emissions per unit of output (370 grams per dollar of GDP at 2000 prices, compared with an EU average of 400 grams and an OECD average of 430 grams). But emissions have risen steadily in recent years and in 2008 were 4.7 per cent higher than in 1990. They are estimated to have declined by 9 per cent in 2009, owing to the recession-induced contraction in energy use. To achieve the Kyoto targets, Italian emissions will have to fall in 2010-12 by a further 6 per cent on average from the 2009 level.

To meet these targets, Italy will need measures to increase the energy efficiency of final uses and to reduce greenhouse gas emissions in the energy sector itself. As for final users, firms will have to adapt their plant and households will need to tailor their durable goods purchases to energy saving (for instance, to improve the energy efficiency of buildings). Measures to improve energy efficiency have the advantage that they eventually pay for themselves, at least in part, out of the savings from reduced consumption.

The cost of cutting down emissions in power generation varies with the technology used (nuclear power, coal-burning plants with carbon capture and storage, renewable sources). The costs of adapting production structures will be borne by the producers themselves. The climate and energy package places special emphasis on the development of renewable sources. Italy has undertaken to expand their share to 17 per cent of gross final energy uses by 2020, from 5.2 per cent in 2005. An intermediate objective is to increase the amount of electricity from renewable sources to 22.55 per cent of consumption in 2010 (from 15.1 per cent in 2005). Thanks in part to the steep decline in total consumption owing to the recession, this objective appears to have been nearly attained in 2009 (21.2 per cent, according to provisional data from the grid operator Terna).

Gross electricity production from renewable sources increased by 13 per cent in 2009, with very sharp gains in photovoltaic (289 per cent) and wind power (25 per cent). However, the lion's share is still accounted for by hydroelectric (16.4 per cent of total electricity generation), far ahead of production from biomass and urban waste (2.7 per cent), wind (2.1 per cent), geothermal (1.8 per cent), and photovoltaic (0.3 per cent). The addition of installed capacity from renewable sources has been fostered by a series of incentives considered to be among the most advantageous in Europe. These incentives have been necessary so far because the cost of generation from renewable sources is higher than that from conventional ones. The need for incentives will diminish as these technologies mature, as fossil fuel prices rise, and as the cost of reducing greenhouse gas emissions is counted as a production cost.

In the medium term the resumption of generation by nuclear power plants should make some contribution to curbing CO_2 emissions. Italy had renounced nuclear power after a popular referendum in 1987. Law 99/2009 sets out a new energy strategy in which nuclear power should cover 25 per cent of electricity demand by 2020 (estimated on the basis of installed capacity of 13 gigawatts and annual production of about 100 TWh).

Containing emissions should also attenuate Italy's external energy dependency and, given the long-term projections of oil prices, the costs of energy procurement. Emission curbs should also encourage the development of renewable sources. About 70 per cent of Italian investment in renewable energy consists in imports of technology and equipment. While Italy can boast a significant presence in such traditional renewable energy technologies as hydroelectric, biomass and geothermal power, most of the components for wind and solar power generation are produced abroad. A positive impact in terms of job creation could come not only from the development of domestic production in these sectors but also from the upgrading of buildings for energy efficiency, which the National Action Plan for energy efficiency sees as one of the areas with the greatest potential for energy savings. The measures' effectiveness can be enhanced by an overall action plan, as the IEA's latest policy review recommends. Italy's National Energy Strategy, envisaged by Law 133/2008, represents an instrument for setting medium and long-term energy objectives and establishing a framework for the coordination of energy plans and initiatives at local and national level.

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

After deteriorating sharply in 2008, the deficit on Italy's external current account edged down from €56.8 billion to €49.4 billion and from 3.6 to 3.2 per cent of GDP (Table 12.1). Most of the improvement came from *fob-fob* trade, which swung back slightly in surplus thanks to the large reduction in the energy deficit, which more than offset the decline in the surplus on manufactures. By contrast, the deficit on services increased: the global recession had an evident impact on *Travel*, the only item of the current account always in surplus, which reflected the steep fall in spending by foreigners in Italy, set against a moderate decrease in that by Italians abroad. The reduction in interest rates and the decline in the net external debtor position helped to contain the deficit on income. Smaller net contributions to the European Union, included in current transfers, were reflected in the improvement in the balance on current account.

Table 12.1

Balance of payments
(billions of euros)

	2005	2006	2007	2008	2009
Current account	**-23.6**	**-38.3**	**-37.7**	**-56.8**	**-49.4**
Goods	0.5	-10.2	3.2	-2.1	1.7
Non-energy products (1)	*37.5*	*37.5*	*47.9*	*55.3*	*42.1*
Energy products (1)	*-36.9*	*-47.7*	*-44.6*	*-57.5*	*-40.3*
Services	-0.5	-1.3	-7.1	-9.6	-11.1
Income (2)	-13.6	-13.6	-19.6	-29.4	-26.7
Transfers	-10.0	-13.3	-14.2	-15.7	-13.3
of which: EU institutions	*-8.2*	*-8.1*	*-8.4*	*-9.9*	*-7.0*
Capital account	**1.3**	**1.8**	**2.3**	**0.8**	**0.6**
Intangible assets	0.1	-0.1	-0.1	..	-0.1
Transfers	1.3	1.9	2.3	0.8	0.7
of which: EU institutions	*3.7*	*3.8*	*3.3*	*2.2*	*1.6*
Financial account	**20.9**	**25.4**	**26.2**	**49.6**	**17.1**
Direct investment	-17.6	-2.3	-37.0	-18.3	-9.6
Outward	*-33.6*	*-33.5*	*-66.3*	*-29.9*	*-31.6*
Inward	*16.1*	*31.3*	*29.4*	*11.6*	*22.0*
Portfolio investment	43.4	44.3	18.1	118.5	24.9
Equities	-16.0	-8.8	-0.3	70.4	3.5
Debt securities	59.3	53.1	18.4	48.1	21.3
Financial derivatives	2.3	-0.4	0.4	6.8	11.1
Other investment	-8.1	-16.7	46.2	-51.8	-9.3
of which: monetary financial institutions (3)	*27.0*	*44.0*	*83.0*	*-18.5*	*-2.4*
Change in official reserves (4)	0.8	0.4	-1.5	-5.6	0.1
Errors and omissions	**1.4**	**11.1**	**9.2**	**6.4**	**31.6**

(1) Based on Istat foreign trade data. – (2) Since January 2009 portfolio investment income is calculated with a different method; at present the data are not comparable with the figures for previous years.– (3) Excluding the Bank of Italy. – (4) A minus sign indicates an increase in the reserves.

Both inward and outward direct investment flows recovered to some extent; the net outflow amounted to €9.6 billion, compared with €18.3 billion in 2008. Net portfolio investment inflows, which had been exceptionally large in 2008 (€118.5 billion) owing to massive disposals of foreign equities at the height of the crisis, amounted to €24.9 billion and reflected non-residents' substantial purchases of Italian government securities, which outweighed Italian investment in foreign shares and bonds. The item *Other investment*, consisting mainly of deposits and loans, recorded net outflows of €9.3 billion, compared with €51.8 billion in 2008.

Balancing an overall deficit of €48.7 billion on the current and capital accounts and net outflows of €17.1 billion on the financial account, errors and omissions amounted to €31.6 billion.

The system of gathering and compiling the statistics of the Italian balance of payments is undergoing radical change in view of the discontinuance of information inputs from bank reports, which are especially important for services and for a good part of the financial account. The new system is based mainly on sample surveys of firms and administrative data, as well as "security-by-security" data provided by depositary banks. Assets and liabilities vis-à-vis non-residents were revised in 2009 to take account of the new data on portfolio investment. In 2010 the statistics will be revised to incorporate the new information on direct investment, services and other investment. The large amount entered under errors and omissions in 2009 reflects recording problems that typically arise during a transition. Significant revisions are possible until the new system is fully phased in.

Italy's net external debtor position decreased last year from 21.5 to 19.3 per cent of GDP simply as a consequence of valuation adjustments.

The current and capital accounts

Merchandise trade. – The *fob-fob* merchandise trade balance showed a small surplus, after being in deficit in 2008. Exports fell by 20.9 per cent as a result of the decline in world demand through June. Imports recorded a contraction of similar size, due in no small part to the drop in exports. After five consecutive years of growth, the surplus on goods excluding refined petroleum products decreased sharply. The energy deficit shrank, benefiting from the fall in oil prices and, to a lesser extent, from the fall in the volume of imports of energy products due to the decline in productive activity.

The improvement in the *fob-fob* trade balance reflected that vis-à-vis non-EU countries, which went from a deficit of €12.3 billion to a surplus of €3.2 billion. This more than offset the increase from €1.4 billion to €10.2 billion in the deficit with EU countries, harder hit by the recession.

The deficit towards the euro-area countries nearly doubled, rising from €4.6 billion to €8 billion, owing to the steeper fall in exports than imports. The surplus with Spain shrank for the second successive year, basically owing to the abrupt drop in exports of refined petroleum products and of machinery and equipment. The surplus with France also diminished, reflecting the decline in the surplus on machinery and equipment. Italy's smaller demand for capital and intermediate goods, particularly for transport equipment, machinery and equipment, and chemical products, reduced the deficit with Germany.

The large improvement in the balance with non-EU countries, which returned to surplus after five years, came primarily from trade with the OPEC countries, which accounted for about 7.3 per cent of total Italian merchandise trade in 2009. The deficit with these countries decreased considerably thanks to the fall in oil prices from the peaks reached in the first half of 2008, only marginally offset by the depreciation of the euro. The reduction in Italian demand for intermediate and capital goods was also reflected in the 17.2 per cent fall in imports from China, Italy's third-ranking supplier after Germany and France. By contrast, Italian exports to China, led by sales of machinery and equipment, rose by 3.4 per cent, thus helping to shrink the bilateral deficit. There was a further decline in the surplus with the United States, with which Italy conducted about 4.5 per cent of its foreign trade in 2009: the fall in exports, particularly of such traditional Italian goods as textiles, clothing, footwear and furniture and in the machinery and equipment sector, was much more pronounced than that in imports, despite the appreciation of the dollar during the year as a whole.

Turning to developments by product sector, the reduction in the surplus on non-energy manufactures was due principally to the contraction in those on machinery and equipment and traditional Italian goods. In both cases, the reduction in exports was greater than that in imports. On the other hand, there was an improvement in the balance of trade in basic metals and metal products, in surplus only since 2008: the fall in imports in the sector, of which some 40 per cent consists of intra-industry inputs, was far larger than that in exports, owing to the drop in both the volume of imports and the corresponding average unit values. The incentives for motor vehicle purchases, introduced in Italy as in the other major European countries, contributed to the small increase in the deficit on trade in transport equipment following three years of contraction.

Services. – The deficit on services, a fixture for most of the last decade, increased again, rising to €11.1 billion as a result of the further reduction in the surplus on travel and the widening of the deficit on *Other business services*. The international crisis had a greater impact on foreigners' spending in Italy than on Italians' spending abroad. By contrast, the first few months of 2010 have seen a slight upturn in the former and a further decline in the latter. In 2009 there was a larger decline in non-residents' work-related expenditure, which is more sensitive to the economic cycle, than in their expenditure for personal motives (8.8 and 6.7 per cent respectively). Spending in Italy by EU visitors, who make up nearly two thirds of the total, diminished by 9.5 per cent. The reduction in spending by visitors from non-EU countries was smaller (2.9 per cent), thanks to the growth in tourist inflows from non-EU European countries and Asia.

Italians' spending abroad for personal motives was unchanged, while their spending abroad on business trips decreased. The reduction in expenditure abroad was steeper in non-EU countries than in EU countries, where the decline recorded for Spain, Germany and the most recent EU members was partly offset by increases in Austria and the United Kingdom.

The deficit under *Other business services* (merchanting, other trade-related services and professional services) increased as exports fell more rapidly than imports.

The large decline in credits and debits for transport services reflected the sharp contraction in both goods trade and freight rates. According to the Bank of Italy's annual survey of international goods transport, freight rates fell by an average of about 15 per cent in 2009. After two years of worsening, the deficit contracted by €1.1 billion. However, there was a larger deficit on passenger traffic by air, the main means of arrival in and departure from Italy. Inflows fell for the second year in a row and more steeply, by nearly 40 per cent, while outflows were about the same. Italian airlines' market share shrank from 21 to 15 per cent; in 2006 it had been 28 per cent.

Income. – The deficit on income, largely due to investment income, edged down from €29.4 billion to €26.7 billion after rising markedly in the two previous years. The improvement came from income on *Other investment*, mainly loans and deposits, for which the deficit declined as a result of the fall in interest rates and the net external liabilities of resident banks engaged in reducing their leverage. The balance on income from direct investment recorded a modest surplus of €3.3 billion, the same as in 2008. That on income from portfolio investment showed a deficit of €22.9 billion: alongside the structural deficit on income from debt instruments, flows of income from equity securities and investment fund units were broadly in balance.

Transfers. – The deficit recorded under current transfers fell from €15.7 billion to €13.3 billion, reflecting the contraction from €9.9 billion to €7 billion in that vis-à-vis the Community institutions. After a decade of rapid expansion, the growth in the deficit on workers' remittances stabilized (€6.5 billion in 2009, against €6.2 billion in 2008).

Investment

Direct investment. – Global flows of direct investment fell drastically again in 2009. The contraction of over 40 per cent mainly involved the advanced economies. Italy, whose average flows are small relative to the size of its economy, did not contribute to the reduction. Foreign direct investment in Italy rose from €11.6 billion in 2008 to €22 billion, while Italian investment abroad increased slightly to €31.6 billion.

Portfolio investment and derivatives. – The precipitation of the financial crisis in 2008 set off a "flight to quality", boosting investors' demand for the government securities of the major countries, including Italy, and leading to the repatriation of capital invested abroad in riskier assets, particularly shares. These factors led to an exceptionally large capital inflow of €118.5 billion in 2008. In 2009 the inflow was smaller (€24.9 billion). The improvement in the economic outlook in the second half of the year and the stabilization of the international financial markets modified investors' preferences, prompting Italians to make net purchases of €11.3 billion of foreign equities and investment funds, against net disposals of €90 billion in 2008. There were also net purchases of Italian securities by non-residents. These amounted to €14.8 billion, offsetting net disposals of €19.6 billion in 2008.

Foreign investment in Italian debt securities diminished. Purchases of government securities were broadly unchanged, while disposals of debt securities issued by the banking sector increased appreciably. From the summer of 2007 onwards non-residents had progressively reduced their purchases of securities issued by Italian banks, which fell to €8.3 billion in 2008, from an average of €34.3 billion in the previous three years. In 2009 non-residents made net disposals of bank bonds amounting to €10.6 billion; this tendency gained pace in the first few months of 2010.

Other investment. – Other investment relating to the non-bank sector registered a net outflow of €6.9 billion, compared with €33.3 billion in 2008. In the fourth quarter this item of the balance of payments included some €35 billion deriving from sales of foreign assets reported under Law 102/2009 (the foreign assets disclosure scheme). The inflows of capital under the scheme come largely from *Deposit accounts* (€33.7 billion) and caused a reduction in the external assets of the non-bank sector. Of the total of €95 billion disclosed up to the end of 2009, the amount included under *Other investment* refers to the foreign assets that were liquidated; the remaining €60 billion of foreign assets, disclosed but not sold, are not subject to entry in the balance of payments.

For the banking sector, there were net outflows of €2.4 billion in respect of an appreciably smaller volume of foreign lending (€38.9 billion) and fund-raising (€41.3 billion).

The net international investment position

Italy's year-end net external debt decreased from €336.5 billion in 2008 to €294.4 billion, or 19.3 per cent of GDP, in 2009 (Table 12.2). Valuation adjustments, due mainly to the accounting treatment of funds covered by the foreign assets disclosure scheme for flows and stocks, more than offset the increase of €17.1 billion in net borrowing recorded in the financial account.

The foreign assets disclosure scheme will determine adjustments in the net international investment position when the data for 2010 are complete as a consequence of the emergence of previously unreported holdings of foreign assets dating from before 31 December 2008. If the amounts now known were included in the data for end-2008 and end-2009, the position would improve by respectively 6.1 and 4 percentage points of GDP. The currently published data on Italy's net international investment position do not take these amounts into account. Foreign assets disclosed under the scheme through the end of April 2010 will be included in the data revision to take place in October 2010.

There were significant valuation adjustments in the components of portfolio investment, but of a similar size for assets and liabilities. Overall, the effect of exchange rate variations was marginal for the components of the net external position.

The Bank of Italy's net external creditor position improved from €131.6 billion to €191 billion in 2009, thanks largely to the increase in net assets within the Eurosystem. The official reserves rose from to €75.6 billion to €92.2 billion. The gold reserves grew by €11.4 billion as a result of the rise in the euro price of gold, reaching €60.4 billion at the end of the year.

Table 12.2

Net international investment position
(billions of euros)

	Stocks at end-2008 (1)	January-December 2009					Stocks at end-2009 (1)
		Flows (2)	Value adjustments			Change in stocks	
			Total	Exchange rate	Other (3)		
	(a)	(b)	(c)=(d)+(e)	(d)	(e)	(f)=(b)+(c)	(a)+(f)
				Resident non-banks			
Assets	1.242.8	28.0	84.4	1.6	82.9	112.5	1.355.3
Direct investment	304.8	27.6	4.4	1.7	2.7	32.1	336.8
Portfolio investment	572.4	27.0	45.5	..	45.5	72.4	644.8
of which: equities	*210.7*	*11.4*	*30.3*	*0.4*	*29.9*	*41.7*	*252.4*
Other investment	351.4	-22.1	34.5	-0.2	34.7	12.5	363.9
Derivatives	14.2	-4.5	..	..	..	-4.5	9.7
Liabilities	1.382.1	92.2	44.2	-1.1	45.2	136.3	1.518.4
Direct investment	237.8	20.7	5.7	..	5.7	26.4	264.2
Portfolio investment	950.6	66.5	38.7	-0.8	39.5	105.1	1.055.7
of which: equities	*96.1*	*9.5*	*13.5*	*..*	*13.5*	*22.9*	*119.0*
Other investment	154.9	4.2	-0.2	-0.2	..	4.0	158.9
Derivatives	38.7	0.9	..	..	..	0.9	39.6
Net position	**-139.2**	**-64.1**	**40.3**	**2.6**	**37.7**	**-23.8**	**-163.1**
				Resident banks			
Assets	477.9	-40.0	-6.0	-0.7	-5.3	-46.0	431.9
Liabilities	806.7	-44.2	-8.4	-0.7	-7.7	-52.6	754.1
Net position	**-328.8**	**4.2**	**2.5**	**..**	**2.5**	**6.6**	**-322.2**
				Central bank			
Assets	131.8	42.9	16.6	-0.5	17.1	59.5	191.3
Liabilities	0.2	0.1	..	..	..	0.1	0.3
Net position	**131.6**	**42.8**	**16.6**	**-0.5**	**17.1**	**59.4**	**191.0**
Total net position	**-336.5**	**-17.2**	**59.4**	**2.1**	**57.2**	**42.2**	**-294.3**

(1) At end-of-period prices and exchange rates. – (2) At the prices and exchange rates obtaining on the transaction date. – (3) Other adjustments include a correction that temporarily eliminates the effects of the capital inflows under the foreign assets disclosure scheme on the external position of the non-bank sector.

Italy's net international investment position is undergoing revision in connection with the changeover to the new system of gathering statistics. The stocks of portfolio investment were revised in 2009. Application of the new methodology established by the European Central Bank (ECB Guidelines of 16 July 2004 and 31 May 2007) has determined very significant changes to the previously published data: net external liabilities at the end of 2008 rose from 12.5 to 21.5 per cent of GDP. The financial accounts statistics have been revised accordingly.

13. THE PUBLIC FINANCES

The contraction in economic activity in 2009 was reflected in a sharp deterioration in Italy's public finances, although less pronounced than those of the other main advanced economies. The general government deficit rose from 2.7 per cent of GDP in 2008 to 5.3 per cent. Primary expenditure recorded rapid growth; revenue contracted less than GDP, thanks in part to one-off receipts. The ratio of debt to GDP rose by nearly 10 percentage points to 115.8 per cent.

With the three-year budgetary adjustment plan approved in the summer of 2008 the Government set itself the objective of reducing net borrowing to 2 per cent of GDP in 2009 and bringing the budget basically into balance in the medium term. The budgetary priorities changed in the autumn of 2008 as a consequence of the worsening of the financial crisis and the outlook for the economy, but the need to avoid prejudicing the public finances continued to be of primary importance.

Between November 2008 and June 2009 three budgetary packages were approved with the aim of limiting the immediate social costs of the crisis and sustaining aggregate demand. For the most part the measures were temporary and were financed by reductions in expenditure and increases in revenue. In August the mid-year budget revision increased the funds available for payments by the central government.

Overall, the support measures are estimated to have increased both expenditure and revenue by about 0.5 per cent of GDP, without materially affecting the deficit for the year, and to have attenuated the contraction in GDP by about half a percentage point.

In order not to aggravate the uncertain outlook for economic recovery, the Government did not foresee additional budgetary adjustment measures for 2010 with respect to what had already been provided for in the three-year budgetary adjustment plan approved in 2008. According to the estimates published in the Combined Report on the Economy and the Public Finances, the public debt will rise to 118.4 per cent of GDP in 2010, while net borrowing will fall to 5 per cent. According to the European Commission, the deficit will remain unchanged at 5.3 per cent.

In the early months of this year the general government borrowing requirement has been smaller than in 2009; in the coming months the difference will tend to disappear as the revenue from one-off taxes winds down.

As part of the excessive deficit procedure the Council of the European Union has asked Italy to bring its deficit below 3 per cent of GDP by 2012, an objective that is in line with the Government's deficit-reduction plan.

On 25 May the Council of Ministers brought forward the budget session and approved a series of adjustment measures to achieve the net borrowing objectives established for 2011 and 2012. According to the official estimates, the adjustment, based mainly on expenditure reductions and the fight against tax evasion, will amount to €24 billion in 2012.

A determined effort will be necessary in implementing the adjustment measures, together with careful monitoring of the public finances in order to correct without delay any divergence from the targets set. Budgetary consolidation will have to continue after 2012, so as to put the debt on a rapidly declining path.

THE PUBLIC FINANCES IN 2009

Budgetary policy for 2009

The three-year budgetary adjustment plan approved in the summer of 2008 had a restrictive stance. In response to the progressive worsening of the economic outlook, between November 2008 and June 2009 the Government adopted three packages with a zero impact on net borrowing aimed at supporting low-income households, strengthening unemployment benefits and wage supplementation schemes, granting tax relief to firms that invested in machinery and encouraging purchases of certain types of durable goods. This was followed in August by the mid-year budget revision, which sought to speed up payments to central government suppliers. The net borrowing forecast for 2009 made in the summer of 2008 was progressively increased by a total of 3.3 percentage points of GDP to 5.3 per cent in the Economic and Financial Planning Document published in July 2009, a figure confirmed by the outturn for the year. Over the same period the forecast growth in GDP was revised downwards by about 6 percentage points.

Objectives and forecasts. – The June 2008 Economic and Financial Planning Document set a target of 2 per cent of GDP for net borrowing in 2009, with a forecast of just under 1 per cent for GDP growth (Table 13.1), and a close-to-balance budget in 2011. Achievement of the objectives was entrusted to the measures contained in the three-year budgetary adjustment plan approved at the same time as the Planning Document (see the box "The budget for the years 2009-2011", *Economic Bulletin*, No. 50, October 2008).

In the Forecasting and Planning Report published in September 2008, the Government lowered the forecast GDP growth rate from 0.9 to 0.5 per cent, while leaving the objective for net borrowing in 2009 basically unchanged.

The first package of anti-crisis measures (Decree Law 185/2008) included income support for households, reductions in the taxation of firms and increased expenditure on capital account, officially estimated to amount to 0.4 percentage points of GDP in 2009, 0.2 points in 2010 and 0.3 points in 2011. The measures were financed by a tax on the voluntary revaluation of corporate fixed assets, the receipts from increased tax assessment and collection activity and the use of resources of the Fund for underutilized areas (see the box "The anti-crisis decree", *Economic Bulletin*, No. 51, January 2009). Accordingly, it was estimated that the measures would not affect net borrowing.

In December 2008 Parliament approved the Finance Law for 2009. It supplemented the budgetary adjustment for the years 2009-11 drawn up during the summer and left the planned balances unchanged.

Table 13.1

Public finance objectives, estimates and outturn for the year 2009
(billions of euros and percentages of GDP)

	Net borrowing	Primary surplus	Interest payments	Debt	*Memorandum items*		
					Real GDP growth rate (%)	Nominal GDP	Estimate of 2008 net borrowing
Objectives							
Economic and Financial Planning Document (June 2008)	32.7	50.1	82.8	….		1,637.2	39.1
as a percentage of GDP	*2.0*	*3.1*	*5.1*	*102.7*	*0.9*		*2.5*
Forecasting and Planning Report and Economic and Financial Planning Document update (September 2008)	34.1	49.7	83.7	….		1,640.2	39.7
as a percentage of GDP	*2.1*	*3.0*	*5.1*	*102.9*	*0.5*		*2.5*
Estimates released in 2009							
Stability Programme and Information Note 2009-2011 (February 2009)	57.7	20.2	77.9	….		1,563.4	40.8
as a percentage of GDP	*3.7*	*1.3*	*5.0*	*110.5*	*-2.0*		*2.6*
Combined Report on the Economy and the Public Finances (April 2009)	71.0	5.5	76.4	….		1,528.9	43.0
as a percentage of GDP	*4.6*	*0.4*	*5.0*	*114.3*	*-4.2*		*2.7*
Economic and Financial Planning Document (July 2009)	81.3	-5.6	75.7	….		1,521.3	43.0
as a percentage of GDP	*5.3*	*-0.4*	*5.0*	*115.3*	*-5.2*		*2.7*
Forecasting and Planning Report and Economic and Financial Planning Document update (September 2009)	80.9	-6.9	74.0	….		1,530.9	43.0
as a percentage of GDP	*5.3*	*-0.5*	*4.8*	*115.1*	*-4.8*		*2.7*
Stability Programme and Updating Note 2010-2012 (January 2010)	80.5	-7.4	73.1	….		1,533.2	43.0
as a percentage of GDP	*5.3*	*-0.5*	*4.8*	*115.1*	*-4.8*		*2.7*
Outturn (1)	**80.8**	**-9.5**	**71.3**	**1,761.2**		**1,520.9**	**42.6**
as a percentage of GDP	*5.3*	*-0.6*	*4.7*	*115.8*	*-5.0*		*2.7*

(1) Sources: Istat; for the debt, Bank of Italy.

In the Stability Programme update published in February 2009 the Government worsened its forecasts sharply. According to the new estimates, GDP would contract by 2 per cent (instead of growing by 0.5 per cent) and the deficit would increase to 3.7 per cent of GDP. The second anti-crisis package (Decree Law 5/2009) was passed in the same month and was also expected to have a neutral impact on the budgetary balance. It introduced incentives for the consumption of durable goods (especially cars) and further tax relief for firms. The financing of the measures was to come almost entirely from the increase in revenue from VAT and other taxes consequent on the expected growth in purchases of goods eligible for incentives (see the box “February’s anti-crisis decree”, *Economic Bulletin*, No. 52, April 2009).

In addition, an agreement was signed between the state and the regions to strengthen unemployment benefits and wage supplementation schemes by providing for about €8 billion of expenditure in 2009-10 (of which €2.7 billion to be financed with regional resources – the European Social Fund – and the remainder by drawing on the Fund for underutilized areas).

In April the Combined Report on the Economy and the Public Finances raised the forecast for net borrowing to 4.6 per cent of GDP. The upward revision reflected the further deterioration in the economic outlook (GDP was estimated to contract by 4.2 per cent) and, to a lesser extent, the outturn of the deficit for 2008 (2.7 per cent of GDP, against 2.6 per cent indicated in the Stability Programme).

At the end of June the Government approved a third anti-crisis package (Decree Law 78/2009). In addition to further measures strengthening unemployment benefits and wage supplementation schemes, firms were allowed to deduct 50 per cent of their investments in machinery and equipment in the following twelve months from their corporate income tax base (see the box "Recent public finance measures", *Economic Bulletin*, Nos. 53 and 54, July and October 2009). The decree law itself provided for the financing of the increases in expenditure and tax relief, estimated to amount to 0.3 per cent of GDP in each of the three years 2009-11. In 2009 the financing was to come mainly from expenditure savings, while in 2010 and 2011 it was to come primarily from increased revenue (deriving principally from measures to counter tax evasion and strengthen collection, provisions concerning gaming and restrictions on the use of tax credits to offset liabilities). In addition, the decree law provided for a one-off tax in connection with a new foreign assets disclosure scheme. The tax was to be paid at the end of 2009 but for prudential reasons the yield was not quantified and therefore was not included in the financing of the decree law (the tax actually brought in about €5 billion). Expenditure savings were obtained as a result of smaller allocations for the re-inclusion in the accounts of expiring expenditure carryovers.

In view of the performance of revenue during the year and an even more pessimistic economic outlook (with GDP expected to contract by 5.2 per cent), the Government's July Economic and Financial Planning Document revised the estimate for net borrowing in 2009 upwards to 5.3 per cent of GDP; the primary deficit was expected to be 0.4 per cent of GDP. The estimates took account of the larger appropriations introduced by the mid-year budget revision, which were officially forecast to increase net borrowing by 0.3 percentage points of GDP.

In October the European Commission launched an excessive deficit procedure against Italy, judging the expected overshoot of net borrowing with respect to the threshold of 3 per cent of GDP to be neither of limited size nor of a temporary nature.

In November the Government used the receipts expected from the foreign assets disclosure scheme to finance a reduction, estimated at €3.7 billion, in the personal income tax payment on account due at the end of 2009 (Decree Law 168/2009). In the Stability Programme published in January of this year the Government confirmed the estimates made in the autumn.

The effects of the anti-crisis budgetary measures on the public finances in 2009. – Overall, the discretionary action taken from the end of 2008 onwards had a limited impact on the public finances in 2009: the net increases in expenditure and revenue produced by the measures were both of the order of 0.5 per cent of GDP. Some of the measures will result in less revenue in 2010 and the following years.

According to the official estimates, the three anti-crisis packages would increase expenditure and tax reliefs in 2009 by 0.8 per cent of GDP (Table 13.2), financed entirely by reductions in expenditure and increases in revenue. The available data

Table 13.2

Expected effects of the anti-crisis decrees on the general government consolidated accounts (1)
(millions of euros)

	2009	2010	2011
Expenditure			
Measures that increase expenditure	**8,884**	**5,049**	**4,131**
Current expenditure	**4,411**	**2,641**	**2,392**
Family bonus and other forms of support	2,829	208	212
Creation of Fund for health-sector interventions	0	800	800
Trenitalia service contracts	480	480	480
Top-up of the Fund for structural economic policy interventions	2	203	4
Other	1,100	950	896
Capital expenditure	**4,473**	**2,408**	**1,739**
Domestic Stability Pact	2,250	0	0
Motor vehicle incentives	1,063	0	0
Employment Fund and labour market interventions	439	534	304
State Railways investments and public works enabling law	60	640	1,220
Other	661	1,234	215
Measures that reduce expenditure	**-4,276**	**-3,147**	**-3,820**
Current expenditure	**-197**	**-1,143**	**-1,288**
Health expenditure	-50	-850	-850
Other	-147	-293	-438
Capital expenditure	**-4,079**	**-2,004**	**-2,532**
Saving of resources in respect of funds for the re-inclusion of expiring expenditure carryovers	-2,250	0	0
Fund for underutilized areas	-604	-941	-1,493
Investment and employment tax credit	-260	-230	-220
Incentive revocations	-311	-211	-215
Reduction of the Employment and Training Social Fund	-85	-230	0
Other	-569	-392	-604
NET CHANGE IN EXPENDITURE	**4,608**	**1,902**	**311**
Revenue			
Measures that increase revenue	**7,347**	**6,025**	**5,780**
Voluntary revaluation of corporate fixed assets	2,761	124	81
Increased tax assessment and collection activity	1,285	2,165	2,266
Car, motor cycle, furniture and electrical appliance incentives	697	0	0
Tax havens and action to counter international arbitrage	0	1,021	996
Regularization of workers and support for households	280	402	421
Restrictions on using VAT credits for offsetting	200	1,000	1,000
Provisions concerning gaming	500	300	0
Other	1,624	1,013	1,016
Measures that reduce revenue	**-2,698**	**-3,835**	**-5,170**
Tax and social security relief	-1,435	-952	-994
Tax relief for investment in machinery and equipment	0	-1,861	-2,406
Effects produced by the voluntary revaluation of corporate fixed assets	0	-463	-1,012
Tax relief for productivity related wages and salaries	-460	-128	0
Facilitations for firms	-10	-50	-190
Other	-793	-381	-568
NET CHANGE IN REVENUE	**4,649**	**2,190**	**610**
CHANGE IN NET BORROWING	**-41**	**-288**	**-299**

Source: Based on the official estimates made at the time the decrees were approved.
(1) Including the effects of Decree Law 185/2008 (ratified by Law 2/2009), Decree Law 5/2009 (ratified by Law 33/2009) and Decree Law 78/2009 (ratified by Law 102/2009).

indicate that the expenditure associated with the extraordinary family bonus was about 0.05 percentage points of GDP less than the Government had expected, that the receipts of the tax on the voluntary revaluation of corporate fixed assets considerably exceeded the forecast (by more than 0.2 points) and that revenue from the foreign assets disclosure scheme was nearly 0.1 points more than was needed to finance the reduction in the personal income tax payment on account due in November. If account is also taken of the official estimate of 0.3 points of GDP for the increase in expenditure deriving from the mid-year budget revision, the measures introduced from the end of 2008 onwards produced net increases in both expenditure and revenue of about 0.5 points. It should be noted, however, that there is considerable uncertainty about the effects of numerous measures and, in particular, about the impact of the budget revision and the actual achievement of the receipts associated with the fight against tax evasion and the increase in tax assessment and collection activity, which were supposed to finance part of the anti-crisis packages. Lastly, larger than expected outlays may have derived, albeit only temporarily, from the February 2009 agreement between the state and the regions.

Some of the measures in the anti-crisis decrees will worsen the budget deficit in the coming years. The most important in this respect are the tax on the voluntary revaluation of corporate fixed assets and the tax relief on firms' investments in machinery. The former brought receipts forward to 2009 that would have contributed larger amounts subsequently; the latter will result in less revenue in 2010 and 2011 because the relief can only be taken when paying the balance of the tax due for the period in which the investment was made. It is officially estimated that these measures will reduce revenue by about 0.2 percentage points of GDP in both 2010 and 2011.

The packages adopted to counter the crisis are estimated to have attenuated the fall in GDP by about 0.5 percentage points.

This estimate is based on a counterfactual simulation made using the Bank of Italy's quarterly econometric model. About 0.2 percentage points of the impact on GDP reflects the widespread recourse (0.5 percentage points of GDP) made in financing the anti-crisis decrees to one-off receipts (above all the tax on the voluntary revaluation of corporate fixed assets). Payment of this tax, since it is decided voluntarily by firms in order to obtain tax benefits in subsequent years, is likely to have had only a limited effect on their spending decisions. The incentives granted to the automobile industry and the tax relief for firms that invested in machinery are believed to have increased GDP in 2009 by about 0.3 percentage points. It should be noted, however, that the former will cause a corresponding contraction in GDP in 2010, while the positive impact of the latter is likely to have continued in the early months of 2010.

Net borrowing

In 2009 general government net borrowing amounted to 5.3 per cent of GDP, in line with the estimates published in the July 2009 Economic and Financial Planning Document (Table 13.3). The worsening with respect to 2008 was equal to 2.6 percentage points of GDP. The primary balance deteriorated by more than 3 points, swinging from a surplus of 2.5 per cent of GDP to a deficit of 0.6 per cent. This result reflects the sharp rise in primary expenditure and the fall in revenue.

Table 13.3

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

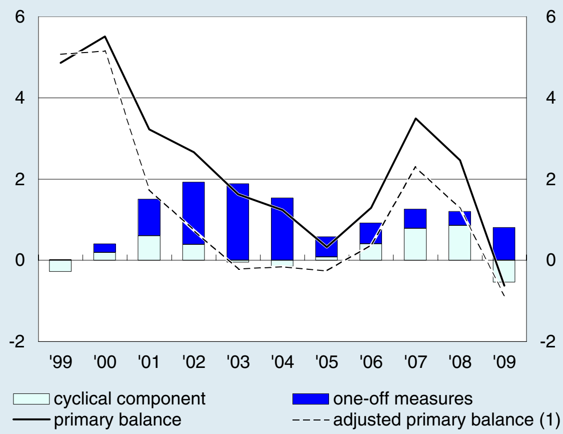
	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Revenue	45.4	45.0	44.5	45.1	44.5	44.2	45.8	46.9	46.7	47.2
Expenditure (2) (3)	47.4	48.1	47.4	48.6	48.0	48.5	49.2	48.4	49.4	52.5
of which: interest payments	*6.3*	*6.3*	*5.5*	*5.1*	*4.7*	*4.6*	*4.6*	*5.0*	*5.2*	*4.7*
Primary surplus	4.3	3.2	2.7	1.6	1.2	0.3	1.3	3.5	2.5	-0.6
Net borrowing	2.0	3.1	2.9	3.5	3.5	4.3	3.3	1.5	2.7	5.3
Borrowing requirement net of privatization receipts	3.5	5.0	3.1	4.2	4.2	5.3	4.0	1.9	3.1	5.7
Debt	109.2	108.8	105.7	104.4	103.8	105.8	106.5	103.5	106.1	115.8

Source: Istat 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) The figure for 2000 does not include the proceeds of the sale of UMTS licences, which were deducted from expenditure in the national accounts.

On the basis of the methodology adopted by the Bank of Italy, in 2009 the structural primary balance (cyclically adjusted and net of one-off measures) worsened by about 2 percentage points of GDP (Figure 13.1). This result reflects the faster growth in expenditure than in trend GDP and revenue losses not due to discretionary measures or the dynamics of the macroeconomic variables used to approximate the main tax bases.

Figure 13.1

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



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

The contribution of the economic cycle to the worsening of the budget balance was equal to about 1.4 percentage points of GDP in 2009. One-off measures produced an improvement equal to nearly half a point. The estimate of the impact of the economic cycle is smaller than that contained in the May 2010 Combined Report on the Economy and the Public Finances (2.7 points) above all because it takes account of the composition effects deriving from the unbalanced growth of the different components of GDP. In 2009 these effects were especially pronounced: in fact the components of GDP that most influence the public finances, household consumption and gross wages and salaries, fell less than GDP, the contraction in which was powerfully affected by the large decrease in exports, which are not directly subject to taxation.

Revenue and expenditure

Revenue. – General government revenue decreased for the first time in the last fifty years, falling by 1.9 per cent to €718.1 billion, whereas nominal GDP contracted by 3 per cent. Especially large falls were recorded by corporate taxes and VAT.

The ratio of tax and social security receipts to GDP rose by 0.3 percentage points to 43.2 per cent (Table 13.4). The ratios of direct and indirect taxes fell by 0.7 and 0.2 percentage points respectively. The fall of 7.1 per cent in direct taxes was accentuated by the one-off reduction in the size of the personal income tax payment on account; by contrast that of 4.2 per cent in indirect taxes was attenuated by the drying up of the effects of tax credits, which had reduced receipts of excise duties on methane in 2008, and the especially rapid growth in receipts from gaming. Actual social security contributions also contracted, by 0.5 per cent (€1.1 billion), in line with the fall of 0.6 per cent in earnings.

Table 13.4

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

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Direct taxes	14.4	14.7	13.9	13.4	13.3	13.3	14.4	15.1	15.3	14.6
Indirect taxes	14.7	14.2	14.3	14.0	14.0	14.2	14.8	14.7	13.8	13.6
Capital taxes	0.1	0.1	0.2	1.3	0.6	0.1	0.0	0.0	0.0	0.8
Tax revenue	**29.2**	**29.0**	**28.4**	**28.7**	**28.0**	**27.6**	**29.2**	**29.8**	**29.1**	**29.1**
Social security contributions	12.4	12.3	12.5	12.6	12.6	12.8	12.8	13.3	13.8	14.1
Tax revenue and social security contributions	**41.6**	**41.3**	**40.8**	**41.4**	**40.6**	**40.4**	**42.0**	**43.1**	**42.9**	**43.2**
Other current revenue	3.4	3.5	3.5	3.4	3.6	3.5	3.6	3.5	3.6	3.8
Other capital revenue	0.3	0.2	0.2	0.3	0.3	0.3	0.3	0.3	0.2	0.3
Total revenue	**45.4**	**45.0**	**44.5**	**45.1**	**44.5**	**44.2**	**45.8**	**46.9**	**46.7**	**47.2**

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

Capital tax revenue increased by 0.8 percentage points as a ratio to GDP. Receipts of the one-off tax on the voluntary revaluation of corporate fixed assets, introduced by the anti-crisis decree of November 2008, together with those deriving from the foreign assets disclosure scheme increased revenue by €11.6 billion.

In the analysis of the performance of individual taxes that follows, reference is made to the receipts entered in the state budget accounts on a cash basis. The main local taxes are considered in the section on local government.

Corporate income tax receipts decreased by 20.6 per cent (€9.8 billion); following the large fall recorded in 2008, they returned just below their level in 2006. More specifically, the balance of taxes due on the income of the previous year fell by 18 per cent (€2.2 billion), while the payments made on account decreased by 23.5 per cent (€8.1 billion). This result reflected the particularly poor performance of the economy, the effects of the reform of corporate income tax that entered into force in 2008 and the impact, amounting to about €1.1 billion, of the partial deductibility of Irap, introduced with the first anti-crisis decree.

Personal income tax decreased by 3 per cent (€4.8 billion). The part withheld on employee incomes and pensions remained basically unchanged, edging up by 0.3 per cent; the increases in unit earnings and pensions, coupled with the highly progressive nature of the tax, basically offset the effect of the reduction in employment. The part paid on a self-assessed basis fell the most, by 19.5 per cent (€5.2 billion); the bulk of the fall was due to the temporary contraction in revenue, officially estimated at nearly €4 billion, deriving from the reduction at the end of 2009 in the size of the personal income tax payment on account.

Revenue from the taxes on households' savings decreased by 7.3 per cent (€1 billion). In more detail, the revenue deriving from asset management fell by €0.5 billion and that deriving from dividends and capital gains by €0.3 billion and €0.2 billion respectively. The tax on interest payments remained unchanged: the large decrease in the bond component, by 20.9 per cent (€1.5 billion), which reflected the fall in the average rate of return in 2009, was offset by the increase in the bank deposit component, by 30 per cent (€1.5 billion), which follows changes in interest rates with a longer lag.

VAT on imports from non-EU countries contracted by 28.5 per cent (€4.4 billion), primarily owing to the fall in the demand for and the price of oil; receipts of domestic VAT declined by 4.2 per cent (€4.3 billion). Overall VAT revenue decreased by 7.4 per cent. Household consumption of goods and services (which constitutes the bulk of the VAT base) declined by 2 per cent. If consumption is weighted by the different tax rates in order to take account of the shift in favour of goods with a lower tax rate, the figure becomes 2.5 per cent.

Receipts from the excise tax on methane increased by 76.6 per cent (€1.9 billion); in 2008 they had fallen by half owing to the large volume of tax credits accumulated previously. Excluding accounting differences, other energy taxes remained basically unchanged. Receipts from lotto and lotteries increased by 13.4 per cent (€1.5 billion), partly as a consequence of the measures introduced by the anti-crisis decrees.

Expenditure. – In 2009 general government expenditure amounted to €798.9 billion. Primary expenditure increased by 4.9 per cent, from 44.2 to 47.8 per cent of GDP (Table 13.5).

Table 13.5

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

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Compensation of employees	10.4	10.5	10.6	10.8	10.8	11.0	11.0	10.6	10.8	11.3
Intermediate consumption	5.0	5.1	5.2	5.3	5.4	5.5	5.2	5.2	5.5	6.1
Market purchases of social benefits in kind	2.3	2.5	2.6	2.6	2.7	2.8	2.8	2.7	2.7	2.9
Social benefits in cash	16.4	16.2	16.5	16.8	16.9	17.0	17.0	17.1	17.7	19.2
Interest payments	6.3	6.3	5.5	5.1	4.7	4.6	4.6	5.0	5.2	4.7
Other current expenditure	3.1	3.2	3.3	3.6	3.6	3.6	3.6	3.7	3.8	4.1
Total current expenditure	**43.6**	**43.9**	**43.8**	**44.2**	**44.0**	**44.4**	**44.2**	**44.3**	**45.7**	**48.2**
of which: current expenditure net of interest payments	*37.3*	*37.6*	*38.3*	*39.1*	*39.3*	*39.8*	*39.5*	*39.3*	*40.5*	*43.5*
Gross fixed investment (2)	2.3	2.4	1.7	2.5	2.4	2.4	2.3	2.3	2.2	2.4
Other capital expenditure (3)	1.4	1.8	1.9	1.9	1.5	1.7	2.7	1.7	1.5	1.9
Total capital expenditure (2) (3)	**3.7**	**4.2**	**3.6**	**4.3**	**4.0**	**4.1**	**5.0**	**4.0**	**3.7**	**4.3**
Total expenditure (2) (3)	**47.4**	**48.1**	**47.4**	**48.6**	**48.0**	**48.5**	**49.2**	**48.4**	**49.4**	**52.5**
of which: expenditure net of interest payments (2) (3)	*41.0*	*41.8*	*41.9*	*43.4*	*43.3*	*43.9*	*44.6*	*43.4*	*44.2*	*47.8*

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

Expenditure on social benefits in cash increased by 5.1 per cent. The pension component increased by 4.3 per cent; as in previous years, the increase in the non-pension component was particularly large at 10.7 per cent (12.1 per cent in 2008).

The number of new pensions was affected by the tightening of the requirements to qualify for a seniority pension under Law 247/2007. From July 2009 onwards it became necessary for retirees to be at least 59 years old and for the sum of their age and contribution period to be not less than 95 years. The rise in the unit value of pensions mainly reflected the automatic increase of 3.5 per cent deriving from their indexation to prices.

Among the other social benefits in cash, there was a large increase in disbursements of wage supplementation (up threefold compared with 2008) and unemployment benefits. This reflects the economic cycle and the measures adopted by the Government during the year to broaden the scope of unemployment benefits and wage supplementation schemes. Non-pension expenditure on social welfare grew by almost 50 per cent, above all owing to the one-off cash transfer of about €1.5 billion to low-income families.

Compensation of employees rose by 1 per cent (3.6 per cent in 2008) to 11.3 per cent of GDP. This result was the net effect of the wage increases granted to almost all non-managerial staff for the 2008-09 contract (amounting to about 3.2 per cent on average over the two years), and the lapsing of the back payments made in 2008.

According to the aggregate data of the national accounts, in 1980 average gross earnings were 21 per cent higher in general government than in the private sector. In 1990 the gap had widened to 39 per cent; in 1995 it had narrowed to 22 per cent; in the early 2000s it began to widen again and in 2008 it had reached 33 per cent. Analyses based on survey data, which allow account to be taken of some differences between the composition of employment in the two sectors, confirm that the gap in favour of the public sector is considerable, although smaller than that found on the basis of national accounts data.

An econometric analysis based on the sample of the Bank of Italy's Survey on Household Income and Wealth found – with account taken of respondents' age, sex, educational qualifications, professional status and geographical location – a gap in favour of the public sector in 2008 that was equal on average to 17 per cent for women and 7 per cent for men, larger in the South (29 and 9 per cent) and for workers with an intermediate professional status (19 and 8 per cent). The gap narrows, and in some cases becomes negative, for managers and, more generally, as the earnings level rises. These estimates are correct only on the assumption that there are no other variables correlated with earnings that can lead workers to find employment in the public rather than the private sector. Controlling for motives other than money for choosing which sector to work in (such as responsibility, job security and the satisfaction deriving from being a public employee), the gap becomes much wider. The correction is especially large for persons with medium to high salaries.

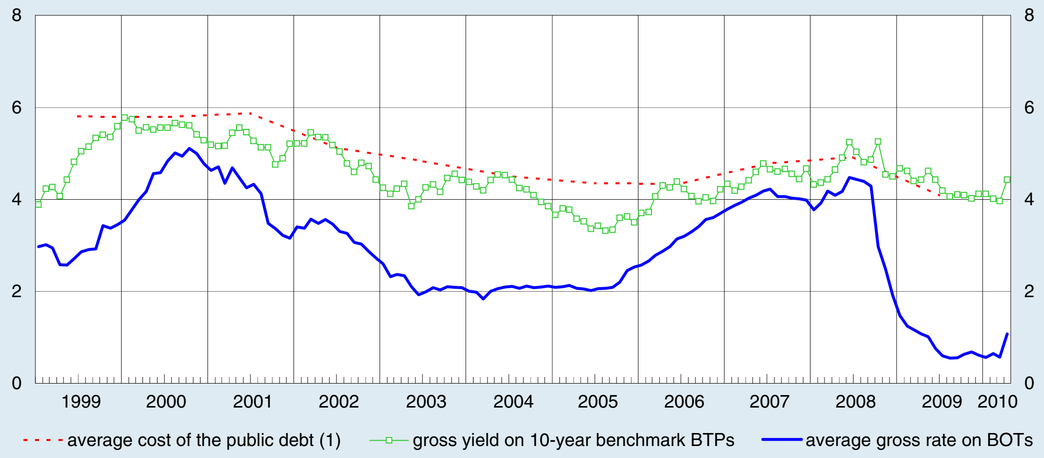
Expenditure on social benefits in kind grew by 4 per cent (2.2 per cent in 2008); that on intermediate consumption by 7.5 per cent (6.4 per cent in 2008), fuelled by the bunching of deliveries to the Ministry of Defence and the rapid growth in indirectly measured financial intermediation services. About 90 per cent of social benefits in kind and 30 per cent of intermediate consumption referred to current health expenditure.

Net of the proceeds of real estate disposals and the cost of repurchasing buildings unsold in the SCIP2 securitization programme (€0.9 billion), expenditure on investment grew by 3.5 per cent. In the four years 2005-08 it had fallen on average by 1.2 per cent per year in nominal terms, above all as a result of the contraction of the local government component.

The sharp 12.2 per cent decrease in interest payments was due to the fall in short-term interest rates, which more than offset the effect of the growth in the average stock of liabilities.

Figure 13.2

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



(1) The average cost of the debt is calculated as the ratio of interest payments to the average size of the debt during the year.

Local government

In 2009 there was a decrease in local government own revenue, especially the tax component. The fall was more than offset by the increase in state transfers. Current expenditure slowed, while the decline in capital expenditure was interrupted. The deficit amounted to 0.4 per cent of GDP, as against 0.3 per cent in 2008.

Local government revenue and expenditure are analysed in what follows excluding the effects of an accounting transaction between the state and the regions that did not impinge on the general government consolidated accounts.

Local government expenditure grew by 1.8 per cent in 2009, to 16.4 per cent of GDP. The growth in the primary current component slowed from 6.9 to 2.4 per cent. Despite the contract renewals in the health sector and for local government workers, compensation of employees decreased by 1.4 per cent; in fact in 2008 the contracts for the preceding two years had been renewed, leading to the disbursement of substantial back payments. Intermediate consumption expanded by 5.5 per cent, reflecting the large increase in indirectly measured financial intermediation services.

Health expenditure, which accounts for about 50 per cent of total current expenditure (nearly all the expenditure on social benefits in kind, more than half the compensation of employees and a large part of intermediate consumption) grew by 1.9 per cent, as against 6.6 per cent in 2008. Expenditure associated with the indirect distribution of pharmaceuticals fell for the third successive year, contracting by 1.9 per cent.

In the last few years Parliament has intervened on several occasions with regard to the financing of the National Health Service by tightening the regions' budgetary constraint. In particular, the measures have concerned the regional health systems with substantial financial imbalances. In 2007 seven regions (Abruzzo, Campania, Lazio, Liguria, Molise, Sardinia and Sicily) approved plans to reduce their healthcare deficits, and in four of them (Abruzzo, Campania, Lazio and Molise) a special administrator has been appointed in view of the delay in implementing the plans. In December 2009 Calabria approved a deficit-reduction plan according to which the region has accumulated €2.2 billion of debt.

Empirical analysis has shown that there is considerable scope for achieving savings in health expenditure by ensuring the widespread adoption of best organizational and operational practices.

An econometric analysis covering the period 1993-2006 of the determinants of the regional differences in per capita healthcare expenditure (corrected on the basis of indicators of the demand for assistance, such as demographic structure, per capita income, life styles and other variables found in the literature) gave the following results. The differences were found to be negatively correlated with indicators of the appropriateness of treatments and significantly influenced by the regions' choices with regard to the organization of the health service. Differences in expenditure are not distributed evenly among the various components. For example, regions with higher levels of expenditure appear to offer scope for particularly large savings in the pharmaceutical field. Moreover, there is no evidence that above-average expenditure is associated with better quality services. Improvements in the ways of providing services and organizing distribution networks can bring appreciable savings. For example, an increase of one percentage point in the direct distribution of pharmaceuticals would correspond on average to a decrease in per capita expenditure of about €15 per year, a reduction of 1.2 per cent.

Investment, net of the proceeds of real estate disposals, increased by 0.2 per cent to €27.9 billion, after falling by 4.1 per cent in 2007-08. The result for 2009 was influenced by the easing of the Domestic Stability Pact for municipalities that had complied with the Pact in the preceding years and by the exclusion from the Pact, with effect from 2008, of some regional expenditure on projects co-financed by European funds.

Total local government revenue rose by 1.7 per cent, to 16 per cent of GDP. Own revenue, calculated by excluding both public transfers and those from abroad (mainly the European Union), contracted by 8.1 per cent, to 8.1 per cent of GDP. This result reflected the sharp fall of 10.6 per cent in tax revenue.

Transfers to local government increased by 14.8 per cent, to 7.8 per cent of GDP. The growth came primarily from current public transfers, which increased by 16.2 per cent. Public contributions to investment rose by 3.9 per cent, after falling sharply in 2008. Transfers from abroad contracted by 14.4 per cent as a consequence of the delays in implementing the new Community fund programmes.

Local authorities' use of derivatives. – Local authorities' use of derivatives decreased further as a consequence of the ban imposed in June 2008 on new contracts until the regulatory framework was revised and the early closing of some transactions.

At the end of March 2010, on the basis of supervisory statistical reports and Central Credit Register data, which cover only contracts concluded with intermediaries operating in Italy, the notional value of the outstanding derivative contracts was €21.8 billion, compared with €26.1 billion at the end of 2008 and €31.5 billion at the end of 2007. The corresponding negative market values to local authorities, the amount the latter would have to pay intermediaries if the outstanding transactions were closed, was about €1.1 billion, virtually unchanged over the last two years. Under the rules established at European level, this amount is not included in the calculation of local government debt. Some contracts have a positive market value to local authorities, with a total value that has remained stable at about €0.1 billion. The number of local authorities with derivative contracts having a negative market value above the reporting threshold of the Central Credit Register (€30,000 since January 2009, €75,000 previously) fell to 426 at the end of 2009, of which 13 were regions, 28 provinces and 371 municipalities, compared with 474 at the end of 2008 and 669 at the end of 2007.

The borrowing requirement and the debt

The borrowing requirement. – In 2009 the general government borrowing requirement rose by €36.6 billion, from €49 billion to €85.7 billion and from 3.1 to 5.6 per cent of GDP (Table 13.6). Privatization receipts amounted to €0.8 billion and derived mainly from the sale to Cassa Depositi e Prestiti S.p.A. of pre-emption rights in Enel's capital increase.

Table 13.6

General government balances and debt
(millions of euros)

	2005	2006	2007	2008	2009
Net borrowing	61,432	49,403	23,191	42,575	80,800
Total borrowing requirement	70,681	58,908	26,511	49,072	85,676
Borrowing requirement net of privatization receipts	75,299	58,947	30,011	49,091	86,475
Debt	1,512,753	1,582,067	1,599,790	1,664,204	1,761,229
Memorandum items:					
Privatization receipts (1)	4,618	38	3,500	19	798
Change in the Treasury's deposits at the Bank of Italy	-1,197	8,230	-13,142	10,611	11,399

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

The disparity between the borrowing requirement and net borrowing. – The gap between the general government borrowing requirement and general government net borrowing was equal to 0.4 percentage points of GDP, as in 2007 and 2008 (Table 13.7).

Table 13.7

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

		2000 (1)	2001	2002	2003	2004	2005	2006	2007	2008	2009
(a)	**Net borrowing (Istat)**	**2.0**	**3.1**	**2.9**	**3.5**	**3.5**	**4.3**	**3.3**	**1.5**	**2.7**	**5.3**
(b)	Balance of financial items (2)	2.3	0.5	0.3	0.3	1.0	1.3	0.5	0.5	0.2	0.6
(c)	Cash basis minus accrual basis	-1.1	0.6	-0.2	0.7	-0.4	-0.4	0.2	0.1	0.3	-0.1
	primary balance	*-0.6*	*0.9*	*0.2*	*0.9*	*-0.2*	*-0.3*	*-0.1*	*0.3*	*0.1*	*-0.3*
	interest payments	*-0.5*	*-0.2*	*-0.4*	*-0.2*	*-0.1*	*-0.1*	*0.3*	*-0.2*	*0.2*	*0.1*
(d)=(a)+(b)+(c)	**Public sector borrowing requirement (MEF)**	**3.1**	**4.2**	**3.0**	**4.4**	**4.1**	**5.2**	**4.0**	**2.1**	**3.3**	**5.8**
(e)=(g)-(d)	Difference between the general government and public sector borrowing requirements	0.5	0.7	0.1	-0.2	0.1	0.0	-0.1	-0.1	-0.1	-0.1
(g)	**General government borrowing requirement net of privatization receipts (BI)**	**3.6**	**5.0**	**3.1**	**4.2**	**4.2**	**5.3**	**4.0**	**1.9**	**3.1**	**5.7**
(h)	Privatization receipts (-)	-1.3	-0.4	-0.2	-1.3	-0.6	-0.3	0.0	-0.2	0.0	-0.1
(i)=(g)+(h)	**Total borrowing requirement (BI)**	**2.2**	**4.6**	**2.9**	**3.0**	**3.6**	**4.9**	**4.0**	**1.7**	**3.1**	**5.6**
(l)	Change in Treasury's deposits at the Bank of Italy	-0.8	0.2	0.0	-0.6	0.2	-0.1	0.6	-0.8	0.7	0.7
(m)	Issue discounts	0.0	-0.2	-1.9	-0.3	0.0	-0.2	0.2	0.3	0.3	0.0
(n)	Change in the euro value of foreign exchange liabilities	0.1	0.0	-0.3	-0.2	-0.1	0.1	-0.1	0.0	0.0	0.0
(o)=(i)+(l)+(m)+(n)	**Change in the debt (BI)**	**1.5**	**4.6**	**0.8**	**1.9**	**3.7**	**4.8**	**4.7**	**1.1**	**4.1**	**6.4**
(p)=(a)-(o)	Difference between net borrowing and the change in debt	0.5	-1.6	2.1	1.6	-0.2	-0.5	-1.3	0.4	-1.4	-1.1
(f)=(a)-(g)	*Difference between general government net borrowing and the general government borrowing requirement*	*-1.6*	*-1.9*	*-0.2*	*-0.8*	*-0.7*	*-1.0*	*-0.6*	*-0.4*	*-0.4*	*-0.4*
(q)=(g)-(o)	*Difference between the general government borrowing requirement and the change in debt*	*2.1*	*0.3*	*2.3*	*2.4*	*0.5*	*0.5*	*-0.7*	*0.8*	*-1.0*	*-0.7*

Sources: For net borrowing and interest payments on an accrual basis, Istat; for the public sector borrowing requirement (net of privatization receipts) and interest payments on a cash basis, the Ministry for the Economy and Finance – MEF (Quarterly Report on the Borrowing Requirement and the Combined Report on the Economy and the Public Finances, various years); for the general government borrowing requirement and debt, the change in the Treasury's deposits at the Bank of Italy, issue discounts and the change in the euro value of foreign exchange liabilities, the Bank of Italy (BI); for the balance on financial asset items, based on BI, *Conti finanziari*.
(1) For the sake of comparability, net borrowing excludes the proceeds of the sale of UMTS licences entered on an accrual basis (€13,815 million); the borrowing requirement of the public sector and that of general government (both net of privatization receipts) exclude receipts from the sale of UMTS licences (€11,899 million, of which €10,709 million is included in privatization receipts). – (2) 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.

The factors contributing to the gap included the accumulation of financial assets (0.6 points of GDP, with half being a consequence of the state's subscription of bonds issued by banks as part of the support provided to the financial system), which increases the borrowing requirement but not net borrowing, and the differences deriving from the use of cash basis accounts for the borrowing requirement and accrual basis accounts for net borrowing (a negative 0.1 per cent of GDP, as against an average of zero for the period 2000-08).

The debt. – The ratio of general government debt to GDP rose for the second successive year to reach 115.8 per cent. Of the total increase of 9.7 percentage points, 8 points reflected the difference between the average cost of the debt (4.3 per cent calculated as the ratio of interest payments to the size of the debt at the end of the year) and the GDP growth rate (a negative 3 per cent), 0.6 points the primary deficit and 1.1 points the residual component due to the difference between net borrowing and the change in the debt.

The debt increased by €97 billion, reflecting the borrowing requirement and the increase in the Treasury's deposits at the Bank of Italy to €31.7 billion, from €20.3 billion at the end of 2008.

Despite the particularly favourable conditions at the short end of the yield curve, the Ministry for the Economy and Finance increased its issues of medium and long-term paper in 2009; this strategy lengthened government securities' average residual maturity by four months and their average duration by six months. The average residual maturity of the total debt lengthened from seven years and two months to seven years and four months. A larger proportion of short-term issues would have brought significant interest payment savings over the year, but would have increased the refinancing risk. Moreover, the increase in interest rates implicit in the yield curve means that the savings would probably have been offset by a higher level of interest payments in future years.

Local government debt rose from 6.8 to 7.3 per cent of GDP (Table 13.8) and at the end of the year the nominal amount was slightly higher than at the end of 2007.

Table 13.8

Composition of the public debt by issuer
(as a percentage of GDP)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
General government	**109.2**	**108.8**	**105.7**	**104.4**	**103.8**	**105.8**	**106.5**	**103.5**	**106.1**	**115.8**
Central government	105.4	104.9	101.9	99.0	98.4	99.7	99.4	96.3	99.3	108.5
Local government	3.2	3.2	3.4	5.1	5.3	6.1	7.1	7.1	6.8	7.3
Social security institutions	0.5	0.6	0.4	0.2	0.1	0.0	0.0	0.0	0.0	0.0

General government trade payables. – The public debt statistics, prepared in accordance with the rules established at European level, do not include general government liabilities associated with deferred terms for the payment of goods and services (trade payables).

Accurate data are not available on the size of general government trade payables. The various sources have different methods of collecting and elaborating the data. On the basis of the responses to the Bank of Italy Survey of Industrial and Service Firms with at least 20 employees, the trade receivables from general government of firms in these sectors amounted to about €40 billion or 2.6 per cent of GDP, an increase of more than 10 per cent on 2008 that reflected the growth in business with general government and the lengthening of the deferral period from 204 to 218 days.

The estimate referred to above does not take account of firms with less than 20 employees, firms in the construction sector and some types of firms in the health sector. Applying the ratio between general government based trade receivables and turnover found for the Bank of Italy sample to the total turnover of all firms with general government (approximated by the sum of intermediate consumption and expenditure on social benefits in kind and investment) indicates that total general government trade payables at the end of 2009 were of the order of 4 per cent of GDP.

General government trade receivables, which accounted for little more than a tenth of the total, remained basically unchanged, partly owing to the resources made available by the mid-year budget revision approved in August 2009. By contrast, there were substantial increases in the local government component.

The general government takes about twice as long to pay as the private sector and the time it takes is very long by international standards. Slow payments entail high costs both for supplier firms, which have to find alternative sources of finance, and for general government itself, which has to pay arrears interest and the cost of court proceedings initiated by creditors. In addition, uncertainty about payment times may distort competition.

In 2002 Directive 2000/35/EC was transposed into Italian law and provided for payment ordinarily to be deferred by 30 days and a high rate of arrears interest. The effectiveness of the rules is diminished, however, by the possibility of contractual waivers.

BUDGETARY POLICY FOR 2010 AND THE MEDIUM TERM

The aim of the Government's budgetary policy is to bring the deficit below the 3 per cent threshold by 2012, in line with the EU Commission's request to Italy under the excessive deficit procedure. In order to achieve this objective, the Government has prepared a new adjustment, officially estimated at €24 billion, for the two years 2011-12.

Budgetary policy for 2010

The July 2009 Economic and Financial Planning Document set the objective for net borrowing in 2010 at 5 per cent of GDP (Table 13.9). No adjustment was planned with respect to the deficit on a current legislation basis.

In September 2009 the Forecasting and Planning Report confirmed the objective for the deficit. The Finance Law for 2010 introduced €4.9 billion of additional expenditure and €1.2 billion of tax relief, to be financed in part by the increase expected in the balance of personal income tax as a consequence of the reduction in the payment on account at the end of 2009 (see the box "The 2010 Finance Law", *Economic Bulletin*, No. 56, April 2010).

Table 13.9

Public finance objectives and estimates for the year 2010
(billions of euros and percentages of GDP)

	Net borrowing	Primary surplus	Interest payments	Debt	*Memorandum items*			
					Real GDP growth rate (%)	Nominal GDP	Net borrowing 2009	Debt 2009
Objectives								
Economic and Financial Planning Document (July 2009)	76.9	2.6	79.5	….		1,549.6	81.3	….
as a percentage of GDP	*5.0*	*0.2*	*5.1*	*118.2*	*0.5*		*5.3*	*115.3*
Forecasting and Planning Report and Economic and Financial Planning Document update (September 2009)	77.6	-0.7	77.0	….		1,564.8	80.9	….
as a percentage of GDP	*5.0*	*0.0*	*4.9*	*117.3*	*0.7*		*5.3*	*115.1*
Stability Programme and Updating Note 2010-2012 (January 2010)	78.0	-1.6	76.3	….	1.1	1,572.4	80.5	….
as a percentage of GDP	*5.0*	*-0.1*	*4.9*	*116.9*			*5.3*	*115.1*
Estimates								
Combined Report on the Economy and the Public Finances (May 2010)	78.1	-6.8	71.4	….	1.0	1,554.3	80.8	….
as a percentage of GDP	*5.0*	*-0.4*	*4.6*	*118.4*			*5.3*	*115.8*

In December, as part of the excessive deficit procedure, the EU Council requested Italy not only to bring its deficit below the 3 per cent threshold by 2012 but also to give full effect to the summer 2008 three-year adjustment from as early as 2010 and to implement a structural fiscal adjustment for the years 2010-12 equal to at least half a percentage point per year.

The January 2010 Stability Programme confirmed the deficit estimate of 5 per cent of GDP for the year. The European Commission judged the estimates to be basically in line with the EU Council's recommendations.

The latest estimates for the public finances. – With growth estimated at 1 per cent (1.1 per cent in the Stability Programme), the May Combined Report on the Economy and the Public Finances confirmed the forecast for the deficit, despite substantial revisions of the estimates of expenditure and revenue. The latter increased in 2010 by 1.3 per cent (nearly €10 billion), notwithstanding the drying up of the receipts of one-off taxes, which had amounted to more than €10 billion in 2009. The modest growth of 0.9 per cent in total expenditure (about €7 billion) reflected the lapsing of some extraordinary current and capital expenditure items and the cuts introduced in the summer 2008 three-year adjustment, estimated at the time as amounting to about €12 billion. Primary current expenditure grew by 2 per cent; capital expenditure contracted by 9.4 per cent; interest payments remained basically unchanged.

The ratio of debt to GDP increased by 2.6 percentage points to 118.4 per cent. These figures do not take account of the measures in support of Greece.

In May the Government approved a decree law authorizing bilateral loans to Greece for a total of €14.8 billion over the three years 2010-12, of which €5.5 billion in 2010, with €2.9 billion disbursed in the same month. The necessary resources were to come from issues of medium and long-term government securities.

In the May 2010 estimates of the European Commission, based on a slightly lower rate of GDP growth (0.8 per cent) than that expected by the Government, indicate the deficit will remain unchanged compared with 2009, when it was 5.3 per cent of GDP.

The Combined Report on the Economy and the Public Finances estimates a reduction from 3.8 to 3.3 per cent of GDP in the budget balance adjusted for the economic cycle and one-off measures. According to the estimates of the European Commission, the decrease is from 4 to 3.7 per cent. Both estimates see the economic cycle as having made a negative contribution of about 1.8 percentage points in 2010. Using the Bank of Italy methodology, which also takes account of the effects on the public finances of changes in the composition of GDP, achievement of the objective for the deficit entails a structural deficit in 2010 of close to 4 per cent of GDP, with an improvement of more than half a percentage point compared with 2009.

According to preliminary estimates, the general government borrowing requirement in the first four months of this year was €43.7 billion, or €5.6 less than in the corresponding period in 2009. The difference will tend to be reabsorbed in the coming months, as a result of the lapsing of the revenue produced by one-off taxes in 2009.

Some of the measures of the package approved by the Council of Ministers on 25 May could contribute to the achievement of the net borrowing objective for this year.

Programmes and prospects for 2011-12

The January 2010 Stability Programme basically confirmed the objectives of the July 2009 Economic and Financial Planning Document and September 2009 Forecasting and Planning Report and set budget deficit targets of 3.9 and 2.7 per cent of GDP for 2011 and 2012. The cumulative adjustment with respect to the budget on a current legislation basis was estimated at 1.2 percentage points of GDP, of which one third to be achieved in 2011 and two thirds in 2012. Structural net borrowing was estimated to improve on average by 0.6 percentage points of GDP per year. In its assessment of the Stability Programme the European Commission deemed the consolidation strategy for 2011-12 to be basically in line with the above-mentioned EU Council recommendations. It nonetheless identified some risks in achieving the objectives announced by the Government, especially in connection with the highly favourable GDP growth predictions and the difficulties encountered in the past in achieving the objectives for curbing expenditure.

In May 2010 the Combined Report on the Economy and the Public Finances revised the estimates of the deficits for 2011 and 2012 on a current legislation basis upwards to respectively 4.7 and 4.3 per cent of GDP as a consequence of a less favourable growth in GDP than had been assumed in January. The objectives for net borrowing were nonetheless confirmed; the cumulative adjustment for the two years was accordingly increased to 1.6 percentage points of GDP and the adjustment measures were redistributed equally in the two years.

Faced with turbulent conditions in financial markets following the Greek crisis, on 25 May the Government brought the budget forward and introduced a package of measures intended to achieve the objectives for net borrowing set for 2011 and 2012.

The adjustment is based largely on reductions in current expenditure and intensifying the fight against tax and social security evasion. No changes were made to investment expenditure, which is forecast to fall significantly on a current legislation basis in 2010 and the two following years.

As regards the fight against evasion, the action taken by the Government in the last two years has been aimed at strengthening the assessment system and collection activity. In addition, new provisions have been adopted on tax havens and international tax arbitrage, implementing the agreements reached within the OECD on the exchange of information between tax authorities. However, in order to simplify the duties of taxpayers, some formalities introduced in 2006-07 in the fight against tax and social security evasion have been eliminated.

According to the Government, the main contribution to budgetary consolidation in the coming years will derive from slowing the rate of increase in primary current expenditure. To achieve this result will require a far-reaching revision of the public sector and a reassessment of the tasks it performs.

In the period 1998-2008 the rate of growth of primary current expenditure was regularly much higher than planned. In particular, the growth rate forecast for the following year in the Forecasting and Planning Report was a little more than 3 per cent on average, against an outturn of 4.5 per cent on average. The excess growth was equal to half a percentage point of GDP per year on average, of which about 0.3 points derived from intermediate consumption and 0.1 points from compensation of employees.

The Forecasting and Planning Reports forecast that the ratio of primary current expenditure to GDP would decrease each year by a little less than half a percentage point, whereas it actually rose from 37.3 per cent in 1998 to 40.5 per cent in 2008, with an annual average increase of about 0.3 percentage points. It has been estimated that nearly 30 per cent of the overshoot of the objectives was due to the actual GDP growth rate, which was always less favourable than that predicted in the planning documents.

The link established by Parliament in the summer of 2009 between the retirement age and the increase in life expectancy, with effect from 2015, may help to attenuate the effects of population ageing on expenditure in the medium term; it will lead to a reduction in the number of pensions and an increase in their unit value.

Reforms and the public finances

To achieve the objectives for budgetary consolidation and enhanced budgetary action, it is necessary to strengthen the ability to control expenditure. The Government took steps in this direction last year by introducing reforms in the fields of public-sector accounting, fiscal federalism and public employment.

Law 196/2009 on public sector accounting and the public finances follows the path that was initiated with the reorganization of the state budget on the basis of missions and programmes and the spending review, increases the transparency of the budgetary documents, and calls for the three-yearly publication of a report on the effectiveness of central government expenditure.

The law charges the Government with harmonizing government departments' accounting systems and reporting formats and moving over three years to the preparation of the state budget on a cash basis. The Economic and Financial Planning Document is replaced by the Public Finances Decision, which should increase the information available and, more specifically, show the balances on a current legislation and a current programmes basis, set objectives for general government as a whole and for the component subsectors (for local government the Decision should specify the content of the Domestic Stability Pact and the related sanctions) and describe, with a certain amount of detail, the initiatives to be undertaken to achieve the objectives. The Finance Law is replaced by the Stability Law, which will be divided for the expenditure provisions into missions and programmes, the units that will count for approval by Parliament; the performance of each programme will be entrusted to a single centre of administrative responsibility. The law also revises the annual calendar of the budget, which will begin on 15 July with the transmission of the guidelines of the Public Finances Decision to the standing committee for the coordination of the public finances; the document is to be submitted to the Chamber of Deputies and the Senate by 15 September; the Stability Bill is to be submitted by 15 October.

Many important aspects are entrusted to the Government's exercise of its delegated powers. Particular attention will need to be paid to the harmonization of the accounting systems of central government, the regions, the provinces and the municipalities.

To strengthen the institutional framework of their public finances, other countries have recently introduced significant reforms. Germany and Switzerland have established constitutional limits to their budget balances. Sweden and Hungary have established independent entities to monitor and assess their budgetary policies. Finland, the Netherlands and Sweden have introduced multi-year quantitative restrictions on the growth of their expenditure.

Fiscal federalism can make an important contribution to the rebalancing of the public finances if its implementation establishes a close connection between expenditure and revenue decisions and strict budgetary rules are introduced for local authorities. A first implementing decree has been approved governing the transfer of part of the assets of the state to local authorities.

By June the Government must submit a report to the Chamber of Deputies and the Senate with quantitative estimates of the distribution of resources between the state and local authorities. By May 2011 the standard resource requirements must be established for the fundamental functions of provinces and municipalities and for the essential levels of services regions are required to supply, for which the law provides an equalization mechanism.

Legislative Decree 150/2009 implementing the reform of public employment has been approved. It increases managers' freedom of action in the management of employees and the organization of work, introduces instruments for assessing results and introduces a system of incentives to reward virtuous behaviour.

The resources available for decentralized negotiations will be distributed on the basis of national agreements according to the results achieved by the individual authorities. It is important that there be incentives for virtuous behaviour not only by single employees but also by the entities involved. If the hoped-for results of the reform are to be achieved, and changes made to the behaviour of staff and managers, considerable efforts will be needed in applying the new rules.

14. THE FINANCIAL CONDITION OF HOUSEHOLDS AND FIRMS

In 2009 households invested in financial assets perceived as being low risk, continuing a longer-term trend. Last year's recovery of prices on the financial markets nonetheless helped foster an upturn in interest in shares and investment funds with respect to 2008. The ratio of net financial wealth to disposable income has declined in relation to pre-crisis levels but remains high compared with the euro-area average. In the second half of 2009, the annualized rate of growth in bank loans to households settled at around 3.5 per cent and rose in the early months of 2010, mostly owing to mortgage loans, the largest component of household debt. In 2009, most mortgages granted were at variable rates, reflecting the much sharper fall in interest rates for them than for fixed rate loans. The Bank of Italy's Survey on Household Income and Wealth (SHIW) shows that in the period 2006-08 the share of debt held by low-income households increased. Difficulties in meeting loan repayments are concentrated in this category and were reflected in a rise in impaired assets held by credit institutions.

Firms' financial conditions deteriorated markedly, as sharply contracting income flows were combined with delays in sales revenue collection and difficulties in accessing credit. Those hardest hit were manufacturers, small businesses and firms that on the eve of the crisis already displayed weaknesses in their balance sheets, such as high debt or low profitability. Debt levels, which resemble those of other major economies, remain at the highest levels of the last ten years. Moderate interest rates have so far keep firms from insolvency, although a much higher number went insolvent than in the past. Financial structures, which have always been tilted towards short-term and variable rate borrowing, are exposed to risks stemming from interest rate increases; any rise in the cost of borrowing would inflict most damage in the sectors where productive activity has been slowest to recover.

Households' financial saving and debt

Financial balance and wealth. – In 2009 the reduction in the disposable income of consumer and producer households translated into a decline in saving. During the year investment in real assets fell sharply and the financial surplus narrowed to €50 billion, equal to 3.3 per cent of GDP (Table 14.1).

After falling by 3.2 per cent in 2008, last year the value of financial assets rose by 2.1 per cent. Net of liabilities, financial wealth amounted to 2.6 times disposable income, down from pre-crisis levels but high compared with the euro-area ratio of 1.9.

Table 14.1

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

	2006	2007	2008	2009
Households (2)	43,222	35,589	55,170	49,670
Non-financial corporations	-37,821	-54,751	-79,917	-36,454
General government	-48,762	-23,748	-39,846	-77,182
Monetary financial institutions	-12,302	22,910	4,624	12,391
Other financial intermediaries (3)	11,498	12,213	25,686	10,992
Insurance companies (4)	12,364	-20,351	-16,878	16,014
Rest of the world account	31,801	28,137	51,162	24,568
	As a percentage of GDP			
Households	2.9	2.3	3.5	3.3
Non-financial corporations	-2.5	-3.5	-5.1	-2.4
General government	-3.3	-1.5	-2.5	-5.1
Financial corporations (5)	0.8	1.0	0.9	2.6
Rest of the world account	2.1	1.8	3.3	1.6
	As a percentage of GDP, adjusted for inflation (6)			
Households	1.7	0.2	2.1	3.0
Non-financial corporations	-1.8	-2.2	-4.2	-2.2
General government	-2.1	0.4	-1.3	-4.9

(1) Rounding may cause discrepancies in totals. – (2) Consumer households, producer households and non-profit institutions serving households. – (3) Includes financial auxiliaries. – (4) Includes pension funds. – (5) Monetary financial institutions, other financial intermediaries, insurance companies and financial auxiliaries. – (6) Only financial instruments denominated in euros with a fixed monetary value at maturity are taken into account in calculating the adjustment for inflation.

A large proportion of households' total wealth consists of real assets (63 per cent), which are equal to over five times disposable income, one of the highest values in the main economies. The overall net wealth is concentrated: the most affluent 10 per cent of households hold almost 45 per cent of the total, while the share held by the bottom 60 per cent is scarcely larger than that of the wealthiest 1 per cent.

Financial assets. – In 2009 households continued to invest in financial assets perceived as being low risk, while keeping a close eye on returns. Net purchases of financial instruments issued by banks, albeit down from the exceptional levels of 2008 (€95 billion), were nonetheless considerable (€47 billion; Table 14.2). Deposits and bank bonds account for almost 30 per cent of household wealth. Net investment in life insurance policies was also substantial (€24 billion, compared with net disinvestment in 2008), especially in traditional policies with guaranteed minimum returns. Equity in insurance policies, pension funds and severance pay rose to 18 per cent of the assets held. During the year, net postal fund-raising doubled, in the savings account and certificate component only, which offers a higher return than that on current account deposits. Postal savings are equal to just under 10 per cent of total assets. Investment in government securities was confined to medium and long-term instruments, whose share of the total wealth remained unchanged at 5 per cent. The bulk of government securities nearing maturity were not rolled over, owing to low yields, giving rise to net redemptions of €63 billion that almost wiped out the share of this instrument in households' portfolio.

During the year there were also signs of a pickup in investment in riskier assets, which benefited from the rise in financial market prices. There were significant net purchases of equity (€49 billion) while the outflow of resources from investment funds, which had been particularly substantial from 2006 onwards, came to a halt. At the end of 2009, shares and investment funds accounted for 29 per cent of financial assets, far less than a decade ago (45 per cent). The decline is attributable both to a shift in investors' preferences and to a reduction in the value of these instruments.

Table 14.2

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

	End-of period stocks			Flows	
	Dec. 2009	Percentage composition		2008	2009
		Dec. 2008	Dec. 2009		
ASSETS					
Cash	106,636	2.8	3.0	10,546	7,062
Instruments issued by banks	1,036,779	28.4	28.8	94,822	46,994
of which: sight deposits	*513,217*	*14.0*	*14.3*	*16,983*	*19,932*
other deposits	*149,811*	*4.1*	*4.2*	*27,069*	*5,853*
medium and long-term securities	*373,751*	*10.3*	*10.4*	*50,770*	*21,210*
Postal deposits and other savings (2)	313,885	8.4	8.7	9,584	17,948
Government securities	199,250	7.5	5.5	3,930	-59,978
of which: short-term	*28,459*	*2.7*	*0.8*	*13,899*	*-63,365*
medium and long-term	*170,791*	*4.8*	*4.8*	*-9,969*	*3,388*
Corporate medium and long-term securities	10,517	0.3	0.3	-3,044	142
Investment fund units	188,102	4.6	5.2	-64,633	8,365
of which: Italian	*135,349*	*3.5*	*3.8*	*-41,959*	*-480*
foreign	*52,753*	*1.0*	*1.5*	*-22,674*	*8,844*
Shares and other equity	853,465	23.4	23.7	28,302	49,230
of which: Italian	*783,879*	*21.7*	*21.8*	*30,278*	*50,922*
foreign	*69,586*	*1.7*	*1.9*	*-1,976*	*-1,692*
Other external assets	133,034	4.5	3.7	4,528	-24,429
of which: deposits	*1,349*	*0.7*	*0.0*	*3,023*	*-23,816*
short-term securities	*3,094*	*0.1*	*0.1*	*251*	*1,147*
medium and long-term securities	*128,592*	*3.7*	*3.6*	*1,255*	*-1,761*
Insurance, pension fund reserves and severance pay entitlements	632,310	16.7	17.6	-5,494	28,643
of which: life insurance reserves	*383,752*	*9.7*	*10.7*	*-10,548*	*24,343*
Other financial assets (3)	120,805	3.5	3.4	3,530	-5,122
Total assets	**3,594,783**	**100.0**	**100.0**	**82,073**	**68,854**
LIABILITIES					
Short-term debt (4)	59,859	6.6	7.0	-631	4,219
of which: bank	*55,936*	*6.3*	*6.5*	*-768*	*3,104*
Medium and long-term debt (5)	581,453	67.0	67.6	17,999	18,253
of which: bank	*440,380*	*49.5*	*51.2*	*8,888*	*25,378*
Other financial liabilities (6)	218,642	26.4	25.4	9,535	-3,288
Total liabilities	**859,954**	**100.0**	**100.0**	**26,903**	**19,184**
BALANCE	**2,734,829**			**55,170**	**49,670**

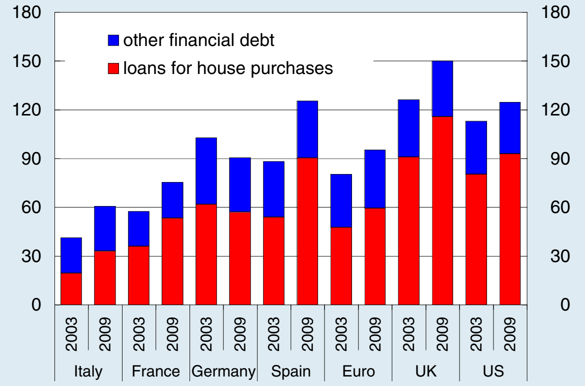
(1) Consumer households, producer households and non-profit institutions serving households. Rounding may cause discrepancies in totals. – (2) Postal current accounts, savings accounts and certificates. – (3) Accounts receivable and other minor items. – (4) Includes finance provided by factoring companies. – (5) Includes securitized loans, finance provided by leasing companies, consumer credit from financial companies and other minor items. – (6) Accounts payable, staff pension provisions and other minor items.

Household debt. – In 2009 household borrowing grew by 3.5 per cent (5.8 per cent in 2008). The expansion appeared more pronounced in the early months of 2010, especially for home mortgages. A similar picture emerged in the euro area, where growth was nonetheless more modest.

At the end of 2009, total financial debt exceeded 60 per cent of disposable income (for all categories of household), an increase of almost 4 percentage points for the year. The level of debt remains lower than in the euro area (95 per cent) or in the UK and United States (over 100 per cent). The differences are largely attributable to loans for house purchases, the main component of total household debt (Figure 14.1).

Figure 14.1

Household debt (1)
(as a percentage of disposable income)



Sources: Bank of Italy and Istat for Italy. For the other countries: Banque de France and INSEE for France, Deutsche Bundesbank for Germany, Banco de España for Spain, Eurostat and the ECB for the euro-area countries, Bank of England and Central Statistical Office for the UK, Federal Reserve System – Board of Governors and Bureau of Economic Analysis for the US.
(1) Consumer households, producer households and non-profit institutions. – (2) For the US, the data relate to consumer households and non-profit institutions serving households.

Loans for house purchases. – In 2009 loans for house purchases grew by 1.8 per cent, over 3 points less than in 2008 (Table 14.3). In the early months of 2010 there were signs of an acceleration, as demand for mortgages made a modest recovery and credit conditions were not subject to any further tightening. Last year new loans fell to just over €50 billion, down 9 per cent from 2008, a similar reduction to that observed in the euro area as a whole. The share of new variable rate mortgages increased sharply, returning to over 80 per cent in the early months of 2010 (as against 64 per cent on average in 2009). The increase was driven by the much sharper fall in interest rates on these loans than on fixed rate mortgages (Figure 14.2).

Table 14.3

Lending to consumer households (1)
(twelve-month percentage changes)

	December 2006	December 2007	December 2008	December 2009	March 2010
			Loans for house purchases		
Banks	15.1	11.8	5.4	1.8	2.1
			Consumer credit		
Banks	13.7	6.9	7.6	5.0	4.1
Financial companies	24.6	21.9	3.1	4.5	3.3
Total banks and financial companies	18.5	13.9	5.4	4.7	3.6
			Other loans (2)		
Banks	5.6	12.4	8.1	7.3	10.1
			Total loans		
Total banks and financial companies	14.3	12.3	5.6	3.3	3.7

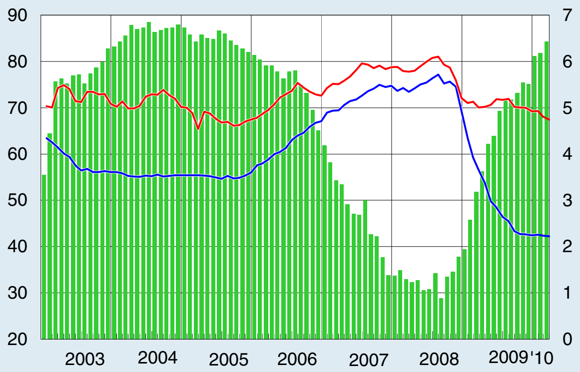
Source: Supervisory returns.
(1) Loans exclude repos and bad debts; households do not include non-profit institutions serving households. The percentage changes are adjusted for the effects of securitizations and reclassifications. The data for March 2010 are provisional. – (2) Other loans consist mainly of current accounts with overdraft facilities and mortgages, especially non-residential property transactions.

In order to reduce borrowers' risk, in 2009 many banks offered contracts that cap debt servicing costs. According to the survey of over 400 banks conducted by the Bank of Italy's branch network, 16 per cent of the new variable rate loans provided for a ceiling on the interest rate and 13 per cent had clauses enabling holders to temporarily suspend or extend the duration of repayments at no additional cost. Households continued to replace existing loans with new mortgage contracts in order to obtain better terms and conditions. Overall, replacement mortgages reached 19 per cent of the total (13 per cent in 2008).

Figure 14.2

Variable rate mortgages and interest rates (1)

(monthly data referred to new transactions; percentages)



Source: Based on ECB data.
Consumer households, producer households and non-profit institutions serving households. – (2) Variable rate or renegotiable within one year. – (3) Left-hand scale. – (4) Right-hand scale.

In Italy, as in other euro-area countries, the households that took out mortgages belong to the higher income brackets. However, according to the latest Survey on Household Income and Wealth, in the period 2006-08 recourse to this form of debt also increased among low-income households (the first quartile of equivalent income). The debt to income ratio for these households' mortgages is three to one, compared with near parity in the highest income category. At the beginning of the last decade, these ratios were lower and the differences between the social classes less marked.

Mortgage interest rates. – Interest rates on new variable rate mortgages fell sharply in 2009, to 2.2 per cent at the end of the year. The reduction of 2.7 percentage points was in line with that in the reference rate (three-month Euribor) and more marked than in the euro area (Figure 14.3). The cost of new fixed rate loans granted for terms of over 10 years, equal to 4.9 per cent at the end of the year, declined by 0.3 points, in line with the fall in the reference rates (10-year interest rate swaps) but less than the average for the euro area (where the reduction was around one percentage point). By the end of 2009, the difference between the cost of fixed rate mortgages for terms of over ten years and that of variable rate contracts was 2.7 percentage points in Italy, around one point more than in the euro area.

Consumer credit. – During the year consumer credit expanded by 4.7 per cent, somewhat less than in 2008 (5.4 per cent). The deceleration continued into the early months of 2010 (Table 14.3). The contraction in special purpose loans continued, reflecting the fall in demand for durable goods. By contrast, personal loans increased, especially those backed by the assignment of one fifth of the borrower's salary.

Data from the SHIW indicate that between 2006 and 2008 recourse to consumer credit increased among pensioners, lower-income households and those with low levels of education. Part of the reason for the increase was the extension to pensioners of the possibility of securing a loan backed by one fifth of their pension (Law 80/2005).

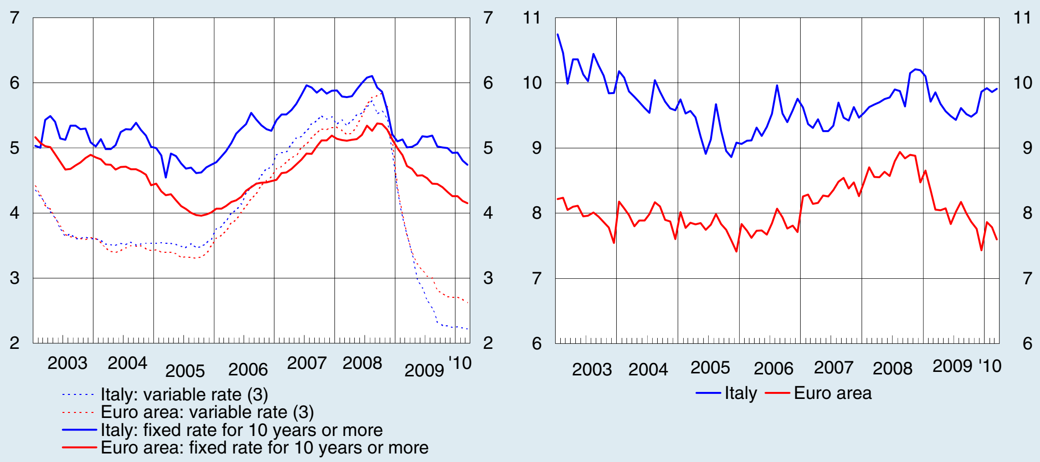
The median ratio of consumer credit to disposable income is around 15 per cent for households that use this instrument, and does not exceed 30 per cent for those in the lowest income bracket.

Figure 14.3

Interest rates on bank loans to households (1)

(monthly data referred to new transactions; percentages)

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



Source: Based on ECB data.
(1) Consumer households, producer households and non-profit institutions serving households. Contracts concluded during the reference period or which constitute a renegotiation of previous terms and conditions. – (2) APRC on new loans. The APRC includes ancillary expenses (administrative expenses, loan examination fees and insurance). It is calculated as the average rate across all maturities, weighted by loan amounts. – (3) Variable rate or renegotiable within one year.

Interest rates on consumer credit. – In 2009 the interest rate banks charged on new consumer credit transactions fell by 0.3 percentage points to 9.9 per cent, as against a drop of one percentage point in the euro area (Figure 14.3). The gap with respect to the euro-area average thus widened to more than 2 percentage points at the end of 2009. The largest difference, over 3 percentage points, is on variable rate consumer credit, which accounts for around one third of disbursements. Variable rate transactions tend to have shorter maturities and involve small amounts, and are therefore likely to be characterized by a higher incidence of fixed costs.

The large share of households behind on payments is a decisive factor in the high cost of consumer credit in Italy. According to the EU survey on income and living conditions (EU-SILC), the share of households behind on consumer credit repayments ranges from 3 to 8 per cent in the other main European countries but is as high as 15.6 per cent in Italy.

Indebted households' vulnerability. – As a consequence of measures to support holders of variable rate mortgages and to redefine the terms and conditions of loans, indebted households emerged from the phase of substantial interest rate increases (2006-08) with a modest overall increase in their debt service burden. According to the SHIW data, for households with mortgages on their primary residence debt servicing costs as a share of disposable income increased by less than one percentage point in the period (from 16.6 to 17.1 per cent). In 2009, they are estimated to have declined by over one percentage point, thanks to the substantial fall in mortgage interest rates.

For households in the lowest income class, the debt servicing cost of mortgages on their primary residence was higher, amounting to 25.1 per cent of income in 2008, not far off the value recorded in other euro-area countries. It is estimated that the incidence of debt service diminished less for these households than for the totality of households with mortgages. Moreover, in this income bracket one indebted household in four faces particularly high debt servicing costs, exceeding 30 per cent of income (one in every ten of all indebted households). These households held just under 20 per cent of the total debt in 2008, around 8 percentage points more than in 2006.

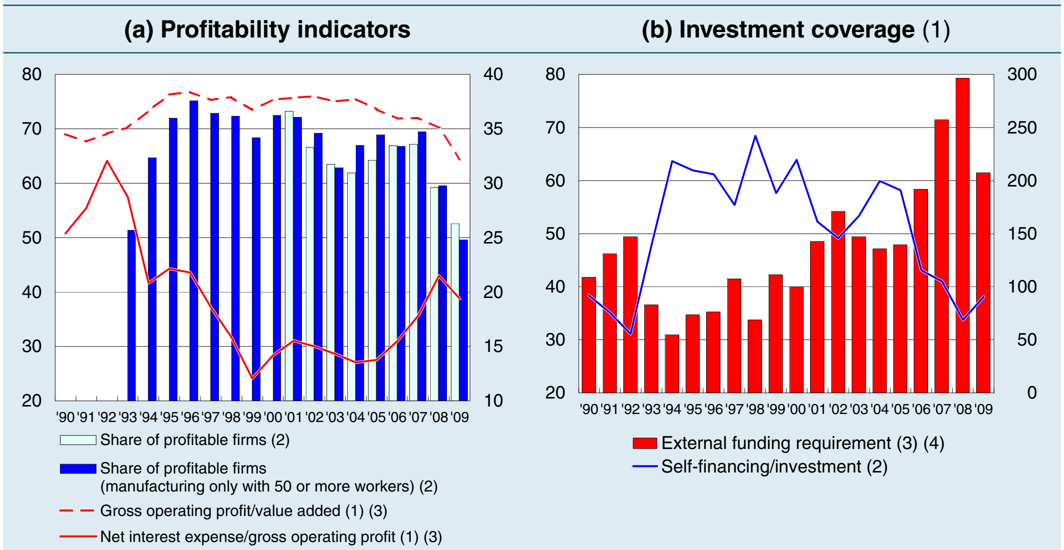
The greater repayment difficulties were reflected in an increase in impaired assets held by credit institutions, most markedly by financial companies. The share of impaired loans, for which banks report serious repayment difficulties that are nonetheless deemed temporary, reached 2.8 per cent in March 2010, 0.4 percentage points more than a year earlier. The insolvency rate also rose: the ratio of new bad debts to bank loans increased by 0.3 percentage points in 2009, reaching 1.4 per cent in the fourth quarter and holding at that level in the first three months of 2010. The insolvency rate has so far remained below the peak recorded during the recession of the early 1990s, when it had exceeded 2 per cent. Looking ahead, the ability to meet loan repayments will be adversely affected by the difficult labour market conditions, which will affect disposable income.

The conditions and financial choices of firms

Profitability, self-financing and the external funding requirement. – Last year the sharp contraction in income flows was the primary source of strain on the financial conditions of Italian firms. Based on the national accounts data, the gross operating profit of non-financial corporations fell by 14.2 per cent, declining as a proportion of value added to levels below those recorded during the 1992-93 recession (Figure 14.4.a).

Figure 14.4

Profitability and the external funding requirement
(percentages; index numbers)



Sources: Based on data from Istat and Banca d'Italia, *Survey of Industrial and Service Firms.*
(1) Estimates based on national accounts data for non-financial corporations, 1990-2008. The data for 2009 are estimated on the basis of the national accounts for the year. Investment includes inventories. – (2) Left-hand scale. – (3) Right-hand scale. – (4) Indices, 2000=100.

The fall in interest rates eased the burden of financial costs. While still high with respect to the average for the decade, as a share of gross operating profit these costs declined by over 2 percentage points, to 19.4 per cent. The low cost of debt is emerging as a vital factor in firms' financial soundness: in 1992-93, when the burden of financial costs amounted to around 30 per cent of gross operating profit, the corporate insolvency rate was above the current level.

Notwithstanding the sharp fall in investment, firms' capacity to cover investment expenditure by drawing on internal resources remained very limited, although it improved slightly compared with 2008 (Figure 14.4.b). In volume terms, it is estimated that the external funding requirement generated by capital investment declined markedly from the previous year's level; firms' financial deficit stood at €36 billion (Table 14.4).

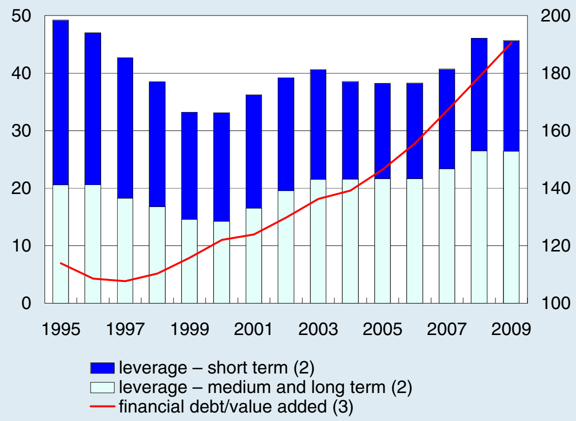
For many firms the external funding requirement linked to working capital increased during the crisis. Funding requirements grew along with the extension of trade credit terms, leading to greater lags between monetary outflows and inflows; the smallest and contractually most vulnerable firms were hardest hit. In the last two years all the Bank of Italy's surveys of firms have highlighted how working capital requirements have been the primary cause of recourse to credit by the firms that increased their demand for bank loans.

Debt and firms' financial structure. – At the end of 2009, firms' financial debt was virtually unchanged from a year earlier (Table 14.4). The deceleration compared with previous years is largely due to the fall in credit from Italian banks, which declined from 69 to 67 per cent of financial debt, compared with an increase in bond issuances and borrowing from foreign banks. The level of firms' indebtedness remains high compared with the past (Figure 14.5): leverage, defined as the ratio of financial debt to the sum of financial debt and shareholders' equity at market prices, was 45.7 per cent. Firms are highly exposed to any increases in market rates: both the ratio of short-term to total debt (42 per cent) and the share of variable rate contracts in long-term debt (94 per cent of the loans granted between 2004 and 2009) remain high.

At the end of 2009, the leverage of Italian firms was four percentage points below that of Spain, in line with Germany and the UK, and around ten points higher than in France and the United States. In proportion to GDP, firms' financial debt in Italy was low by international standards. Compared with all the other countries, Italian firms display the highest share of short-term borrowing and the greatest dependence on bank credit.

Figure 14.5

Corporate debt (1)
(percentages)



Sources: Bank of Italy, Istat.
(1) The data relate to the non-financial corporations sector. – (2) Left-hand scale. Leverage is calculated as the ratio of financial debt to the sum of financial debt and shareholders' equity at market prices. – (3) Right-hand scale. Value added for 2009 is estimated from national accounts data.

Table 14.4

Financial assets and liabilities of firms (1)
(millions of euros and percentages)

	End-of-period stocks			Flows	
	Dec. 2009	Percentage composition		2008	2009
		Dec. 2008	Dec. 2009		
ASSETS					
Domestic assets	**1,164,557**	**68.4**	**66.0**	**-25,088**	**-35,418**
Cash and sight deposits	187,462	10.1	10.6	1,481	12,395
Other deposits	15,499	1.0	0.9	337	-1,476
Short-term securities	1,214	0.1	0.1	1,017	-1,171
Medium and long-term securities	50,630	2.4	2.9	-243	18,955
of which: government	*34,636*	*1.8*	*2.0*	*665*	*5,133*
corporate	*2,270*	*0.1*	*0.1*	*1,067*	*4,051*
Shares and other equity	326,235	20.1	18.5	-19,424	-48,392
Investment fund units	1,894	0.1	0.1	-582	-7
Accounts receivable	511,082	30.8	29.0	-7,098	-19,669
Other financial assets (2)	70,543	3.8	4.0	-576	3,949
External assets	**599,075**	**31.6**	**34.0**	**45,859**	**14,466**
of which: deposits	*58,708*	*2.7*	*3.3*	*-5,420*	*12,882*
accounts receivable	*53,410*	*3.3*	*3.0*	*-1,270*	*-3,664*
short-term loans	*200,517*	*11.4*	*11.4*	*47,221*	*3,240*
securities	*25,332*	*1.5*	*1.4*	*-2,950*	*264*
shares and other equity	*252,470*	*12.2*	*14.3*	*9,822*	*1,523*
Total assets	**1,763,632**	**100.0**	**100.0**	**20,771**	**-20,952**
LIABILITIES					
Domestic liabilities	**3,022,600**	**88.9**	**86.8**	**84,665**	**-19,759**
Short-term debt (3)	402,038	12.1	11.5	21,464	-17,683
of which: bank	*357,304*	*10.5*	*10.3*	*17,370*	*-8,536*
Medium and long-term debt (4)	635,141	18.6	18.2	60,401	-14,742
of which: bank	*491,780*	*14.4*	*14.1*	*43,758*	*-10,078*
Securities	38,044	1.0	1.1	-2,556	6,580
of which: medium and long-term	*33,062*	*0.8*	*0.9*	*441*	*6,806*
Shares and other equity	1,250,754	36.7	35.9	15,271	25,541
Accounts payable	521,512	15.5	15.0	-10,290	-20,071
Other financial liabilities (5)	175,110	5.0	5.0	376	616
External liabilities	**458,442**	**11.1**	**13.2**	**16,024**	**35,261**
of which: accounts payable	*24,557*	*0.8*	*0.7*	*-898*	*-3,739*
financial debt	*183,582*	*4.5*	*5.3*	*23,626*	*23,139*
shares and other equity	*247,247*	*5.7*	*7.1*	*-6,043*	*15,027*
Total liabilities	**3,481,042**	**100.0**	**100.0**	**100,689**	**15,502**
BALANCE	**-1,717,410**			**-79,917**	**-36,454**

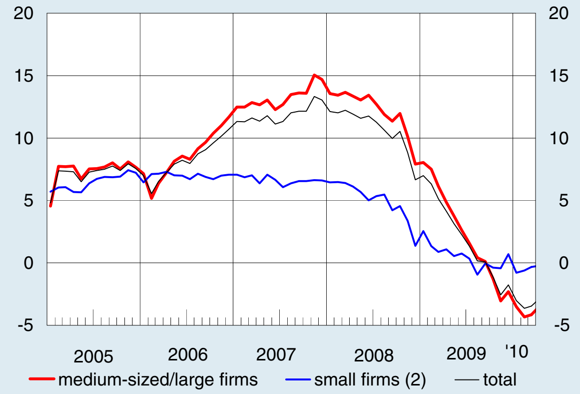
(1) The data refer to the non-financial corporations sector. Rounding may cause discrepancies in totals. – (2) Insurance technical reserves, domestic derivatives and other minor items. – (3) Includes finance provided by factoring companies. – (4) Includes securitized loans and finance provided by leasing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

Lending to firms. – The reduction in the flow of credit to firms was one of the outstanding features of the crisis and helped heighten financial tensions, especially among the smaller and more vulnerable firms. In 2009, lending to non-financial corporations and producer households declined by around €28 billion, that is by 3 per cent on a twelve-month basis. The decline has persisted in recent months (2.9 per cent in March 2010; Figure 14.6). It was sharpest among medium-sized and large firms, in part owing to the decision of several major industrial groups to replace part of their bank debt with alternative sources of finance. There was a marked contraction (9.3 per cent in March 2010) in lending to manufacturing firms, dealt the hardest blow by the recession (Table 14.5). In all sectors lending performed better in the South of Italy than in the Centre and North.

Figure 14.6

Bank loans by firm size (1)

(twelve-month percentage changes)



Source: Supervisory returns.
(1) Loans exclude repos, bad debts and several minor items that come under the harmonized definition of the Eurosystem. The percentage changes are calculated net of the effects of securitizations, reclassifications, exchange rate variations and other non-transaction-based variations. – (2) Limited partnerships, general partnerships, informal partnerships, de facto companies and sole proprietorships with fewer than 20 workers.

Table 14.5

Lending to firms (1)

(twelve-month percentage changes)

	Total			Centre and North			South		
	Dec. 08	Dec. 09 (2)	Mar. 10	Dec. 08	Dec. 09 (2)	Mar. 10	Dec. 08	Dec. 09 (2)	Mar. 10
				Banks					
Branches of economic activity (3)									
Manufacturing	3.8	-8.9	-9.3	4.4	-9.3	-9.9	0.2	-5.5	-3.6
Construction	8.6	-1.1	-1.4	8.3	-2.0	-2.2	9.8	2.5	1.4
Services	6.9	-0.5	-0.6	7.3	-0.9	-1.1	4.2	2.1	2.7
Other	11.9	-4.5	-2.2	12.4	-5.8	-3.3	8.7	4.3	5.7
Technical forms									
Overdrafts	8.5	-6.9	-6.4	8.5	-7.5	-7.1	8.2	-2.0	-1.4
Loans	7.4	5.6	5.9	7.9	5.7	5.9	5.1	4.9	5.7
Other	4.8	-12.0	-12.8	5.3	-12.8	-13.7	1.0	-5.9	-5.2
Total (3) (4)	**7.0**	**-3.0**	**-2.9**	**7.3**	**-3.6**	**-3.5**	**5.3**	**0.5**	**1.3**
				Financial companies					
Leasing	9.6	5.6	6.0	8.6	5.8	5.4	16.5	4.5	3.4
Factoring and other	13.0	-2.2	-2.5	14.0	-2.0	-2.3	9.9	-3.5	-3.7
Total	**10.4**	**4.2**	**4.4**	**9.7**	**4.3**	**4.8**	**15.1**	**3.0**	**2.2**

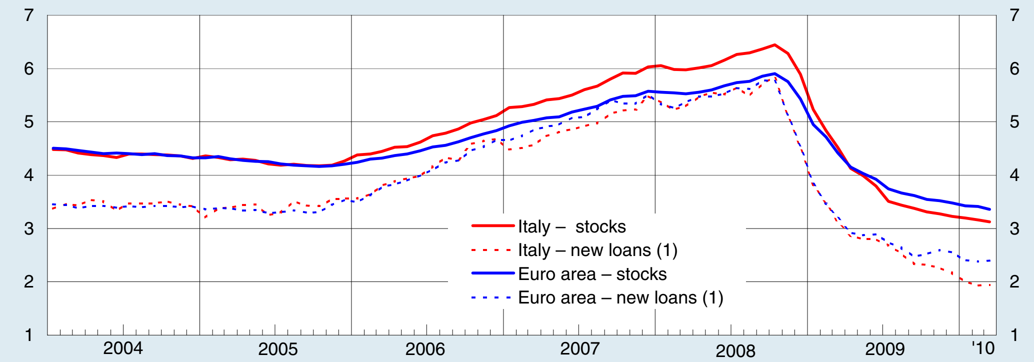
Sources: Supervisory returns and Central Credit Register data on financial corporations.
(1) Data refer to the sectors of non-financial corporations and producer households. Loans exclude repos and bad debts. The data for March 2010 are provisional. – (2) January 2010 for financial corporations. – (3) The percentage changes are adjusted for the accounting effect of reclassifications. – (4) The percentage changes are adjusted for the accounting effect of securitizations.

The trend in lending was affected by the tightening of credit standards, above all by the largest banking groups. In March 2010 lending by the five largest groups declined by 5 per cent. Based on the recent survey of 400 Italian banks conducted by the Bank of Italy's branches, in the second half of 2009 the tightening of credit conditions was apparently attenuated. However, surveys of firms suggest that the difficulties in accessing credit remain substantial compared with the years preceding the crisis. The Bank of Italy's Survey of Industrial and Service Firms indicated that 8 per cent of firms had received a request for early repayment from creditors, while 7 per cent reported having applied unsuccessfully for new loans (down from 8 per cent in 2008 and an average of 4 per cent in the previous five years). Difficulties remained substantial among small firms, in industry, and in the South of Italy, while firms with more than 500 workers reported a significant improvement.

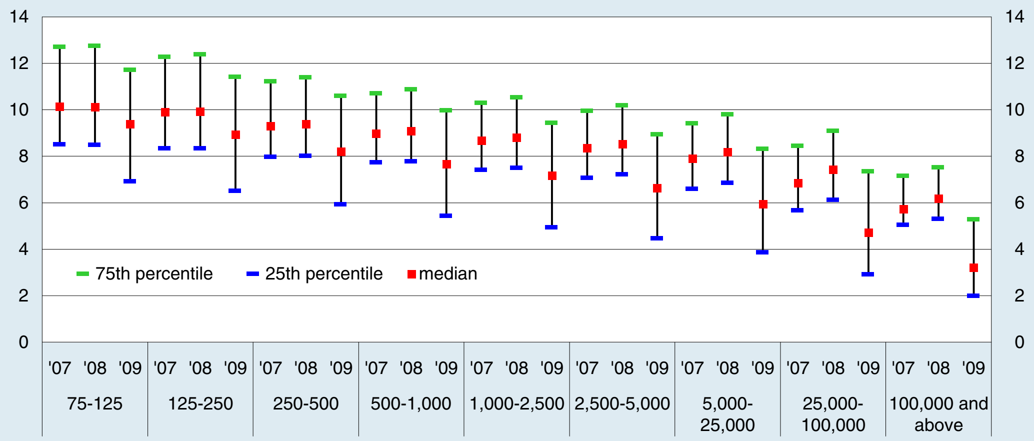
Interest rates applied by banks. – For those firms that did have access to credit, its cost declined further, reaching historically low levels: in March 2010 the average interest rate was 3.1 per cent, down by over one percentage point on the year-earlier period. Excluding current accounts, the rates applied to new loans fell to 1.9 per cent (Figure 14.7.a). The reduction was greater than that in the euro area, both for variable and fixed rate loans. In 2009 the difference between the Italian and euro-area rates, calculated on the basis of total outstanding amounts, narrowed to nil, and from April onwards turned negative.

Figure 14.7

(a) Interest rates on bank loans to firms
(monthly data; percentages)



(b) Interest rate dispersion on current account overdrafts by borrowers' size class (2)
(percentages)



Sources: Based on ECB and Bank of Italy data.
(1) New loans. Excluding current account overdrafts. — (2) The size classes, expressed in thousands, are calculated based on the credit granted to each individual borrower by all the reporting intermediaries.

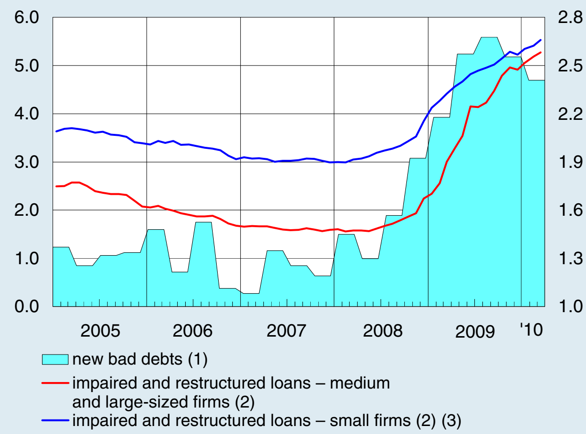
Against a backdrop of tightening credit standards and falling official rates, in 2009 the differences in the rates applied to borrowers widened, reflecting both the higher risk premium demanded by banks and the bargaining power of the largest and most creditworthy firms. A breakdown of interest rates shows that the fall in those on current accounts was significant for the largest firms; interest rate dispersion increased within all size classes (Figure 14.7.b).

Measures to support access to credit. – Last year the Government adopted numerous measures to sustain firms' financial conditions, aimed primarily at easing access to credit. Considering the disbursements of new loans and the suspension of payments of existing ones, the overall impact of the main interventions – which presumably have not yet ceased to deploy their effects – is currently estimated at €20 billion.

Financial strains and repayment difficulties. – In 2009 firms reacted to the crisis first and foremost by cutting operating costs, fixed investment and expenditure on staff. Net disposals of financial assets were also substantial (€21 billion; Table 14.4) and helped to ease the strains on liquidity: the low level of financial investment was concentrated in instruments that could be liquidated at short notice, such as deposits and bank bonds.

Figure 14.8

Firms' bank loan repayment difficulties
(percentage of loans)



Source: Central Credit Register.
(1) Right-hand scale. Seasonally adjusted quarterly data. The flow of adjusted new bad debts calculated on an annual basis and in relation to adjusted performing loans at the end of the previous quarter. – (2) Left-hand scale. Impaired loans refer to borrowers with temporary repayment difficulties. – (3) Limited partnerships, general partnerships, informal partnerships, de facto companies and sole proprietorships with fewer than 20 workers.

The worsening of firms' financial conditions was reflected in the greater difficulties they had repaying bank loans on schedule. In March 2010 banks reported that compared with 2008 temporary repayment difficulties (impaired and restructured loans) had risen by over 2 percentage points, to 5.3 per cent. The largest increase involved medium-sized and large firms in the southern regions and those in the manufacturing sector (Figure 14.8).

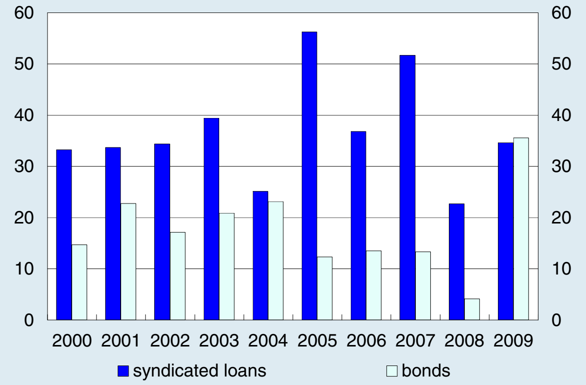
In the most serious cases, the deterioration in financial conditions resulted in bankruptcy proceedings. Based on data from the Chambers of Commerce there were about 10,000 such proceedings in 2009, 26 per cent more than in the previous year. Banks' exposure to these firms and to others in equally grave financial conditions resulted in a flow of adjusted new bad debts of €23 billion in all of 2009, 2.5 per cent of the stock of outstanding loans at the beginning of the year (over €5 billion and 2.4 per cent in the first quarter of 2010). Defaults were most frequent among manufacturing firms, especially in the fashion and basic metal and engineering industries, where last year the flow of new bad debt rose to 6.9 and 4.1 per cent, respectively.

The finances of large firms. – The few Italian firms that have access to the international financial markets benefited from the markets' upturn by intensifying their fund-raising activities to the detriment of bank credit. Based on Dealogic data, in 2009 gross bond issuances of Italian industrial groups on the international markets rose to €36 billion (Figure 14.9) and continued to expand in the first quarter of 2010. Compared with the years before the crisis, the increased risk aversion of investors continues to affect the characteristics of the securities issued: in 2009 the spreads over the reference rate stayed above 200 basis points, compared with an average of around 100 points in 2003-07.

Figure 14.9

Bonds and syndicated loans

(gross issuances and new loans; billions of euros)



Source: Dealogic.

In 2009, syndicated loans returned to growth. According to Dealogic data, gross disbursements totalled €35 billion, as against €23 billion in the previous year. Around half of this amount was for the refinancing of Enel's acquisition of Endesa. Meanwhile loans to smaller industrial groups amounted to much less than the average for the pre-crisis years. The riskiest segment of the market – leveraged loans – contracted further.

Venture capital and private equity. – In 2009 the shareholder equity of Italian firms increased by €41 billion (€9 billion in 2008; Table 14.4). The increase is partly due to the fund-raising of listed companies (around €13 billion), which grew essentially owing to capital increases by Enel and Snam Rete Gas. There were just four new listings (down from 6 in 2008 and 26 in 2007), and the same number again in the first quarter of 2010.

The financial crisis had a major impact on the private equity and venture capital market in 2009. According to the data published by the Italian Private Equity and Venture Capital Association (AIFI), fund-raising by companies in the sector more than halved, settling at around €1 billion. However, there are still abundant resources for investment, thanks to the substantial fund-raising of previous years. Investment declined to a similar extent, from €5.5 billion to €2.6 billion, due to weaker demand from firms and bleaker earnings forecasts. Buyouts declined most, as did venture capital investment.

15. THE FINANCIAL MARKETS

Conditions in the Italian financial markets improved in 2009 along with those in the other euro-area countries. Share and bond prices rose sharply, benefiting from the improvement in the economic picture and, in all the advanced countries, from abundant liquidity and measures to support the banking system. The lively demand for corporate bonds fostered an expansion of net issues by Italy's large non-financial corporations, compensating in part for the pronounced slowdown in bank lending.

From November onwards, however, there were mounting strains due to increased sovereign risk in the advanced countries, and specifically in the euro area. In the first four months of 2010 the Greek government securities market deteriorated, despite the financial support plans announced by the international community. The increase in volatility infected other countries and markets, and from the end of April the tensions spread further. Risk premiums on government securities rose significantly in a number of countries. In Italy the rise was relatively moderate. The share and bond markets fell and their volatility increased, especially for bank securities. The widening of the spread on euro-area government securities has been partially reversed since the announcement on 10 May of a series of support measures by EU governments and the IMF, including the institution of a European Stabilization Mechanism, and by the European Central Bank. Tensions nevertheless remain strong in all the advanced economies' currency and stock markets.

Public sector securities

Supply and demand. – Net issues of Italian public sector securities rose from €62 billion in 2008 to €86 billion last year. This mainly reflected the growth in the overall general government borrowing requirement and an increase in the balance on the Treasury's account with the Bank of Italy. The year-end stock of public securities outstanding rose from 88.3 to 96.8 per cent of GDP, approaching the levels of a decade earlier.

The average residual maturity of government securities increased by 4 months to 6 years and 11 months, reflecting increased longer-term issues, while their average duration increased more markedly (by 6 months to 5 years and 2 months), thanks in part to a further pronounced fall in the portion consisting of CCTs. Against net redemptions of securities of short duration (BOTs and CCTs), there was a sharp increase in net issues of CTZs (from €1 billion to €17 billion) and BTPs (from €58 billion to €100 billion). Among the latter, net issues of ten-year securities fell from €27 billion to €11 billion, while those of shorter-term paper rose appreciably. There was also a strong increase in net issues of securities indexed to euro-area inflation, from €4 billion to €17 billion. Net issues of Republic of Italy bonds were practically nil, after net redemptions of €9 billion in 2008.

Italian local authorities continued to make modest net redemptions, amounting to €1.4 billion compared with €0.4 billion the previous year; new issues were negligible at €174 million. By the end of the year local government securities had fallen from 2.5 to 2.3 per cent of total Italian public securities outstanding.

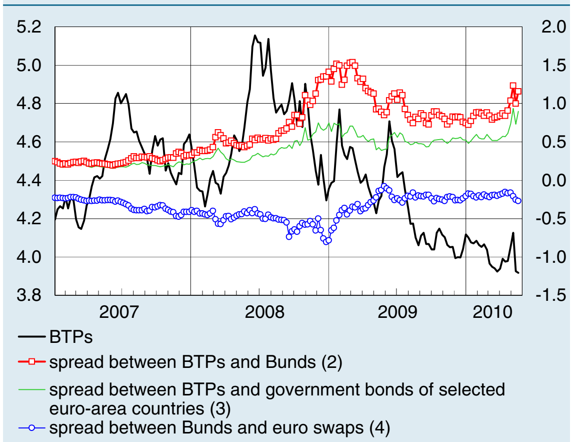
Discouraged by low short-term yields, households and firms made substantial net disposals of BOTs and CCTs (€65 billion and €9 billion respectively), only partially offset by new investment in BTPs and CTZs (€16 billion and €6 billion). Banks were net purchasers of government securities for €31 billion, and investment funds, after five consecutive years of disinvestment, also returned to making net purchases. The purchases involved mostly BOTs and CTZs, while there were net disposals of CCTs and BTPs. Foreign investors again made large-scale net purchases of Italian government securities (€69 billion), concentrating on BOTs and BTPs. During the year the share of total Italian public securities held by non-residents rose by about 2 percentage points to 51 per cent.

Interest rates. – Rates on ten-year government securities declined in 2009. In the first six months they fluctuated around 4.5 per cent and then fell to just over 4 per cent from September (Figure 15.1). The decrease reflected both extremely expansionary monetary policy conditions, which fostered a fall in yields on all public securities, and also, until the autumn, a diminution in the sovereign risk premium that investors were demanding on Italian government paper. Over the course of the year the yield on the benchmark bond declined by about 0.2 percentage points to 4.1 per cent. Real interest rates for that maturity, derived from the price of the ten-year bond indexed to euro-area consumer prices, showed a similar pattern but fell by more overall, to 1.8 per cent. In the first four months of 2010 the yield on the benchmark ten-year bond held at around 4 per cent, peaking at 4.3 per cent on 7 May in concomitance with the turmoil in the euro-area government securities markets.

Figure 15.1

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

(weekly averages; percentages and percentage points)



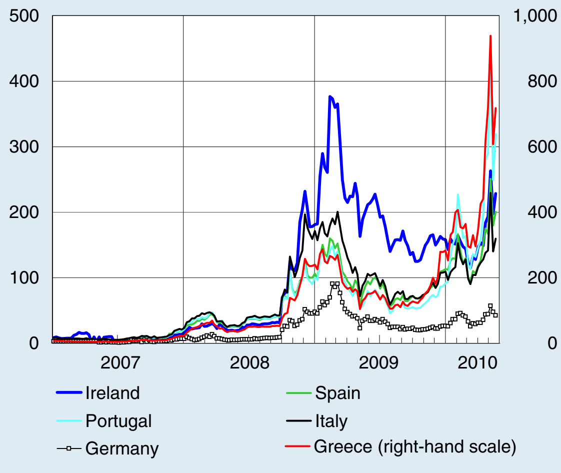
Source: Based on Bloomberg data.
(1) Yields on benchmark ten-year bonds. – (2) Right-hand scale. – (3) Spread between the yield on ten-year BTPs and the simple average of yields on corresponding government securities of three euro-area countries that were rated AAA by all of the leading agencies at the end of 2009 (Austria, Finland, France, Germany and the Netherlands); right-hand scale. – (4) Spread between ten-year Bunds and ten-year euro swaps; right-hand scale.

The yield spread between the benchmark ten-year BTP and the corresponding German Bund had become very wide at the start of 2009 in response to the global financial crisis, but in the months through July it then narrowed by 0.6 percentage points (Figure 15.1). Since the end of this April spreads have widened again, however, as fears over the sustainability of the public finances in Greece and other euro-area countries triggered new financial market strains. After peaking at 155 basis points on 7 May, at the height of the turmoil, the BTP spread narrowed to 132 points on 20 May. The pattern for premiums on five-year credit default swaps on Italian government securities, which signal the probability that the markets assign to the issuer's insolvency, was similar to that for the ten-year BTP-Bund spread, diminishing in the first three quarters of 2009. Between mid-October and mid-May of 2010 they rose significantly, reflecting the Greek financial crisis. Overall they more than doubled to 160 basis points.

Figure 15.2

Premium on 5-year CDSs on government securities of selected euro-area countries

(end-of-week data; basis points)



Source: Thomson Reuters Datastream.

The volatility of interest rates on long-term euro government securities implied by the prices of ten-year Bund futures options, which had reached historically high levels towards the end of 2008 in the wake of the Lehman Brothers failure, subsided in the course of 2009 and the early months of 2010, as the international financial market strains eased. In the last ten days of April it turned sharply upwards in connection with the Greek crisis, returning to the levels of a year earlier.

Corporate bonds and bank bonds

Issuance. – Net Italian private sector bond issues declined to €137 billion, from €199 billion in 2008 (Table 15.1). The contraction can be ascribed to the significant reduction in issues by banks and other financial corporations, which are mostly bank-controlled.

Table 15.1

Medium and long-term bonds of Italian banks and firms (1)

(at face value; millions of euros)

	Net issues (2)			Stocks			as a % of GDP
	2007	2008	2009	2007	2008	2009	2009
Banks	63,928	123,655	77,886	617,874	741,806	819,692	54
Other financial corporations	12,569	73,171	45,429	166,370	239,164	284,677	19
Non-financial corporations	10,700	1,975	13,926	60,934	61,864	76,029	5
Total	87,197	198,801	137,241	845,178	1,042,834	1,180,398	78
Memorandum item:							
International market (3)	62,176	108,057	86,139	572,573	678,209	764,679	50

(1) The nationality and sector refer to the issuer and not to its parent company, except as indicated. Only includes securities with a maturity at issue of more than one year. – (2) Difference between the face values of issues and redemptions. – (3) Source: BIS. The nationality and sector refer to the issuer's parent company and not to the issuer. Includes medium-term notes with a maturity at issue of less than one year. The international market consists of bonds sold partly to residents of countries other than that of the issuer.

Net issues by non-financial corporations, by contrast, increased substantially, from €2 billion to €14 billion. The resumption of bond placements consisted mainly in large issues by Eni, Enel and Telecom Italia, which accounted for 51 per cent of total gross issues. The net issues of smaller companies were again modest. Issuance remained strong in the first four months of 2010, owing mainly to placements by Enel and Telecom Italia.

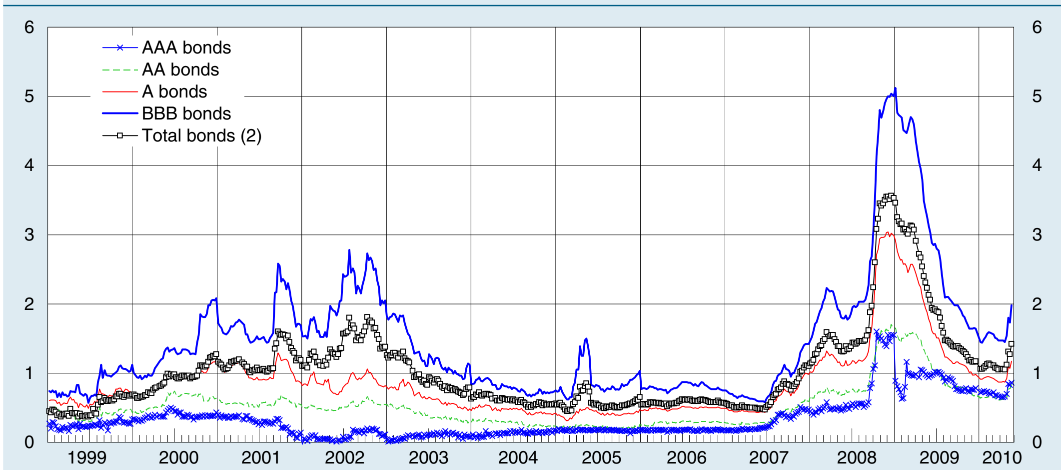
Net issues of Italian asset-backed securities (i.e. securities issued by special purpose vehicles and covered bonds, which are secured by assets that remain on the issuers' balance sheet) fell from €71 billion to €42 billion last year. A good part of securitization issues, mainly residential mortgage-backed securities, was posted as collateral for ECB refinancing operations. In May 2009 the ECB announced a programme for the purchase of €60 billion worth of covered bonds, and in the second half of the year Italian banks issued residential mortgage-backed bonds worth €7.5 billion, compared with €6.5 billion in all of 2008. Net issuance proceeded at a rapid pace in the first four months of 2010 as well.

Gross issues of Italian commercial paper rose substantially, from €145 billion in 2008 to €215 billion last year, owing above all to placements by Intesa Sanpaolo, which accounted for over half the total volume, UniCredit, Eni and Enel.

Yields. – The cost of funds raised via euro-denominated bond issues by non-financial Italian and foreign corporations of investment grade (rated at least BBB- or Baa3) fell by about 3 percentage points to 3.6 per cent, a level not matched since the second half of 2005, consequent to the plunge in risk premiums from 3.5 to 1.1 points, on average (Figure 15.3) and the fall in the yield on government securities. The cost of funds also fell sharply for issuers of high-yield bonds, dropping from the historic peak of 27 per cent in March to 10 per cent at the end of the year. Between the start of 2010 and the middle of May the yields on investment-grade private sector bonds fell by more than half a point; the decline in the yields on French and German government paper more than offset the rise in risk premiums.

Figure 15.3

Yield differentials between euro-denominated corporate bonds and government securities (1)
(weekly data; percentage points)



Source: Merrill Lynch.
(1) Fixed-rate euro-denominated Eurobonds with a residual term to maturity of not less than one year issued by non-financial corporations resident in countries whose long-term foreign currency debt bears a rating not lower than BBB- or Baa3. The differentials are calculated with reference to French and German government securities of corresponding maturity. – (2) Includes all investment-grade bonds (i.e. rated at least BBB- or Baa3).

The yield spread on investment-grade Italian corporate bonds narrowed by 2.3 percentage points in 2009, in line with the fall relative to comparable firms in other euro-area countries. After holding broadly unchanged for the first four months of this year, spreads widened by 0.5 points in the first three weeks of May as financial market conditions deteriorated rapidly.

The improvement in financial market conditions during 2009 also benefited the yield spreads on the bonds of the leading Italian banks, which diminished by 1.2 percentage points year on year, compared with a drop of 0.6 points for those of other euro-area banks. The spreads held steady to the end of April this year before jumping 0.4 points in the first three weeks of May owing to worries over the Greek public debt.

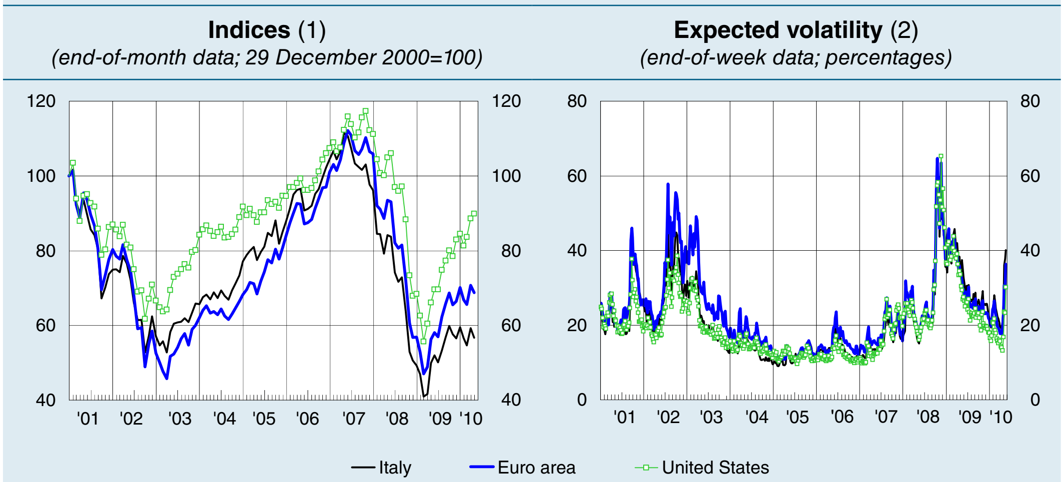
The equity market

Share prices and trading. – The progressive improvement in the state of the international banking system during the year and the strengthening domestic and world economy fostered a rise in the general Italian share price index, which gained 21 per cent for the year as a whole, broadly in line with the main euro-area index (Figure 15.4). Between the start of 2010 and the middle of May Italian share prices lost 16 per cent, in response to worries over the public finances in some euro-area countries and resurgent international market strains.

The general index in Italy was outperformed by basic materials (with a gain of 105 per cent, benefiting from rising raw materials prices), as well as automobile shares (98 per cent), consumer products (62 per cent), basic industry (25 per cent), services (24 per cent) and banking (23 per cent). The sectors that did worse than the general index were oil (with a gain of 13 per cent), utilities (6 per cent) and insurance (2 per cent). As in the rest of the area, telecommunications shares, weighed down by a high level of debt, were heavily penalized (a loss of 4 per cent).

Figure 15.4

Share markets



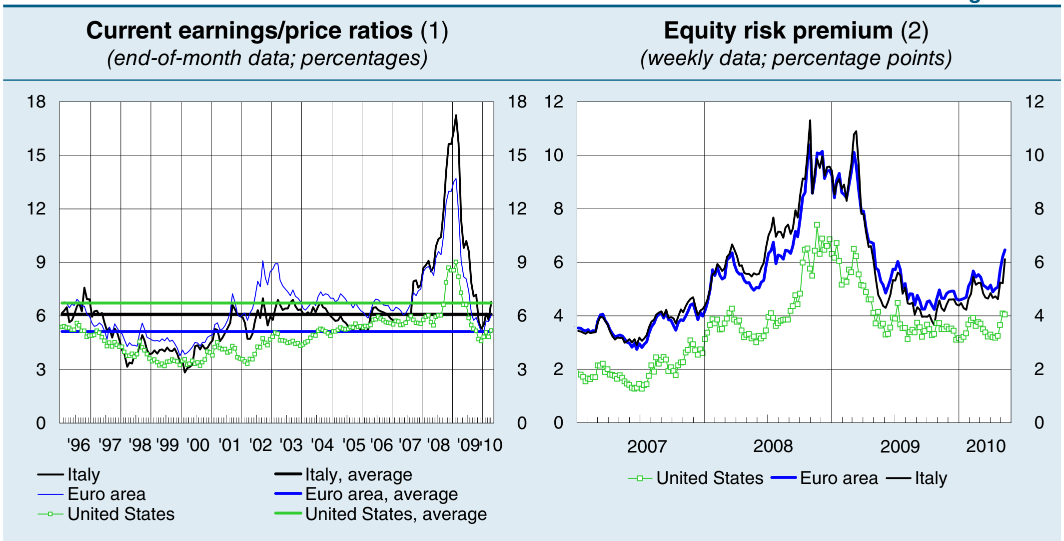
Source: Based on Bloomberg data.
(1) Indices: FTSE MIB for Italy, Dow Jones Euro Stoxx for the euro area, Standard & Poor's 500 for the United States. – (2) Volatility implied by stock index options.

The gain in share prices recorded in 2009 can be attributed mainly to a pronounced decrease in the risk premium demanded by investors, which more than counterbalanced the adverse effect of lower current and expected earnings. Prices were also buoyed by the moderate fall in long-term interest rates.

The expected volatility of share prices, very high in January and February, declined for the rest of 2009 and by the end of the year had come back down to near its long-run average. After a further fall in early 2010, in mid-April it rose sharply in response to financial market turmoil.

The current earnings/price ratio for Italian listed companies fell very sharply in the course of 2009, to 5.3 per cent at the end of the year (Figure 15.5). At present the ratio stands just below its average since the mid-1980s. Based on price levels and short-term earnings expectations, the risk premium demanded by investors for holding shares can be estimated at about 5.7 percentage points, compared with 7.3 points in 2008; this is about 3 points above the average for the last ten years (Figure 15.5).

Figure 15.5



Sources: Based on IBES and Thomson Reuters Datastream data.
(1) The averages are calculated from January 1990 onwards. – (2) The risk premium is calculated as the difference between the ratio of the expected earnings/price ratio for the subsequent twelve months to the yield on ten-year government bonds.

Supply and demand. – Despite the stock market recovery, there were again very few initial public offerings – just seven, the same as in 2008. Six were in the segments for small and medium-sized firms (two in the MAC alternative capital market segment and four in the AIM Italia alternative investment market segment). The funds raised in IPOs came to €160 million, compared with €143 million in 2008. By contrast, fund-raising through capital increases by already listed companies more than doubled, from €7.7 billion to €18.6 billion (Table 15.2). A large proportion of these funds (31 per cent) was raised by banks, which continued the previous year's tendency to strengthen their capital bases. The number of IPOs slumped in the euro area as a whole, from 57 to 34, before turning sharply upwards in the first quarter of 2010.

At the end of the year, 291 Italian companies were listed on Borsa Italiana, down from 294 twelve months earlier, and 41 foreign companies. Thanks to the rise in share prices and to capital increases, the total capitalization of the Italian companies rose from €375 billion to €457 billion and from 24 to 29 per cent of GDP. The ratio of market capitalization to GDP at the end of the year was 37 per cent in Germany, 67 per cent in the four European countries of the NYSE Euronext platform (Belgium, France, the Netherlands and Portugal), 106 per cent in the United States and 124 per cent in the United Kingdom.

Table 15.2

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

	2004	2005	2006	2007	2008	2009
Annual change in prices (1)	17.5	13.9	19.0	-8.0	-48.7	20.7
Listed Italian companies (number at end of year)	269	275	284	301	294	291
of which: in the STAR segment	*46*	*70*	*75*	*82*	*75*	*72*
Total market capitalization (2)	568,901	676,606	778,501	733,614	374,702	457,126
as a percentage of GDP	*43.1*	*49.3*	*52.8*	*48.0*	*24.3*	*29.1*
percentage breakdown: (3)						
industrials	*23*	*26*	*29*	*31*	*33*	*37*
insurance	*12*	*12*	*10*	*10*	*11*	*9*
banking	*25*	*32*	*33*	*30*	*25*	*26*
financials	*3*	*4*	*4*	*4*	*3*	*2*
services	*37*	*26*	*24*	*26*	*28*	*26*
Total	**100**	**100**	**100**	**100**	**100**	**100**
Gross share issues (4)	3,197	12,599	6,098	5,441	7,700	18,628
of which: in the STAR segment	*89*	*279*	*290*	*409*	*238*	*97*
Market value of newly-listed companies (5)	5,999	6,405	12,919	11,178	464	561
of which: foreign companies	..	..	..	..	..	*51*
of which: in the STAR segment	..	*797*	*3,620*	*4,243*	..	*226*
Dividends distribuited (6)	21,712	22,755	28,475	30,442	31,432	16,578
Earnings/price ratio (7)	6.0	5.2	5.8	7.8	15.6	5.3
Dividend yield (7)	3.4	3.0	3.2	3.7	8.0	5.0
Turnover:						
spot market (8)	*641,376*	*893,853*	*1,078,390*	*1,513,634*	*993,511*	*645,993*
FTSE MIB index futures (9)	*467,122*	*585,445*	*761,580*	*954,524*	*698,258*	*418,714*
FTSE MIB index options (9)	*152,839*	*209,526*	*262,312*	*368,966*	*268,264*	*140,345*
Turnover ratio (10)	121	144	148	200	179	155

Sources: Borsa Italiana, Thomson Reuters Datastream and World Federation of Exchanges.
(1) Percentage change in the FTSE MIB index over the year. – (2) End-of-period data. Italian companies. – (3) Does not include the Expandi Market. – (4) The value of share issues is obtained by multiplying the number of shares issued by the issue price. Includes bond conversions. Italian companies. – (5) Sum of the market values of each company on the placement date. – (6) Sources: to the end of 2007, based on Borsa Italiana data; from 2008, World Federation of Exchanges data. – (7) End-of-period data. Percentages. 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. Italian companies.

The Expandi Market ceased operations in June of last year. The companies listed on it shifted into the various segments of the electronic share market (MTA). AIM Italia and MAC offer less stringent listing requirements than those of the main list. The MIV market in investment vehicles has been instituted for shares of investment companies, real estate investment companies and units/shares of closed-end funds. Last June the S&P MIB index of the main corporations listed on Borsa Italiana was supplanted by a new FTSE MIB index, which will serve as the underlying asset for all Borsa Italiana index derivatives traded on regulated markets.

BANKS AND NON-BANK INTERMEDIARIES

16. THE ITALIAN FINANCIAL SYSTEM IN 2009

Developments over the year

The impact on the Italian banking system of the financial crisis that began in the summer of 2007 has been relatively moderate compared with other countries. The limited presence in their balance sheets of the assets hit hardest by the crisis, their lesser dependence on wholesale funding markets, specialization in traditional activities and a prudent regulatory and supervisory framework are the factors underpinning the soundness of Italian banks. However, they have been affected by the drying up of international liquidity and the heightened perception of the risks of banking.

In 2009, set against an improvement in their liquidity position, banks' balance sheets showed a marked deterioration in loan quality as a result of the recession that began in the second quarter of 2008. The flow of bad debts grew rapidly compared with the increase in overall lending, especially with regard to corporate borrowers. The increase in impaired loans and higher estimates of the probability of default within a year indicate that significant new loan losses might emerge during the current year. With the progressive deterioration in the quality of loans, credit supply conditions were tightened; they were also affected by pressures on capital and, to a lesser extent, by the difficulties in raising funds on the international wholesale markets. These trends, together with the slowdown in the demand for loans in a period of weak capital investment and of stagnation in the real estate market, resulted in a reduction in lending to the economy, which decreased by 0.7 per cent, against an increase of 5.9 per cent in 2008. The contraction reflects the decline of 4.4 per cent in lending by the five largest banking groups, not entirely offset by the expansion of 2.8 per cent in lending by the other banks.

Although operating profitability held up, the increase in loan losses weighed heavily on banks' earnings: the return on equity (ROE), which had already fallen by 8 percentage points in 2008, declined from 4.5 to 3.6 per cent. Thanks to capital increases, containment of the share of profits distributed to shareholders, asset sales and, in the case of four banks, the issue of securities subscribed by the Ministry for the Economy and Finance, the banking system's capital base strengthened in 2009. Core tier 1 capital increased by €14 billion; as a ratio to risk-weighted assets, it rose by 1.2 percentage points to 8.2 per cent. The share of high-quality components of capital is relatively large for Italian banks compared with the major banks of the euro area.

The stress tests on the banking system, now used regularly by the Bank of Italy for the evaluation of risks, indicate that in an adverse macroeconomic scenario, characterized by real GDP growth 3 percentage points lower than the estimates of the main international forecasters for the two years 2010-11, the losses on Italian banks' overall exposure not covered by operating profit would amount to about 60 per cent of the capital held by the banking system in excess of the regulatory minimums at the end of 2009. The stress tests conducted by the top five banking groups for credit and market risks indicate that these intermediaries would maintain their capital ratios well above the legal minimums. As a whole, these exercises confirm the solidity of Italian banks; however, in the future it will be necessary to continue with capital strengthening.

On the basis of market indicators, the riskiness of Italian banks is low by international standards. Nevertheless, in May 2010 the strong tensions in the international financial markets, triggered by the critical situation of the public finances in Greece and by fears of contagion to other economies, were reflected in sudden increases in risk premiums – measured by the premiums on credit default swaps – and in abrupt falls in banks' share prices.

In 2009, as the economic situation worsened, supervisory activity concentrated on monitoring the quality of loan portfolios and other assets. Inspections were carried out at the main banking groups to evaluate the evolution of credit risk, especially in the corporate segment. The integration of off-site analysis, on-site inspections, stress tests and ad hoc investigations made it possible to monitor the evolution of risks and request corrective action where necessary. The need for banks to adopt all possible measures to strengthen their capital base was underscored. The careful monitoring of banks' liquidity continued.

Controls on non-bank intermediaries that supply credit were centred on ensuring compliance with the rules on transparency of contractual conditions, proper conduct, money laundering and usury; including by strengthening their organizational safeguards. In the sector of real estate funds, where some weaknesses had emerged, supervisory activity was particularly vigorous.

Italian institutional investors' net fund-raising turned positive in 2009, following massive outflows in 2008. The sector is penalized by a poorly diversified distribution structure and by scant variety in the range of products offered. Italian investment funds suffer, moreover, from a less favourable fiscal regime compared with foreign funds. The large outflow of savings from open-end investment funds recorded in previous years practically came to a halt. The net flow of savings to individually managed portfolios and life insurance policies turned positive; in the insurance sector, investors' strong risk aversion continued to penalize products of a more markedly financial nature, to the benefit of traditional products such as with-profits insurance polices, which guarantee a minimum yield. Supplementary pension plans' assets grew, thanks to positive yields on average, following the losses recorded in the preceding years; the number of new participants was modest.

The structure of the Italian financial system

Banks and banking groups. – There were 788 banks operating in Italy at the end of 2009, 11 fewer than a year earlier (Table 16.1). During the year 18 new banks were added to the register (small limited companies and branches of foreign banks) and 13 banks became operational. Twenty-four small banks closed as a result of 19 takeovers, mergers or asset transfers, 3 voluntary liquidations and 2 compulsory administrative liquidations. The number of banking groups declined by 6.

Table 16.1

The structure of the Italian financial system

	31 December 2008				31 December 2009			
	Number of intermediaries				Number of intermediaries			
	Banking group members (1)	Investment firm group members	Non-group members	Total	Banking group members (1)	Investment firm group members	Non-group members	Total
Banking groups	–	–	–	81	–	–	–	75
Investment firm groups	–	–	–	7	–	–	–	18
Banks	223	–	576	799	217	–	571	788
of which: limited company banks	*196*	–	*51*	*247*	*191*	–	*56*	*247*
cooperative banks (banche popolari)	*16*	–	*22*	*38*	*16*	–	*22*	*38*
mutual banks (banche di credito cooperativo)	*10*	–	*422*	*432*	*9*	–	*412*	*421*
branches of foreign banks	*1*	–	*81*	*82*	*1*	–	*81*	*82*
Investment firms	16	8	89	113	15	20	80	115
Asset management companies and SICAVs	54	3	157	214	39	5	160	204
Financial companies entered in the special register under Article 107 of the Consolidated Law on Banking	103	–	388	491	64	–	108	172
Electronic money institutions	–	–	3	3	–	–	3	3
Other supervised intermediaries (2)	–	–	2	2	–	–	2	2
Financial companies entered in the general register under Article 106 of the Consolidated Law on Banking	29	–	1,160	1,189	72	2	1,337	1,411

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

The number of bank branches fell from 34,146 to 34,036, mainly as a result of the closure of 544 branches by the two leading banking groups. The average number of inhabitants per branch is 1,610 nationally (1,320 in the Centre and North and 2,690 in the South).

At the end of 2009 the banks listed on the stock exchange numbered 25, down by one from a year earlier. Eight of the first 20 groups ranked by consolidated assets were not listed. The listed groups and banks accounted for 64.3 per cent of system assets (63.1 per cent in 2008); 7 of the listed parent companies are cooperative banks.

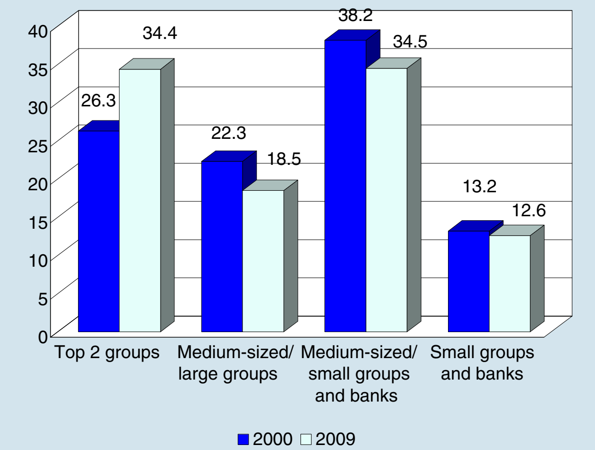
The degree of concentration of the banking system. – The mergers and acquisitions of the last decade have led to an increase in the degree of concentration of the banking system nationwide: between 2000 and 2009, the Herfindahl-Hirschman index, calculated on the total assets of the units operating in Italy, increased from 600 to 760 (on a scale of 10,000). However, in the same period the degree of concentration of local credit markets decreased. The average number of banks per province rose from 25 to 27.

Classifying banks according to size and group affiliation, the two major groups (UniCredit and Intesa Sanpaolo) hold 33.9 per cent of the banking system's assets in Italy (Figure 16.1), while the other three medium-sized/large groups (Banca Monte dei Paschi di Siena, Banco Popolare and Unione di Banche Italiane) account for 18.6 per cent. A third category comprises 51 medium-sized/small groups and stand-alone banks (including specialized banks and subsidiaries of foreign banking groups), with 35 per cent of total assets; the remaining 12.5 per cent is held by 590 small intermediaries with prevalently local operations.

Figure 16.1

Degree of concentration of the Italian banking system (1)

(percentages)



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. – For the top five banking groups, 36 per cent of total lending at the end of 2009 consisted in transactions with foreign banks and customers, compared with 38.3 per cent at the end of 2008. For all Italian banks, the share was 26.9 per cent (29 per cent in 2008).

Italian banks' presence abroad with local units is significant in the euro-area countries, particularly Germany and Austria, and is also well-established in central and eastern European countries: the share of exposure to these countries is 6.1 per cent, almost all of it concentrated in the two largest banking groups.

At the end of 2009 there were 22 subsidiaries of foreign companies and banks operating in Italy, two of which figured among the top 10 banking groups, with a market share of 9.7 per cent of total assets. The 81 branches of foreign banks not included in Italian groups held 8.2 per cent of system assets, compared with 9.1 per cent in 2008. In the case of 47 banks, 38 foreign investors – prevalently from EU countries – had shareholdings of over 5 per cent.

Non-bank intermediaries. – At the end of 2009 there were 201 asset management companies in operation, 10 fewer than a year earlier, and three Italian SICAVs, unchanged from the end of 2008.

There were 115 investment firms operating at the end of 2009. The number of bank-controlled investment firms fell from 29 to 25 over the year.

The number of financial companies entered in the special register referred to in Article 107 of the Consolidated Law on Banking fell significantly, from 491 to 172, following the deletion of securitization special purpose vehicles, which from October 2009 are only entered in the general register under Article 106 of that law. The majority (69 per cent) of Article 107 intermediaries engage in financing (leasing, factoring and consumer credit, including loans secured by a pledge of one fifth of the borrower's salary or pension). Fewer engage in the issuance of credit cards, purchase of non-performing assets, securitization servicing and merchant banking.

At the end of 2009 there were 1,411 intermediaries entered in the general register established under Article 106 of the Consolidated Law on Banking for entities that engage in a financial activity on a public basis (acquisition of shareholdings, granting of loans, payment services and trading in foreign exchange). Net of the increase due to the inclusion of 395 securitization vehicles previously entered in the special register, their number diminished by 173.

The number of intermediaries not operating on a public basis and entered in a special section of the general register pursuant to Article 113 of the Consolidated Law on Banking fell from 19,579 to 19,038 as a result of new regulations exempting "pure holding companies". The sections referred to in Article 155 of the Consolidated Law on Banking contained 753 collective loan guarantee consortiums, 453 money-changers and 127 credit unions (*casse peota*).

There were 121,542 loan brokers (including 9,865 companies), 67,585 financial agents (4,952 companies) and 216 professional gold traders.

17. THE ACTIVITY OF BANKS AND FINANCIAL INTERMEDIARIES

Assets

Lending to residents by banks operating in Italy contracted in 2009; the twelve-month change in loans, net of bad debts and repos, fell by nearly seven percentage points to minus 0.7 per cent (Table 17.1). The fall in lending continued in the first quarter of 2010, although its twelve-month pace eased to minus 0.2 per cent.

Table 17.1

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

	General govern-ment	Financial and insurance companies	Firms				Consumer households	Non-profit institutions serving households and units n.e.c.	Total
				medium-sized, large	small (2)				
						producer households (3)			
					Centre and North				
2008 – Dec.	6.1	-0.5	7.3	8.3	2.5	1.6	5.1	5.4	5.7
2009 – Mar.	6.2	-10.7	4.3	5.0	1.1	0.7	4.5	-0.5	2.8
June	8.3	-11.1	1.4	1.6	0.5	1.5	3.1	0.2	1.3
Sept.	5.7	-8.1	-1.2	-1.4	-0.3	0.8	2.9	-3.1	-0.1
Dec.	5.0	-6.4	-3.5	-4.1	-0.9	0.9	2.8	2.5	-1.3
2010 – Mar.	4.0	-2.4	-3.5	-4.2	-0.1	1.7	3.2	5.5	-0.8
					South				
2008 – Dec.	6.1	11.1	5.0	5.8	2.6	1.2	9.0	9.4	6.7
2009 – Mar.	8.2	-0.9	3.3	4.1	1.1	0.0	7.5	8.3	5.3
June	8.7	3.1	1.0	1.5	-0.3	-0.9	5.8	5.3	3.6
Sept.	14.2	-0.4	-0.7	-0.8	-0.7	-0.8	5.0	2.0	2.9
Dec.	8.0	-4.4	0.5	0.7	-0.1	0.2	4.5	6.5	2.7
2010 – Mar.	4.0	-1.2	1.3	2.0	-0.7	-0.2	5.5	0.9	3.2
					Italy				
2008 – Dec.	6.1	-0.3	7.0	8.0	2.5	1.5	5.9	5.8	5.9
2009 – Mar.	6.4	-10.5	4.1	4.8	1.1	0.5	5.1	0.5	3.1
June	8.4	-10.8	1.4	1.6	0.4	0.9	3.7	0.8	1.6
Sept.	6.5	-8.0	-1.1	-1.3	-0.4	0.4	3.3	-2.5	0.3
Dec.	5.3	-6.4	-3.0	-3.5	-0.8	0.8	3.2	3.0	-0.7
2010 – Mar.	4.0	-2.4	-2.9	-3.5	-0.2	1.2	3.7	4.9	-0.2

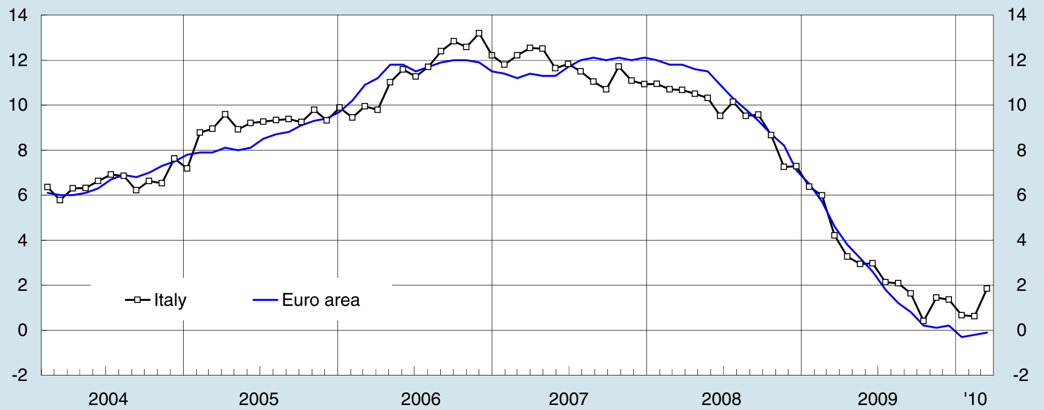
(1) Supervisory statistical reports. Statistics for March 2010 are provisional. Loans exclude repos and bad debts. The allocation by geographical area is according to customer residence. The percentage changes are adjusted for the accounting effects of securitizations and reclassifications. – (2) Limited partnerships and general partnerships with fewer than 20 workers; partnerships, de facto companies and sole proprietorships with fewer than 20 workers. – (3) Partnerships, de facto companies and sole proprietorships with up to 5 workers.

Lending to firms contracted by 3 per cent in the twelve months ending in December, while lending to consumer households continued to expand, though slowing to growth of 3.2 per cent.

The rate of growth in loans to the private sector including bad debts and repos, the only aggregate permitting comparison with the euro area, fell by about six percentage points to 1.4 per cent (Figure 17.1). The slowdown was slightly less marked than that recorded in the euro area, where growth practically came to a halt.

Figure 17.1

Growth in lending to the private sector in Italy and the euro area (1)
(monthly data; twelve-month percentage changes)



Sources: ECB and calculations based on ECB data.
(1) The percentage changes are calculated net of the effects of securitizations, reclassifications, exchange rate variations, value adjustments and other variations not due to transactions.

Developments in lending in Italy reflected both demand factors, linked to the slump in economic activity, the reduction in investment and the weakness of the property market, and supply factors. The responses of the Italian banking groups that take part in the Eurosystem's quarterly Bank Lending Survey indicate that from the fourth quarter of 2008 onwards they tightened credit conditions, albeit with decreasing intensity. The tightening did not end until a year later, in the fourth quarter of 2009. In the first quarter of this year, banks reported that they had kept their lending standards broadly unchanged.

Lending by banks belonging to the five largest groups began to contract in March 2009 and by the end of the year had fallen by 4.4 per cent, while that by the branches of foreign banks decreased even more sharply, by 11.3 per cent. The growth in credit disbursed by the other banks operating in Italy, while remaining positive, slowed significantly to 4.7 per cent.

The fall in lending by banks belonging to the five largest groups partly reflected the need to reduce risk-weighted assets in order to improve capital ratios, while that in lending by the branches of foreign banks was mainly due to a reduction in fund transfers from their respective headquarters. The sounder initial capital position of banks not belonging to the major groups helps to explain the expansion in their lending, which could result, however, in larger loan losses in the future.

The growth in loans to households for house purchases and the change in the composition of those to firms, partly in connection with debt restructurings, caused the share of medium and long-term loans to increase. The portion with a maturity exceeding five years grew in 2009 by four percentage points to 56.5 per cent, still low by international standards.

The lengthening of loan maturities was accompanied by an increase in the share of secured loans. Financing backed by collateral, largely in the form of mortgages, rose from 50 to 52 per cent of the total of loans to households and firms reported to the Central Credit Register; the increase was more pronounced for small banks and mutual banks.

Banks' proprietary holdings of debt securities issued by residents in Italy grew by 27.7 per cent (Table 17.2). Almost all of the increase involved securities eligible as collateral in Eurosystem refinancing operations.

Table 17.2

Banks' main assets and liabilities (1)

(quarterly data; millions of euros and percentage changes)

	Changes in amounts on 12 months earlier				Percentage change on 12 months earlier				Stocks at December 2009
	December 2009	June 2009	December 2008	June 2008	December 2009	June 2009	December 2008	June 2008	
					Assets				
Cash	-1,478	550	1,164	712	-11.3	5.9	9.7	8.3	11,647
Debt securities (2)	44,772	60,094	40,452	6,801	27.7	41.1	29.7	5.8	228,532
of which: government securities	38,362	38,448	11,386	-10,228	34.1	38.2	13.3	-6.3	164,142
Loans	8,485	41,325	79,090	110,060	1.0	2.8	5.4	8.9	1,760,751
External assets	-39,555	-62,442	-11,134	25,605	-10.8	-14.0	-1.3	8.5	324,809
Shares and other equity	4,064	-19,833	-3,777	21,455	13.4	11.3	13.5	12.3	151,583
Claims on resident MFIs									
Loans	44,395	77,974	82,805	50,259	8.2	18.0	19.7	11.2	614,597
Securities	57,135	66,537	60,014	52,909	32.2	49.1	67.5	64.5	210,674
Other assets (3)	-60,414	12,219	54,120	26,963	-13.4	1.3	11.8	4.5	389,375
					Liabilities				
Total funding	34,535	40,183	96,924	130,914	1.8	1.1	4.2	8.3	2,200,552
Funds raised from residents in Italy	91,045	95,574	134,713	126,690	5.8	5.8	8.9	11.3	1,684,220
Deposits	57,293	49,197	70,422	50,668	5.2	4.0	6.2	7.2	1,165,788
Bonds (4)	33,752	46,377	64,291	76,022	6.9	10.1	15.6	21.3	518,432
Funds raised from non-residents	-56,510	-55,391	-37,789	4,224	-9.3	-10.1	-7.0	2.4	516,332
Deposits of non-bank customers	3,053	414	7,293	6,711	5.3	-1.2	12.3	14.7	64,453
Liabilities to non-resident MFIs	-59,563	-55,806	-45,082	-2,487	-11.1	-11.1	-8.9	1.2	451,879
Deposits	-47,756	-48,429	-43,243	14,826	-10.9	-12.0	-10.6	5.7	361,384
Bonds (5)	-11,807	-7,377	-1,839	-17,313	-11.6	-6.9	-1.5	-15.1	90,495
Capital and reserves	17,509	10,981	11,748	35,413	6.4	5.0	5.5	11.4	293,936
Liabilities to resident MFIs	61,119	154,014	185,985	101,470	7.7	26.4	35.9	18.8	818,027
Deposits	3,983	87,477	125,970	48,561	1.4	20.3	29.7	10.6	607,353
Bonds	57,135	66,537	60,014	52,909	32.4	49.2	67.4	64.5	210,674
Other liabilities	-55,759	-28,752	8,079	26,966	-9.6	3.6	10.9	9.2	379,453

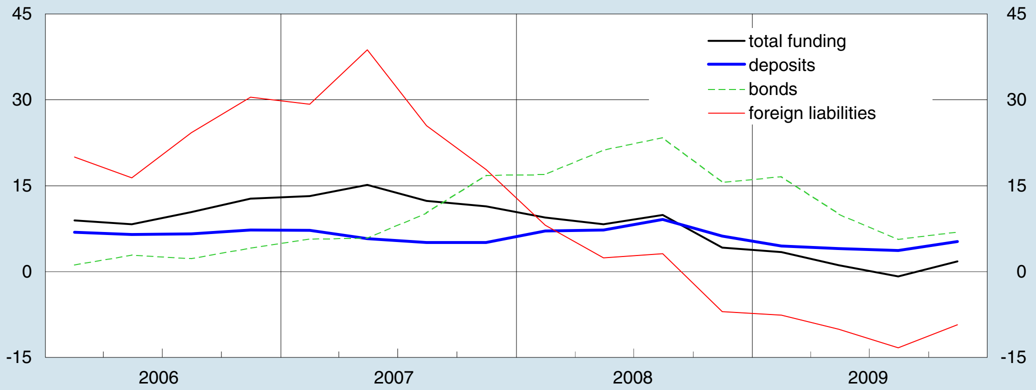
(1) Based on ECB data. The percentage changes are calculated net of the effects of reclassifications, exchange rate variations, value adjustments and other variations not due to transactions. Repos and reverse repos with post-trading-service providers are, by convention, included in loans and deposits in respect of monetary financial institutions (MFIs). – (2) Excludes bonds issued by resident MFIs. – (3) Money market fund units, movable and immovable assets, and other items of minor importance. – (4) Excludes bonds held by MFIs resident in Italy and in the euro area.– (5) Only includes bonds held by MFIs resident in the euro area.

Funding and liquidity management

The twelve-month growth in the Italian banking system's total funding – deposits from non-bank customers, bonds not held by other Italian banks and foreign liabilities – continued to slow in 2009, from 4.2 per cent to 1.8 per cent (Figure 17.2); in March 2010 it declined further, to 1 per cent.

Figure 17.2

Growth in funding of banks operating in Italy (1)
(quarterly data; twelve-month percentage changes)



Sources: Supervisory reports and calculations based on ECB data.
(1) The percentage changes are calculated net of the effects of reclassifications, exchange rate variations, value adjustments and other variations not due to transactions. Repos and reverse repos with post-trading-service providers are, by convention, included in loans and deposits in respect of monetary financial institutions (MFIs).

The growth in deposits from resident customers fell by one percentage point to 5.2 per cent, owing largely to the 50.3 per cent contraction in repos. Bond funding continued the strong expansion of 2008 with growth of 6.9 per cent, although the pace decelerated markedly over the course of the year.

The share of retail deposits in the funding of banks operating in Italy, high by international standards, rose by more than two percentage points in 2009. At the end of the year the sum of deposits from non-financial non-bank customers and bank bonds held by investors other than euro-area banks and money market funds amounted to 73.2 per cent of total funding, well above the level in the main euro-area countries and the area average of 60.6 per cent.

At the end of March 2010 Italian banks' outstanding bonds, excluding those repurchased by intermediaries belonging to the same group, amounted to €629 billion, just under one third of total funding. Some 39 per cent of these securities will fall due by the end of 2011 and nearly 80 per cent by 2014.

Foreign intermediaries reduced their assets in respect of banks resident in Italy reflecting their greater propensity to invest in their own markets and to hold government securities. Italian banks' liabilities vis-à-vis foreign banks fell by €60 billion (11.1 per cent) and by 3 percentage points to 21 per cent of total funding.

As in 2008, banks were again unable to raise funds through securitizations, as that market segment was at a virtual standstill. More than 90 per cent of the claims securitized (for a value of €52 billion) generated securities that were wholly repurchased by the originators (self-securitizations). Operations of this kind are aimed at obtaining assets eligible for collateral in Eurosystem refinancing.

At the end of 2009 eight banks had initiated covered bond issue programmes. Covered bonds have a low risk profile by virtue of the high quality of the underlying assets and the fact that, in contrast with securitizations, they are backed by the issuer's capital. In 2009 market placements amounted to €7.5 billion, thanks in part to the liquidity provided by the Eurosystem's purchase programmes. As of the end of the year, issue plans for a further €29 billion had been drawn up.

As a result of the progressive reduction in monetary policy interest rates and the subsidence of tension in the markets, the average cost of funds declined by nearly 180 basis points in 2009, to 1.2 per cent at the end of the year, and continued to come down in the first few months of this year. Starting in May, the strains engendered in the financial markets by fear of contagion in connection with the critical state of the Greek public finances pushed up the premiums on the credit default swaps of the largest banks in Italy as elsewhere. This could lead to significant increases in the risk premiums requested on new bond issues.

The interbank market and liquidity management. – Interbank deposits grew by 1.4 per cent in 2009. Excluding liabilities towards the Bank of Italy, almost all deriving from Eurosystem refinancing operations, the increase amounted to 6.6 per cent.

After peaking in the fourth quarter of 2008, at the height of the financial crisis, total lending by the Eurosystem to banks operating in Italy diminished by nearly €30 billion, reflecting banks' greater ability to resort to the market. At the end of 2009 the share of eligible securities pledged as collateral with the Bank of Italy in respect of open market operations was less than 10 per cent of the total.

Italian banks' liquidity position improved in 2009 thanks to the increase in the volume of assets eligible as collateral for Eurosystem operations. Although the banks are better equipped today to manage liquidity risk, the current condition of the international markets requires continual assessment on the part of the authorities and by banks themselves.

Risks

Asset quality and credit risk. – The recession worsened the quality of credit significantly. On the basis of Italian banking groups' consolidated reports, the amount of non-performing exposures to customers (bad debts, substandard loans, restructured loans, and exposures past due or in breach of overdraft ceilings) increased by 43.4 per cent in 2009, driven by the growth of more than 50 per cent in exposures to borrowers in temporary difficulty (substandard loans). Non-performing assets rose from 6.5 to 9.1 per cent of total exposures to customers.

For the whole banking system, the ratio of adjusted new bad debts to total loans rose sharply in the course of 2009. In the first quarter of 2010 it stood at 2 per cent on an annual, seasonally adjusted basis (Figure 17.3). Year on year, the adjusted new bad debts of banks operating in Italy increased from €18 billion in 2008 to €28 billion in

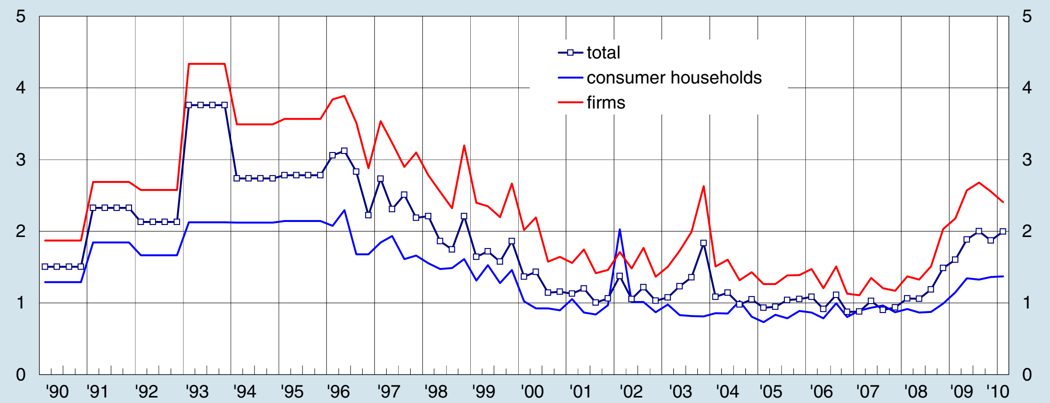
2009. The ratio to total loans outstanding at the end of the previous year rose by more than 0.6 points to 1.9 per cent; the increase was more pronounced (0.7 points) for banks belonging to the five largest groups.

The increase in the bad debt flow ratio last year was comparable in magnitude to that recorded during the 1993 recession, when it rose to 3.8 per cent, from 1.5 per cent in 1990. Compared with the first half of the 1990s, however, the current deterioration in loan quality started out from structurally lower levels of risk in all the main borrower sectors and geographical areas.

Figure 17.3

Ratio of new bad debts to outstanding loans (1)

(seasonally adjusted, annualized quarterly data; percentages)



Sources: Central Credit Register and supervisory reports.
(1) Annualized flow of adjusted new bad debts in the quarter as a percentage of total loans excluding adjusted bad debts at the end of the previous quarter. The data for the first quarter of 2010 are provisional. All the time series are adjusted for seasonal effects, where applicable.

Country risk. – At the end of 2009 the balance sheet exposure of Italian banks and their foreign subsidiaries to non-residents was €667 billion, equal to 27 per cent of their total loan portfolio; 74 per cent of this amount was on the books of subsidiaries and, to a lesser extent, branches established in the counterparty's country. The five largest banking groups accounted for 94 per cent of the total foreign exposure. Claims on non-residents fell by 10.2 per cent during the year.

The decline in foreign assets was entirely due to the reduction in claims on residents in industrial countries. The most substantial of these exposures were to Germany (€190.8 billion), Austria (€79.8 billion), the United Kingdom (€35.8 billion) and the United States (€34.9 billion). Claims on borrowers resident in Spain and Ireland were significantly smaller and consisted mainly of credits and securities issued by banks and financial companies. Claims on borrowers resident in Greece and Portugal amounted to €4.8 billion and €4.7 billion respectively and consisted primarily of public sector or bank securities.

At the end of December 209 the consolidated balance sheet exposure to the countries of central and eastern Europe stood at €151 billion, 1.5 per cent less than a year earlier. Intra-group loans to local subsidiaries, which are not counted in the consolidated exposure, amounted to about €20 billion.

The recession that hit the main countries of central and eastern Europe (with the exception of Poland) caused a marked deterioration in the quality of loans to both firms and households. For the first seven countries by total exposure, Italian banking groups' share of foreign currency loans to customers can be estimated at 60 per cent in Hungary, Croatia, Romania and Bulgaria and 30 per cent in Poland and Russia; it is small in the Czech Republic.

Investment banking risks. – In Italy 39 banks, mostly belonging to groups and accounting for about 6 per cent of the banking system's assets, specialize in investment banking (securities trading for own or third-party account, or portfolio management and placement of financial instruments). On the basis of unconsolidated data, the main prudential indicators show that financial leverage (the ratio of assets to capital), which had been rather high in 2008, was reduced in 2009. Profitability improved from the very low levels of the most acute phase of the crisis. Operational and interest rate risks increased considerably. Credit risk, of limited bearing on these intermediaries, rose slightly.

Profitability

Italian banks' profitability deteriorated further in 2009. Profits for the year fell by 15.6 per cent and the return on equity (ROE) decreased from 4.5 to 3.6 per cent (Table 17.3).

Net interest income declined by 5.8 per cent (or €3.5 billion) as a result of the sharp reduction in the margins on funding and the decline in the volume of assets.

Gross income rose slightly, by 1 per cent. Profits from trading grew significantly, thanks to the recovery of the financial markets from the lows reached in March 2009, but net fee income fell by 4.7 per cent, particularly that from asset management services. Overall, non-interest income increased by 13.7 per cent and its contribution to gross income rose from 34.6 to 39 per cent, still less than it had been before the financial crisis.

Thanks to the steps taken to curb operating expenses, which fell by 5.1 per cent, operating profit grew by 13.2 per cent.

Allocations to provisions and value adjustments rose by 12.9 per cent. Those in connection with the deterioration in loan quality increased by 48.3 per cent, absorbing 59.8 per cent of operating profit (45.6 per cent in 2008). Allocations and write-downs to financial assets and the impairment of goodwill diminished substantially as the financial markets recovered.

The decline in profit is also due to the increase in taxes and the smaller contribution of income from asset sales. In 2008 banks' tax liabilities had been particularly low, owing to the effects of the adjustment of goodwill for tax purposes. In 2009 the significant reduction in these effects produced larger tax liabilities connected with the non-deductibility of a portion of interest expense, introduced in 2008, and with the tax treatment of write-downs on loans.

The five largest banking groups distributed an average of about one third of their net profit, compared with almost two thirds in 2008.

Table 17.3

Consolidated income statement of Italian banking groups (1)
(millions of euros; growth rates and percentage indicators)

	All groups			Main groups (2)		
	2008	2009 (3)	Change	2008	2009 (3)	Change
Net interest income (a)	60,462	56,976	-5.8	38,722	35,775	-7.6
Non-interest income (b)	32,027	36,428	13.7	19,936	21,810	9.4
of which: fees	*27,882*	*26,580*	*-4.7*	*19,272*	*16,522*	*-14.3*
Gross income (c=a+b)	92,488	93,404	1.0	58,659	57,585	-1.8
Operating expenses (d)	61,721	58,583	-5.1	39,244	35,660	-9.1
of which: staff costs	*34,099*	*32,753*	*-3.9*	*21,945*	*20,330*	*-7.4*
Operating profit (e=c-d)	30,769	34,821	13.2	19,414	21,924	12.9
Allocations to provisions and net value adjustments (f)	21,130	23,848	12.9	15,366	16,699	8.7
of which: in respect of loans	*14,037*	*20,824*	*48.3*	*9,624*	*14,625*	*52.0*
Ordinary profit (g=e-f)	9,639	10,972	13.8	4,048	5,226	29.1
Extraordinary profit (h)	843	1,796	113.0	931	1,734	86.1
Gross profit (i=g+h)	10,482	12,769	21.8	4,980	6,960	39.8
Taxes (l)	1,558	4,800	208.1	-796	2,033	355.5
Profit from asset classes in the process of being liquidated (after tax) (m)	1,260	427	-66.1	1,256	403	-67.9
Minority interests' share of profit (n)	1,020	663	-35.0	764	460	-39.8
Parent company's share of profit (o=i-l+m-n) (4)	9,163	7,733	-15.6	6,268	4,869	-22.3
Indicators						
Ratio of non-interest income to gross income	34.6	39.0		34.0	37.9	
Cost/income ratio (5)	66.7	62.7		66.9	61.9	
Value adjustments in respect of loans/Operating profit	45.6	59.8		49.6	66.7	
ROE	4.5	3.6		5.0	3.6	

(1) Consolidated supervisory reports for banking groups and individual supervisory reports for banks not belonging to groups. Rounding may cause discrepancies. For the sake of homogeneous comparison, the composition of the banking groups is that of the end of 2009. – (2) Five largest groups by total assets as of December 2009. – (3) Provisional data. – (4) Includes the after-tax profit of banks not belonging to groups. – (5) Ratio of operating expenses to gross income.

Capital

In 2009 the Italian banking system's capital position improved, particularly in the components most able to absorb losses. At the end of the year consolidated regulatory capital amounted to €217.4 billion, up by 6.4 per cent from the end of 2008 (Table 17.4). The capital increases carried out by some large groups, the retention of a sizeable share of earnings and, for four banks, the issue of securities subscribed by the Ministry for the Economy and Finance boosted tier 1 capital by 11.3 per cent to €161.3 billion. By contrast, supplementary capital diminished by 4.7 per cent to €61.6 billion.

Risk-weighted assets fell by 5.8 per cent as a result of the contraction in the volume of business, the disposal of non-strategic assets and, to a lesser extent, the shift in the composition of portfolios towards assets with a lower weighting.

Table 17.4

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

	Banking system		Main groups (2)	
	2008	2009	2008	2009
Allocations to regulatory capital	10,854	5,981	8,025	3,584
Regulatory capital	204,267	217,388	123,280	131,662
Core tier 1 capital ratio (%)	7.0	8.2	5.8	7.2
Tier 1 capital ratio (%)	7.6	9.0	6.6	8.3
Total capital ratio (%)	10.8	12.1	10.3	11.8
Financial leverage (3) (4)	22	19	26	22
Excess capital	54,378	73,733	28,857	42,595

(1) Consolidated supervisory reports for banking groups and individual supervisory reports for banks not belonging to a group. Excludes the Italian branches of foreign banks. – (2) Five largest groups by total assets as of December 2009. – (3) Ratio of total balance sheet assets to tier 1 capital. – (4) Provisional data.

Compared with the end of 2008, the total capital ratio rose by 1.3 percentage points to 12.1 per cent, the tier 1 capital ratio by 1.4 points to 9 per cent, and the core tier 1 ratio by 1.2 points to 8.2 per cent.

Large Italian banks' capital ratios continue to be generally low by international standards. The gap reflects both prudential regulation that sets more stringent limits on the inclusion of some instruments in the tier 1 aggregates and very substantial public recapitalizations of some large European banks. The tier 1 capital ratio of a sample of 12 large European banks averaged 11.6 per cent. On the other hand, the financial leverage of the largest Italian groups, measured by the ratio of total balance sheet assets to tier 1 capital, is lower on average: 22 as against 31.

Stress tests on the Italian banking system: credit and market risks

The Bank of Italy periodically runs stress tests to assess the banking system's ability to operate in adverse situations. The top-down exercise conducted this May for the whole Italian banking system analysed the evolution of credit quality in the two years 2010-11 assuming bad macroeconomic conditions. The adverse scenario hypothesizes that the Italian economy is hit by shocks to world trade that hold down exports. Further, the risk premium on the interbank market increases with a tightening of credit supply policies, leading to a weakening of domestic demand. The macroeconomic effects are amplified by an increase in precautionary saving, accentuating the decline in household spending. Real GDP growth in the two years 2010-11 is lower by a total of 3 percentage points than the forecasts compiled by Consensus Economics.

Under this scenario, it is estimated that adjusted bad debts and other non-performing loans would rise to 6.4 per cent of total on- and off-balance-sheet exposures to customers resident in Italy in 2010 and to 7.1 per cent in 2011. In the two years losses would amount to €80 billion, €56 billion from positions classified as adjusted bad debts. Including exposures to non-residents in the form of both loans and debt and equity securities, the losses not covered by forecast operating profit would amount to some 60 per cent of the Italian banking system's excess capital at the end of 2009. The result for the foreign component assumes particularly unfavourable changes in the main parameters of risk.

The five largest banking groups were asked to run simulations on the basis of their own internal models using common macroeconomic and financial scenarios. This bottom-up exercise concerned credit and market risks; the deterioration of equity securities and of securitization paper held for purposes other than trading was also assumed.

The adverse macroeconomic scenario is similar to that used for the top-down exercise carried out by the Bank of Italy. For market risks, the assumptions were: a significant fall in stock market prices; increases in both short and longer-term interest rates and in volatility on financial markets; and a widening of credit spreads.

In both 2010 and 2011 the loan losses of the five largest banking groups would be greater than in 2009 but less than predicted in the top-down exercise. The presumed losses due to the other risks examined are of limited size.

The impact on the tier 1 ratio differs from intermediary to intermediary. The ratio would decrease by 45 basis points on average and by 80 basis points for the median bank. The capital ratios of all the groups would remain well above the regulatory minima.

The activity of non-bank intermediaries

Asset management companies. – Asset management companies recorded net profit of €562 million in 2009, virtually the same as in 2008 (Table 17.5). Gross operating profit edged down by 1.8 per cent in concomitance with a steep decline in fee income due to the contraction in assets under management. Operating costs fell by 10 per cent, in part reflecting some restructuring initiatives such as the completion of mergers begun in 2008 between traditional asset management companies and hedge-fund management companies. The contribution of the result on financial operations, considerable in 2008 thanks to a good number of major corporate actions, fell by 44 per cent.

The ratio of regulatory capital to the overall capital requirements, while remaining at amply satisfactory levels, declined slightly, from 6.1 in 2008 to 5.9. The growth in regulatory capital from €1,731 million in December 2008 to €1,770 million in December 2009 did not quite keep pace with the increase in the overall prudential requirement.

The performance of asset management companies managing open-end funds. – After falling steeply in 2008, Italian open-end funds' assets under management rebounded in the second half of 2009. Italian investment funds' difficulties depend in part on a chain of distribution controlled by banking groups and on unfavourable tax treatment compared with foreign products.

Table 17.5

Asset management companies: income statement data (1)
(millions of euros and percentages)

	2008		2009		Percentage change
	Amount	Percentage (2)	Amount	Percentage (2)	
Fee and commission income	4,704	261.2	3,999	226.1	-15.0
Fee and commission expense	2,903	161.2	2,230	126.1	-23.2
Gross operating profit (3)	**1,801**	**100.0**	**1,769**	**100.0**	**-1.8**
Administrative expenses	1,224	68.0	1,137	64.3	-7.1
of which: staff costs	*607*	*33.7*	*611*	*34.6*	*0.8*
Other operating expenses	618	34.3	526	29.7	-14.9
Total operating costs (4)	**1,341**	**74.5**	**1,205**	**68.1**	**-10.2**
Other operating income	159	8.8	133	7.5	-16.7
Net operating profit	**619**	**34.4**	**697**	**39.4**	**12.5**
Result on financial operations	210	11.7	117	6.6	-44.1
Result on ordinary activities	**829**	**46.0**	**814**	**46.0**	**-1.8**
Taxes	268	14.9	252	14.3	-5.8
Net profit (loss) for the year	**561**	**31.2**	**562**	**31.7**	**0.1**

(1) Supervisory reports. – (2) Amount as a percentage of gross operating profit – (3) Individual and collective portfolio management. – (4) Includes value adjustments to tangible and intangible fixed assets.

Investment firms. – Italian investment firms' profitability improved, though remaining well below the pre-crisis levels. Overall, profits grew by 37 per cent to €57 million, while ROE was equal to 5.9 per cent, not much higher than in 2008 (4.3 per cent) and far below the average for the two years 2006-07 (22.4 per cent).

Investment firms' regulatory capital, consisting essentially of core elements (share capital and reserves), grew by 8 per cent, thanks essentially to the legislation allowing intermediaries that belong to investment firm groups not to deduct the non-negotiable components of assets. Total capital requirements increased by 6 per cent in relation to a larger exposure to credit and market risk. The ratio of regulatory capital to the overall requirement rose from 4.2 to 4.3.

Financial companies. – In 2009 financial companies entered in the register established by Article 107 of the Consolidated Law on Banking recorded a decline in their volume of operations and a worsening in the risk on their loan portfolios and earnings capacity.

Article 107 companies made a profit of €0.7 billion, down by 24 per cent from 2008. The result reflects the sharp increase in value adjustments to loans, which absorbed 64 per cent of net interest income, compared with 48 per cent in 2008. The incidence of value adjustments was particularly high for consumer credit (73 per cent).

Leasing, factoring and consumer credit companies had adequate capital buffers. Their solvency ratio averaged 8.3 per cent at the end of 2009, in line with the previous year's figure.

18. INSTITUTIONAL INVESTORS

Italian institutional investors had net fund-raising of €18 billion in 2009, compared with an outflow of €150 billion in 2008 (Table 18.1), as a result of a reduction in the massive redemptions of investment fund units and withdrawals from individually managed portfolios that had been induced by the financial crisis and of a shift on the part of savers towards investment instruments offering guaranteed minimum yields, such as with-profit insurance policies. The consolidated net assets of the sector increased by 7 per cent to €902 billion, thanks in part to the rise in the value of portfolio assets. In proportion to GDP the value rose from 53.7 to 59.3 per cent.

Table 18.1

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

	Net flows		End-of-period stocks			
	2008	2009 (1)	2008	2009 (1)	Percentage composition 2008	Percentage composition 2009 (1)
Investment funds (2)	-80,048	-7,019	245,352	247,791	22.3	20.9
Insurance companies (3)	-10,710	24,437	400,520	442,000	36.4	37.3
Pension funds (4)	1,482	8,101	40,948	49,049	3.7	4.1
Individually managed portfolios	-94,410	6,741	414,301	447,066	37.6	37.7
Total	**-183,686**	**32,259**	**1,101,121**	**1,185,906**	**100.0**	**100.0**
Consolidated total (5)	**-150,155**	**18,316**	**841,354**	**902,022**	**–**	**–**
as a percentage of GDP	*-9.6*	*1.2*	*53.7*	*59.3*	–	–

Sources: Based on data from Bank of Italy, Isvap, ANIA and Covip.
(1) Provisional. – (2) Italian investment funds and SICAVs. – (3) Technical reserves. Does not include branches in Italy of reinsurance companies of other EU countries. – (4) Balance-sheet assets. – (5) Net of investments in Italian collective investment undertakings by the other categories of intermediary, investments by insurance companies and pension funds in portfolios individually managed by asset management companies, and the technical reserves of insurance companies deriving from the management of open pension funds.

The Italian institutional investment sector remains small by international standards. According to OECD data, at the end of 2008 the financial assets of insurance companies and open-end investment funds were equal to 20 per cent of households' financial assets in Italy, compared with 83 per cent in France, 54 per cent in Germany, 46 per cent in the United Kingdom and 37 per cent in the United States. The distribution structure is still relatively undiversified and the product range limited. Italian investment funds also suffer from less favourable tax treatment than foreign funds.

The massive net outflow of resources from open-end investment funds operated by Italian groups under way for several years was practically staunched in 2009. The inflow of investment to exchange-traded funds and closed-end real estate funds continued. The net flow of savings to individually managed portfolios and life insurance policies turned positive; in the insurance sector households' pronounced risk aversion continued to penalize the more markedly financial products in favour of traditional insurance policies. The insurance companies remain exposed to the risk that the current phase of low interest rates may be protracted, with an adverse impact on the profitability of policies with guaranteed minimum yield.

The assets under management of pension funds increased, owing partly to the rise in value of their portfolio assets after the losses registered in 2008. The number of new members was modest. For much of the population retirement saving remains very limited, especially among lower-income workers and those with less stable employment.

Investment funds

Fund-raising and net assets. – Owing to the reduction in redemptions, the massive net outflow of resources from the open-end investment funds controlled by Italian intermediaries practically came to a halt. Among them, foreign funds returned to positive net investment of some €8 billion, as against net redemptions of €34 billion in 2008, while Italian funds' net redemptions were greatly diminished (€11 billion as against €84 billion; Table 18.2). At the end of 2009 the net assets of the foreign funds controlled by Italian groups amounted to €159 billion, up 14 per cent, thanks in part to the rise in share prices; the net assets of the Italian funds remained unchanged at €216 billion.

Among the open-end funds controlled by Italian intermediaries, the net flows of single segments were modest. Within the bond segment there was a shift of resources towards funds investing in short-term government securities and those specializing in investment grade corporate bonds. Total net fund-raising turned positive in the second half of the year, spurred by the rise in prices on the main financial markets.

In the other main euro-area countries investment funds returned to positive net fund-raising, with a significant shift from money market to other funds, favoured by relatively high yields.

The net fund-raising of Italian closed-end funds was just under €4 billion in 2009, about the same as in 2008 (Table 18.2). Against a substantial inflow of €3.6 billion to real estate funds, the net flow to closed-end private equity funds was practically nil. At the end of the year the net assets of the closed-end funds amounted to €32 billion, or 13 per cent of the total net worth of Italian investment funds.

Supply. – The number of open-end funds operated by Italian asset management companies declined further in 2009. All the main segments were affected except flexible and money market funds (Table 18.2). The supply side restructuring was prompted in part by the substantial reduction in the volume of assets under management in previous years, which led the companies to close or amalgamate smaller funds in order to improve operating efficiency. The number of hedge funds dropped by 35 per cent (from 249 to 163), mainly due to rationalization triggered by the regulatory change at the end of 2008, which removed the ceiling on the number of investors. The average size of open-end funds began to increase once more, from €203 million to €243 million. By international standards both the number of funds marketed by the main Italian management companies and their average assets under management remain small.

Table 18.2

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

	Number of funds (2)		Net assets		Net fund-raising (3)	
	2008	2009	2008	2009	2008	2009
Harmonized open-end funds	661	608	179,446	185,501	-65,421	-6,673
Equity	236	200	21,884	25,946	-12,082	-532
Balanced	76	62	14,615	14,104	-8,125	-2,136
Bond	203	184	72,054	75,736	-26,960	1047
Money market	34	34	56,977	55,849	-10,967	-2223
Flexible	112	128	13,915	13,866	-7,287	-2,830
Non-harmonized open-end funds	403	283	36,414	30,631	-18,545	-4,168
Hedge funds (4)	249	163	17,187	12,085	-7,093	-3,506
of which: funds of funds	*218*	*145*	*15,174*	*9,601*	*-7,003*	*-3,621*
Other	154	120	19,227	18,546	-11,452	-662
of which: funds of funds	*82*	*67*	*6,827*	*5,963*	*-4,603*	*-721*
Total open-end funds	**1,064**	**891**	**215,860**	**216,132**	**-83,966**	**-10,841**
Closed-end securities funds	110	117	5,082	5,321	380	252
of which: funds of funds	*100*	*109*	*4,786*	*5,101*	*497*	*248*
Closed-end real estate funds	228	266	24,410	26,338	3,538	3,570
of which: reserved to qualified investors	*199*	*239*	*17,434*	*20,046*	*3,664*	*3,597*
Total closed-end funds	**338**	**383**	**29,492**	**31,659**	**3,918**	**3,822**
Total	**1,402**	**1,274**	**245,352**	**247,791**	**-80,048**	**-7,019**
Memorandum item:						
Foreign funds controlled by Italian intermediaries (5)	785	734	139,690	159,182	-33,861	8,000
of which: hedge funds	*28*	*27*	*4,862*	*4,666*	*-814*	*-349*

Sources: Bank of Italy and Assogestioni.
(1) Includes SICAVs. – (2) For Italian funds, those in operation at the end of the year indicated. For foreign funds, those acquired by Italian investors. – (3) For closed-end funds, net fund-raising is calculated as the difference between subscription orders and any redemptions by asset management companies shown in supervisory reports. – (4) Side-pocket accounts are included in net assets and net fund-raising; they are not included in number of funds. – (5) Funds run by management companies resident in Luxembourg or Ireland. Net assets and net fund-raising refer to the value of units held and subscribed, respectively, by Italian and foreign investors. The data on fund-raising are net of redemptions.

According to Morningstar data on open-end investment funds, the number of products available to investors in Italy fell by about 5 per cent. The decline was sharper (13 per cent) for the funds marketed by Italian management companies, more modest (4 per cent) for those of companies domiciled abroad. At the end of the year the top ten Italian management companies by assets under management were operating an average of 43 funds each with average assets of €16 billion. In Germany, France and the United Kingdom the ten leading management companies were operating an average of 80, 108 and 120 funds, respectively, with average assets under management of €17 billion, €20 billion and €26 billion.

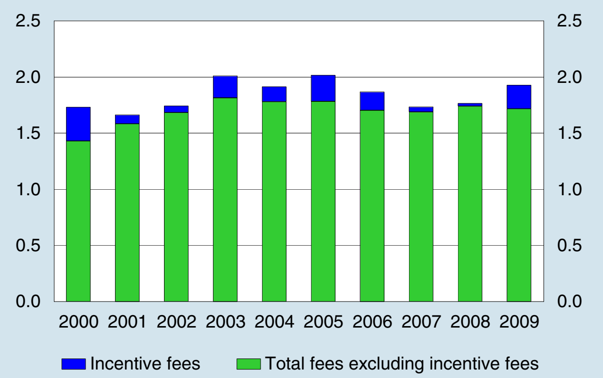
Real estate funds. – The number of real estate investment funds grew again in 2009. The increase involved only reserved and hedge funds, while the number of retail funds diminished. The returns on the real estate funds – which invest mainly in non-residential properties, whose value is particularly sensitive to current economic performance – have been affected by the recession.

An analysis of 232 of the 236 Italian real estate funds in business at the end of June 2009 highlighted a number of weaknesses in financial structure, profitability and capital that were addressed by specific regulatory measures. As to financial structure, some 30 per cent of the funds had liabilities concentrated in the short term; many funds had obtained finance in the form of loans that are callable in the case of a decline in specified indicators (e.g. the loan-to-value ratio). In terms of profitability, in mid-2009 some funds estimated negative net earning flows for the next 12 and 24 months. To estimate the impact of a hypothetical fall in property prices and in income flows on the capital adequacy of the funds, a stress test was conducted to determine the probability that the value of real estate assets would fall below net liabilities within three years. The analysis found that, assuming particularly adverse property market conditions, the funds' capital situations could become precarious for a group of intermediaries that account for just over 3 per cent of the sector's total assets.

Exchange-traded funds. – ETFs are collective investment vehicles with a passive investment strategy, typically replicating the performance of some underlying reference asset (generally a share or bond index). Unlike other "passively managed" funds, they have units that are traded on regulated markets. At the end of April 2010 Borsa Italiana listed 368 ETFs, with total capitalization – for the units deposited in Italy – of €15 billion. These funds were managed exclusively by foreign intermediaries. The ETF market has expanded considerably in recent years and been relatively unaffected by the recent financial crisis. The funds' growth has been fostered by high liquidity and transparency and low management fees. In 2009 their bid-ask spreads – which had widened in the acute phase of the crisis, especially for funds specializing in emerging country markets – came back down to the levels of 2007, about 0.2 per cent of the value of the units. Total annual fees to ETF subscribers have remained low; in April 2010 they averaged 0.4 per cent of the funds' net assets.

Figure 18.1

Italian securities investment funds: total fees (1)
(percentages)



(1) Simple average of total fees paid by the individual funds, calculated as the percentage ratio of total annual fees to annual average net assets. For continuity with the data for 2000-02, securities brokerage commissions are excluded. The data relate to harmonized investment funds and SICAVs. The data for the last two years are provisional.

Yields and fees. – The average yield on Italian harmonized investment funds, net of taxes and fees, turned positive at 6.9 per cent, thanks to rising prices in the main securities markets. The gain in unit prices was sharpest in equity funds (25.4

per cent), balanced funds (10.9 per cent) and flexible funds (7.1 per cent). Bond and money market funds registered more modest rises of 4.5 and 1.9 per cent respectively.

The total fees charged to harmonized investment funds (management fees, incentive fees, fees paid to depositary banks, securities brokerage commissions and other minor items) came to €2.2 billion, consisting almost entirely in management and incentive fees. The ratio of total fees to average annual net assets rose by 0.11 percentage points to 1.88 per cent (Figure 18.1). The increase was due to incentive fees, which rose by 0.18 points to 0.21 per cent as a consequence of the improvement in financial results. The ratio of other fees to net assets remained broadly unchanged.

Individual portfolio management

In 2009 individually managed portfolios registered net inflows of €7 billion after the massive outflows of €24 billion in 2007 and €94 billion in 2008. The total value of assets under management rose by 8 per cent to €447 billion. The sector's fund-raising benefited from rising financial market prices and decreased volatility.

The yield – the percentage increment in net assets less net fund-raising – was 6.3 per cent last year, compared with negative yield of 2.7 per cent in 2008. This performance was slightly worse than that of investment funds, owing to the smaller share of equities in these portfolios.

The portion of individually managed portfolio assets consisting in Italian government securities rose for the third year to 34 per cent, while that of investment fund units and foreign government securities continued to shrink, to 24.1 and 8.2 per cent respectively. The weight of Italian and foreign equities was broadly unchanged at 4.9 and 7.2 per cent respectively.

Insurance companies

The premium income of insurance companies returned to growth last year (28.1 per cent) after two years of decline. The increase came entirely in the life sector, with a gain of 48.7 per cent, while the non-life sector registered a slight decline of 1.9 per cent owing in part to the recession.

Life insurance premium income amounted to €24 billion net of claims and redemptions (compared with negative figures of €10.5 billion in 2008 and €12.8 billion in 2007), owing in part to a reduction in applications for early surrender of policies. Savers' strong aversion to risk continued to penalize unit-linked and index-linked life insurance policies, whose investment risk is borne directly by the insured; they recorded net outflows of €12.6 billion (€4.5 billion in 2008). There was an increasing propensity to invest in traditional insurance products, with their more extensive yield guarantees, and purchases of these jumped from $2.1 billion in 2008 to €35.9 billion last year.

Insurance companies' technical reserves returned to rapid growth, expanding by 10 per cent. At the end of the year they amounted to €442 billion, or 12 per cent of households' financial assets. The increase was accounted for entirely by the life sector, thanks both to the rise in securities prices and to the inflow of fresh funds. The reserves of the non-life sector remained virtually constant.

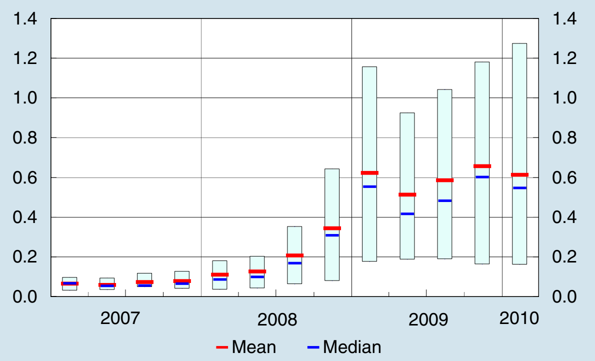
The relative size of the insurance industry in Italy is small by comparison with the euro area as a whole. The investment assets of Italian insurance companies were worth €435 billion at the end of 2008, or 28 per cent of GDP, compared with an average of 54 per cent for the euro area. The Italian non-life insurance market is more concentrated than those of other countries. In 2007 the top five insurers in Italy accounted for 70 per cent of the sector's premium income, compared with an area-wide figure of 56 per cent. By contrast, in the life insurance sector, where the top five companies' share of premium income was about 60 per cent, the degree of concentration is on a par with the rest of Europe.

Market indicators in 2009 showed an overall improvement in the economic outlook for the insurance industry, though still not regaining the levels recorded in the pre-crisis period. Insurance share prices turned back upwards in the second quarter, recouping part of the losses suffered at the height of the crisis. The upswing came to an end in the last few months of the year. Trends for euro-area insurance companies overall were similar.

Figure 18.2

Expected default frequencies for selected leading Italian insurance companies (1)

(percentage points)



Source: Based on data from Moody's KMV.
(1) Distribution of quarterly averages of daily data for single companies (mean, median, minimum, maximum). Expected default frequency is an estimate of the company's probability of default over the next twelve months.

The average expected default frequency calculated by Moody's for the leading Italian insurance companies was higher in the first quarter of 2010 than in the last quarter of 2007 (0.6 as against 0.1 per cent), with substantial dispersion between the values for the single companies (Figure 18.2). The risks to the insurance industry from the impact of the financial crisis on portfolio assets were attenuated last year, but those arising from the protracted sluggishness of economic activity were accentuated. In the current period of low interest rates the profitability of the life sector continues to be compressed by the high share of liabilities with guaranteed minimum yields – some 70 per cent of total life insurance technical reserves at the end of the year.

Links between insurers and banks within financial groups and in distribution agreements are quite common, as a way of diversifying sources of income and exploiting synergies in the placement of financial products. Italy now has six financial conglomerates. Three are primarily insurance-based (Generali, Unipol and Mediolanum), two are bank-centred (Intesa Sanpaolo and Carige) and one focuses on investment services (Azimut). In 2009 almost 60 per cent of the life insurance sector's premium income in Italy was channelled through bank and postal branches; one fourth of this fund-raising was through distribution agreements between companies belonging to the same group.

Pension funds

Membership in supplementary retirement schemes increased by 4 per cent in 2009 to 5.1 million (Table 18.3). The rise in membership was small for open pension funds (3 per cent) and practically nil for occupational funds. Holders of individual retirement insurance policies again increased sharply in number, by 12 per cent, thus rising from 28 to 31 per cent of total supplementary retirement scheme members.

Fund-raising by insurance schemes rose by 7 per cent to €2 billion. The increase came entirely in with-profit policies and capitalization contracts, with growth of 21 per cent, while unit-linked products registered a decline of 5 per cent.

Assets under management by the various retirement schemes increased by 22 per cent to €58 billion, or 3.8 per cent of GDP (Table 18.3). At the end of the year 43 per cent of the sector's total assets was held by pension funds instituted after the reform of 1993, 41 per cent by pre-existing funds and 16 per cent by insurance schemes. About three quarters of the new funds' assets were held by occupational funds and the rest by open funds.

Table 18.3

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

	Number of funds (2)		Persons enrolled (3)		Total assets	
	2008	2009 (4)	2008	2009 (4)	2008	2009 (4)
Pension funds set up after the 1993 reform	122	115	2,839,114	2,860,535	18,755	25,003
Occupational funds	41	39	2,043,509	2,040,150	14,092	18,735
Open funds	81	76	795,605	820,385	4,663	6,268
Pension funds set up before the 1993 reform	411	391	677,453	673,039	22,091	23,884
Insurance-type individual retirement plans	75	75	1,376,151	1,547,923	6,594	8,966
Total	**608**	**581**	**4,851,203**	**5,055,284**	**47,440**	**57,876**

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-type individual retirement 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 insurance-type plans compliant with Legislative Decree 252/2005 and in other insurance-type individual retirement schemes. For funds set up before the 1993 reform, estimates. – (4) Provisional data.

The financial results of the pension funds turned positive again in 2009, thanks to rising prices in the main stock exchanges. According to Covip data, the average yield of occupational pension funds (net of taxes and management fees) was 8.5 per cent (compared with minus 6.3 per cent in 2008). Open funds and unit-linked insurance plans – in which the equity component is relatively larger – achieved higher yields of 11.2 and 16.5 per cent respectively, after negative returns of 14 and 24.9 per cent in 2008.

The differences in the average cost of the various retirement schemes remain substantial. The fees charged by insurance schemes are particularly high, partly as a consequence of the placement costs sustained by their sales networks and the provision of yield guarantees. The data supplied by Covip indicate that at the end of March 2010 the composite cost indicator, which measures the reduction in the annual percentage yield due to total costs charged to the subscriber, was on average, for a membership period of 25 years, quite low for occupational pension funds (0.24 percentage points) and much higher for open funds and individual retirement plans (1.04 and 1.62 points respectively).

Table 18.4

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

	2008				2009 (2)			
	Pension funds			Non-INPS social security institutions (4)	Pension funds			Non-INPS social security institutions (4)
		Set up before the 1993 reform	Set up after the 1993 reform (3)			Set up before the 1993 reform	Set up after the 1993 reform (3)	
Liquidity	**4,672**	**3,356**	**1,316**	**4,214**	**3,939**	**2,550**	**1,389**	**5,652**
Securities portfolio	**31,185**	**13,853**	**17,332**	**16,950**	**40,010**	**16,234**	**23,776**	**9,797**
Bonds	22,030	9,358	12,672	11,102	27,087	10,626	16,461	9,092
Shares	4,309	1,233	3,076	1,647	6,378	1,432	4,946	256
Investment fund units	4,846	3,262	1,584	4,201	6,545	4,176	2,369	449
Mortgage loans and other financial assets	**2,467**	**2,259**	**208**	**4,496**	**2,559**	**2,559**	**0**	**21,154**
Real estate	**2,623**	**2,623**	**–**	**9,352**	**2,541**	**2,541**	**–**	**1,019**
Total assets	**40,948**	**22,091**	**18,857**	**35,012**	**49,049**	**23,884**	**25,165**	**37,622**

Sources: Based on data from the Bank of Italy, Covip and social security institutions.
(1) The composition is partly estimated. – (2) Provisional. – (3) Includes the Bank of Italy staff pension fund. The item *Mortgage loans and other financial assets* is net of liabilities. – (4) Data for 13 institutions.

Although the number of private pension fund members has risen considerably in recent years, especially following the 2007 reform, the membership rate among workers remains low. At the end of 2009 about 20 per cent of employed workers belonged to supplementary retirement schemes. According to the Bank of Italy's Survey on Household Income and Wealth (SHIW) for 2008, the membership rate was lowest among young workers, the less well-educated, and low-income workers. Participation rates were also low in the South and Islands and among self-employed workers, among whom occupational funds are less common.

The Survey found that knowledge of the supplementary retirement rules is quite limited, especially among younger workers, those with low incomes and those with relatively little education. And it is modest even among those who do belong to some retirement scheme. Among pension fund members, moreover, a large portion do not know or do not remember their fund's investment strategy, the size of their contributions, or the amount of equity accumulated.

The 2008 SHIW asked workers whether, hypothetically, upon retirement they would forgo an annuity in favour of an immediate lump sum payment. Analysing the responses it appears that the propensity to convert one's retirement wealth into an annual flow of income in order to guard against longevity risk diminishes significantly as the price of the annuity increases. It is especially low among the less well-educated and those less well-informed about financial and retirement matters, as well as among those with lower income. A low propensity to convert wealth into an annuity may be an impediment to membership in supplementary retirement schemes.

The risk that retirement saving will be insufficient to provide a decent standard of living after retirement is particularly serious for workers, especially the younger generations, whose public pensions will be sharply curtailed. According to the estimates of the State Accounting Department, a private sector employee who under certain contribution conditions would have been entitled in 2010 to a pension equal to about 70 per cent of his last paycheck gross of taxes and social contributions, would get scarcely 50 per cent under those same conditions in 2040. This value varies notably with individual characteristics such as number of contribution years, income trends over the career and age at retirement.

The SHIW for 2008 finds that the income replacement rate of public pensions (ratio of the first pension to the last paycheck) expected by workers is 64 per cent, on average. Younger workers expect lower replacement rates, consistent with the award formula now in place. The expected replacement rate is also lower for self-employed workers, those with atypical employment relationships and those with lower incomes. About 10 per cent of employed workers expected replacement rates of less than 50 per cent, and at the same time had saving rates of less than 10 per cent; a significant portion of these workers are in the bottom wealth and income classes and display very low rates of membership in supplementary retirement schemes.

19. SUPERVISION

International cooperation

Implementation of the recommendations of the Group of Twenty (G20), the Financial Stability Board (FSB) and the European Union for strengthening financial regulation and supervision is at the centre of international cooperation. At the Pittsburgh summit in September 2009 the G20 leaders pledged to complete the reform of prudential capital and liquidity regulations, draft measures to cope with the risks posed by systemically important institutions and improve the management of crises involving cross-border groups. Work on the revision of accounting standards and banks' compensation policies has continued. Initiatives have been undertaken to foster broader compliance with the international recommendations on supervision and cooperation among authorities. The FSB, whose new Statute was approved, will continue to coordinate the implementation of the reforms.

Strengthening of prudential regulations on capital and liquidity. – The experience of the crisis has demonstrated the need to strengthen the international regulation of banks' capital and to introduce prudential rules aimed at limiting liquidity risks. In December 2009 the Basel Committee released proposals on both fronts for consultation. The proposals on capital are aimed at, among other objectives, improving the quality of capital and curbing excessive financial leverage, those on liquidity at promoting balanced structures of assets and liabilities.

The revision of the definition of regulatory capital is intended to enhance banks' capacity to absorb losses. In particular, the Committee proposes: ordinary shares and retained earnings as the main components of core tier 1 capital; extension and harmonization of the list of elements to be deducted – among others, deferred tax assets and equity holdings in banks, financial and insurance entities – and exclusion of minority interests from core tier 1 capital; and more stringent criteria for the inclusion in tier 1 of securities other than ordinary shares (for example, preference shares and hybrid capital instruments). In addition, the various components of capital would have to be announced to the market and reconciled with the balance-sheet items.

Concerning risk coverage, beyond the reform of the treatment of the trading book and securitizations, approved definitively in July 2009, the Committee proposes stiffer capital requirements for counterparty risks arising from exposures in derivatives, repos and securities lending.

The introduction of a leverage ratio constraint is designed to make the build-up of total assets, including off-balance-sheet assets, consistent with the availability of an adequate capital base. This constraint should operate during the phases of rapid economic expansion and limit the consequences of a possible underestimation of risks by banks using the advanced methods envisaged by Basel II.

The Committee has also suggested a set of measures to limit procyclicality. The first is aimed at containing the fluctuations of the minimum requirement for banks that adopt internal rating systems in which the estimates of the probability of default vary significantly over the economic cycle. The second is the introduction of a target ratio, equal for all banks, to be reached during expansions, with restrictions on the distribution of profits and constraints on staff compensation policies in the event of non-compliance. The third is meant to ensure that banks increase their capital buffers during periods of excessive credit growth. The fourth, lastly, has the objective of promoting the adoption of accounting methods for the calculation of provisions for credit risk based on estimates of expected losses throughout the economic cycle.

To improve liquidity risk management, the Committee proposes introducing two quantitative requirements. The first, the liquidity coverage ratio, requires banks to have sufficient reserves of liquidity to cover expected cash outflows over a 30-day horizon without resorting to the market, even in times of severe stress. The second, the net stable funding ratio, is intended to avert structural mismatches in the maturity composition of balance-sheet assets and liabilities.

Together with the consultation, early this year the Committee launched a quantitative impact study to assess the impact and effectiveness of the proposed measures and to determine the levels of capital and liquid assets that banks will be required to hold in the coming years.

The Committee will present the final version of the proposals by the end of this year. There will be a transitional regime for the phasing in of the new rules, which will take effect at the end of 2012 provided the economic recovery has firmed up.

In parallel with the analyses conducted through the quantitative impact study, which are called “bottom-up” in that they are based on data collected from banks, the FSB and the Basel Committee have promoted a diversified set of macroeconomic assessments (“top-down calibration”) to analyse the impact of the regulatory changes in terms both of the short-run costs to the banking system and of the effect on its capacity to finance the economy in the medium- and long-term.

The risks connected with systemic institutions and management of cross-border crises. – The G20 called on the FSB to present proposals on systemically important financial institutions this autumn, with the following objectives: reducing the probability and the impact of the failure of such institutions; improving the capacity to manage crises of complex financial institutions, thereby attenuating the effects on the supply of essential financial services; strengthening market infrastructures so as to limit the risks of contagion. Further, the G20 asked the IMF to study ways for the financial industry to bear part of the costs of safeguarding systemic stability.

The proposals under consideration to reduce the probability and impact of the failure of systemically important financial institutions include the application of additional capital requirements, calibrated to the contribution of each institution to systemic risk, intensified macro- and micro-prudential supervision, and greater recourse by these institutions, compared with others, to bonds that are automatically converted into equity in situations of difficulty (contingent capital).

With regard to improving the management of the crises of internationally active intermediaries, the G20, FSB and European Union are examining proposals for preventive interventions, crisis management and orderly resolution. The FSB has begun a study of bank crisis management systems and by autumn of this year will develop common principles for handling crises of cross-border institutions, to enhance consistency between national resolution systems and improve coordination of different countries' measures.

At European level, in October 2009 the Commission published a communication on management of the crises of cross-border banking groups containing possible options for the definition of a harmonized crisis management regime.

The Ecofin Council, in its meetings of 2 December 2009 and 18 May 2010, has emphasized that the reform of the European crisis management framework is intended to strengthen financial stability and minimize costs by developing three complementary components: a system for the coordination of measures to deal with crises; a common regulatory framework for the prevention, management and resolution of crises; and mechanisms to mitigate systemic risk and ensure that the financial sector bears the costs of crises.

To strengthen market infrastructures, the G20 recommends that all over-the-counter standardized derivatives be traded on regulated markets or on electronic trading platforms and, from the end of 2012 onwards, be cleared through central counterparties. In addition, contracts on OTC derivatives would have to be recorded in special trade repositories and, if not centrally cleared, be subject to a higher capital charge. At European level, the Commission issued a communication on the matter in October 2009 and will present a legislative proposal by June of this year.

Revision of the international accounting standards. – The financial crisis brought to light some weak points of the current international accounting standards. At the behest of the G20 and the FSB, the International Accounting Standards Board has undertaken a revision of the standard on financial instruments (IAS 39) divided into three phases: classification and valuation, impairment of financial instruments valued at amortized cost, and hedge accounting.

Revision of compensation policies – In September 2009 the FSB issued implementation standards for its principles on compensation policies, pay structure, alignment with risks and results, transparency, and the action of the supervisory authorities. To ensure homogeneous application of the new rules, in January 2010 the Basel Committee published guidelines for supervisory assessment of banks' compensation policies and practices. The international standards will be made obligatory for EU banks with the transposition of the amendments to the Capital Requirements Directive (CRD III).

Strengthening compliance with international standards and enhancing cooperation. – In the first few months of 2010 the FSB undertook initiatives to promote global adherence to international standards of financial supervision, particularly those regarding cooperation and information exchange between authorities. The initiatives include the possible publication this year of a list of non-cooperative jurisdictions.

European cooperation on financial stability and supervision. – In 2009 and the first few months of 2010 action to strengthen European cooperation under the aegis of the Committee of European Banking Supervisors (CEBS) proceeded with the evaluation of the stability of banking systems and the drafting of supervisory standards and guidelines. To evaluate the soundness of the European banking system, particularly its overall capital endowment and the resources available for the financing of the economy, the Ecofin Council invited the CEBS to repeat the stress test conducted in 2009 in the first half of 2010.

The CEBS continued work on drafting common standards for implementing the Capital Requirement Directive II. In December it published a consultation document containing proposals concerning the financial instruments that may be included without limit in tier 1 capital and approved the guidelines on hybrid capital instruments that may be included with restrictions. In the same month the Committee published its guidelines on large exposures setting out criteria for the identification of related parties with particular regard to the notions of control and economic connection. In accordance with the principle of proportionality, the criteria for identifying related parties can be applied only to exposures exceeding 2 per cent of regulatory capital.

For the convergence of supervisory practices, the CEBS worked on strengthening the activity of supervisory colleges – which are meant to improve the individual and consolidated supervision of cross-border groups and to facilitate the preparation of plans for handling emergency situations – by giving impetus to the establishment of the colleges for European banking groups and drafting guidelines for their functioning.

The reform of supervision in the European Union

Work began on implementing the reform of European financial supervision according to the guidelines approved by the Ecofin Council and the European Council, respectively, on 9 and 19 June 2009. In September 2009 the Commission published draft regulations regarding the creation of the European Systemic Risk Board (ESRB) and the European Supervisory Authorities (ESAs). In its meetings on 10 October and 2 December 2009 the Ecofin Council reached a general agreement on the legislative proposals that will be approved in the coming months, at the conclusion of the co-decision procedure with the European Parliament, so that the bodies can begin to operate in 2011.

The European Systemic Risk Board will be charged with macro-prudential supervisory functions. In particular, it will conduct analyses of the European financial system, issue risk warnings and, if necessary, make non-binding recommendations for corrective interventions at European or national level. It will oversee the implementation of its recommendations. The ESRB will not have legal personality; the European Central Bank will provide the necessary logistical and administrative support and staff.

The new European authorities, bodies established with legal personality under Community law, will replace the current third-level committees in the banking, securities and insurance sectors and perform functions relating to micro-prudential supervision. In particular, they will contribute to establishing common rules and consistent supervisory practices at European level (single rulebook), ensure uniform application of European legislation, promote consistent supervisory college operating procedures and ensure a coordinated response by the authorities in emergency situations. In addition, the ESAs will manage shared databases by gathering the micro-prudential information needed for evaluation of the risks of the financial system, in cooperation with the ESRB. To achieve these objectives, the legislative proposals would assign the ESAs significant powers: to draft binding technical rules in the areas specified by primary legislation; to make binding decisions in order to resolve disputes between national supervisory authorities; and to request the national authorities, in emergency situations, to take steps to deal with risks to the stability and orderly functioning of financial systems. Furthermore, in case of incorrect application of the Community rules, the European authorities will be able to adopt measures in respect of national supervisory authorities and also, where the rules are directly applicable, vis-à-vis individual financial institutions.

In the sphere of the reforms recommended by the G20 to expand the perimeter of regulation, on 18 May 2010 the Ecofin Council agreed on an approach to the draft directive aimed at introducing harmonized rules for managers of alternative investment funds (such as hedge funds, private equity funds and real estate funds) reserved to professional investors. The draft directive lays down rules for the authorization of management companies, organizational and risk management requirements, measures to deal with excessive leverage and transparency requirements, and subjects these entities to the supervision of national authorities. Derogations are envisaged for small funds and for the marketing of third-country funds in Europe.

Italian legislation

Capital, risks and funding instruments. – Numerous measures were adopted to ensure maintenance of adequate capital levels by the banking system.

In August 2009 the Bank of Italy specified the criteria for banks to follow in operations on regulatory capital. In particular, early redemption of instruments included in regulatory capital may be authorized provided that the instruments are wholly replaced in advance by others of equal or higher quality and that the bank is able to sustain any additional costs connected with the replacement. In September, in keeping with the position taken by the Basel Committee, the obligation for banks authorized to calculate their capital requirements on the basis of internal models to maintain a minimum requirement equal to at least 80 per cent of that deriving from the previous rules (Basel I) was extended to 2010.

In March 2010 the regulatory framework governing Italian banks' covered bonds was revised with a view to fostering further issuance. The new provisions clarify essential aspects such as the valuation report on the assets transferred and the tasks of the audit firm engaged to conduct the checks on the regularity of the transaction and the integrity of the guarantee in favour of investors.

In May 2010 the Bank of Italy, bringing the rules in Italy into line with those of the other major EU countries and the United States, modified the prudential treatment of EU countries' government securities for the calculation of Italian intermediaries' regulatory capital. The aim is to prevent unjustified volatility of regulatory capital stemming from sudden shifts in the prices of these securities unrelated to enduring changes in the issuers' creditworthiness. The measure, which does not affect the regulations on banks' financial statements, incorporates an option provided for in the CEBS guidelines on prudential filters.

Also in May, and again to preserve the full availability and stability of banks' capital, provisions were issued concerning disposals by banks or banking groups of buildings used for business purposes.

Banks' organization and corporate governance. – In October 2009 the Bank of Italy issued further guidance on banks' compensation and incentive systems, following up the supervisory measures issued in 2008 and taking the evolution of the international context into account. The Bank called banks' attention to the need for prompt and scrupulous compliance with the applicable supervisory provisions and identified the banking groups that must also comply with the Financial Stability Board's Implementation Standards. The groups in question were asked to conduct a specific check on the extent of their compliance with the FSB standards and to plan any measures of adaptation found necessary.

Ownership structures. – Transposing into Italian law the changes introduced by Directive 2007/44/EC, Legislative Decree 21/2010 amended the provisions of the Consolidated Law on Banking and the Consolidated Law on Finance regarding the acquisition of qualifying holdings in banks, insurance companies, investment firms and asset management companies.

The amendments to the Consolidated Law on Banking raise the threshold requiring notification of holdings from 5 to 10 per cent, without prejudice to the obligation for cases of significant influence and control; explicitly indicate the additional authorization thresholds for changes in holdings (20, 30 and 50 per cent, and, in any event, control); reformulate the criteria for the assessment of applications, bringing them into line with the Directive; and extend the rules to cover acquisitions made in concert and, accordingly, the related sanctions consisting in the suspension of voting rights and compulsory sale.

Banks' eligible holdings and risk assets vis-à-vis connected persons. – In December 2009 the Bank of Italy began a consultation on the provisions implementing the Credit Committee's resolution of July 2008 concerning the eligible holdings of banks and banking groups. The reform has the twofold objective of simplifying Italian regulations and harmonizing them with the EU rules.

In May 2010 the Bank of Italy began a public consultation on draft supervisory provisions concerning banks' and banking groups' risk assets and conflicts of interest in respect of connected persons, to implement Article 53 of the Consolidated Law on Banking and the Credit Committee's resolution of July 2008. The aim of the proposed measure is to guard against the risk that the proximity of certain persons to banks' decision-making centres could compromise the objective and impartial nature of decisions, thereby causing distortions in intermediaries' allocative function, exposures to insufficiently measured or controlled risks, and potential losses for depositors and shareholders.

The perimeter of connected persons includes relations both upstream, between the bank and its corporate officers, controllers and qualifying shareholders, and downstream, towards companies or firms on which the bank exercises control or significant influence. The provisions set prudential limits, in relation to consolidated and individual regulatory capital, to the amount of risk assets that can be held in respect of such persons. More stringent limits are established for "non-financial" related parties, in order to contain the risks connected with the growth of bank-industry relations. In addition, the measure establishes procedural rules, calibrated to the scale of the transaction, aimed at ensuring the integrity of decision-making processes.

To ensure consistency between procedural rules and to limit the costs to the parties concerned, the provisions under consultation were examined with Consob in the light of the latter's measure implementing Article 2391-*bis* of the Civil Code, concerning related-party transactions by companies that have recourse to the equity capital market.

Asset management. – Regulatory measures in this sector were intended to enhance the value of managers' autonomy and independence and to simplify administrative activity. In October provisions were issued concerning group parent companies' direction and coordination of asset management companies. The new provisions, reflecting the recommendations of the working group promoted by the Bank of Italy, reconcile the bank parent company's powers of direction and coordination with the need to safeguard the ability of asset management companies to act in the interest of investors.

In March 2010 the Bank began a public consultation on a draft amendment to the regulation on collective asset management that would increase the number of cases in which management companies can resort to standing authorization of the rules of funds not intended for retail customers and would introduce governance principles for closed-end funds.

Financial intermediation. – In May 2010 the Ministry for the Economy and Finance began a public consultation on the measures drafted, with the cooperation of the Bank of Italy, under the mandate contained in the 2008 Community Legislation Implementation Law for the reform of the provisions governing non-bank financial intermediaries and financial agents and loan brokers. The objectives of the reform are: to permit only persons that ensure sufficient reliability and correctness to engage in the reserved activities; to provide for more effective supervisory instruments calibrated to the activities performed and risks taken; and to introduce administrative sanctions and more effective, proportionate forms of intervention. The rules on financial agents and loan brokers are revised with a view to ensuring greater professionalism and reliability and strengthening the access requirements; control mechanisms are revised accordingly.

Provision of investment services. – In accordance with the October 2008 memorandum of understanding between the Bank of Italy and Consob, the supervisory rules regarding the provision of investment services by banks were amended in July 2009 to expand the information accompanying the application.

Transposition of the Payment Services Directive. – Legislative Decree 11 of 27 January 2010 transposed Directive 2007/64/EC on payment services in the internal market into Italian law. The decree amends the Consolidated Law on Banking to modify the reserved activities provided for in Article 106 and establishes rules governing payment institutions, a new species of authorized intermediary, together with banks and electronic money institutions in the European Union. Payment institutions are placed under a regime of controls similar to that for other supervised intermediaries (rules on capital, requirements for corporate officers and shareholders, organizational provisions); they may grant short-term credit in connection with the payment services provided, and they may engage in other business activities (called hybrid payment institutions). The decree also contains a set of provisions on the rights and obligations of users and providers of payment services and rules for transparency of services and transactions. The regulation of payment institutions was completed with the implementing provisions issued by the Bank of Italy in February 2010.

Supervision of banks

In 2009 the integrated use of off-site analysis, inspections, stress tests and ad hoc surveys enabled the Bank of Italy to monitor the evolution of risks, detect the situations warranting further examination in a timely manner, and request banks to take the necessary corrective action.

The process of prudential supervision. – The approach established in the Guide for Supervisory Activity issued in mid-2008 was applied for the first time in both off- and on-site supervision, under a unitary logic based on risks, focused on consolidated situations and calibrated according to banks' size, operations and factors of weaknesses.

The new approach capitalizes on the strengths of the traditional system of supervision, most notably interaction between off-site and on-site controls, integrated use of all available sources of information, and dialogue with intermediaries, and it stresses the importance of the interrelations between macro- and micro-prudential analysis. On the methodological plane, the new elements are many. The new approach to risk measurement requires that the size of the exposure be assessed in conjunction with the factors of mitigation and control ("net risk"). Assessment of financial, operational and reputational risks is integrated in the "bank analysis system" with models and structured schemes of analysis. In addition, refinements have been made to the methodologies used for traditional risks (credit and liquidity risks), profitability and capital. Special importance is now attached to strategic risk and the governance system; banks' business decisions and governance capacity are evaluated on the basis of their consistency with their risk profile and operating environment.

The worsening of credit risk profiles and earnings capacity weighed heavily on the overall assessments assigned to banks. The examination of capital positions and risk management systems took account of the internal capital adequacy assessment process (ICAAP) provided for in the rules on the second pillar of Basel II. Especially in the case of the main groups, this activity required probing discussions with banks' risk management units. On the basis of the inquiries conducted, the banks were asked to prepare more accurate risk identification procedures, measurement methods that are reliable and robust even in adverse conditions, and prudent criteria for determining available financial resources. Banks' governing bodies were urged to take a more active role in shaping and implementing the process.

As part of the new supervisory approach, inspections were a key tool for corroborating banks' assessments with robust, up-to-date information on risk management and on governance and control structures. Calibrated in their scope and frequency, inspections concentrated primarily on the largest intermediaries and the problem banks. Controls at the main groups were continual; in addition to the loan portfolio, they concerned the liquidity profile, the reliability of statistical and prudential reports, internal control structures and processes, and the organizational measures to ensure business continuity.

A total of 205 inspections of stand-alone banks and intermediaries belonging to banking groups were carried out in 2009. These included a significantly greater number of targeted checks (33), conducted mainly at the largest banking groups and designed to examine specific sectors of activity, areas of risk or operational profiles. In accordance with the principle of proportionality, the number of wide-ranging inspections was reduced to 164, mostly at small intermediaries. Eight follow-up inspections were performed to verify the outcome of the corrective measures taken by banks either at their own initiative or at the prompting of the Bank of Italy.

Risk analysis. – As the macroeconomic situation deteriorated, priority was given to controls on the quality of the loan portfolio and, more generally, of assets. Inspections were carried out at the main banking groups to evaluate the evolution of credit risk, especially in the corporate segment. Specialized task forces conducted thematic inquiries serving as the basis for a comparative evaluation of the adequacy of lending processes in the light of the economic and financial crisis. In this connection, an examination was made of the performance of the statistical models for measurement of credit risk and their functioning for purposes of the stress tests run by the banks. Off-site analyses focused on monitoring the phenomena that from time to time could represent factors of vulnerability.

Although banks' liquidity situation improved progressively starting in early 2009, the controls introduced at the height of the tension in the financial markets – weekly monitoring of the net liquidity position, simulations based on stress scenarios, contacts with banks' cash managers, checks on operating arrangements and procedures, targeted inspections – were reinforced and consolidated. They are now flanked by a new liquidity analysis model requiring an assessment of the structural equilibrium of the balance sheet and of the adequacy of organizational safeguards. Studies were undertaken to adapt the existing supervisory apparatus consistently with the principles being defined in international forums. The banks were urged to plan the necessary steps to bring their liquidity management policies, instruments and processes up to best practices.

Examinations were performed to evaluate the techniques for managing interest rate risk and verify the quality of the banks' supervisory reports concerning the residual maturity of operations. Interchange was particularly intensive with the groups that use statistical models, whose quantification of this type of risk depends on the validity of the hedging strategies used and of the assumptions made regarding the duration of balance-sheet items, such as deposits, lacking a predetermined contractual maturity.

Internal risk measurement systems. – The validation of internal models used to calculate capital requirements is one of the most complex and delicate tasks of the Bank of Italy, which must verify that the use of these instruments actually serves to improve risk management processes and not just to reduce capital requirements. Considering the outcome of the assessments conducted and the factors of vulnerability that the financial crisis brought to light, the Bank of Italy confirmed its line of rigour: for validations, including new validations, internal systems are evaluated in relation to the intermediary's overall operations; their validity for prudential purposes is recognized only in the event of not merely formal compliance with the quantitative and qualitative regulatory requirements, among which special importance attaches to full utilization of all the information available and the actual use of these systems in the management of the banks (data completeness and experience requirements).

Capital strengthening. – As it has since the onset of the financial turmoil, the Bank of Italy proceeded to encourage banks to use all available means to raise their capital ratios. This objective was pursued without any easing of the rigour applied in evaluating the quality of capital and the correctness of the calculation of risk assets. Despite the improvement achieved by banking groups overall, supervisory action will continue in this direction, bearing in mind the evolution of international regulations on the definition of capital.

Governance, compensation, organizational and control structures. – The time limit for implementing the provisions on governance issued in 2008 expired in 2009. The Bank of Italy took the occasion of its examination of banks' bylaws and "corporate governance projects" to remind supervised institutions of the need to ensure the balanced composition of their governing bodies, the clear demarcation of responsibilities, correct checks and balances and effective internal dialogue. Cooperative banks, particularly those that are listed or are parent companies of complex groups operating on a national scale, were asked to reconcile the stability of governance structures with the need to ensure adequate participation of the members in shareholders' meetings and representation of minorities. Adaptation of incentive and compensation systems to Italian regulations and the FSB guidelines was a priority issue for supervisory controls and required intense discussion with intermediaries. Supervisory interventions mainly concerned the six largest groups, which are completing the process of bringing their systems into line with the standards by modifying the relationship between the fixed and variable portions of management compensation, introducing medium- and long-term incentives and mechanisms for the deferment of the variable component, and refining risk-adjusted performance indicators. Especially in the groups that are most complex in terms of size, cross-border operations or composition of the shareholder base, the Bank of Italy stepped up its effort to make the parent companies aware of the need for effectively ensuring unitary guidance and integrated risk management.

Supervision of Italian-controlled international groups and foreign subsidiaries. – Supervision of the two Italian banking groups with the most extensive international operations was conducted increasingly through the supervisory colleges and through bilateral as well as multilateral meetings with the authorities responsible for the foreign subsidiaries and branches of greatest importance within the group or within the countries where they are established. Action was also stepped up with regard to the major Italian subsidiaries of foreign banking groups within the respective supervisory colleges; the companies in question were asked to increase their awareness of the risks taken on at local level and their knowledge of the risk measurement and management instruments even when these are developed centrally by the parent company.

Partly in view of the developments being decided at international level regarding the operations of the supervisory colleges, the colleges coordinated by the Bank of Italy dealt with an expanded range of issues. Besides conducting analyses aimed at standardizing or extending the internal models already validated for calculation of the first-pillar requirements, the colleges examined risks both at consolidated level and with regard to groups' main components, studied specific organizational profiles (such as compensation policies, integration of information systems, and the mechanisms of group coordination and control) and compared the evaluation methods and procedures used by the different authorities. On the procedural plane, the practice of coordinating programmes of analysis and intervention was established; the formation of joint inspection teams for targeted on-site controls and validation of internal models is increasingly common.

Supervision of specialized banks. – In accordance with the principle of proportionality, analysis and intervention in respect of specialized banks focused mainly on those that engage in lending (in the form of leasing, factoring, consumer credit and the provision of guarantees), given their greater exposure to the cyclical downswing. For banks active in investment services, analysis concerned the evolution of operational risks and the degree of financial leverage.

Supervision of smaller banks and local banking groups. – Prudential controls carried out by the Bank of Italy's branches on minor banks, active above all at local level, found generally satisfactory situations at a large number of banks, accompanied, however, by marked disparities in operating efficiency and profitability, capital soundness, and quality of control and corporate governance arrangements. The weaker banks were advised, in terms commensurate with their vulnerability, of the need for more efficient conduct of business, attention to risks and effective corporate government systems in concomitance with the heightened complexity of operations.

Supervision of non-bank intermediaries

Asset management companies. – Supervisory action focused on evaluating the effects of the financial market crisis on an asset management industry already beleaguered by structural difficulties. Intervention, calibrated to the size and problems of companies, increased in intensity.

In the open-end hedge fund sector, the initiatives taken by intermediaries to cope with the asset liquidity problems that arose in 2008 were examined. Hedge fund managers continued to avail themselves of the opportunities offered by regulations, resorting to alternatives to fund liquidation. Mergers between collective investment undertakings, the hiving off of the illiquid component of portfolios and deferment of redemption requests helped to mitigate the difficulties. The rationalization of hedge fund management companies continued, thanks to mergers fostered by the elimination of operational segmentation.

The Bank of Italy carried out in-depth controls on real estate funds with a view to preventing financial imbalances in the riskiest initiatives, through targeted monitoring, stress testing and constant interchange with fund managers.

In September 2009 a survey of the financial structure of closed-end real estate funds was conducted in order to detect any signs of fragility capable of impeding investment plans. The problem situations, concentrated among reserved hedge-type funds, are characterized by a high degree of financial leverage, unlikely growth forecasts and financial difficulties among counterparties and investors. The managers were invited to monitor the state of implementation of strategic plans closely and to take timely action to limit risk and create the conditions for an orderly liquidation of the portfolio in the case of initiatives approaching maturity. The management companies were asked to assess the possible impact of the funds' difficulties in terms of legal and reputational risks.

The effects of the crisis on private equity funds were seen in the deterioration of the situation of investee companies and the difficulty of realizing portfolio disinvestment plans. New initiatives were hampered by banks' greater caution in financing projects with high financial leverage and, for fund-raising, by the greater risk aversion of institutional investors, to which most of the initiatives in the Italian market are reserved.

Investment firms. – The protraction of the crisis affected the technical situation of many investment firms, aggravating weaknesses. The impact of the difficult conditions was greatest on small investment firms, whose capital is often barely sufficient to meet the requirements. For these firms, the decline in operations to less than minimum levels of profitability required vigorous supervisory action to prompt the strengthening of regulatory capital, eroded by losses for the financial year, and the taking of appropriate strategic measures. In the most extreme cases, the deterioration in the company's situation led to its exit from the market or to the search for a way out through consolidation; in these cases the Bank of Italy verified that the processes were orderly.

For large investment firms, supervisory interventions often involved fact-finding or were of a preventive nature, relying on continual interchange with corporate officers. ICAAP reports were put to good use in connection with action to encourage correct measures against risk. With profitability still low, many firms acted to curb costs. The Bank of Italy called their attention to the need to maintain adequate standards of reliability in risk management and control and to ensure the regulatory compliance and effectiveness of organizational and internal control structures.

Financial intermediaries in the special register. – Supervision of financial intermediaries entered in the special register referred to in Article 107 of the Consolidated Law on Banking concentrated on the sectors that had already shown a worsening in credit quality in 2008: leasing and personal credit in the technical forms of consumer credit, loans secured by one fifth of salary or pension, and credit cards. The actions taken by leasing companies to strengthen their organizational safeguards in terms of lending and exposure management and monitoring were monitored.

Given the cancellation of securitization vehicles from the special register, supervisory assessments of the risks taken on by banks and financial companies in securitizations can make use of the data reported directly by servicers, which are subject to supervision by the Bank of Italy in connection with their auditing tasks.

Financial intermediaries in the general register. – In 2009 and the opening months of 2010 controls on intermediaries entered in the general register referred to in Article 106 of the Consolidated Law on Banking focused not only on consumer credit but also on other sectors with a high risk profile, such as money-changing, the provision of guarantees and money-transfer services.

Controls were triggered by analysis of the first statistical reports transmitted in 2009 by Article 106 intermediaries. Procedures were initiated for the deletion of several intermediaries from the register following their failure to transmit two consecutive reports.

With regard to loan brokers and financial agents, controls were performed, including on a sample basis, to verify their possession of the qualifications they had self-certified for registration.

Recognition of ECAIs. – The number of the rating agencies recognized as external credit assessment institutions (ECAIs) by the Bank of Italy remained unchanged in 2009. They are three major international agencies, subject to joint assessment at Community level, and Lince, an Italian agency (which has merged with Cerved, the economic and financial data company, in the new entity called Cerved Group).

For recognized ECAIs, the Bank of Italy assesses ongoing compliance with the regulatory requirement by examining the communications sent by the agencies when there are significant changes in their rating systems and the updated data bearing on the mapping of ratings to the weightings for risk-weighted assets. For the international agencies, the evaluation of ongoing compliance is coordinated at Community level.

Crisis procedures for banks and non-bank intermediaries

Since the end of 2008 there has been a significant increase in the number of crisis management procedures, which have mainly involved small intermediaries. Twenty procedures were begun in 2009 and another four in January-April of this year. The adoption of crisis procedures is generally the consequence of irregularities and regulatory violations, accompanied in about half of the cases by serious or exceptionally severe capital losses. On four occasions the urgency of intervening necessitated provisional management; in two cases liquidity strains triggered the suspension of payments.

A total of 13 banks were involved in crisis procedures, including 6 mutual banks and 3 cooperative banks. The non-bank intermediaries subjected to procedures were two investment firms, three asset management companies and one electronic money institution.

In terms of size, the intermediaries subjected to crisis procedures since the start of 2009 represent marginal shares of the banking and financial system. The insured deposits of the banks put into special administration accounted for 0.2 per cent of the total deposits covered by guarantee systems at the end of 2009, and the assets held for custody or management by the intermediaries subjected to crisis procedures similarly made up a tiny share of the total. However, the number of savers and customers affected and financial sector workers involved is considerable.

Designing interventions to solve crisis situations through consolidation with other intermediaries is more difficult than in the past. In some cases it has been necessary to initiate the procedures envisaged for staff redundancy.

In the present conditions, depositor guarantee systems can make a crucial contribution to solving bank crises. In 2009 the Mutual Bank Guarantee Fund approved several supplementary support interventions in favour of banks in difficulty but not subjected to crisis procedures.

Consumer protection, financial education and anti-money-laundering controls

The Bank of Italy engaged in a range of activities for consumer protection in 2009. Major regulatory measures were adopted, controls were stepped up, the Banking and Financial Arbiter began operating, and more work was done in the field of financial education. Special attention was paid to compliance with the rules against money laundering.

The revision of the rules on transparency. – In July 2009, after completion of a public consultation, the Bank of Italy issued new provisions on the transparency of banking and financial transactions and services and correct conduct in relations with customers. The new provisions constitute the foundation of the reform. Subsequent measures have dealt with specific aspects: practical guides to current accounts and mortgages, the "simple current account", instructions for calculating the composite cost indicator for current accounts, and payment services.

The practical guides to current accounts and mortgages, available at intermediaries and on the Bank's website, explain the characteristics and main risks of these products in simple language. The "simple current account" is designed for the needs of basic customers and covers a predetermined number of transactions and services; the content of the services offered and the price structure, which are the same for all banks, make this a product whose costs are readily comparable. In February 2010 the rules were finalized for the calculation of the composite cost indicator for current accounts offered to consumers; customers can know the cost of the account in advance, compare it with that of other products and check whether their present accounts are still advantageous. Also in February 2010, in concomitance with the transposition of the Payment Services Directive, the secondary legislation on the transparency of payment services was amended. The new rules were coordinated with the general rules issued in July 2009 to ensure standards of protection as close as possible to those for other banking services.

Transposition of the Consumer Credit Directive and other amendments to Title VI of the Consolidated Law on Banking. – Article 33 of Law 88/2009 (the 2008 Community Legislation Implementation Law) mandates the Government to transpose Directive 2008/48/EC on credit agreements for consumers into Italian law and to revise and include in the Consolidated Law on Banking other statutory provisions that have affected the rules protecting banks' customers in recent years. The common objective is to enhance consumer protection and strengthen the apparatus of control. In early May 2010 the Ministry for the Economy and Finance published, for consultation, the draft legislative decrees implementing the mandate.

Bank charges and the cost of current accounts. – Decree Law 78 of 1 July 2009 set a ceiling on the amount that banks can charge for making funds available in the form of overdrafts, after the limitations introduced at the end of 2008. Oversight of compliance with these provisions is entrusted to orders of the Ministry for the Economy and Finance.

For better transparency on the charges for loans and overdrafts, in July the Bank of Italy issued measures on the transparency of contract terms, instituting specific, stricter safeguards. Banks were expressly warned not to introduce complex forms of remuneration such as maximum overdraft fees or any others providing for a multiplicity of cost items. Further, the new rules require banks to calculate and make public in their information sheets on accounts with credit facilities a composite cost indicator displaying the total cost of the credit based on a set of scenarios defined by the Bank of Italy. The information sheets must clearly and distinctly display all the cost items relating to loans, unauthorized drawings and current account overdrafts.

The Bank of Italy conducted studies both of the new types of fees charged by the banks and of the cost of current accounts. The fee survey envisaged 12 different hypothetical scenarios on the utilization of lines of credit and overdrafts, for different combinations of amount of credit, number of debit transactions, and duration of the credit in days. For most of the scenarios the respondent banks reported that charges would be less than in the previous regime. The average decrease would be 41 per cent for drawing on a credit line and 35 per cent for overdrafts. However, these averages conceal very substantial variations, especially in the case of overdrafts. Since in many cases the new charges are not applied to very small or very short-lived drawings, most of the benefit for customers would derive from scenarios involving that type of use. As the duration of the overdraft lengthens, the prospective saving diminishes, and for some types of credit utilization the terms actually worsen.

The 2009 survey of bank current account costs found the average account-holder's expenditure roughly unchanged at €114 a year. Fees and expenses for withdrawals and payments diminished slightly, thanks in part to greater use of Internet banking, while there was an increase in other variable costs, which include any charges for overdrafts.

Controls for transparency and complaint handling. – The Bank of Italy's checks for substantial and not merely formal compliance with transparency rules were especially severe and were oriented in part by the complaints received. Organizational shortcomings and internal control inadequacies were detected, and supervisory actions proportionate to the gravity and nature of the anomalies were taken.

The Bank of Italy received over 6,700 complaints in 2009, 29 per cent more than in 2008. In addition there were 1,000 complaints of erroneous reports to the Central Credit Register. While the number of complaints concerning credit management, payment services and instruments and alleged violations of transparency rules was about the same as in 2008, there was a sharp rise in complaints over the tightening of credit.

The Banking and Financial Arbiter. – The Banking and Financial Arbiter (ABF), the Bank of Italy's alternative dispute resolution mechanism for out-of-court settlement of customers' complaints to banks and other intermediaries, began operations on 15 October. Alternative dispute resolution guarantees effective protection, proper representation of the various interests at stake, and rapid and impartial decision. By offering an incentive for virtuous conduct on the part of banks it also encourages market self-discipline.

Financial education. – Last year the Bank of Italy stepped up its activity in the field of financial education. The Survey on Household Income and Wealth published in 2010 confirms that many Italians are relatively unaware of their saving and investment needs and have trouble projecting their future financial requirements.

In view of the success of the experimental programme for Italian students, the economic and financial education project, patterned after international best practices, was conducted again in the 2009-10 school year under a memorandum of understanding with the Ministry of Education, Universities and Research. More than 200 schools and 8,500 students at all levels and in all parts of the country participated. The Bank also took part in initiatives promoted by schools in the provinces of Sassari and Trento.

Usury. – In August the Bank of Italy issued new instructions, in effect as of the observations for the third quarter of 2009, for the calculation of annual percentage rates of charge, in order to curb the practice of levying charges not counted towards the usury ceiling and more effectively verify the economic terms applied to borrowers.

Anti-money-laundering controls. – Activities to prevent and repress money laundering continued in 2009. The Bank issued instructions on the recording in the single electronic database of the customer data that banks and other financial intermediaries acquire in the course of customer due diligence. It also prepared a draft measure on organization, procedures and internal controls for anti-laundering purposes, public consultation on which was concluded in March 2010.

Controls are increasingly targeted according to the degree of money-laundering risk to which the supervised institutions are exposed. This approach is designed for greater efficacy, in keeping with standards of efficient resource use, proportional oversight activity and minimization of costs to the supervised institutions. Money-laundering assessments are integrated into the broader supervisory evaluations. The anti-laundering profile is considered specifically in administrative proceedings on banks' suspicious transaction reports.

National and international cooperation is ever closer and more fruitful. Especially important is the exchange of information with the judicial and law enforcement authorities relevant to the various institutions' mandates. Coordination between the Bank's Supervision Area and the Financial Intelligence Unit under a memorandum of understanding guarantees consistent and effective performance of their respective duties.

The Bank of Italy transmitted to the judicial authorities 26 reports of violations of Legislative Decree 231/2007 detected in the course of supervisory activity. Under agreements with the Bank, the Finance Police carried out 19 inspections at intermediaries entered in the general register provided for in Article 106 of the Consolidated Law on Banking, considerably more than in 2008. In investigations to check compliance with the money-laundering law by financial agents and loan brokers, the Finance Police carried out 230 inspections and made 466 information requests to the Bank of Italy.

The Supervision Area called the FIU's attention to 39 anomalous transactions not reported by intermediaries. The FIU submitted 45 reports of organizational failings, lack of customer due diligence or failure to keep data on file.

Sanctions

More intensive controls on intermediaries and the obligations imposed by sectoral rules resulted in a significant increase in sanctions. The Bank of Italy levied 113 fines last year (compared with 58 in 2008) on over 730 natural and legal persons, being careful to distinguish separate responsibilities within corporate bodies and to calibrate the sanctions with the governance role of each individual.

Deletions from the register. – In 2009 and the first part of 2010 the deletion of one intermediary from the special register under Article 107 of the Consolidated Law on Banking was ordered. At the Bank of Italy's proposal the Ministry of the Economy and Finance ordered the deletion from the general register under Article 106 of that intermediary and 53 others, nearly half of them engaged in the activity of granting credit in the form of guarantees. Controls on loan brokers resulted in the deletion of 94 brokers for failure to meet the integrity requirements and the cancellation from the register of 927 inactive companies. Following the annual verification of financial agents' actual performance of their supposed activity, 13,811 were removed from the register.

THE PAYMENT SYSTEM, THE MARKETS AND THEIR INFRASTRUCTURES

20. THE LARGE-VALUE PAYMENT SYSTEM, MONEY MARKET AND FINANCIAL MARKET INFRASTRUCTURES

For the money and financial markets the first few months of 2009 were a period of great uncertainty, contracting turnover and high price volatility. Over the rest of the year the tensions gradually eased, although factors of uncertainty persisted and risk aversion was strong. In the new year the strains caused by Greece's public finance difficulties and the fears that the instability might infect other euro-area countries resulted in sharply rising sovereign risk premiums.

Internationally, there is a growing tendency to extend post-trading services to clearing and settlement of products traded in over-the-counter markets, with benefits in terms of counterparty risk limitation, liquidity management and efficient use of collateral.

In keeping with the indications and recommendations of the Financial Stability Board and those issued by the G20 in September 2009, a broad revision of financial regulation and oversight was carried forward. At the end of 2009 the European Commission began work on new regulations governing central counterparties (European Market Infrastructures Legislation). As concerns the European oversight structure, the Commission, the Council and the Parliament agreed on the need to review the division of responsibilities between the nascent central authorities and the existing national authorities for systemically relevant market infrastructures such as central counterparties.

Perceived counterparty and liquidity risk continued to limit trading in the transparent e-MID interbank market, while turnover continued to grow in the anonymous collateralized segments with central counterparty. It is too early to tell whether this presages a permanently marginal role for the uncollateralized money market. In any case, various initiatives have been taken for the functional and business integration of electronic trading platforms, central counterparties and securities depositories capable of providing advanced collateral management services.

To accompany market participants' increasing preference for collateralized trading and enhance the efficiency of banks' liquidity management, in 2008 the Bank of Italy constituted the Collateralized Interbank Market (MIC) with anonymous and collateralized transactions. The MIC became operational in 2009 and can continue to play an important role even after the Bank of Italy's guarantee arrangements expire at the end of 2010. The market operator e-MID SIM S.p.A. and the Italian financial marketplace's post-trading infrastructures, now members of the London Stock Exchange Group, have begun work to ensure the continuity of the collateralized interbank market segment, giving it a more markedly European perspective.

Despite the pronounced liquidity strains during the financial crisis, the TARGET2 gross settlement system registered no lateness either in the closing of the business day or in intraday settlement; 99.96 per cent of all payments were settled within five minutes. And the system had perfect business continuity, with 100 per cent operational availability during the year.

Two major Eurosystem infrastructure projects went forward – TARGET2-Securities (T2S) and Collateral Central Bank Management (CCBM2). T2S is the future European system for euro securities settlement in central bank money. It will also be available for settlement in other European currencies. Harmonization and standardization of operating processes will make post-trading services more efficient and cheaper, fostering the integration of European financial markets by lowering cross-border transaction costs. T2S will become operational in September 2014. In 2009 the project's top body, the Programme Board, was established to handle relations with the market and with the four NCBs charged by the Eurosystem to set up the new infrastructure (Banca d'Italia, Banco de España, Banque de France, and Deutsche Bundesbank). The CCBM2 project will produce a single technology platform to manage the financial assets posted by Eurosystem counterparties as collateral for monetary policy operations and intraday credit.

Settlement in central bank money

In 2009 TARGET2 settled a daily average of over 345,000 payments worth around €2,150 billion, 60 per cent of funds transfers via the two main EU payment systems by number and 89 per cent by value. For the first time since the launch of TARGET in 1999, payments diminished both in number (by 6.5 per cent) and, more significantly, in value (by 19.2 per cent). Euro1, the alternative system operated by EBA Clearing, settled more than 227,000 payments a day in 2009, down 9.2 per cent from 2008, for an average daily value of €255 billion, down 11 per cent. The fall in payments was due chiefly to the slowdown in economic activity and the drop in financial market transactions throughout the euro area. The value decrease in TARGET2 in 2009 can be traced to two other factors as well: the reduction in the number of monetary policy operations and the changes made in January in the statistical reporting of transactions settled.

The flows handled by the Italian clearing and settlement systems operated by the Bank of Italy (TARGET2-Banca d'Italia and BI-Comp) amounted to just over €42.2 trillion in 2009, down nearly 22 per cent compared with 2008. These flows were equivalent to 27.8 times GDP (Table 20.1). Average daily flows in 2009 were about the same as in December 2008. Year on year, the turnover fell from €161 billion to €123 billion a day. Apart from the crisis, the decline reflected the migration from BI-REL to TARGET2-Banca d'Italia in May 2008, which encouraged Italian branches of foreign banks to centralize treasury management at their parent banks abroad (Figure 20.1).

The Italian gross settlement system also handles payments coming from ancillary domestic systems. One of the most important is the Express II securities settlement system, which includes large foreign intermediaries accounting for more than 30 per cent of all the payments settled through TARGET2-Banca d'Italia. In 2009 the average daily value of the payment flows from Express II fell from €64 billion to €42 billion as a result of the contraction in financial market activity.

Table 20.1

Flows handled by Italian clearing and settlement systems

(billions of euros)

	Clearing systems (1)			Gross settlement (2) (c)	Total flows	
	BI-Comp gross flows (a)	Multilateral clearing balances				
		BI-Comp	Securities settlement and Express II (b)		(d)=(a+b+c)	(d)/GDP
2001	2,449	266	2,252	34,980	39,681	31.8
2002	2,598	276	1,954	32,145	36,697	28.3
2003	2,839	291	2,116	30,873	35,828	26.8
2004	3,011	323	2,190	31,650	36,851	26.4
2005	3,181	376	2,531	37,656	43,368	30.3
2006	3,402	420	2,818	43,635	49,855	33.5
2007	3,376	415	3,123	49,902	56,401	36.5
2008	3,449	444	4,111	46,476	54,036	34.4
2009	3,094	426	2,858	36,256	42,208	27.8

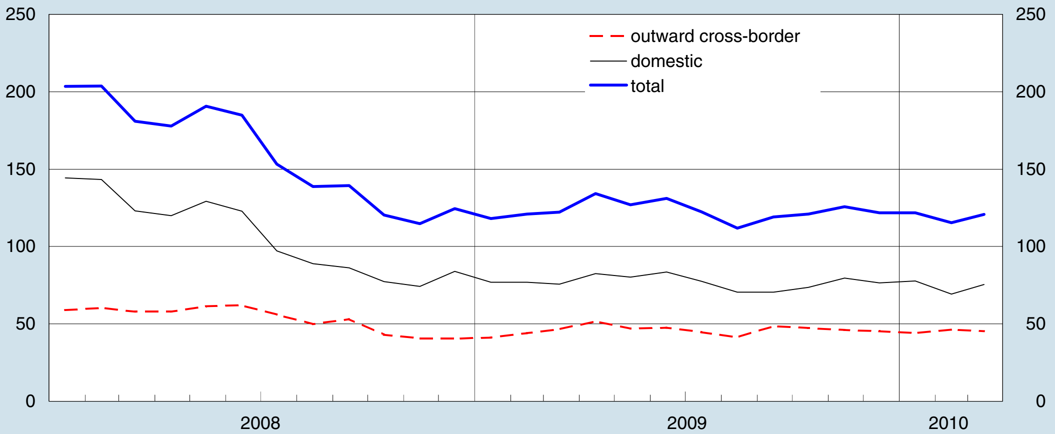
Sources: Based on SIA-SSB, Istat and Bank of Italy data.
(1) Including transactions of the Bank of Italy, provincial treasury sections and Poste Italiane S.p.A. From 19 May 2008, with the migration to TARGET2, the balances from the provincial treasury sections are included in those of the Bank of Italy. Express II began operations on 8 December 2003, and the old securities settlement procedure (*Liquidazione titoli*) was terminated on 23 January 2004. – (2) Transactions net of the balances of ancillary multilateral clearing systems. Includes incoming and outgoing cross-border payments net of transactions with the Bank of Italy. Does not include transactions settled on accounts outside BI-REL/TARGET2-Banca d'Italia.

The financial market turmoil had no repercussions on the efficiency and reliability of TARGET2-Banca d'Italia. About 70 per cent of the transactio ns entered (by value) were settled on time, by 13:00. The orderly functioning of the system is further confirmed by the very small number of payments rejected for lack of funds and by the short waiting time to settle queued payments (between 30 seconds and 1 minute).

Figure 20.1

Value of transactions settled through BI-REL and TARGET2-Banca d'Italia, January 2008-March 2010

(average daily values in billions of euros)



The volume of intraday liquidity available to the banks, i.e. the value of collateralized lines of credit, expanded to over €40 billion, from around €28 billion in 2008. The increase reflected the banks' prudent approach to treasury management consequent to the financial crisis, encouraged by emergency measures taken by the Eurosystem. The actual use of intraday credit increased less markedly, from a daily average of €6.4 billion to €8.2 billion. The peak drawing of intraday credit, which averaged €13 billion in 2009 compared with €12.6 billion in 2008, again came in the first few hours of the trading day. It reflects the use of self-collateral mechanisms for settlement of the balances from Express II and fund-raising by some foreign bank branches on behalf of their parent banks. The drawing of intraday credit was concentrated among just a few banks.

Collateral assets. – The collateral posted against Eurosystem lending amounted to €2,270 billion at the end of 2009, 7 per cent more than a year earlier. Cross-border collateral accounted for 38 per cent of the total – 25 per cent through the CCBM and 13 per cent through links between central depositories. Use of the CCBM channel diminished significantly, reflecting greater use of domestic assets.

During the year Italian banks held a daily average of more than €73 billion in collateral assets with the Bank of Italy against monetary policy repos and intraday credit (Table 20.2), representing an increase of 61 per cent over 2008. The rise mainly involved negotiable domestic assets, which increased from €18 billion to €37 billion, but also, to a smaller extent, bank loans, up from €14 billion to €21 billion. The substantial increase in the domestic component of negotiable securities again stemmed from the deposit by some intermediaries of collateral deriving from the securitization of their own loans.

Table 20.2

Collateral assets deposited with the Bank of Italy

(average stocks in millions of euros)

		Intraday credit and monetary policy repos							Italian securities as collateral with foreign NCBs via CCBM
		Securities				Bank loans	Total collateral assets		
		Italian	CCBM	Links	Total			*of which:* intraday credit (%)	
2008		18,482	3,216	9,227	30,925	14,594	45,519	51	58,373
2009		37,751	3,015	11,064	51,830	21,538	73,368	49	54,906
2009 –	Q1	42,290	3,382	13,522	59,193	19,884	79,077	42	63,678
	Q2	31,791	2,958	11,449	46,198	21,901	68,099	50	57,691
	Q3	38,488	2,823	10,402	51,713	21,782	73,495	51	50,993
	Q4	38,469	2,900	8,941	50,310	22,584	72,894	54	47,484
2010 –	Q1	40,279	3,128	10,203	53,610	21,559	75,168	51	48,446

Rounding may cause discrepancies in totals.

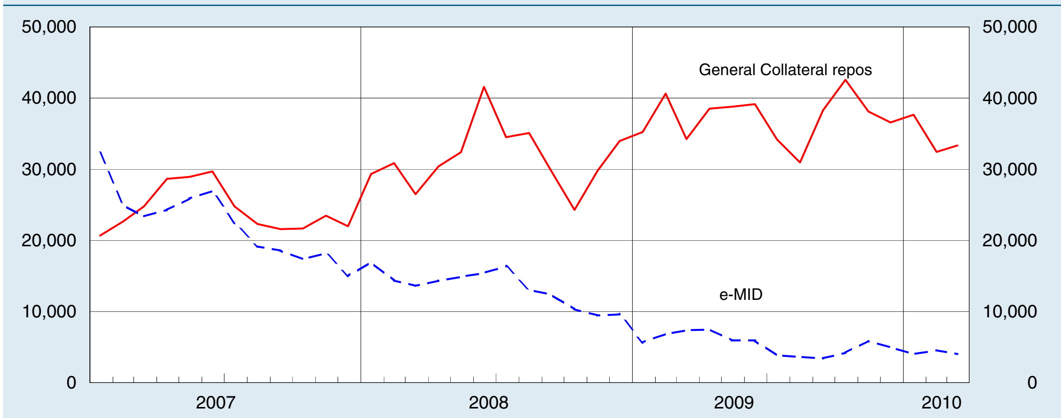
The interbank deposit market

Trading in the transparent segment of the e-MID interbank deposit market continued to contract in 2009, and volumes have settled at around a quarter below those recorded until the summer of 2007. The drop in trading continues to reflect high perceived counterparty risk and fear of the "stigma" effect of a bank's having to disclose its liquidity needs.

The contraction of e-MID business was offset by an expansion in the General Collateral segment of the repo market in government securities (Figure 20.2), thanks to the presence of central counterparties, which eliminates credit risk and ensures full anonymity, as well as by unsecured trading in the OTC market and Collateralized Interbank Market. Average daily trading in e-MID deposits fell from €13.4 billion in 2008 to €5.4 billion last year. Cross-border trades accounted for 20 per cent of the total, compared with 42 per cent in 2008. In the first quarter of 2010 the value of the contracts traded was €4.2 billion a day. The maturity structure is still dominated by the overnight segment (over 90 per cent).

Figure 20.2

Trading on e-MID and the General Collateral repo market
(average daily volume in millions of euros)



Sources: e-MID SIM S.p.A. and MTS S.p.A.

At the end of the year e-MID counted 190 members, including 105 Italian banks. The ten most active traders accounted for more than 40 per cent of all the contracts, compared with 30 per cent in 2008. Business on the bilateral (request for quote) segment, which registered a daily average of €600 million during the year, peaked in March at €900 million a day before falling to lower levels as confidence in interbank relations was gradually restored.

The volume of trading on the Collateralized Interbank Market increased steadily, reaching maturities that are unusual on other exchanges (after peaking at 90 days the average maturity declined progressively to about 70 days at the end of April 2010, from September 2009 onwards MIC trading for maturities longer than a week was heavier than on the transparent e-MID platform, gauged in terms of overnight equivalent amounts. The total volume of MIC deposits at the end of 2009 was €6.9 billion, and it has increased steadily in the early months of 2010 to more than €11 billion in recent weeks.

The wholesale market in government securities

Trading on the MTS Cash market in government securities was very slow in the early months of 2009, with an average daily volume of €2.3 billion, just a third of the level recorded in 2007. This was a time of serious cyclical difficulties, marked by investors' search for more secure assets, very low liquidity levels and historically high bid-ask spreads. From September onwards trading volumes recovered to a daily average of €3.8 billion and the market deepened.

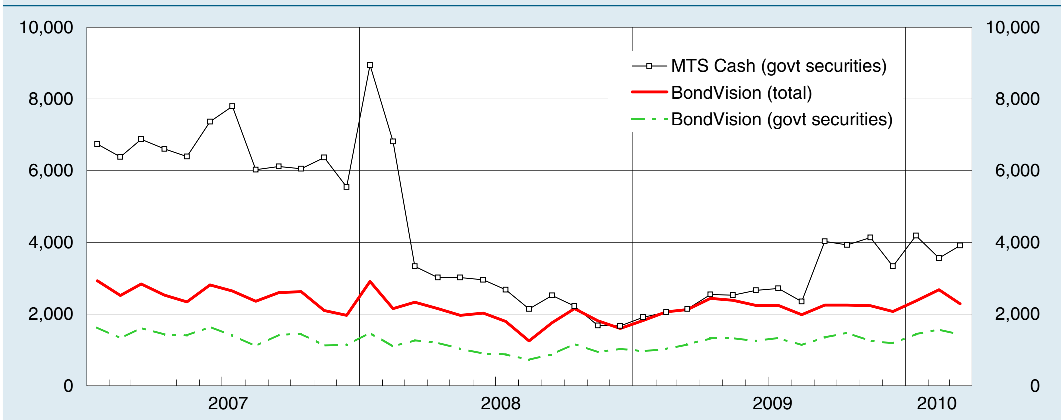
There was an increase in 2009 of the share of turnover consisting in BOTs (from 17 to 20 per cent) and BTPs (from 52 to 54 per cent), at the expense of inflation-indexed BTPs (from 8 to 4 per cent). The portion accounted for by the top five dealers rose from 26 to 33 per cent and that of the top ten from 49 to 56 per cent. The number of MTS participants fell from 101 to 94. The share of trades guaranteed by the two central counterparties, Cassa di Compensazione e Garanzia (CC&G) and LCH.Clearnet SA, rose from 80 to 84 per cent.

Market trends in late 2009 and early 2010 were affected by the downgrading of the Greek public debt and fears of contagion in the euro area, resulting in wider bid-ask spreads and greater variability in turnover.

By contrast, Italian government securities trading expanded on the BondVision exchange, the MTS Group's platform for institutional investors (investment funds, asset management companies, smaller banks and financial companies), partly because of the greater flexibility allowed by the possibility of auction trading and for smaller amounts than on MTS. Turnover in this segment rose by almost 20 per cent to €l.2 billion a day, 62 per cent of it accounted for by Italian institutional investors (Figure 20.3). Despite differences in trading procedures, BondVision and MTS Cash displayed a high degree of integration, with the same prices for the same securities.

Figure 20.3

Trading on MTS Cash and BondVision
(average daily volume in millions of euros)



Source: MTS S.p.A.

Trading volume in the repo segment of MTS amounted to €61 billion a day in 2009, basically unchanged from the year before. Daily turnover increased from €31 billion to €37 billion in the General Collateral segment, which handles money market contracts based on a basket of Italian government securities, while that on the Special Repo segment, which trades contracts on specific securities generally taken to hedge cash market positions, fell from €29 billion to €24 billion. The Special Repo segment was affected by the scant liquidity on the MTS Cash market, especially in the early part of the year. Security shortages were frequent, repeatedly leading to substantial spreads between the rates negotiated on the General Collateral segment and the equivalent Special Repo rate on a number of different types of assets.

The Continuous Linked Settlement (CLS) system

The CLS system, launched in 2002 and involving the direct or indirect participation of numerous Italian intermediaries, handles foreign exchange transactions in 17 currencies through a Payment-versus-Payment mechanism that safeguards against settlement risk. Since 2007 CLS has also settled payments deriving from some kinds of OTC derivatives, notably credit default swaps. The range of services provided was broadened last year. In November, together with a new company specializing in post-trading services, CLS introduced a new function for the aggregation of small transactions, thus reducing the number of settlement instructions.

The system's protection against counterparty risk, all the more appreciated following the Lehman Brothers failure, brought a significant increase in the number of indirect participants. The number of direct participants remained unchanged in the year to 31 March 2010 at 60, including two Italian banks, but the number of indirect participants jumped by 57 per cent to 7,519, owing above all to the increased participation of foreign investment funds. Indirectly participating banks numbered 455, including 18 Italian banks. Average daily turnover on CLS in the first quarter of 2010 was nearly $4,000 billion, up 29.4 per cent from the same quarter of 2009.

Central depository, settlement and guarantee systems

Post-trading activities relating to clearing and settlement of OTC-traded products increased in 2009.

In June the Committee of European Securities Regulators and the national central banks belonging to the ESCB issued their recommendations for securities settlement systems and central counterparties. In July the Committee on Payment and Settlement Systems and IOSCO announced the formation of a working party to produce a guide to the application of the 2004 recommendations on central counterparties in the light of the specific features of OTC derivatives. In February 2010 the two committees began a comprehensive review, with the participation of the IMF and the World Bank, of standards for market infrastructures (payment systems, securities settlement systems and central counterparties).

Within the framework of the broad reform called for by the Financial Stability Board, in September central banks, market oversight authorities, and banking and financial supervisors formed a permanent OTC Derivatives Regulators' Forum to cooperate, exchange views and share information related to market infrastructures (specifically, central counterparties and trade repositories). The Forum now has more than 40 member institutions representing individual countries (the Bank of Italy among them) or supranational organizations such as the ECB, the European Commission, the Committee on Payment and Settlement Systems and IOSCO.

In the United States, in June 2009 the Treasury set out a reform proposal entitled the Over-the-Counter Derivatives Markets Act. At European level, new arrangements are being developed for oversight of markets and supervision of financial intermediaries, envisaging a European System of Financial Supervisors. The Commission, in addition to the work on OTC derivatives regulations, is formulating a proposal for a Directive on legal certainty of securities holding and transactions to be known as the Securities Law Directive.

Italian post-trading companies, part of the London Stock Exchange Group since 2007, broadened their range of services and undertook initiatives to extend activities abroad. Monte Titoli extended the application of its X-TRM procedure for matching and addressing contracts to the International Order Book segment and the MOT-UK retail bond segment, both part of the London Stock Exchange. In addition, given its key role in executing corporate operations, Monte Titoli is developing new procedures to manage capital transactions in line with international standards. The clearing house Cassa di Compensazione e Garanzia (CC&G) introduced a new function on the Italian derivatives energy exchange (IDEX), allowing traders, at expiry of futures contracts, to take physical delivery in lieu of cash settlement of the price difference. Starting in 2010 CC&G has been providing IT outsourcing for LCH.Clearnet Ltd, the British central counterparty for the EDX share and bond derivatives exchange of the London Stock Exchange Group. In July 2009 CC&G was granted "recognized overseas clearing house" status by the Financial Services Authority, a requisite for performing post-trading services in the United Kingdom.

Central depository services. – Monte Titoli's central depository activity expanded in 2009, in terms of face and market value of the financial instruments in custody and membership. The face value of instruments in custody rose by 10.2 per cent to €2,537 billion at the end of the year, and their market value by 3.4 per cent to €2,825 billion. Monte Titoli remains the third largest depository in Europe in terms of value of securities, behind the international depositories Euroclear, with €20,200 billion in securities in custody, and Clearstream, with €10,700 billion. The number of issuers increased by 36 to 2,197 and total membership rose from 2,484 to 2,494.

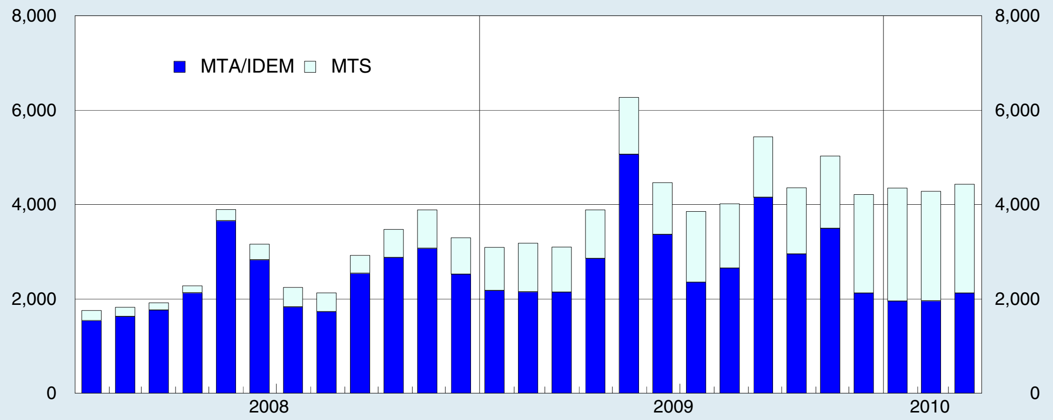
Securities settlement. – The Express II securities settlement system, which is divided into net and gross components, registered an increase in the number of the transactions handled in 2009 but a slight decrease in their value. The number of payments rose by 9.6 per cent to over 106,000 a day, while their value dipped by 2.4 per cent to €178 billion. The number of participants slipped from 115 to 112, and the concentration of business declined. The top three intermediaries accounted for 46.4 per cent of the transactions entered in the net component, compared with 54 per cent in 2008. For much of the year the Consob's ban on short sales of shares remained in place and this, together with the more orderly performance of the financial markets, enabled the system to limit the transactions not settled the same day to 0.8 per cent of the total (by value), compared with 1 per cent in 2008. In the first quarter of 2010 renewed tensions in the government securities markets raised the portion of pending transactions at the end of the day to 1.8 per cent.

Clearing and guarantee services. – The measures adopted by Consob following the Lehman Brothers failure – the share short selling ban – together with traders' decreasing risk propensity resulted in divergent trends in the CC&G's activity: contraction in the share and derivatives markets against a sharp expansion in the collateralized bond market.

The increased activity on some collateralized markets, together with more prudent risk management, resulted in a substantial increase in the average initial margins required by the CC&G, which rose to €4.2 billion. The central counterparty service for MTS, provided jointly with LCH.Clearnet SA, contributed about 30 per cent of total margins deposited (compared with 14 per cent in 2008). In November the service was extended to overnight repos, which increased the incidence of MTS margins on the total to about 50 per cent at the end of the year (Figure 20.4).

Figure 20.4

Initial margins
(average daily requirement in millions of euros)



Source: Cassa di compensazione e garanzia S.p.A.

In the course of 2009 the total number of participants rose from 137 to 144. At 31 December the IDEM derivatives segment counted 80, the MTA electronic share market 115, the bond segment 21 and the IDEX energy futures market 22.

21. RETAIL PAYMENT SERVICES AND THE STATE TREASURY SERVICE

SEPA and the integration of European retail payment services and systems

The Single Euro Payments Area project advanced further in the course of 2009 with the transposition into national laws of the Payment Services Directive (Directive 2007/64/EC) harmonizing the rules governing the provision of payment services in Europe. Other Community measures were also issued, notably EC Regulation 924 of 16 September 2009 on cross-border payments within the Union. These measures are intended to modernize retail payment services and so make the euro area more competitive.

Adaptation to the new SEPA pan-European standards, which began in January 2008 for credit transfers, is proceeding slowly, but there have been some encouraging signs. In the early part of 2010 the pace of migration to the SEPA-standard credit transfer (SCT) accelerated, and from January through April SCTs accounted for more than 7 per cent of all credit transfers in the euro area, compared with 3 per cent a year earlier. For Italy, the rise was from scarcely 1 to around 4 per cent.

In 2009 about 30 per cent of all euro-area SCTs were settled through the pan-European STEP2 system, the rest through the other 15 European clearing and settlement mechanisms, including via interoperability arrangements among 7 of them. In Italy, SCTs are settled via two channels, BI-COMP and STEP2. In 2009 the latter settled 68 per cent of Italian banks' credit transfers, rising to 72 per cent in March 2010. The SCTs transmitted by BI-COMP to the two mechanisms with which it has interoperability arrangements (Equens in the Netherlands and STEP.AT in Austria) numbered 262,000, 10.9 per cent of all BI-COMP SCTs, for a value of €1.3 billion.

Greater progress was made last year in the adaptation of payment card circuits to the chip card security standards. In Italy more than half the cards in circulation and 80 per cent of ATM and POS terminals now comply with the standard.

The new SEPA direct debit schemes (SEPA Direct Debit) became operational in November 2009. They will be compulsory, de facto, in November 2010 for all institutions already offering analogous domestic debit services.

The migration to SEPA could be speeded up by the Commission's considerations on whether to make the use of SEPA instruments in lieu of the corresponding domestic products compulsory, as well as by the introduction of new governance arrangements for the SEPA project that are more consonant with the complexity of the market. A new coordinating body, the SEPA Council, has been created, chaired jointly by the ECB and the Commission and involving all the stakeholders (service providers and users).

The transposition of the Payment Services Directive (in Italy by Legislative Decree 11 of 27 January 2010) makes the rules on European and domestic transactions fully uniform, eliminating any regulatory advantage for the latter. The Directive broadens the range of entities (payment institutions) authorized to provide payment services in addition to the traditional intermediaries (banks and electronic money institutions) and harmonizes the rules for all payment services. The ultimate goal is to improve the quality of retail payment services for households, firms and general government and to smooth trade in Europe.

The adaptation of clearing and settlement mechanisms to the new SEPA instruments proceeded. At the end of March 2010, of the 16 euro-area CSMs already handling SCTs, only 11, including one Italian operator, had developed the new SEPA direct debit schemes for their members.

The Bank of Italy has taken steps to establish additional links between its BI-COMP retail clearing and settlement system and foreign CSMs, so that participants can settle SEPA payments to and from cross-border counterparties. This will also facilitate compliance with the Community regulation requiring reachability of all payment service providers within the euro area for all direct debit transactions by 1 November 2010.

Payment instruments

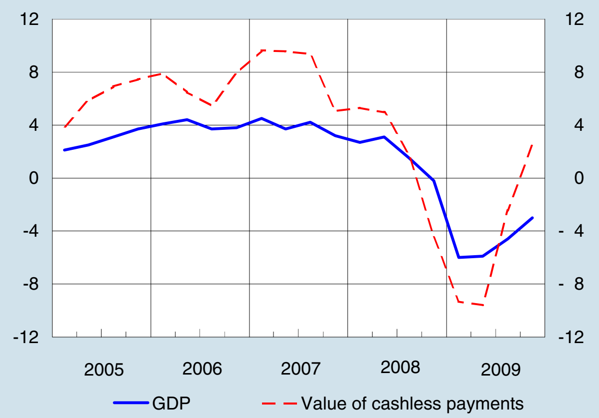
Economic developments. – Trends in the relative use of the various retail payment instruments in 2009 continued more or less as in past years, but volumes were affected by the contraction in economic activity that began in the second half of 2008 (Figure 21.1). The use of business-to-business collection orders diminished with the fall in production and trade. The use of personal cheques contracted further, especially among households, as they were progressively supplanted by electronic instruments.

There were some 4 billion cashless payments in Italy in 2009. This represented an increase of 1.4 per cent from 2008, compared with average annual growth of 3 per cent over the five years before the crisis, and their value fell by 5 per cent. The number of cheques paid decreased by 12 per cent, following the 15 per cent fall in 2008, while the number of automated payments (credit transfers, direct debits, cards) rose by over 2 per cent. Automated credit transfers increased by 1 per cent and direct debits by 4 per cent, while automated bank receipts, which are not pre-authorized, fell sharply, by 19 per cent in number and 26 per cent in value. POS transactions using debit, credit and pre-paid cards increased by 6 per cent; once

Figure 21.1

Cashless payments and GDP

(percentage changes on corresponding quarter)



Sources: Bank of Italy and Istat.

again pre-paid cards showed the fastest growth with a gain of 24 per cent, following the 40 per cent increase registered in 2008. Cash withdrawals from ATMs decreased by 1 per cent, but their average size remained large (€175 compared with a European average of €100).

Developments in the retail payment market. – Despite the progress of recent years, the use of non-cash bank and postal payment instruments is still low by European standards: 66 transactions per capita in 2009 in Italy, compared with 157 in the EU, 170 in the Eurosystem countries, and 250 or more in France, the Netherlands and the United Kingdom (in 2008).

Tracing the indicators of the demand for notes and coins, there is in any case a downtrend in the use of cash for retail purchases, which is consistent with the spread of digital money (above all, payment cards). This trend is confirmed by the Bank of Italy's latest Survey on Household Income and Wealth (referring to 2008), which found that households' average monthly cash outlays had fallen to 44 per cent of their total expenditure, from about 48 per cent in 2004 and 2006 and 60 per cent over the previous decade. The cash portion of household consumer spending is highest in the South, among the less-educated and in poorer households.

On-line transactions have expanded at very rapid rates in recent years, although they still account for only around 5 per cent of all cashless payments. In 2009 they increased by 20 per cent: on-line credit transfers by 17 per cent, on-line transactions using credit cards by 20 per cent and those using pre-paid cards by 25 per cent.

A survey conducted by the Bank of Italy in 2009 found that a variety of economic agents are interested in the development of mobile payments for small amounts (micropayments). There are high growth expectations for remote services (via text messaging, for instance, or mobile internet applications) and, subsequently, for contactless payment services. Additional impetus to the development of these services can come from the transposition into national legislation – by 30 April 2011 – of the new electronic money directive (Directive 2009/110/EC).

Guaranteeing security is essential to user confidence in electronic payment instruments. There has been considerable success in combating fraud, especially in "contact" transactions, thanks to the adoption of chip technology to replace magnetic cards, effective preventive measures on the part of intermediaries and special incentives for virtuous operators. The use of electronic means of payment can also be encouraged by intelligent pricing on the part of intermediaries. In Italy, as elsewhere, payment card fees have been reduced in recent years.

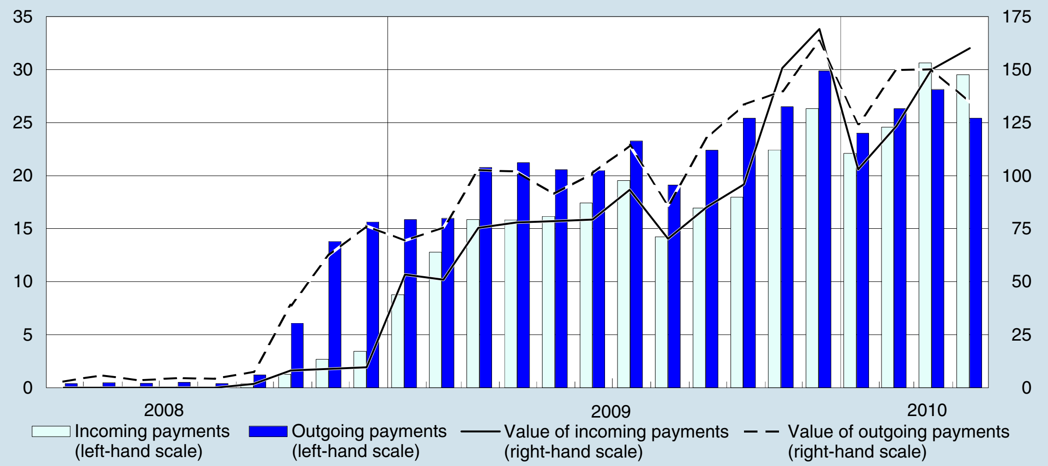
BI-COMP operations. – The value of the transactions handled by the BI-COMP clearing and settlement system, equal to over €3 trillion, fell by 10 per cent in 2009, while their number was roughly unchanged at around 2 billion (Table 20.1). The shift from paper-based to electronic payments continued, the latter reaching 97 per cent of the total.

SEPA credit transfers settled through BI-COMP numbered 2.4 million last year, or 0.7 per cent of all those handled by the clearing and settlement system. This figure includes SCTs transferred to and from the Dutch Equens and the Austrian STEP.AT clearing and settlement mechanisms (Figure 21.2), which increased in line with the overall increase in SCTs handled by BI-COMP. Interoperability accounted for 20 per cent of total flows by number and 12 per cent by value. In the first four months of 2010 BI-COMP settled 1,287 payments a day ordered by participants in the two foreign CSMs, while transferring 1,251 payments to them for settlement, for daily amounts of €6.5 million and €6.7 million respectively.

Figure 21.2

SCT interoperability of ICBPI/BI-COMP with Equens and STEP.AT

(monthly data; thousands of payments and millions of euros)



Source: Based on data from Istituto Centrale delle Banche Popolari Italiane.

The interbank database on irregular cheques and payment cards. – After diminishing in 2008, the number of persons and of cheques registered in the database for lack of funds or authorization rose by 6.9 and 6.1 per cent respectively. The total value of the bad cheques registered also rose, to nearly €1.4 billion, and their ratio to those regularly debited to the account-holder increased slightly. Geographically, as in past years, the South accounted for most of the irregular cheques (Table 21.1).

Table 21.1

Interbank database on irregular cheques and payment cards: irregular cheques by geographical area (1)

	Persons banned from issuance	Unpaid cheques				Average cheque amount
	No.	No.	% composition	Amount (millions of euros)	% composition	Euros
North-West	16,195	45,267	14.9	214,9	15.5	4,748
North-East	7,854	23,926	7.9	145,0	10.5	6,059
Centre	17,283	61,708	20.4	301,7	21.8	4,890
South	44,116	169,864	56.1	710,8	51.4	4,184
Foreign	582	2,282	0.8	11,5	0.8	5,039
Total	**86,030**	**303,047**	**100.0**	**1,383,9**	**100.0**	**4,566**

Rounding may cause discrepancies in totals.
(1) At 31 December 2009.

Again there was an increase in the number of persons whose payment cards were revoked for non-payment or lack of funds. At the end of 2009 the payment card section of the database covered some 258,000 persons, 23.6 per cent more than a year earlier, and once again two thirds of the newly registered were domiciled in the Centre and South.

In January 2010, after a public tender, SIA-SSB S.p.A. was awarded the contract to manage the database for the next five years, with savings of some €1.4 million a year for the banking system.

The outsourcing of retail payment services. – One aspect of payments industry modernization is the emergence of technological service providers, many of them not bank-controlled. A survey of Italian banks and financial intermediaries conducted by the Bank of Italy in the first half of last year found that they had more than 200 outside payment service providers. However, a small group of technology providers serve most of the institutions interviewed and handle the most important segments of the payment process. The banks outsource more than 70 per cent of the activities making up the various phases of retail payments. Outsourcing is more common for payment cards and electronic money than for credit transfers and direct debits. The non-bank intermediaries report a high degree of outsourcing above all for payment card management (over 70 per cent for acquiring and nearly 80 per cent for issuing).

The State treasury service and public payments

The Finance Law for 2010 (Law 196/2009) redesigned the structure and the set of rules for management of the central and general government budget. A number of the provisions affect the State treasury service. In particular, the reform of the Treasury payments account at the Bank of Italy radically alters the legal framework and the financial relations between the Ministry for the Economy and Finance and the Bank of Italy, requiring a major planning and IT commitment on the part of both institutions.

To help address the requirements of Eurosystem monetary policy conduct, Law 196 aims to moderate the volatility and reduce the unpredictability of the balance on the Treasury payments account. The new terms for the account will be set out in an agreement between the Ministry and the Bank, with remuneration based on money market rates and a ceiling on the balance eligible for remuneration. The non-remuneration of any balance above the ceiling will be an incentive for the Ministry to invest any excess funds in the money market. A ministerial decree will determine – in accordance with standards of transparency, efficiency and competitiveness – the eligible market transactions and the modalities for selecting the entities to manage the funds.

The State treasury service and public payment system has made greater use of information and communications technology and automated procedures. These initiatives follow along the path first taken by the Digital Administration Code, now being revised by Parliament. More than 59 million payments were made in 2009 (53 million in 2008), of which 57 million with electronic procedures. The share of non-automated transactions (just over 2 million, or 3.5 per cent of the total, in 2009) will soon be reduced by the progressive inclusion of local expenditure units within the electronic handling of special accounting procedures and the computerization of expenditure orders issued against lines of credit. On the revenue side, the growth of nearly 20 per cent in bank credit transfers confirms the broad appreciation enjoyed by this instrument as an alternative to direct payment of taxes at post office branches, the Treasury or tax collection agents.

THE GOVERNOR'S CONCLUDING REMARKS

The reorganization of the Bank of Italy's branch network to enhance the efficiency of its essential functions, which was begun in September 2008, proceeded on schedule last year. A total of 39 of the original 97 branches have ceased operations, and another 25, specializing in services to users, have been streamlined. In six provinces detached units of the corresponding regional branches have been instituted to perform banking and financial supervisory functions. The reorganization is to be completed this year with the specialization of six branches in cash handling. Permanent savings of some €80 million a year have been achieved.

The systematic revision of organizational arrangements and operating processes that was begun in 2007 continued at the central administration as well, last year focusing on banknote production. The use of more advanced technology and the changeover to simpler procedures produced gains in efficiency and in the quality of services to the banking system and to citizens.

In a year of economic and financial crisis and of management and operational challenges to our organizational structures, the skill and dedication of the staff have been decisive.

The Bank of Italy will contribute to next year's celebration of the 150th anniversary of Italian unification with two initiatives.

A research project entrusted to Italian and foreign historians, economists, and legal scholars will examine the ability shown by our economy to adapt to changes in the international environment over the past century and a half.

Next spring we will hold an exhibition on Italian monetary unification – a little known but crucial aspect of the broader process of national unification.

The evolution of the crisis and international cooperation

Twenty months ago the collapse of Lehman Brothers opened up grim prospects for global finance and the world economy. The action of monetary authorities and governments staved off the collapse of confidence among financial operators, savers, investors and consumers. In the G7 countries as a group, public financial support for the economy exceeded 5 percentage points of GDP in 2009. Real short-term interest rates turned negative and the central banks provided unprecedented volumes of liquidity.

Output declined by 2.4 per cent in the United States, 4.1 per cent in the euro area, and 5 per cent in Italy; GDP continued to expand in the emerging economies, although slowing to growth of 2.4 per cent.

This year the leading international institutions predict that world output will grow by more than 4 per cent. However, this is the average of widely disparate rates:

high in the emerging economies, above all China; substantial in the United States and Japan; and weak in Europe, where output is still well below the pre-crisis level.

Government budget deficits and public debt have spiralled. Relief at having avoided catastrophe has given way on international financial markets to apprehension about the sustainability of growing sovereign debt. Sales target the government securities of countries with large budget deficits and high levels of public debt, in particular those that combine these two characteristics with weak economic growth. The weaker this growth, the more exacting and pressing are the demands by international investors for a rapid adjustment of imbalances in the public finances.

These countries have no alternative but to map out promptly a path to restoring budgetary equilibrium, with a reallocation of current expenditure and with structural reforms aimed at raising potential output and competitiveness.

These are difficult courses of action and unless coordinated at international level they risk extinguishing the hesitant recovery. The crisis has attenuated, not eliminated, the worrying geographical imbalances in world demand. The curbing of debt and increase in saving in the United States and some European economies are compressing consumption and investment; they should be offset, more than is already happening, by stronger expansion in domestic demand in the countries that have built up large external surpluses. In Pittsburgh last year the G20 launched an ambitious programme of multilateral surveillance of macroeconomic and structural policies. It is important that this be translated into concrete strategies to restore balance and support growth. However, it is probable that the process will not be rapid; the deficits will need to be financed, requiring sound and transparent markets.

Lessons from the crisis

The roots of the crisis that has beset the world for nearly three years lie in regulatory and supervisory deficiencies in the main financial centres. The expansionary monetary policy conducted by the United States from the end of the 1990s helped to create a financial environment conducive to the explosion in private debt and the aggravation of global imbalances; these factors heightened the effects of the crisis and fostered their transmission. Clear indications derive from this for the future, regarding both the system of financial regulation and monetary policies.

From the start of the crisis the Financial Stability Board was entrusted by the world's highest political authorities with responsibility for designing the regulatory framework in which the financial industry will operate in the years to come. On several occasions I have described the guidelines that continue to inform this plan; how they draw from the diagnosis of past weaknesses a model for present and future action; and how the ultimate objective of this work is to make the system more resistant to crises. Some crises may be prevented, others will be inevitable; but we can take action to limit their damage and contagion.

The agenda develops in four directions:

i) draw up general rules for the banks: a more robust capital base, lower financial leverage and control of liquidity risk are the pillars of this;

ii) introduce specific provisions for systemic intermediaries designed to reduce the likelihood of their failing, enable their orderly administration if this should happen, and prevent contagion;

iii) reduce the importance of ratings in supervision, while simultaneously increasing the competition between rating agencies and exercising effective control over the integrity of their decision-making and the transparency of their evaluations;

iv) increase the transparency of trading on regulated financial markets; and bring over-the-counter markets back within a framework of universally accepted rules that impose standard contracts and the settlement of trades with central counterparties that are subject to supervision.

The first set of reforms requires the utmost international convergence, otherwise regulatory arbitrage and market integration will preclude their effectiveness. For the second set it would be more appropriate to talk of minimum harmonization: all countries should adopt measures in respect of systemic intermediaries, but it is illusory to imagine that the method and timing of their implementation will be the same across countries because differences in institutions, markets, business models and economic history are too great. Only when governments and regulators can allow the institutions that deserve to fail to do so without causing a catastrophe such as that following the collapse of Lehman Brothers will they have regained true independence from the financial services industry.

In the United States an ambitious project to reform the regulation of the financial system is taking shape; for the aspects bearing most closely on international cooperation it is in line with the agenda of the FSB, whose work is proceeding according to schedule. However, this year's appointments will be decisive. The most important deadline is the presentation to the G20 Summit in Seoul next November of the new rules reforming the Basel II Accord.

The financial industry contends that the regulatory reform could impede the recovery. But the application of the new rules will be gradual and will not begin until the recovery has gathered force. The changeover to the new definition of banks' capital will be long enough to render its effects on banks' market value and on credit negligible during the transition. It is important that the difficulties of the moment not lead to a loosening of the long-term objectives, which must be kept firm.

The experience of the crisis also influences the design of monetary policies. Their objective continues to be price stability, but they must be more prepared to counter developments in credit and money that can fuel financial disequilibria, even in the absence of immediate inflationary dangers.

Our analyses, among others, show that in order to attenuate the volatility of credit, financial asset prices and economic activity it is also necessary to prepare instruments such as countercyclical variations in banks' capital requirements or in loan-to-value ratios. This is what is known as macroprudential policy. The central banks must play a role in designing and implementing it.

In times of severe crisis the balance sheets of financial intermediaries are altered and, with them, the monetary policy transmission channels. The constraints on the availability of credit, which are only marginally binding in normal times, become stringent when the markets do not function in an orderly manner; support for credit has a much greater effect on the economy than the expansion of the monetary aggregates. Changes in the size and composition of central banks' balance sheets have proven useful in the efforts to stabilize the markets. This is what the ECB has done and is doing.

The euro area

Euro-area monetary policy has been strongly expansionary for some time. It has ensured orderly conditions in the credit system and provided support for the recovery of the economy in a context of moderate inflation expectations firmly anchored to price stability.

The exceptional liquidity expansion measures averted a systemic crisis; they pushed down interest rates in the money market and helped to reduce those on loans to firms and households. In order to extend intermediaries' access to funds, refinancing operations were conducted at a fixed rate and with full allotment of the amounts requested; the range of financial assets eligible as collateral was widened; the maturity of operations was lengthened to twelve months. At the end of last year, the Governing Council of the ECB, while not renewing some exceptional measures it deemed no longer indispensable, continued to provide all the liquidity necessary to support the economy and the financial system.

But in the last few months the consequences of the crisis have tested the cohesion of the euro area. The massive creation of public debt, in a phase in which extraordinary quantities of bank bonds are falling due on the markets, suddenly increased the risk premium on some sovereign debtors. For Greece, the question had been posed for some time: the loss of credibility of the public finances, the magnitude of the budget deficit, the public debt and the external current account deficit, low growth, and the country's weak industrial structure and unsustainable wage dynamics were pitching Greece into a fiscal crisis that the country's authorities were slow to recognize.

Just as in the case of American private debt, political indecision and the absence of crisis resolution mechanisms aggravated the situation. In the Greek case the difficulty of finding a European accord on a rescue plan, but also the unavailability of a process permitting orderly management of the debt crises of sovereign states, amplified the damage and the contagion and at the same time heightened moral hazard.

What was paralyzing the markets was the prospect that Greece's fiscal crisis might lead, through a deterioration in the quality of collateral, to a collapse of the country's banking system, which would no longer have had access to ECB refinancing. In addition, there were fears for other countries' banks with large exposures to Greek counterparties. The risk was becoming systemic: interbank liquidity was evaporating, the stock markets were plunging.

The ECB and the national central banks intervened promptly, maintaining the option to accept lower-rated collateral; reactivating the unlimited supply of liquidity in long-term refinancing operations; and initiating, with the Securities Markets Programme, purchases of securities in order to resuscitate markets that had become illiquid. The governments of the euro-area countries and the European Union, in agreement with the International Monetary Fund, allocated €110 billion for loans to Greece and prepared a mechanism able to mobilize up to €750 billion in financial assistance to euro-area sovereign debtors hit by a liquidity crisis, with a contribution of the IMF. The beneficiary countries will have to draw up adjustment programmes which, if approved by the European Council, will be subject to periodic verification.

In evaluating the exceptional circumstances that justified intervention in the government securities market, the Governing Council of the ECB considered that the functioning of the monetary policy transmission mechanism was endangered and the stability of the euro's financial system at risk. The ECB sterilizes these interventions, which do not finance public deficits. Its independence is not in question.

These measures will have to be discontinued as quickly as possible, as soon as the markets spontaneously resume trading of the securities of the countries involved. This will require rapid, significant and discernable progress in adjusting government budgets and the fully operational status of the financing mechanism set up by the European Union and the IMF.

But enduring stability of the markets can only come with the resumption of growth, for it must not be forgotten that this crisis is above all a crisis of competitiveness.

The recent events pose, again and more powerfully, the old problem of European economic governance.

A strengthening of the Stability and Growth Pact is urgent. The commitment to achieve a structural budgetary position in balance or in surplus must be made cogent by introducing sanctions, including political sanctions, for non-compliance; the accuracy of statistical information, particularly public finance statistics, must be ensured.

Cogent constraints and commitments must also be introduced for structural policies. The disparities we have been witnessing for some time in actual and potential growth rates and the seriousness of the imbalances in intra-area trade in goods and services signal inadequacies and inconsistencies in national policies. Some objectives of public action to enhance economic growth in the long run, for example those bearing on the labour market participation of both the young and the old and on competition in the markets for services, should be accompanied by controls and, in some cases, sanctions.

The Italian economy

In the two years 2008-09 GDP contracted by 6.3 per cent, almost half the entire growth achieved in the ten preceding years. Households' real income diminished by 3.4 per cent, their consumption by 2.5 per cent. Exports fell by 22 per cent. Rapidly spreading uncertainty and the deteriorating outlook for demand led firms to cut investment, causing it to contract by 16 per cent. Wage supplementation rose to 12 per cent of total hours worked in industry at the end of 2009. Employment decreased by 1.4 per cent, the number of hours worked by 3.7 per cent.

Some 9,400 firms became involved in bankruptcy proceedings in 2009, a quarter more than in the previous year. The firms hardest hit are the smallest ones, which often depend on subcontracted work. Those that had embarked on restructuring before the crisis have withstood its effects better and now have the best prospects. According to the Bank of Italy's periodic survey, they expect their turnover to increase in 2010 by

3 percentage points more than that of comparable firms that had not restructured. Industrial firms with 50 or more employees that had invested in R&D in the three years preceding the crisis expect their turnover to increase by more than 6 per cent.

Economic policy limited the damage, containing the fall in GDP by an estimated two percentage points, of which about one point can be attributed to monetary policy, half a point to the automatic stabilizers built into the budget and the rest to the recomposition of revenue and expenditure enacted by the Government. The extension of income support programmes attenuated the immediate costs of the crisis. The increase in the budget deficit was smaller than in the other main advanced economies, thanks in part to the solidity of the banking system, which did not need significant public support. In the other G7 economies this amounted to 3.8 per cent of GDP on average.

At the beginning of this year it was estimated that the Italian economy would return to the, albeit modest, growth of the ten years preceding the crisis. In the first quarter GDP grew by 0.5 per cent compared with the previous quarter; there was an improvement in the opinions of firms, especially exporters, regarding the performance of orders and their expectations for production. Destocking appeared to have come to an end.

The explosion of the Greek crisis could change the outlook. Some European governments have taken action to reduce their budget deficits.

The Italian Government has reaffirmed the objective of bringing the deficit below the threshold of 3 per cent of GDP by 2012, confirmed the commitment to achieving budgetary balance over a longer time horizon, and brought forward the formulation of the adjustment measures for 2011-12. According to the official estimates, the measures recently approved by the Council of Ministers will reduce the baseline budget deficit in 2012 by €24.9 billion; the measures bear on the main items of expenditure and focus on the operating costs of the public administration. The package is intended to slow the annual growth in primary current expenditure to below 1 per cent in 2011 and 2012, thereby reducing its ratio to GDP by more than 2 percentage points. Over the last ten years expenditure expanded at an average annual rate of 4.6 per cent and rose by nearly 6 percentage points in relation to GDP. Careful monitoring of the effects of the package will therefore be needed to ensure the objectives are achieved.

Italy's financial structure has many strong points. Household wealth, net of debt, is nearly 2 times GDP, considering just the financial component, and about 5.5 times GDP, including real estate. These levels are among the highest in the euro area, while the household debt ratio is among the lowest and that of firms is below the average. The net external debt position of the entire economy can be estimated at 15 per cent of GDP, one of the lowest values in the euro area, except for Germany, which has a large credit position.

The ratio of public debt to GDP declined by 18 percentage points between 1994 and 2007. In the last two years of recession it increased by 12 points, to stand at 115.8 per cent. In the new market conditions action had to be taken even though the budgetary tightening adversely affects the prospects for economic recovery in the short term.

Competitiveness and growth

In the Monetary Union stagnation, unemployment and, in the long run, budgetary strains are the inevitable consequence of the loss of competitiveness. The consolidation of the public finances needs to be accompanied by the revival of growth.

In the ten years preceding the crisis hourly productivity rose by 3 per cent in Italy, by 14 per cent in the euro area. In the same years the economy grew by 15 per cent in Italy, as against 25 per cent in the euro area. Italy's employment rate remains low, 57 per cent in 2009, 7 percentage points less than in the euro area as a whole. The gap is wider for the young and reaches 12 points for women.

On many other occasions we have addressed the question of structural reforms. The crisis makes them all the more urgent: the fall in GDP increases the burden of financing the public administration; the costs imposed by tax evasion and corruption become even more unsustainable; stagnation destroys human capital, especially among the young.

The management of turnover in the public sector and the cuts in the discretionary expenditure of government departments recently decided by the Council of Ministers must provide the opportunity to rethink the scope and structure of government, rationalize resource allocation and reduce waste and duplication between different entities and levels of government. A reform plan covering the entire public sector is needed, to accompany the measures already adopted to raise the productivity of the public administration by evaluating the performance of managers and the results of individual units.

Fiscal federalism must enhance efficiency in the use of resources. Only a strong budgetary constraint, together with the necessary taxing power, can make the fiscal cost of each decision transparent and cost centres accountable. The specification of the standard costs and financial needs with which central government transfers will be commensurate, with the necessary solidarity component, will need to refer to best practices. Each entity will have to balance its budget, net of investment expenditure, as laid down in Article 119 of the Constitution. The total amount of local investment expenditure must be fixed for a multi-year period, in accordance with the objectives for general government net borrowing. Continuing along the lines laid down for the regions with healthcare deficits, the system of constraints and disincentives for non-compliant entities will need to be strengthened.

But the budgetary rules are not sufficient to guarantee efficient use of resources. Clear and comparable information is needed on the quality of the services provided by the various entities so that single administrations can locate the weak points in their own systems, citizens can evaluate the performance of administrators, and the State can apply sanctions, including the power to take over the management of entities that fail to guarantee essential service levels. Costs and results vary enormously between entities providing the same services; this indicates that there is substantial scope for improvement. But today we are beginning to get the data needed for evaluation and concrete action.

A number of initiatives are moving in this direction. The Ministry of Health has drawn up an experimental set of indicators for healthcare quality, efficiency and appropriateness, both at regional level and for individual hospitals or health units. The Ministry of Education has introduced standardized tests into student evaluations to increase the comparability of the marks awarded and their weight in evaluating teaching effectiveness. The High Council of the Judiciary has identified a methodology to define standard workloads for judges as a tool for assessing their productivity.

Tax evasion is a brake on growth because it imposes higher taxes on those who do pay; it reduces the resources for social policies and obstructs interventions in favour of low-income persons. The tax wedge on labour is about 5 points higher than the average for the other euro-area countries; the tax rate on low labour incomes and the corporate tax rate, including the regional tax on productive activities, are 6 points higher. Istat estimates that the shadow economy amounts to 16 per cent of GDP. Comparing national accounts data with tax returns, it can be estimated that between 2005 and 2008 30 per cent of the VAT tax base was evaded: in terms of tax receipts, this is more than €30 billion a year, 2 points of GDP.

The Government has introduced measures to combat tax evasion. The immediate objective is to contain the deficit, but in the medium term the reduction of evasion must be a lever for growth by allowing tax rates to be lowered; the connection between the two must be made visible to taxpayers.

Corrupt dealing between private agents and general government, in some cases encouraged by organized crime, is widespread. In the international rankings that are compiled periodically, Italy stands further and further down on the list. Empirical studies show that corruption impedes economic growth. There is a close connection between the density of organized crime and the level of development: in the three regions in the South where 75 per cent of Italy's organized crime is concentrated, per capita value added in the private sector is only 45 per cent of that in the Centre and North.

Action to prevent and combat money laundering continues. The Financial Intelligence Unit and the Bank's Supervision Departments have intensified cooperation with the judicial authorities and the law enforcement forces, especially in cases where there is a close connection with criminal investigations.

The crisis has exacerbated the difficulties of young people in the labour market. In the 20-34 age group, the unemployment rate reached 13 per cent on average in 2009. The fall in the employment rate of younger workers with respect to 2008 was almost seven times that of their older counterparts. This was due both to the more widespread use of fixed-term contracts for young people and to a contraction of 20 per cent in new hiring. For some time now, the gap in employment conditions between the new generations and their predecessors has been widening to the disadvantage of the former. Entry-level wages have stagnated for fifteen years in real terms.

A slow recovery increases the likelihood of persistent unemployment. This condition, particularly at the start of one's working life, tends to be linked to permanently lower earnings later on.

The reform of the labour market must be completed, overcoming segmentation and stimulating participation.

Young people alone cannot cope with the growing burden of an ageing population. Nor will the contribution of foreign workers suffice. Only 36 per cent of Italians aged between 55 and 64 are in employment, against a European average of 46 per cent, and 56 per cent in Germany.

In Italy in the last thirty years, against a lengthening of more than five years in life expectancy at age 60, the average age at retirement in the private sector is estimated to have risen by about two years to around 61. Working life will have to be extended, partly to guarantee an adequate standard of living to the older people of tomorrow. The countries in Europe with the highest employment rate in the 55-64 age group are also those with the highest youth employment.

In 2009 the Government took an important step by automatically establishing a link, from 2015, between the minimum retirement age and changes in life expectancy; a regulation now being drafted will implement this provision. Actions on the so-called retirement "windows" and on regulations for women employed in the public sector move in the same direction. INPS has launched initiatives to give better information to workers about their personal pension position. The process of pension system reform could be completed by measures that gradually standardize the retirement age among different groups of workers, speed up adjustments to the transformation coefficients of the contributions-based system, and provide greater retirement flexibility.

Banks, supervision

Lending to firms declined by 3.7 per cent on an annual basis between September and December 2009. In 2010 the pace of the contraction eased and in the three months ending in April came to 1 per cent. The sharpest decline has been in northern Italy, where industrial activity is most intensive; lending to firms in the South has begun to grow again. Credit to households has continued to expand, albeit slowly.

Last year's credit contraction largely reflected the weakness of demand for loans, but there were also supply-side tensions. According to the Eurosystem's Bank Lending Survey, these gradually eased from mid-2009 onwards. We recently conducted the survey at regional level, expanding the sample; the results indicate improving supply conditions in the early months of this year in the North-West and the South.

In Italy, as in other countries, the quality of bank loans deteriorates during recession. In 2009 the loan losses of our five largest banking groups absorbed almost 70 per cent of their operating results; their profits fell by over a fifth. The trend, though moderating in early 2010, has continued and is affecting smaller lenders too, who were less badly hit in the early stages of the crisis.

With the onset of the Greek crisis, acute liquidity strains in the interbank market have returned after subsiding last year. Transactions are mostly very short term. There is a large share of collateralized contracts, a tendency to deal with domestic counterparties and frequent recourse to bilateral trades. Banks must be prepared to face recurrent and protracted periods of abnormal market conditions.

As more and more public and private issuers have turned to the markets, in 2011 a flurry of bank bonds are due to mature for very large amounts; banks must continue to strengthen their sources of fund-raising, including by making greater use of covered bonds.

Although 2009 was a year of reduced profits, Italian banks made encouraging progress in strengthening their capital base. Contributions came from market issues, asset divestments, dividend restraint, and injections of public capital. By March of this year the core tier 1 ratio of the five largest Italian banking groups had risen to 7.6 per cent, from 5.8 per cent at the end of 2008.

Our stress tests show that even under adverse scenarios in line with those used in comparable international exercises, such as GDP growth 3 points lower than current estimates in 2010-11, compliance with the minimum regulatory requirements and financial stability would not be at risk in Italy.

However, in the face of persistent market volatility and uncertainty over the macroeconomic outlook, capital strengthening must continue.

Preparations for the new international standards must be made. The analysis of the overall effects that the new capital and liquidity rules will have on Italian banks is still under way. The parameters must be defined; the specific regulatory provisions will be applied flexibly and with a calendar permitting a smooth and gradual transition. Capital instruments already issued based on the old rules will continue to count towards the requirement for a long time (grandfathering).

Supervisory action in Italy has several distinctive features. It does not stop at establishing general prudential principles, leaving their interpretation up to the market. Nor does it limit itself to verifying compliance with the rules. Instead, it weighs intermediaries' strategies and management; without interfering in business decisions, it verifies that governance, organization, operating processes and control systems are consistent with the risks.

Our off-site controls are supplemented by a high level of on-site supervision. In 2009 there were over 200 inspections of banks and other intermediaries. Targeted checks increased substantially. In the largest banking groups the presence of inspectors is continuous and, in cooperation with the other European authorities, is being extended to their cross-border operations.

This system of controls, together with particularly prudent regulations, proved vital in preserving banks' stability during the crisis.

The role of foundations as shareholders in banks cannot be other than that established by law: investors whose sole objective resides in the economic value of the investment. The foundations, in their autonomy, will be the first to safeguard the independence of management.

Major banks are also judged by how they are organized locally: maintaining and capitalizing on relations with the local economy means basing customer assessments on knowledge accumulated over the years, which is much more reliable than that inferable from quantitative models; it means knowing how to discern a creditworthy firm even when the data are not in its favour; it means knowing your business as a banker. The response of large banks to local needs, consistent with sound and prudent management, must be compatible with global strategies and vision.

Thorough supervisory screening of the requirements of officers of banks and other intermediaries is a fundamental instrument of control, a guarantee of stability. So is the possibility of removing those responsible for mismanagement or highly risky conduct before the situation precipitates, necessitating crisis measures against the bank as such. An extension of the Bank of Italy's supervisory powers in this direction would be welcome; supervisory authorities in major economies already have such powers. The Committee of European Banking Supervisors has proposed it and the European Commission is considering its adoption at Community level.

Customer protection is now a supervisory objective in itself. We carefully follow the implementation of our rules on the transparency of banking and financial services and on correctness in relations between intermediaries and customers.

The Banking and Financial Arbiter, in operation since October, is an independent body that provides customers with rapid responses in disputes with their bank. The majority of the 560 decisions taken to date – on current account and consumer credit charges, mortgage portability and payment card irregularities – have found in favour of the customers.

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The crisis has reminded us, brutally, of the importance of joint action, common objectives and policies, shared sacrifices. This lesson goes for the world, for Europe and for Italy.

The reform of the rules governing finance transcends national borders. It requires consensus among a large number of different jurisdictions. But there is no alternative: a globally integrated financial services industry requires regulation that is universal, at least in its fundamental principles. The harsh experience of the last few years must not be forgotten. Excessive risks exact an extremely high price from the community. Strengthening the defences of the system is indispensable, within each country and at international level. Banking will be less profitable, but also less risky. All will benefit. I am certain that the political project launched by the G20 will succeed.

The euro area as a whole is sounder than other currency areas. Public budgets and the external accounts are more balanced. But the attack on it now under way is not directed against the area as a whole. Exploiting the opportunity offered by the unfinished state of the project, it isolates the weakest members. There is but one answer: the euro lives with all its members, large and small, strong and weak. If in the past it was an illusion to think that the currency alone could "make" Europe, today the only course of action is to reinforce the construction of Europe: in the political sphere, with a more active government of the Union; in budgetary discipline and in progress on structural reform, with a new stability and growth pact that is at once broader and more binding.

Two years ago I devoted a good part of my concluding remarks to the persistent gap between the North and South of Italy. And it was with that examination that, in practice, the Bank of Italy began the celebration of Italy's 150 years of national unity. We are convinced that national unity must be honoured by strengthening it, ensuring its vitality and adapting it to a new era. This is not the first time in its history that Italy has been faced with an arduous collective challenge. It has faced and overcome many in the past century and a half. Let me mention two examples.

The greatest challenge of all, in terms of structural reforms, arose when Italy, immediately after national unity, prepared to participate in the life of Europe with a population that was 75 per cent illiterate, against 30 per cent in the United Kingdom and 10 per cent in Sweden. National political leaders, administrators, teachers, North and South, joined together to fight the battle for literacy. In the end we did come up to the level of the rest of Europe, and this was one of the factors behind the economic miracle after the Second World War.

In 1992 we were confronted with a much more severe budget crisis than those facing some European countries today. The government of the day presented a financial adjustment plan which, enjoying national consensus, gained credibility in the markets with no assistance either from international institutions or from other countries. The struggle was long drawn out: under a flexible exchange rate regime, three years on, spreads still exceeded 650 basis points. Yet the battle was won, because the successive governments maintained fiscal discipline: stability had been incorporated into the country's political culture.

Today's battle too – to combine fiscal discipline with the return to growth – must be fought by calling on those same values that have enabled us, together, to vanquish the difficulties of the past: the capacity to act, equity; the desire to know, solidarity. Let us take up this challenge in the awareness of the weaknesses that we must overcome but also of the considerable strengths on which we can draw.

THE BANK OF ITALY’S ANNUAL ACCOUNTS

22. MANAGEMENT REPORT AND ANNUAL ACCOUNTS[1]

The Bank of Italy's annual accounts consist of the balance sheet, the profit and loss account and the notes to the accounts. Amounts are presented in euros in the official schemes and in thousands of euros in the tables of the notes to the accounts.

In February the Bank sends the balance sheet to the European Central Bank for consolidation with 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 management report provides information on events in 2009 that influenced the Bank's operations and had an impact on the annual accounts. In addition to the Annual Report, the instruments used by the Bank to report on its activity are: the Report to Parliament and to the Government, the Bollettino di Vigilanza, and periodic and occasional testimony before Parliament by the Bank's highest officers.

[1] This abridged English version of the Bank's annual accounts does not contain all the information required by law in the Italian version, nor is it accompanied by the audit report issued by PriceWaterhouseCoopers. The complete Italian version can be found on the Bank of Italy's website (www.bancaditalia.it).

MANAGEMENT REPORT

The year ended 31 December 2009 closed with a net profit of €1,669 million (€175 million in 2008). The gross profit before tax and transfer to/from the provision for general risks was equal to €3,174 million, representing an increase of €2,495 million with respect to 2008, despite the decline in interest income due to the drop in market rates. Direct taxes for the year amounted to €805 million.

The Bank's institutional structure

The governance of the Bank of Italy is entrusted, as specified in the Statute, to the following central bodies: the shareholders' meeting, the General Council, the Governing Board, the Governor, the Director General and the three Deputy Directors General, and the Board of Auditors.

Measures of an institutional nature having external significance are adopted by the Governing Board on a collegial basis. The Bank of Italy has adopted a Code of Conduct for the members of the Governing Board that is in line with the codes in force in the rest of the Eurosystem.

The General Council, made up of the Governor and thirteen directors elected by general meetings of shareholders at the main branches, is charged with the general administration, management oversight and internal control of the Bank. Acting on a proposal from the Governing Board, the General Council examines and approves the draft annual accounts; it also approves their submission to the Board of Auditors and the shareholders' meeting for final approval.

The Board of Auditors is responsible for overseeing the Bank's administration as regards observance of the law and the Bank's Statute and general regulations; it is also entrusted with accounting control. The annual accounts are audited by independent external auditors to attest compliance with the accounting standards for the purposes of Article 27 of the Statute of the European System of Central Banks.

Information on the Bank's functions and more details on its system of governance can be found on its website (www.bancaditalia.it), where information on the Bank's organization, organization chart and branch structure are also available.

Organizational developments

The reform of the Bank's territorial organization, on which a start had been made in the second half of 2008, continued last year with the closure of 39 branch offices and the transformation of 6 into specialized supervision units. The plan also affects 25 branch offices, which are now dedicated to providing customer services. The process will be completed in 2010, with the assignment of cash management duties to 6 branch offices.

Last year also saw further significant organizational changes at the Bank's Head Office, including the completion of the structural and functional reform of the Banknote Printing Department.

In October last year, the new system for the out-of-court settlement of disputes between banks and financial intermediaries and their customers, the Banking and Financial Arbiter (ABF), was launched. The Bank of Italy's role will be to provide assistance to the panel of judges for the examination of technical issues and to act as coordinator, thereby ensuring standardized operational practices and methods of analysis. In particular, specialized secretariats have been set up at the Rome, Milan and Naples branches with the task of supporting the panels in their activity.

Human, logistical and IT resources

At 31 December 2009 the Bank had 7,523 employees: 4,481 assigned to the Head Office and 3,042 to the branch network. Managers and officers made up, respectively, 8.7 and 19.3 per cent of total personnel. The staff's average age was 48.9 years. About one third of all employees were women.

Table 22.1

Composition of the Bank's staff

	At 31 December 2009					At 31 December 2008				
	Men	Women	**Total**	At branches	At Head Office (1)	Men	Women	**Total**	At branches	At Head Office (1)
Managers	522	131	**653**	156	497	534	131	**665**	181	484
Officers	968	482	**1,450**	389	1,061	974	472	**1,446**	407	1,039
Coadjutors	763	510	**1,273**	544	729	777	509	**1,286**	557	729
Other	2,756	1,391	**4,147**	1,953	2,194	2,916	1,442	**4,358**	2,177	2,181
Total	**5,009**	**2,514**	**7,523**	**3,042**	**4,481**	**5,201**	**2,554**	**7,755**	**3,322**	**4,433**

(1) Includes members of the staff assigned to the Financial Intelligence Unit and the representative offices abroad and those seconded to other organizations.

The total number of staff decreased by 232 compared with the end of 2008. In 2009 there were 179 new appointments (131 men and 48 women), 52.5 per cent of which served to meet technical or specialist requirements. Of the 404 terminations, 40.6 per cent referred to branch employees who accepted early retirement. Staff numbers, which have decreased steadily during the last decade, continued to fall; in the first two months of 2010 there were 235 terminations, of which 188 concerned branch personnel.

Training involved 5,300 employees in 2009 (70 per cent of the staff). Overall there were 24,700 participations in courses and 145,000 hours of training, corresponding to 28 hours per participant.

Information technology plays a particularly important role in support of the Bank's activity. The projects undertaken last year were directed at: consolidating the Bank's leading role in the development of IT initiatives for the ESCB; drawing up strategic plans for the Bank's institutional and corporate sectors; continuing the updating of applications in support of statistical functions; and enlarging the range of services available to end-users.

At European level, further progress was made with the new securities settlement system, TARGET2-Securities, the design and specification of which were finalized in conjunction with the central banks of France, Germany and Spain.

Concurrently with the review of internal procedures to bring them into line with the provisions of the law on electronic communications between general government departments, citizens and firms, in conformity with the Digital Administration Code (Legislative Decree 82/2005 as amended), a complete overhaul of the document management procedure will be undertaken in the near future.

In 2010 work has continued on strategic projects in support of both institutional and corporate activities. At European level, in addition to the launching of the TARGET2-Securities platform, special importance attaches to the creation of a geographical telecommunications network capable of supporting new methods of disbursing services within the ESCB and the adoption of a technical infrastructure for the management of IT security.

At the national level, procedures will be updated with a view to the Bank's participation in the Collateral Central Bank Management (CCBM2) common platform for the management of assets transferred as collateral for Eurosystem lending operations. In the retail payment sector, the process of assigning the Bank the functions of application centre for the management of the pan-European payment instruments (SEPA Credit Transfer and SEPA Direct Debit) will enter its final phase.

The Bank administers its logistical resources with the aim of guaranteeing the efficient operation of all premises for institutional use and maximizing the value of its real estate portfolio and the quality of work environments, including from the point of view of security and safety. Under the new branch organization, the space available in the branch offices will be reorganized according to the functions assigned to each branch. Interventions at the branches that will specialize in cash management will be completed by the end of this year.

The branch at L'Aquila, which was closed after the earthquake of 6 April 2009, re-opened on 27 July 2009 when it was declared fit for use after restoration. Work is in progress to render the premises to be rented fit for use.

Expenditure control

Among the expenditure planning and control procedures serving to ensure compliance with the principles of economical, functional and transparent management of resources, the Bank's management accounting system now conforms with the harmonized rules of the Eurosystem (Common Eurosystem-wide Cost Methodology) agreed among the central banks with the aim of making their costs comparable and thus facilitating assessments of relative efficiency and contributing to the determination of the charges for the services offered. Expenditure is also controlled through the General Council's approval of the annual budget.

The increase in expenditure commitments for goods and services in 2009 compared with the previous year was partly due to the shift in the composition of spending towards investment. In particular, it reflected the implementation of plans to automate the handling of notes at the Bank's branches, the increase in the quota of banknote production entrusted to the Bank of Italy by the Eurosystem, and renovation work on the Head Office and branch premises, partly in connection with the reorganization of the branch network.

The budget for 2010 approved by the General Council shows a reduction in overall allocations owing to an increase in those for investment and a decrease in those for expenditure on goods and services. Planned expenditure will be affected by: the reorganization of the branch network, which this year produced its first effects in terms of reducing overall financial requirements despite the continuing costs of implementing the reform; commitments for IT expenditure associated with infrastructural improvements and new projects; and the decline in staff costs as personnel is downsized.

Note issue

The Bank contributes to meeting the Eurosystem's demand for banknotes, participates in the preparations for a second series of euro notes, and is involved in drafting common guidelines for the quality of the banknotes in circulation and measures against counterfeiting.

The production of euro banknotes, which has grown steadily in recent years, increased further in 2009. The changes under way within the Eurosystem, including the planned issue of the second series of euro notes, have made it necessary to draw up a plan to raise the Bank's annual production capacity from 1 billion notes to around 1.5 billion. Since the plan could only be implemented at the end of the year, it became necessary in 2009 as well to acquire a limited quantity of notes from another country in order to fulfil the Bank's obligations vis-à-vis the Eurosystem.

In 2009 the Bank of Italy produced 1.1 billion banknotes in €20, €50 and €100 denominations. It continues to provide the necessary support to the ECB during preparations for the second series of notes, and to this end has also strengthened the infrastructure and instruments assigned to banknote research and development and the automation of controls.

The Bank of Italy put 2.1 billion banknotes into circulation in 2009, for a total value of €82.1billion. The return flow to the Bank amounted to 2.1 billion banknotes worth €78.4 billion; most of these notes were selected automatically at the Bank's branches.

The value of the banknotes in circulation at the end of 2009 amounted to €143.2 billion (17.8 per cent of the Eurosystem total) and was up by 2.7 per cent from €139.5 billion at the end of 2008; the amount recorded in the accounts (€132.8 billion) represented the 16.5 per cent share of total Eurosystem circulation notionally assigned to the Bank of Italy.

Financial resources

Ownership of the country's official reserves (gold and assets on non-euro-area residents in foreign currency) is assigned by law to the Bank of Italy. The reserves make it possible to service the Italian Republic's foreign currency debt and meet its commitments to international organizations such as the International Monetary Fund. In addition, since the nation's official reserves are an integral part of the Eurosystem's reserves, their overall level and proper management contribute to safeguarding the credibility of the ESCB. 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. To ensure that these institutional tasks are performed effectively, the foreign currency reserves are managed with the aim of guaranteeing high levels of liquidity and security, while also seeking to maximize the long-term expected yield.

The item *Gold and net foreign currency assets*, the composition of which is detailed in Table 22.2, includes the official reserves as well as other claims on euro-area residents denominated in foreign currency held by the Bank and foreign currency liabilities.

Table 22.2

Gold and net foreign currency assets (1)
(millions of euros)

	31.12.2009	31.12.2008
Gold	60,410	48,995
US dollars	16,396	22,192
Pounds sterling	3,487	4,234
Japanese yen	4,524	4,739
Swiss francs	228	229
Other currencies	4	2
SDRs relating to net assets vis-à-vis the IMF	1,221	1,014
Total	**86,270**	**81,405**

(1) Valued at market exchange rates and prices. The reserves do not include financial assets (shares of ETFs and UCITS) denominated in foreign currency representing the investment of ordinary and extraordinary reserves, provisions and other capital funds, as they constitute a separate foreign currency item.

At 31 December 2009 the gold and net foreign currency assets were worth €86.3 billion, compared with €81.4 billion a year earlier. The increase mainly reflected the 23.3 per cent rise in the price of gold, which increased the value of the stock by €11,415 million. The decline in the value of net foreign currency assets was due to the absence of temporary operations under the US dollar Term Auction Facility programme (amounting to €6,141 million at the end of 2008) and, to a smaller extent, to the general trend in exchange rates. As in the preceding years, the foreign currency reserves were mostly invested in government securities, securities of government agencies and the BIS, commercial paper, certificates of deposit and deposits at leading international banks. Limited use was also made of international futures markets for the management of the reserves.

As part of the unconventional monetary policy measures adopted to counter the financial crisis, the Governing Council of the ECB decided, at its meetings on 7 May and 4 June 2009, on a Eurosystem purchase programme of euro-denominated covered bonds issued by euro-area counterparties. At the end of 2009 the book value of the securities held by the Bank for monetary policy purposes was €5 billion. In accordance with the ECB Governing Council's decisions, these covered bonds were booked as being held to maturity.

The Bank also holds a financial portfolio containing assets other than those linked to monetary policy and the management of the foreign currency reserves. The strategic asset allocation of this portfolio reflects risk-return combinations defined over a long time horizon and on the basis of prudential criteria. The portfolio also includes investments of balance-sheet provisions and reserves and of the severance pay provision. The management of the Bank's investments is subject to the ban on the monetary financing of member states and euro-area public institutions; accordingly securities of such issuers are not acquired at issue. In addition, operating methods are used that do not interfere with the formation of the prices of financial instruments; investments in bank shares are excluded.

At the end of 2009 the book value of the portfolio was €98 billion, compared with €88 billion at the end of 2008. The portfolio was invested mainly in bonds (especially Italian and other euro-area country government securities) and equities (primarily listed in the euro area).

Table 22.3

Composition of the financial portfolio
(millions of euros)

	31.12.2009	31.12.2008
Government securities	90,619	82,281
Shares and participating interests	5,285	4,573
Convertible bonds and warrants	25	23
Other bonds	231	231
ETF and UCITS shares	2,176	845
Total	**98,336**	**87,953**

In 2009 the Bank's bond portfolio was invested in Italian and foreign securities, the latter issued by euro-area countries whose sovereign debt rating is not more than one level below Italy's. Further progress was made on the geographical diversification of the equity portfolio.

The General Council decides the classification of securities held to maturity. The bulk of the portfolio (89 per cent), including securities linked to monetary policy, consists of securities held to maturity and therefore is valued at cost, subject to impairment. If all marketable financial instruments were valued at market prices, the portfolio would be worth €107 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 2009 the fund's total assets in the Bank's balance sheet amounted to €143 million. Returns on assets and exposure to risk are measured daily.

Financial risks

The financial assets held by a central bank, in particular those in foreign currency (including gold) entail high exposure to market risk. The accounting rules of the Eurosystem are therefore based on the principle of prudence. In particular, revaluation surpluses are not entered in the profit and loss account but are booked in specific revaluation accounts; instead, unrealized losses from revaluation that are not covered by past revaluation surpluses are entered in the profit and loss account.

The Bank of Italy manages financial risks (market, credit and liquidity risks) on an integrated basis and assesses and controls the operating risk associated with investments of its own funds, foreign currency reserves and other portfolios in euros and foreign currency. In addition, the Bank evaluates the risk of assets eligible for monetary policy operations (including extraordinary operations) taking account of the underlying risks according to the guidelines agreed by the Eurosystem.

The *risks associated with managing the foreign currency reserves* derive, above all, from exchange rate risk, the price of gold and the fluctuations of the yield curves of the single markets. Credit risk is controlled by means of a prior assessment of the soundness of eligible counterparties, which include sovereign states (mainly the United States, Japan and the United Kingdom), agencies, supranational bodies and banking counterparties. There exist category and individual limits on exposure, which are checked daily. Regarding the category limits, which relate to investments in securities other than government bonds, there are ceilings on the amount of deposits, commercial paper and instruments issued by supranational counterparties and agencies. The liquidity of the investments is guaranteed by maturity limits. The financial position is determined by setting strategic and tactical benchmarks and limits on the deviation of the Value at Risk with respect to them.

The *risks associated with the financial portfolio* are interest rate risk and price risk. The exchange rate risk for non-euro-denominated assets is hedged through foreign exchange forward sales. Credit risks are contained through rigorous selection of investment instruments and counterparties. The degree of liquidity of the financial instruments for investment is generally very high. Risk management refers to the whole portfolio, including the part which the Bank intends to hold until maturity. The risk of fluctuations in the market price of bonds is taken into account, even though most of these investments are valued at cost in the Bank's balance sheet. In this way the risks associated with investments in fixed income securities as a consequence of variations in market yields are made fully evident. The exposure to risk is monitored on the basis of several indicators. For the bond component, first the elasticity of the portfolio's value to interest rate fluctuations is calculated (duration). Then, the maximum potential loss is estimated, separately for the various classes of financial assets and market segments, using the VaR indicator, both long-term and short-term. This indicator is also used to assess the impact of investment initiatives on the portfolio's overall level of risk. Estimates are also made of long and short-term losses in the event of particularly unfavourable market developments with a low probability but a large impact.

At the end of 2009, the overall riskiness (gold, foreign currency reserves and portfolio of financial assets) was greater than at the end of 2008, mainly owing to the increased volatility of the price of gold in the last quarter of 2009. Market developments and investments made in 2009 partially altered the composition of the Bank's portfolio of euro-denominated financial assets and its risk profiles. In particular, the lengthening of positions in BTPs, the rise in the share of euro-area fixed rate government securities combined with a reduction in the proportion of floating rate government securities led to an increase in the overall duration of the bond component.

The Bank of Italy bears the *risk 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 and collected in the document *The implementation of monetary policy in the euro area*. The risks taken on in monetary policy operations are assessed by the ECB and discussed in special sessions of meetings of the Governing Council and competent Eurosystem committees and working groups.

In 2009, monetary policy was still heavily influenced by the difficult situation of the money and credit markets. The Governing Council of the ECB cut official rates on four occasions during the year, as a result of which the interest rate on main refinancing operations was reduced from 2.50 to 1 per cent. Throughout the year the allotment of liquidity in main refinancing operations and in longer-term facilities was made at fixed interest rates and with full allotment of the volumes of funds requested. Longer-term refinancing operations were conducted according to the new method and schedule introduced in the last quarter of 2008. In June, September and December, refinancing operations were also conducted with a maturity of one year. As a result of the ECB's increased use of longer-term facilities and in particular with the introduction of one-year refinancing tenders, the average maturity of open-market operations changed: at the beginning of 2009, 65 per cent of total liquidity had a maturity of more than one week, compared with over 90 per cent at the end of the year.

According to Article 18.1 of the ESCB Statute, every financing operation by the Eurosystem must be secured by eligible collateral. The national central banks share the risk of monetary policy operations with the whole of the Eurosystem according to their shares in the ECB's capital key. The effects of the measures to increase temporarily the eligible assets, which the ECB Governing Council had decided in October 2008 and prolonged until December 2010, came into play in 2009. The risk exposure of the Eurosystem remained significantly higher than before the crisis and steps to contain it were taken during the year. From 1 February 2009 the prudential haircuts on uncovered bank bonds and asset-backed securities were increased. Limits were placed on investments in uncovered bank bonds as of March 2009, together with further restrictions on the eligibility of ABSs. In April 2010 the ECB Governing Council decided to maintain the minimum rating for eligible assets at BBB- into the following year, except in the case of ABSs, and also announced a review of the valuation haircuts.

Risks associated with new types of operations

As part of the measures taken to support the banking and financial system in connection with the international financial crisis, the Collateralized Securities Loan and the Collateralized Interbank Market were launched. Under the Collateralized Securities Loan, the Bank of Italy lends euro-area government securities to banking counterparties eligible to participate in Eurosystem monetary policy operations against investment-grade collateral. The operations normally have a maturity of one month. The risk is limited by the precautions embodied in the technical form of the operations: limits are imposed on the riskiness and types of eligible collateral and provision is made for prudential haircuts on the value of collateral assets, concentration limits per issuer and ceilings per counterparty. Three operations were carried out during 2009, amounting to about €2.2 billion. At 31 December 2009 no operations were outstanding.

The Collateralized Interbank Market began operating in 2009. It is a segment of the interbank deposit market in which funds are traded anonymously. The default risk of each counterparty is covered by the collateral provided by that counterparty and, where it is insufficient, by up to 10 per cent of the total pool of collateral provided by the participants. Where the collateral provided by the defaulting counterparty does not cover the amount of its debt and the 10 per cent mutual guarantee is not enough to cover the amount of the default, a direct guarantee is offered by the Bank of Italy until the end of 2010. The eligible assets are bonds and bank loans. The measures used to control and mitigate the risk of the Collateralized Interbank Market are the same as those adopted for the Collateralized Securities Loan. From December at least 30 per cent of the collateralized assets must consist of those accepted in the monetary policy operations by the Eurosystem; in addition, a limit has been introduced whereby the gross exposure of each participant must not exceed 20 per cent of the total collateral provided by all the participants in the market.

In July, the ECB and the NCBs launched a purchase programme, for monetary policy purposes, of euro-denominated covered bonds issued by euro-area counterparties. During 2009, a total of 259 transactions were carried out, with an end-year book value of €5 billion. Taking account of the riskiness of these operations, which were designed to offset the negative effects of the financial crisis on market liquidity, the purchases of covered bonds are subject to specific limits per issue, per issuer and per country of issue. The ECB conducts weekly ex post checks on the transactions on the basis of the NCBs' reports. Credit risk is mitigated by the very nature of the bonds, which are backed by financial assets of the issuing bank; the extent to which these are separate from the other components of capital depends on the applicable legislation. The Bank of Italy, which bears the risk of its own operations, adopts a more conservative approach than the general eligibility criteria of the Eurosystem and only purchases covered bonds rated AAA. As regards market risk, since the portfolio relates to extraordinary operations to support the market, no stringent criteria are imposed in terms of duration, as this could limit the Bank's scope for intervention.

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.

The internal audit function works to improve the quality of services and risk management of the various sections of the Bank, including through dialogue with the audit functions of the other central banks of the Eurosystem.

The question of operational risk is a focus of attention for central banks, considering both their greater exposure to it and the considerable progress made in managing it by financial intermediaries in implementation of the new Basel Accord. An initiative has been launched by the ESCB to establish a common Eurosystem frame of reference for operational risk management by national central banks. An operational risk management system that reflects this approach is now being developed.

Of particular importance is the risk of non-compliance with tax law, which is overseen by an ad hoc unit.

As far as legal questions in particular are concerned, the Bank of Italy has its own team of lawyers, who are listed in a special annex to the professional register. One of their main tasks is to handle legal disputes. In their advisory capacity, they provide the various departments of the Bank and ad hoc working parties in which they participate with legal opinions concerning both general matters and the adoption of legislative and other acts and measures; they assist the competent departments in identifying violations of administrative regulations, with a view to the Bank initiating sanction procedures falling within its authority, or of signs of the commission of crimes, with a view to reporting the matter to the judicial authorities.

Environmental policy and workplace safety

In line with the strategic objectives set out in the Bank's environmental policy document, in 2009 the Bank of Italy implemented measures to reduce the environmental impact of its activity with a view to reducing costs and improving the efficiency of internal processes. A number of initiatives were launched, such as the requirement that contracts with electricity suppliers make provision for a quota from renewable sources, the inclusion of "green" clauses in bids and tenders, and the recycling of waste from offices and canteens. Digitalization, the adoption of electronic signatures and the use of certified e-mail have indirectly produced environmental benefits. The Bank's environmental performance is monitored periodically by means of specific indicators, analysis of which has revealed a reduction in paper consumption in offices and a significant increase in the volume of recycled paper. Further environmental protection measures will be taken in 2010, notably regarding the use of renewable energy, and a programme of initiatives to be undertaken by the end of 2011 will be drawn up.

The new regulations in the field of workplace health and safety – in particular those set out in Legislative Decree 106/2009 amending Legislative Decree 81/2008 –

have provided a framework for the measures that the Bank has taken in this field. During 2009 further progress was made in fine-tuning risk assessment methods to take account of the changes introduced by the above-mentioned decrees and of the organizational changes affecting the Bank's Head Office and branch network.

Highlights of the annual accounts

The main factors that influenced the results for the year are described below, with reference to the reclassified accounts shown in Table 22.4.

In 2009 gross profit before tax and transfers to/from provision for general risks came to €3,174 million (€679 million in 2008). The result does not include the return on investment of the ordinary and extraordinary reserves (€445 million), which, although it is included in the Bank's corporate income tax base, is allocated directly to the reserves pursuant to the Bank's Statute and therefore does not contribute to the formation of profit.

The improvement in the results for 2009 is mainly due to the absence of both foreign currency valuation losses (€1,222 million in 2008) and allocations to the provision linked to Eurosystem monetary policy operations (€1,031 million in 2008). The Governing Council of the ECB also decided to reduce this provision, with a further positive effect on the Bank's profit and loss account of €310 million.

The profit on ordinary operations, consisting of interest and dividends, decreased from €4,387 million to €3,875 million, as a result both of the reduction in net interest income (-€436 million), due mainly to the lower average level of yields in 2009 and to the drop in dividends (-€75 million), including the dividend on participation in the ECB's capital.

The contribution from trading and the valuation of financial positions in euros and foreign currency was positive (+€480 million, compared with -€982 million in 2008). The result for 2009 not only reflected the absence of foreign currency valuation losses but also benefited from smaller write-downs for the prices of securities (-€150 million) and the increase in net profits from trading (+€90 million).

Other net income increased by €51 million, basically owing to the better net result of the pooling of monetary income; operating expense and other costs decreased by €44 million, mainly as a result of smaller transfers to the severance pay and pensions provisions. Extraordinary income and expense showed a positive balance of €48 million and included the income from the payment of tax credits dating back more than 10 years and related interest (+€29 million) and the income from adjustments to the redistribution of monetary income for the years 2007 and 2008 (+€9 million). The negative result for 2008 (-€61 million) was due to the provision for early retirement incentives connected with the reorganization of the branch network.

The General Council approved the transfer from gross profit of €700 million to the provision for general risks, which resumed the replenishment of this provision after the withdrawals that had been necessary in recent years.

Taxes for the year amounted to €805 million (€328 million in 2008). Consequently net profit for 2009 amounted to €1,669 million (€175 million for 2008).

Table 22.4

Summary of the annual accounts - Reclassified (1)
(millions of euros)

	Balance-sheet aggregates	Profit and loss account			
		Interest and dividends	*Results and write-downs*	*Other components of income*	*Contribution to net profit*
2009 FINANCIAL YEAR					
Gold	60,410				
Position in foreign currency	25,860	*439*	*403*		*842*
Portfolio of financial assets	104,371	*3,715*	*66*		*3,781*
Lending to euro-area credit institutions	27,156	*452*			*452*
Net intra-Eurosystem claims	52,117	*708*			*708*
Banknotes in circulation	-132,840				
Deposits for minimum reserve system	-26,283	*-324*			*-324*
General government deposits	-31,027	*-663*			*-663*
Revaluation accounts	-44,968				
Capital, reserves and provisions	-35,881				
Other net income		*4*		*466*	*470*
Operating expense and other costs				*-2,005*	*-2,005*
Transfer from the provision for monetary policy operations				*310*	*310*
Extraordinary income and expense				*48*	*48*
Transfer of investment income to statutory reserves		*-456*	*11*		*-445*
GROSS PROFIT		**3,875**	**480**	**-1,181**	**3,174**
Transfer to the provision for general risks				*-700*	*-700*
Taxes on income for the year and productive activities				*-805*	*-805*
NET PROFIT		**3,875**	**480**	**-2,686**	**1,669**
2008 FINANCIAL YEAR					
Gold	48,995				
Position in foreign currency	32,410	*729*	*-863*		*-134*
Portfolio of financial assets	88,793	*3,857*	*-454*		*3,403*
Lending to euro-area credit institutions	50,344	*803*			*803*
Net intra-Eurosystem claims	17,357	*1,494*			*1,494*
Banknotes in circulation	-126,159				
Deposits for minimum reserve system	-28,435	*-935*			*-935*
General government deposit	-19,413	*-1,061*			*-1,061*
Revaluation accounts	-33,880				
Capital, reserves and provisions	-34,964				
Other net income		*-22*		*415*	*393*
Operating expense and other costs				*-2,049*	*-2,049*
Transfer to the provision for monetary policy operations				*-1,031*	*-1,031*
Extraordinary income and expense				*-61*	*-61*
Transfer of investment income to statutory reserves		*-478*	*335*		*-143*
GROSS PROFIT		**4,387**	**-982**	**-2,726**	**679**
Transfer to the provision for general risks				*-176*	*-176*
Taxes on income for the year and productive activities				*-328*	*-328*
NET PROFIT		**4,387**	**-982**	**-3,230**	**175**

(1) The annual accounts data refer to the end of the year. They are reclassified as follows: the *Position in foreign currency* includes the securities and other assets denominated in foreign currency (Items 2 and 3 on the asset side) net of the corresponding liabilities (Items 6, 7 and 8 on the liability side); the *Portfolio of financial assets* includes bonds, shares and other equity, and other assets denominated in euros and foreign currency allocated to Items 4, 6, 7, 8 and 11.2 It also includes the participating interest in the ECB (Item 9.1); the *Intra-Eurosystem claims* (Items 9.2 and 9.4 on the asset side) are shown net of the debt related to the adjustment of the note issue (Item 9.2 on the liability side). With reference to the balance-sheet aggregates that include shares and other equity, the column Interest and dividends includes income from ETF and UCITS shares; net income from fees and commissions, the pooling of monetary income and other withdrawals from provisions are included under *Other net income*.

Post-balance-sheet events

In the final months of 2009, an agreement was approved whereby the Bank of Italy undertakes to grant loans to the IMF on behalf of the Italian Government up to a maximum amount of €8.11 billion. These loans are part of the strategy agreed by the G20 last year at the London and Pittsburgh summit meetings aimed at increasing the IMF's lending capacity to cope with the financial crisis. The signing of the agreement has been suspended, however, pending the issue of a provision concerning the government guarantee against credit and exchange risk. The loans will be denominated in SDRs but disbursed in euros.

On 1 January 2010 Law 196/2009 came into force, changing the rate of interest paid on the Treasury's accounts at the Bank of Italy, subject to agreement between the Bank and the Ministry for the Economy and Finance.

In March 2010 the Bank completed the tenth updating of the "Security planning document for the handling of sensitive and legal data" referred to in Legislative Decree 196/2003 (the Personal Data Protection Code).

On 30 April 2010 the exchange rates of the US dollar, pound sterling, yen and Swiss franc against the euro stood at $1.3315, £0.8703, ¥125.81 and CHF1.4341 respectively, an appreciation compared with the values obtaining at the end of 2009 ($1.4406, £0.8881, ¥133.16 and CHF1.4836).

In May, following renewed tensions on the financial markets, the Governing Council of the ECB decided to launch a new Securities Market Programme. It also reintroduced some of the measures adopted previously for longer-term refinancing operations and reactivated the US dollar Term Auction Facility.

ANNUAL ACCOUNTS
for the year ended 31 December 2009

BALANCE SHEET

ASSETS	Amounts in euros 31.12.2009	31.12.2008
1 GOLD AND GOLD RECEIVABLES	**60,410,210,727**	**48,995,407,036**
2 CLAIMS ON NON-EURO-AREA RESIDENTS DENOMINATED IN FOREIGN CURRENCY	**31,782,352,237**	**26,646,915,328**
2.1 Receivables from the IMF	8,379,559,058	1,790,146,957
2.2 Securities	21,567,519,807	22,875,908,700
2.3 Current accounts and deposits	1,524,717,296	1,938,236,284
2.4 Reverse operations	306,591,246	39,234,949
2.5 Other claims	3,964,830	3,388,438
3 CLAIMS ON EURO-AREA RESIDENTS DENOMINATED IN FOREIGN CURRENCY	**1,658,245,926**	**6,952,216,251**
3.1 Financial counterparties	1,658,245,926	6,952,216,251
3.1.1 Securities	*445,534,706*	*321,818,532*
3.1.2 Reverse operations	–	*6,140,968,671*
3.1.3 Other claims	*1,212,711,220*	*489,429,048*
3.2 General government	–	–
3.3 Other counterparties	–	–
4 CLAIMS ON NON-EURO-AREA RESIDENTS	**11,014,687**	**8,519,610**
4.1 Claims on EU central banks	–	–
4.2 Securities	–	–
4.3 Other claims	11,014,687	8,519,610
5 LENDING TO EURO-AREA CREDIT INSTITUTIONS RELATED TO MONETARY POLICY OPERATIONS	**27,156,064,391**	**50,344,218,525**
5.1 Main refinancing operations	1,945,114,474	12,979,778,198
5.2 Longer-term refinancing operations	25,192,669,720	36,975,612,330
5.3 Fine-tuning reverse operations	–	–
5.4 Structural reverse operations	–	–
5.5 Marginal lending facility	–	382,609,617
5.6 Credits related to margin calls	18,280,197	6,218,380
6 OTHER CLAIMS ON EURO-AREA CREDIT INSTITUTIONS	**359,247,972**	**154,259,813**
7 SECURITIES OF EURO-AREA RESIDENTS	**50,708,551,385**	**41,227,623,953**
7.1 Securities held for monetary policy purposes	5,014,842,548	–
7.2 Other securities	45,693,708,837	41,227,623,953
8 GENERAL GOVERNMENT DEBT	**17,793,527,911**	**17,945,631,742**
9 INTRA-EUROSYSTEM CLAIMS	**63,211,185,171**	**31,392,000,673**
9.1 Participating interest in the ECB	736,441,704	721,792,464
9.2 Claims arising from the transfer of foreign reserves to the ECB	7,198,856,881	7,217,924,641
9.3 Net claims related to the allocation of euro banknotes within the Eurosystem	–	–
9.4 Other claims within the Eurosystem (net)	55,275,886,586	23,452,283,568
10 ITEMS IN COURSE OF SETTLEMENT	**2,902,400**	**1,878,465**
11 OTHER ASSETS	**48,163,015,789**	**43,761,958,630**
11.1 Euro-area coins	28,775,838	35,621,922
11.2 Financial assets related to the investment of reserves and provisions	34,882,726,470	28,813,592,336
11.3 Intangible fixed assets	35,251,380	36,034,194
11.4 Tangible fixed assets	3,425,586,198	3,570,053,947
11.5 Accruals and prepaid expenses	1,678,069,883	1,484,285,165
11.6 Deferred tax assets	6,019,937,451	6,412,807,316
11.7 Sundry	2,092,668,569	3,409,563,750
TOTAL	**301,256,318,596**	**267,430,630,026**

THE ACCOUNTANT GENERAL: Claudio Clemente

THE GOVERNOR: Mario Draghi

Audited and found correct - 30 March 2010

THE BOARD OF AUDITORS: Giovanni Fiori, Elisabetta Gualandri, Gian Domenico Mosco, Angelo Provasoli, Dario Velo

BALANCE SHEET

LIABILITIES	Amounts in euros 31.12.2009	31.12.2008
1 BANKNOTES IN CIRCULATION	**132,840,084,030**	**126,159,171,125**
2 LIABILITIES TO EURO-AREA CREDIT INSTITUTIONS RELATED TO MONETARY POLICY OPERATIONS	**34,313,124,121**	**35,441,362,984**
2.1 Current accounts (covering the minimum reserve system)	26,282,720,647	28,434,547,371
2.2 Deposit facility	8,030,403,474	6,966,292,052
2.3 Fixed-term deposits	–	–
2.4 Fine-tuning reverse operations	–	–
2.5 Deposits related to margin calls	–	40,523,561
3 OTHER LIABILITIES TO EURO-AREA CREDIT INSTITUTIONS	**–**	**–**
4 LIABILITIES TO OTHER EURO-AREA RESIDENTS	**31,027,160,253**	**19,413,226,051**
4.1 General government	31,026,787,668	19,412,943,302
4.1.1 Treasury payments account	*29,708,702,789*	*19,095,319,108*
4.1.2 Sinking fund for the redemption of government securities	*37,489,791*	*19,793,408*
4.1.3 Other liabilities	*1,280,595,088*	*297,830,786*
4.2 Other counterparties	372,585	282,749
5 LIABILITIES TO NON-EURO-AREA RESIDENTS	**312,071,832**	**200,744,792**
5.1 To EU central banks	30,803	41,973
5.2 Other liabilities	312,041,029	200,702,819
6 LIABILITIES TO EURO-AREA RESIDENTS DENOMINATED IN FOREIGN CURRENCY	**419,385,594**	**411,281,150**
6.1 Financial counterparties	–	–
6.2 General government	419,385,594	411,281,150
6.3 Other liabilities	–	–
7 LIABILITIES TO NON-EURO-AREA RESIDENTS DENOMINATED IN FOREIGN CURRENCY	**2,225,172**	**2,329,622**
7.1 Deposits and balances	1,903,635	2,329,622
7.2 Other liabilities	321,537	–
8 COUNTERPART OF SDRs ALLOCATED BY THE IMF	**7,158,754,663**	**776,011,520**
9 INTRA-EUROSYSTEM LIABILITIES	**10,358,203,300**	**13,313,088,780**
9.1 Promissory notes backing debt certificates issued by the ECB	–	–
9.2 Net liabilities related to the allocation of euro banknotes within the Eurosystem	10,358,203,300	13,313,088,780
9.3 Other liabilities within the Eurosystem (net)	–	–
10 ITEMS IN COURSE OF SETTLEMENT	**16,294,725**	**50,764,574**
11 OTHER LIABILITIES	**2,292,246,232**	**2,643,870,990**
11.1 Bank of Italy drafts	384,351,800	509,460,949
11.2 Accruals and income collected in advance	39,988,064	80,949,431
11.3 Sundry	1,867,906,368	2,053,460,610
12 PROVISIONS	**8,006,055,142**	**8,245,924,958**
12.1 Provisions for specific risks	1,454,426,090	1,775,411,272
12.2 Staff-related provisions	6,551,629,052	6,470,513,686
13 REVALUATION ACCOUNTS	**44,967,625,546**	**33,879,592,386**
14 PROVISION FOR GENERAL RISKS	**7,795,675,075**	**7,095,675,075**
15 CAPITAL AND RESERVES	**20,078,836,397**	**19,622,374,328**
15.1 Capital	156,000	156,000
15.2 Statutory reserves	12,339,169,476	11,882,707,407
15.3 Other reserves	7,739,510,921	7,739,510,921
16 NET PROFIT FOR THE YEAR	**1,668,576,514**	**175,211,691**
TOTAL	**301,256,318,596**	**267,430,630,026**

OFF-BALANCE-SHEET ACCOUNTS at 31 December 2009 amounted to **255,011,026,359** euros.

THE ACCOUNTANT GENERAL: Claudio Clemente

THE GOVERNOR: Mario Draghi

Audited and found correct - 30 March 2010

THE BOARD OF AUDITORS: Giovanni Fiori, Elisabetta Gualandri, Gian Domenico Mosco, Angelo Provasoli, Dario Velo

PROFIT AND LOSS ACCOUNT

		Amounts in euros	
		2009	2008
1.1	Interest income	4,162,813,688	6,082,271,202
1.2	Interest expense	-1,162,505,238	-2,697,870,694
1	**Net interest income**	**3,000,308,450**	**3,384,400,508**
2.1	Realized gains/losses arising from financial operations	536,814,031	362,029,442
2.2	Write-downs on financial assets and positions	-76,980,116	-1,245,175,896
2.3	Transfers to/from the provision for general risks for exchange rate, price and credit risks	-700,000,000	-176,000,000
2	**Net result of financial operations, write-downs and transfers to/from risk provisions**	**-240,166,085**	**-1,059,146,454**
3.1	Fee and commission income	28,539,936	27,216,185
3.2	Fee and commission expense	-6,739,543	-5,632,303
3	**Net income from fees and commissions**	**21,800,393**	**21,583,882**
4	**Income from participating interests**	**161,903,322**	**216,751,123**
5	**Net result of the pooling of monetary income**	**682,954,411**	**-715,013,081**
6.1	Interest income	892,751,465	956,886,118
6.2	Dividends from equity shares and participating interests	255,265,917	302,114,983
6.3	Gains, losses and write-downs	8,982,827	-434,006,073
6.4	Other components	21,384,462	4,625,331
6	**Net income from financial assets related to the investment of reserves and provisions**	**1,178,384,671**	**829,620,359**
7	**Other transfers from provisions**	**3,176**	**8,817**
8	**Other income**	**70,792,383**	**76,890,892**
	TOTAL NET INCOME	**4,875,980,721**	**2,755,096,046**
9	**Transfer of investment income to statutory reserves** (1)	**-445,165,393**	**-143,003,405**
10.1	Staff wages and salaries and related costs (2)	-715,508,104	-697,282,152
10.2	Other staff costs	-82,574,180	-54,351,489
10.3	Transfers to provisions for accrued expense and staff severance pay and pensions	-174,604,867	-347,139,545
10.4	Pensions and severance payments	-333,240,852	-281,071,566
10.5	Emoluments paid to head and branch office collegial bodies	-3,812,095	-3,860,760
10.6	Administrative expenses	-450,371,883	-431,739,114
10.7	Depreciation of tangible and intangible fixed assets	-196,067,054	-203,452,913
10.8	Banknote production services	-18,220,529	-7,074,951
10.9	Other expenses	-30,531,635	-22,632,931
10	**Expenses and charges**	**-2,004,931,199**	**-2,048,605,421**
11	**Other transfers to provisions**	**–**	**–**
12.1	Extraordinary income	55,495,962	5,726,248
12.2	Extraordinary expense	-7,735,146	-66,274,213
12	**Extraordinary income and expense**	**47,760,816**	**-60,547,965**
	PROFIT BEFORE TAX	**2,473,644,945**	**502,939,255**
13	**Taxes on income for the year and productive activities**	**-805,068,431**	**-327,727,564**
	NET PROFIT FOR THE YEAR	**1,668,576,514**	**175,211,691**

(1) Made in accordance with Article 40 of the Statute. – (2) The average number of employees in 2009 was 7,629, compared with 7,809 in 2008.

THE ACCOUNTANT GENERAL: Claudio Clemente **THE GOVERNOR:** Mario Draghi

Audited and found correct - 30 March 2010
THE BOARD OF AUDITORS: Giovanni Fiori, Elisabetta Gualandri, Gian Domenico Mosco, Angelo Provasoli, Dario Velo

NOTES TO THE ACCOUNTS

Legal basis, methods of preparation and layout of the annual accounts

Legal basis of the annual accounts. — In drawing up its annual accounts, the Bank of Italy is subject to special statutory provisions and, if they do not provide any guidance, applies the rules laid down in the Civil Code, taking generally accepted accounting principles into account where necessary.

The main statutory provisions referred to above are:

– Article 8.1 of Legislative Decree 43/1998 ("Adaptation of Italian law to the provisions of the treaty establishing the European Community for matters concerning monetary policy and the European System of Central Banks"). The Decree states that "in drawing up its annual accounts, the Bank of Italy may adapt, *inter alia* by way of derogation from the provisions in force, the methods it uses in recognizing amounts and preparing its annual accounts to comply with the rules laid down by the ECB in accordance with Article 26.4 of the ESCB Statute and the recommendations issued by the ECB in this field. The annual accounts drawn up in accordance with this paragraph, with regard in particular to the methods used in their preparation, are also valid for tax purposes". This validity is recognized by Article 114 of Presidential Decree 917/1986 (Consolidated Income Tax Law) as amended by Legislative Decree 247/2005.

  The rules adopted by the ECB are set out in Guideline ECB/2006/16, 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. The Guideline was amended most recently by ECB/2009/18 and 2009/28.

  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 the investment of the reserves.

As regards the matters concerning the preparation of the accounts not covered by the foregoing rules, the following provisions apply:

– Legislative Decree 127/1991 ("Implementation of Directives 78/660/EEC on the annual accounts of certain types of companies and 83/349/EEC on consolidated accounts pursuant to Article 1.1 of Law 69/1990"), as amended;

– Legislative Decree 87/1992 ("Implementation of Directive 86/635/EEC on the annual accounts and consolidated accounts of banks and other financial institutions and 89/117/EEC on the obligations of branches established in a Member State of credit institutions and financial institutions having their head offices outside that Member State regarding the publication of annual accounting documents"), as amended;

– Article 65 (transactions involving government bonds) of Law 289/2002, as amended by Decree Law 203/2005, ratified by Law 248/2005.

Main innovations in the annual accounts for 2009. — By the decisions of the Governing Council of 7 May and 4 June 2009, the European Central Bank and the national central banks initiated a programme, for monetary policy purposes, of purchases of covered bonds in euros issued by euro-area counterparties. ECB Guideline 18 of 17 July, amending Guideline ECB/2006/16, modifies the layout of the balance sheet. Specifically, item 7 – *Securities of euro-area residents* – is now split into two sub-items: 7.1 *Securities held for monetary policy purposes*, and 7.2 *Other securities*. The securities purchased under the covered bond programme have been classed as securities to be held to maturity.

The breakdown of item 11 *Other assets*, has also been modified, with the elimination of sub-item 11.2 *UIC endowment fund* and sub-item 11.4 *Other financial assets*, which had been retained in the balance sheet for 2008 for purposes of comparison. The remaining items have been renumbered accordingly.

In correspondence with the changes to the balance sheet, the form for the monthly accounts has been modified, at the Bank of Italy's proposal, by a decree of the Minister for the Economy and Finance of 21 October 2009.

Accounting policies. — The accounting policies applied in preparing the annual accounts for 2009 are described below. Where provided for by law, they were agreed with the Board of Auditors.

GOLD, FOREIGN CURRENCY ASSETS/LIABILITIES, SECURITIES

At the start of the Third Stage of EMU (1 January 1999) gold, foreign currency assets/liabilities and securities eligible for use in monetary policy operations were adjusted to the market prices and exchange rates at that date, with the resulting capital gains assigned to special revaluation accounts. These capital gains are included in the profit and loss account on a pro rata basis in the event of disposals, redemptions and write-downs.

For gold, the capital gains still existing at 30 December 2002 were used in connection with the government bond conversion pursuant to Article 65.3 of Law 289/2002; the cost of gold, for tax purposes as well, is equal to the value stated in the accounts net of the pertinent revaluation account.

Gold and foreign currency assets/liabilities

- *stocks, including those represented by foreign currency securities, are valued by applying, for each currency and for gold, the method of the "average daily net cost", determined in the manner established by the ECB, which at the end of the year 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;*
- *for inclusion in the annual accounts gold and foreign currency assets/liabilities are valued on the basis of the year-end exchange rates and gold price communicated by the ECB; unrealized gains are included in the corresponding revaluation account, while unrealized losses are covered first by earlier unrealized gains and any amount in excess thereof is included in the profit and loss account;*
- *the International Monetary Fund quota is translated on the basis of the euro/SDR exchange rate communicated by the IMF on the occasion of the last transaction undertaken for the part in national currency and at the euro/SDR exchange rate communicated by the ECB for the remaining part.*

Securities

- *each type of security is valued by applying the method of the "average daily cost", determined in the manner established by the ECB. In the case of bonds, account is taken of the amount of the amortization of the premium/discount, which, for those denominated in foreign currency, is recorded daily;*
- *the year-end valuation is effected:*

  1) *for securities held to maturity and securities held as permanent investments, at cost, with account also taken of particular situations concerning the position of the issuer, which cause the value of the security to fall below cost;*
  2) *for securities other than those held to maturity and other than those held as permanent investments:*
     a) *equity shares, ETFs and marketable bonds, at the market price available at the end of the year; units of collective investment undertakings at the year-end value published by the management company. Unrealized gains are included in the corresponding revaluation accounts; unrealized losses are covered first by earlier unrealized gains for the relevant security and any amount in excess thereof is included in the profit and loss account. Foreign currency ETFs and units of collective investment undertakings stated in the balance sheet item* Financial assets related to the investment of reserves and provisions *are not included in the net foreign exchange position but shown as a separate item;*
     b) *non-marketable bonds, at cost with account taken of any diminution in value corresponding to special situations related to the position of the issuer;*
     c) *non-marketable shares and equity interests not represented by shares, at cost, reduced where the losses shown in the last approved annual accounts or special situations of the issuer are such as to cause the security's value to fall below cost;*

PARTICIPATING INTERESTS

The Bank's participating interests in subsidiary and associated companies classified as permanent investments are stated at cost, with account taken of any losses that reduce the value of the Bank's interest in the shareholders' equity. The participating interest in the capital of the ECB is valued at cost.

Dividends and profits are recognized on a cash basis.

The Bank's accounts are not consolidated with those of investee companies insofar as the Bank is not among the entities referred to in Article 25 of Legislative Decree 127/1991.

TANGIBLE FIXED ASSETS

Depreciation begins in the quarter subsequent to that of acquisition both for buildings and for plant and equipment.

Buildings

– *are stated at cost, including improvement expenditure, plus revaluations effected pursuant to specific laws. The depreciation of "instrumental" buildings used in the Bank's institutional activities and those that are "objectively instrumental", in that they cannot be used for other purposes without radical restructuring, included among the investments of the provision for staff severance pay and pensions is on a straight line basis using the annual rate of 4 per cent established by the ECB. Land is not depreciated.*

Plant and equipment

– *are stated at cost, including improvement expenditure. They are depreciated on a straight line basis using the rates established by the ECB (plant, furniture and equipment, 10 per cent; computers and related hardware and basic software and motor vehicles, 25 per cent).*

INTANGIBLE FIXED ASSETS

Procedures, studies and designs under way and related advances are valued at purchase or directly allocable production cost. Procedures, studies and designs completed 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.

STOCKS

The valuation of stocks, with reference exclusively to the IT Resources Area, is made at cost using the LIFO method. Pursuant to Recommendation NP7/1999 of the Governing Council of the ECB, the costs borne for the production of banknotes are not included in the valuation of stocks.

ACCRUALS AND DEFERRALS

Include accruals and prepaid expenses and accruals 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, have issued euro banknotes since 1 January 2002 (ECB Decision No. 15 of 6 December 2001 on the issue of euro banknotes, in Official Journal of the European Communities, *L337 of 20 December 2001, pp. 52-54, as amended).*

The total value of euro banknotes in circulation is allocated within the Eurosystem on the last working day of each month on the basis of the criteria set out hereinafter.

As of 2002 the ECB has been allocated a share of 8 per cent of the total value of euro banknotes in circulation, while the remaining 92 per cent has been allocated to 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. 16 of 6 December 2001 on the allocation of monetary income of the national central banks of participating Member States from the financial year 2002, in* Official Journal of the European Communities*, L337 of 20 December 2001, pp. 55-61, as amended). The adjustments recorded in 2009 arise from the entry into the Eurosystem of the central banks of Slovenia in 2007, Malta and Cyprus in 2008, and Slovakia in 2009; they will terminate at the end of 2012, 2013 and 2014 respectively.*

The interest income and expense on intra-Eurosystem balances is cleared through the accounts of the ECB and is disclosed under Net interest income.

The Governing Council of the ECB has decided that the seigniorage income of the ECB arising from the 8 per cent share of banknotes allocated to the ECB shall be recognized separately to the NCBs on the second working day of the year following the reference year in the form of an interim distribution of profit (ECB Decision No. 11 of 17 November 2005, in Official Journal of the European Union*, L311 of 26 November 2005, pp. 41-42). It is to be distributed in full unless the ECB's net profit for the year is less than its income earned on euro banknotes in circulation and subject to any decision by the Governing Council to reduce this income in respect of costs incurred by the ECB in connection with the issue and handling of banknotes. The Governing Council of the ECB may also decide to transfer part or all of the ECB's seigniorage income to a provision for foreign exchange rate, interest rate, credit and gold price risks. The seigniorage income distributed by the ECB is recorded on an accrual basis in the year to which the income refers, by way of derogation from the cash policy applied in general to dividends and profits from participating interests.*

INTRA-EUROSYSTEM ASSETS AND LIABILITIES

For each NCB the intra-Eurosystem balance arising from the allocation of euro banknotes is included under Net claims/liabilities related to the allocation of euro banknotes within the Eurosystem.

PROVISIONS FOR RISKS

In determining the provisions for risks, the riskiness of the various sectors of the Bank's operations is taken into account in an overall evaluation of adequacy. The riskiness of the Bank's foreign exchange positions and securities portfolio is evaluated on a value-at-risk basis, with consideration also given to the size of the revaluation accounts.

The provision for general risks is also for risks in connection with the Bank's overall activity that cannot be determined individually or allocated objectively.

Transfers to and withdrawals from the provisions are decided by the General Council.

TAX PROVISION

The provision for taxation is equal to the amount of taxes to be paid (including deferred tax liabilities), determined on the basis of a realistic estimate of the foreseeable liability under the tax rules in force and of amounts arising from possible disputes with the tax authorities.

PROVISION FOR MONETARY POLICY OPERATIONS

This provision corresponds to the Bank's share of the provision set up by the Eurosystem for 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 ASSET AND LIABILITY ITEMS

Receivables are stated at their nominal value, except in the case of diminutions in value connected with particular situations concerning the counterparty.

Deferred tax assets and liabilities are included in the financial statements on the basis of their presumable tax effect in future years. Deferred tax assets include those deriving from the application of Article 65.2 of Law 289/2002, as amended by Decree Law 203/2005, ratified by Law 248/2005.

The items Other assets *and* Other liabilities *include the investments and separate patrimony of the defined-contribution supplementary pension fund created for staff hired from 28 April 1993 onwards. The fund is invested in financial instruments, which are valued at year-end market prices. The resulting revaluation gains (losses) are treated as revenues (expenses) and, in the same way as for other operating revenues (expenses), added to (subtracted from) the fund's patrimony.*

The item Other liabilities *includes the lira banknotes that have not yet been presented for conversion, net of the payments on account made to the tax authorities under Article 87 of Law 289/2002.*

The other components are stated at their nominal value.

OFF-BALANCE-SHEET TRANSACTIONS AND MEMORANDUM ACCOUNTS

Forward purchases and sales of foreign currency

– *forward purchases and sales are recorded in the memorandum accounts at the trade date at the spot exchange rate of the transaction. The difference between the values at the spot and forward exchange rates is recorded, on a pro rata temporis basis, under interest in the profit and loss account.*

Foreign currency swaps

– *forward and spot purchases and sales are recorded in the memorandum accounts at the trade date at the spot exchange rate of the transaction. The difference between the values at the spot and forward exchange rates is recorded, on a pro rata temporis basis, under interest in the profit and loss account. The forward position is valued in conjunction with the corresponding spot position.*

At the time of the settlement of forward purchases and sales of foreign currency and foreign currency swaps, the entries in the memorandum accounts are transferred to the appropriate items of the balance sheet.

Interest rate futures denominated in foreign currency

– *are recorded in the memorandum accounts at the trade date at their notional value and translated at the end of the year at the exchange rate communicated by the ECB. Initial margins in cash are recorded in the balance sheet among foreign currency claims, those in securities are recorded in the memorandum accounts. Positive and negative daily variation margins are communicated by the clearer and taken to the profit and loss account, converted at the exchange rate of the day.*

Other cases with the amount entered in the memorandum accounts

– *securities denominated in euros held on deposit are stated at their nominal value; shares are stated on a quantity basis; those of other kinds at face value or at conventional value;*

- *securities that are the subject of temporary exchange transactions to support the market's liquidity, loaned by the Bank of Italy and received as collateral by the counterparties are stated at their market value and adjusted to the end-of-year exchange rate;*
- *collateral supplied by counterparties to take part in the collateralized interbank market is stated at nominal value;*
- *commitments in respect of foreign currency transactions are shown at the contractually agreed exchange rate. The entries are deleted at the time the commitments are settled;*
- *other foreign currency amounts are converted at the year-end exchange rates communicated by the ECB.*

Comments on the items of the balance sheet

Gold and assets and liabilities denominated in foreign currency (Items 1, 2 and 3 on the asset side and Items 6, 7 and 8 on the liability side)

Table 22.5

Gold and assets and liabilities denominated in foreign currency
(thousands of euros)

	31.12.2009	31.12.2008	Changes
Gold (Item 1)	**60,410,211**	**48,995,407**	**11,414,804**
Net assets denominated in foreign currency	**25,860,232**	**32,409,508**	**-6,549,276**
Assets denominated in foreign currency	**33,440,598**	**33,599,131**	**-158,533**
Receivables from the IMF (Sub-item 2.1)	*8,379,559*	*1,790,147*	*6,589,412*
Securities other than those held to maturity (Sub-items 2.2 and 3.1.1)	*22,013,055*	*23,197,727*	*-1,184,672*
Current accounts and deposits (Sub-items 2.3 and 3.1.3)	*2,737,428*	*2,427,665*	*309,763*
Reverse operations (Sub-items 2.4 and 3.1.2)	*306,591*	*6,180,204*	*-5,873,613*
Other assets (Sub-item 2.5)	*3,965*	*3,388*	*577*
Liabilities denominated in foreign currency	**7,580,366**	**1,189,623**	**6,390,743**
Counterpart of SDRs allocated by the IMF (Item 8)	*7,158,755*	*776,012*	*6,382,743*
Advances of general government departments (Sub-item 6.2)	*419,386*	*411,281*	*8,105*
Deposits and balances (Sub-item 7.1)	*1,904*	*2,330*	*-426*
Other liabilities (Sub-item 7.2)	*321*	*–*	*321*

The increase in the value of gold – the quantity of which remained unchanged compared with 2008 (79 million ounces or 2,452 tons) – was entirely due to the rise in the metal's price. The reduction in the amount of net assets denominated in foreign currency mainly reflected the absence of reverse operations in dollars as part of the US dollar Term Auction Facility, which at the end of 2008 had amounted to €6,141 million. Exchange rate variations also had a negative effect.

Gold reserves are valued at the year-end market price in euros per fine ounce communicated by the ECB. This price was obtained by converting the dollar price of the London fixing on 31 December 2009 using that day's exchange rate of the euro against the dollar. Compared with end-2008, gold appreciated by 23.3 per cent (from 621.542 to 766.347 euros per ounce). The exchange rates of the main currencies against the euro showed depreciations of the US dollar (from 1.3917 to 1.4406 dollars per euro) and the yen (from 126.14 to 133.16). The pound sterling instead appreciated (from 0.9525 to 0.8881 pounds per euro). The Swiss franc was broadly stable (from 1.4850 to 1.4836), as was the SDR (from 1.1048 to 1.0886 euros per SDR).

On the basis of these exchange rates there were unrealized gains at the end of the year that were entered in the corresponding revaluation accounts for gold (€11,415 million) and sterling (€229 million) and unrealized losses, entirely covered out of the corresponding revaluation accounts, for dollars (€578 million), yen (€250 million), SDRs (€27 million) and Swiss francs (€8 million).

*After the above-mentioned movements, the revaluation accounts amounted at the end of 2009 to €42,368 million, of which €40,989 million was in respect of gold, €859 million the yen, €253 million the dollar, €229 million the pound sterling, €24 million the SDR and €14 million in respect of the Swiss franc (*see Revaluation accounts*).*

Net assets vis-à-vis the IMF increased mainly as a result of withdrawals by debtor countries that led to an increase in Italy's net position vis-à-vis the Fund. In connection with increasing requests for financial assistance owing to the world crisis, the IMF made two new assignments of SDRs to member countries in 2009. These measures were part of a broader strategy of increasing the Fund's lending capacity in favour of the world financial system.

Table 22.6

Accounts with the International Monetary Fund
(thousands of euros)

	31.12.2009	31.12.2008	Changes
Assets			
Receivables from the IMF (Sub-item 2.1)	**8,379,559**	**1,790,147**	**6,589,412**
a) Reserve Tranche Position in the IMF	1,281,848	1,090,828	191,020
quota in the IMF	*7,603,802*	*7,790,981*	*-187,179*
IMF holdings	*-6,321,954*	*-6,700,153*	*378,199*
b) Participation in the PRGF	560,456	511,783	48,673
c) Special Drawing Rights	6,537,255	187,536	6,349,719
Liabilities			
Counterpart of SDRs allocated by the IMF (Item 8)	**7,158,755**	**776,012**	**6,382,743**

The portfolio of securities denominated in foreign currency consists primarily of bonds issued by government bodies and international organizations. Of the total portfolio 65 per cent consisted of securities denominated in US dollars, 20 per cent of securities denominated in yen and 15 per cent of securities denominated in pounds sterling.

The other foreign currency assets, denominated primarily in US dollars, consist mainly of reverse operations (€1,812 million), current accounts (€925 million), time deposits (€307 million) and foreign banknotes (€4 million).

*Sub-item 3.1.2 (*Claims on euro-area residents denominated in foreign currency: reverse operations*) included at the end of 2008 claims (€6,141 million) in respect of reverse operations with Eurosystem counterparties guaranteed by securities in connection with the Term Auction Facility, which were not present at the end of 2009. On the basis of this programme the Federal Reserve supplies the ECB with dollars within the context of a foreign currency swap line aimed at providing short-term funding in dollars to euro-area counterparties. At the same time the ECB activates back-to-back swaps with the NCBs that have adopted the euro, which use the dollar funds to provide liquidity to euro-area counterparties through reverse operations or foreign currency swaps. Transactions involving back-to-back swaps with the ECB are settled on intra-Eurosystem accounts (see* Intra-Eurosystem claims and liabilities*).*

*Sub-item 11.2 (*Financial assets related to the investment of reserves and provisions*) includes foreign currency investments that constitute a separate position with respect to the foreign assets and liabilities previously described (see* Securities portfolio*).*

Monetary policy operations (Item 5 on the asset side and Item 2 on the liability side)

The operations carried out by the Bank of Italy within the framework of the single monetary policy of the Eurosystem are shown in Table 22.7 (for a discussion of the covered bonds purchased for monetary policy purposes, see *Securities portfolio*). The Eurosystem's total monetary policy assets amounted to €749,906 million, of which €27,156 was held by the Bank of Italy. Under Article 32.4 of the ESCB Statute, the risks of monetary policy operations can be allocated, should they materialize, among the Eurosystem NCBs in proportion to their shares of the ECB's capital.

Table 22.7

Monetary policy operations
(thousands of euros)

	31.12.2009	31.12.2008	Changes
Lending to euro-area credit institutions (Item 5)			
5.1 Main refinancing operations	1,945,114	12,979,778	-11,034,664
5.2 Longer-term refinancing operations	25,192,670	36,975,612	-11,782,942
5.3 Fine-tuning reverse operations	–	–	–
5.4 Structural reverse operations	–	–	–
5.5 Marginal lending facility	–	382,610	-382,610
5.6 Credits related to margin calls	18,280	6,218	12,062
Total	**27,156,064**	**50,344,218**	**-23,188,154**
Liabilities to euro-area credit institutions (Item 2)			
2.1 Current accounts (covering the minimum reserve system)	26,282,721	28,434,547	-2,151,826
2.2 Deposit facility	8,030,403	6,966,292	1,064,111
2.3 Fixed-term deposits	–	–	–
2.4 Fine-tuning reverse operations	–	–	–
2.5 Deposits related to margin calls	–	40,524	-40,524
Total	**34,313,124**	**35,441,363**	**-1,128,239**

On the asset side, the stock of *Main refinancing operations* again decreased, both year-end value and average stock (the latter from €11,879 million to €6,248 million). The stock of *Longer-term refinancing operations*, even though rising substantially again in terms of average stock (from €7,988 million to €24,041 million), displayed a fall in end-year stock. The average stock of the *Marginal lending facility* fell from €76 million to €8 million, and at the end of the year no such operations were outstanding. No recourse was made to *Fine-tuning* or *Structural reverse operations* during 2009.

On the liability side the deposits held by banks to fulfil their minimum reserve obligations decreased at year-end while the average stocks rose (from €22,882 million to €25,321 million). Banks' holdings in the *Deposit facility* increased substantially, both at year-end and in terms of average stock (from €1,731 million to €2,522 million). The average stock of *Fixed-term deposits* decreased from €277 million to €194 million. As in 2008, no recourse was made to *Fine-tuning reverse operations* in 2009.

Other claims on euro-area credit institutions (Item 6 on the asset side)

These claims increased by €205 million (from €154 million to €359 million); they consist in large part (€172 million) in liquidity in connection with the management of cross-border euro payments and collections on account of general government and in repurchase operations on securities in euros (€100 million).

Securities portfolio (Items 7 and 8 and Sub-item 11.2 on the asset side)

The bulk of the Bank's securities portfolio consists of bonds denominated in euros and shares, participating interests, ETFs and units of undertakings for collective investment in transferable securities (UCITS), denominated in euros and foreign currency. It also includes covered bonds held for monetary policy purposes, purchased under the programme announced on 7 May 2009 by the Governing Council of the ECB (see *Legal basis, methods of preparation and layout of the annual accounts*, above). Securities making up part of the foreign exchange reserves are commented under *Gold and assets and liabilities denominated in foreign currency*.

Table 22.8

Securities portfolio - stocks
(thousands of euros)

	31.12.2009	31.12.2008	Changes
A) Financial assets related to the investment of reserves and provisions (Sub-item 11.2)			
1. Securities held to maturity and held as permanent investments	**27,415,221**	**23,393,824**	**4,021,397**
a) Government securities	27,073,352	23,052,211	4,021,141
b) Other bonds	177,176	176,920	256
c) Shares and participating interests	164,693	164,693	–
of subsidiary companies and entities	*107,949*	*107,949*	–
of other companies and entities	*2,196*	*2,196*	–
of other companies and entities denominated in foreign currency	*54,548*	*54,548*	–
2. Securities other than those held to maturity and other than those held as permanent investments	**7,467,506**	**5,419,769**	**2,047,737**
a) Government securities	141,382	138,120	3,262
b) Other bonds	29,295	28,393	902
c) Shares and participating interests	5,120,730	4,408,437	712,293
of subsidiary companies and entities	*23,968*	*19,650*	*4,318*
of other companies and entities	*5,096,762*	*4,388,787*	*707,975*
d) ETFs and units of UCITS	2,176,099	844,819	1,331,280
of which: denominated in foreign currency	*511,918*	*149,258*	*362,660*
Total A	**34,882,727**	**28,813,593**	**6,069,134**
B) Other securities denominated in euros (Items 7 and 8)			
1. Securities held to maturity	**64,213,846**	**54,785,528**	**9,428,318**
a) Securities held for monetary policy purposes (Sub-item 7.1)	5,014,842	–	5,014,842
b) Government securities (Sub-item 7.2)	41,389,879	36,824,502	4,565,377
c) Other securities (Sub-item 7.2)	49,289	49,086	203
d) Government securities assigned to Bank of Italy (Item 8)	17,759,836	17,911,940	-152,104
2. Securities other than those held to maturity	**4,254,541**	**4,354,036**	**-99,495**
b) Government securities (Sub-item 7.2)	4,254,541	4,354,036	-99,495
Total B	**68,468,387**	**59,139,564**	**9,328,823**
Total A+B	**103,351,114**	**87,953,157**	**15,397,957**

In order to treat the securities held for monetary policy purposes separately from the rest of the portfolio, Item 7 (*Securities of euro-area residents*) has been split into two sub-items: 7.1, *Securities held for monetary policy purposes*, and 7.2, *Other securities.* The former comprises the covered bonds purchased by the Bank starting in July 2009; the latter comprises other securities, those not connected with Eurosystem monetary policy operations, which in 2008 constituted all of Item 7.

In more detail:

A) *Financial assets related to the investments of reserves and provisions* (Sub-item 11.2) 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 the remainder of shares, participating interests, ETFs and units of UCITS. Most of the investments in shares consisted of listed securities. For the most part, net purchases during 2009 consisted in government securities.

The Bank invests in ETFs and units of UCITS denominated in foreign currency. The resulting position is hedged against exchange rate risk by forward sales of the corresponding currencies.

The controlling interests refer to *Società italiana di iniziative edilizie e fondiarie S.p.A.* (SIDIEF) and *Bonifiche Ferraresi S.p.A.* The participating interests held as permanent investments also include shares of the Bank for International Settlements, which are denominated in SDRs, valued at cost and translated at historic exchange rates. The Bank's interest is equal to 9.61 per cent of the BIS's capital.

B) Other securities denominated in euros consists of bonds. In particular:

– Sub-item 7.1 (*Securities held for monetary policy purposes*) consists of covered bonds issued by euro-area counterparties purchased by the Bank consequent to the decision of the ECB Governing Council of 7 May 2009;

– Sub-item 7.2 (*Other securities*) consists of bonds, of which 53 per cent were issued by the Italian government and most of the remainder by other euro-area governments;

– Item 8 (*General government debt*) contains bonds assigned to the Bank following the bond conversion under Law 289/2002 and the termination of the mandatory management of stockpiling.

  The government securities provided for in Law 289/2002 consist of BTPs issued at market conditions and received in 2002 to convert the 1 per cent government securities previously assigned to the Bank to convert the Treasury's former current account in accordance with Law 483/1993. The reduction of €102 million corresponded to the annual accrued amount of the difference between the purchase price and the redemption value (discount).

  The securities deriving from the termination of the mandatory management of stockpiling consist of non-interest-bearing BTPs; the reduction of €50 million was due to the annual amount redeemed.

Another €34 million of claims deriving from the termination of the management of mandatory stockpiling, also included in Item 8, have not been converted into securities, because the relevant legislation made the issue of such securities subject to approval by the State Audit Office of the accounts of the transactions that gave rise to the claims. Following legislation on this matter, the Bank is waiting for the Ministry for the Economy and Finance to decide how the amount is to be paid.

Securities held to maturity include bonds whose book value (€9,875 million) was higher than the year-end valuation at market prices (€9,848 million). The securities in question – there being no particular circumstances relating to the position of the issuers – are recorded at cost in accordance with the accounting rules of the Eurosystem.

Intra-Eurosystem claims and liabilities (Item 9 on the asset side and Item 9 on the liability side)

Table 22.9

Positions with the ECB and the other euro-area NCBs
(thousands of euros)

	31.12.2009	31.12.2008	Changes
Assets			
9.1 Participating interest in the ECB	736,442	721,792	14,650
9.2 Claims arising from the transfer of foreign reserves to the ECB	7,198,857	7,217,925	-19,068
9.4 Other claims within the Eurosystem (net)	55,275,886	23,452,284	31,823,602
Total	**63,211,185**	**31,392,001**	**31,819,184**
Liabilities			
9.2 Net liabilities related to the allocation of euro banknotes within the Eurosystem	10,358,203	13,313,089	-2,954,886
Total	**10,358,203**	**13,313,089**	**-2,954,886**

On the asset side:

– the *Participating interest in the ECB* increased by €15 million as a result of:

a) the five-year adjustment of the interest, which resulted in a reduction of €2 million;

b) the recalculation of the NCBs' shares in the equity of the ECB, which resulted in an increase of €17 million.

– the *Claims arising from the transfer of foreign reserves to the ECB* diminished by €19 million as a consequence of the five-year adjustment.

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, reducing the Bank of Italy's share of the ECB's subscribed capital from 12.5297 to 12.4966 per cent. Considering only the NCBs belonging to the Eurosystem, the Bank of Italy's share of the ECB's capital was 17.9056 per cent at the end of 2009.

The claims deriving from transfers of reserves to the ECB represent the interest-earning claim denominated in euros recorded at the start of the Third Stage of EMU against the transfer of gold, foreign securities and foreign currencies to the ECB in proportion to the Bank's share of the ECB's capital, as in the case of the other Eurosystem NCBs (see the comment on the items of the profit and loss account: Net interest income*).*

– there was an increase in *Other claims within the Eurosystem (net)*, which derive mainly from the operation of the TARGET2 system. The latter gave rise to a credit position that rose by €31,834 million (from €22,919 million to €54,753 million); the average position over the year also increased, from €40,629 million to €59,065 million.

As in 2008, the liabilities refer exclusively to the allocation of euro banknotes within the Eurosystem (see *Legal basis, methods of preparation and layout of the annual accounts*).

Other assets (Item 11 on the asset side)

This item consists mainly of securities (see *Securities portfolio*) and *Deferred tax assets*, primarily in connection with prior-year tax losses.

Fair value of the buildings owned by the Bank at the end of the year was estimated to be €4,172 million for those used for its operations and €1,305 million for those related to investments of severance pay and pension provisions.

Deferred tax assets (Sub-item 11.6) decreased by €393 million as a consequence of:

– the offsetting of €284.5 million of the deferred taxes deriving from the carry-forward of the tax losses for 2002-04;

– the decrease of €100 million in the deferred tax assets on the year's allocation to a buffer against counterparty risk associated with Eurosystem monetary policy operations (see *Provisions and provision for general risks*);

– the decrease of €8 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 deriving from the bond conversion under Law 289/2002. At the end of 2009 the tax losses relating to 2003 and 2004 had been fully utilized. 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 (€143 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 tax credits (and accrued interest) in respect of prior years and payments on account of corporate income tax and Irap made in 2008.

Banknotes in circulation (Item 1 on the liability side)

Banknotes in circulation, which represent the Bank of Italy's share (16.5 per cent) of the total Eurosystem note issue (see *Legal basis, methods of preparation and layout of the annual accounts*), increased by €6,681 million (from €126,159 million to €132,840 million). The banknotes actually in circulation, without taking account of the adjustments for their distribution within the Eurosystem, increased by €3,726 million (from €139,472 million to €143,198 million). The average stock of banknotes rose from €126,816 million to €135,409 million, an increase of 7 per cent, compared with 11 per cent for the euro area.

Liabilities to general government and other counterparties in euros (Item 4 on the liability side)

The item refers mainly to the deposits held by the Treasury with the Bank of Italy. The other liabilities include other Treasury claims of €1,115 million (compared with €187 in 2008) and debtor positions with general government in respect of advances received for the management of the external collection and payment services in euros (€133 million, compared with €74 million).

The year-end balance on the Treasury accounts with the Bank of Italy increased significantly, as did the average balance, from €23,588 million in 2008 to €44,018 million in 2009. The average balance of the sinking fund for the redemption of government securities also increased, from €20 million to €28 million.

Liabilities to non-euro-area residents denominated in euros (Item 5 on the liability side)

These consist essentially in *Other liabilities* of €312 million (€201 million in 2008), referring mainly to accounts held by customers that use the Eurosystem Reserve Management Services (ERMS).

Other liabilities (Item 11 on the liability side)

The sub-item *Sundry* (11.3) includes, inter alia, the lira banknotes not yet presented for conversion, excluding the two payments on account that the Bank of Italy has already made to the Treasury for the banknotes that will presumably not be presented within the legal time limit (€671 million).

Provisions and provision for general risks (Items 12 and 14 on the liability side)

Balances and movements in *Provisions* (Item 12) are shown in Table 22.10.

Table 22.10

Provisions (Item 12) - balances and movements
(thousands of euros)

	Insurance cover	Tax provision (1)	Provision for Euro-system monetary policy	Staff-related provisions				Total
				for staff severance pay and pensions	for staff costs	for se-verance pay (2)	for grants to BI pensioners and their survivors	
Opening balances	**309,874**	**434,344**	**1,031,193**	**6,290,060**	**175,703**	**2,656**	**2,095**	**8,245,925**
Increases	**–**	**412,598**	**–**	**88,769**	**85,630**	**209**	**71**	**587,277**
Allocations	–	412,300	–	88,769	85,630	135	71	586,905
Other increases	–	298	–	–	–	74	–	372
Decreases	**–**	**-423,470**	**-310,113**	**-79**	**-93,405**	**-54**	**-26**	**-827,147**
Withdrawals	–	-423,099	–	-79 (3)	-93,405	-51	-26	-516,660
Other decreases	–	-371	-310,113	–	–	-3	–	-310,487
Closing balances	**309,874**	**423,472**	**721,080**	**6,378,750**	**167,928**	**2,811**	**2,140**	**8,006,055**

(1) Changes in the *tax provision* include the flat-rate withholding tax for the alignment of book/accounting and fiscal values. *Other* changes include deferred tax liabilities for Irap. – (2) Includes severance pay of contract staff and of ordinary staff prior to joining the supplementary pension fund. – (3) Includes the transfer of severance pay of staff participating in the supplementary pension fund.

The reduction in *Provisions for specific risks* (Sub-item 12.1) was due mainly to the decrease, €310 million, in the provision relating to Eurosystem monetary policy operations. In accordance with Article 32.4 of the ESCB Statute, a buffer against the counterparty risk associated with monetary policy operations has been constituted, funded by all the Eurosystem NCBs in proportion to their subscribed capital key shares in the ECB in the year in which the events occur. In accordance with the general accounting principle of prudence, the Governing Council of the ECB has revised the amount of the buffer created by the NCBs in the previous year, reducing it to €4,011 million, from €5,736 million at the end of 2008. 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 €1,031 million to €721 million (see *Comments on the items of the profit and loss account: Net result of the pooling of monetary income)*.

The increase in *Staff-related provisions* (Sub-item 12.2) was the result of:

a) the increase of €89 million to the severance pay and pension provisions, which rose from €6,290 million at the end of 2008 to €6,379 million at the end of 2009. Of this amount €5,227 million was for supplementary pensions and €1,152 million for severance pay;

b) the decrease of €8 million in the provision for staff costs, which amounted to €168 million at the end of the year. Of this figure, €50 million relates to early retirement measures in connection with the reorganization of the Bank's branch network.

The *Provision for general risks* (Item 14) rose from €7,096 million in 2008 to €7,796 million after the allocation of €700 million approved by the General Council. The allocation for 2009 continues the replenishment of the provision following the utilizations of previous years.

Revaluation accounts (Item 13 on the liability side)

These include the valuation at market prices of gold, foreign currency, securities and forward operations (see *Gold, assets and liabilities denominated in foreign currency* and *Securities portfolio*).

Table 22.11

Revaluation accounts (Item 13)
(thousands of euros)

	Opening balance	Withdrawals	Net revaluations	Closing balance
Exchange rate revaluations	**31,587,842**		**10,780,630**	**42,368,472**
of which: *gold*	*29,574,514*		*11,414,804*	*40,989,318*
net foreign currency assets	*2,013,159*		*-634,005*	*1,379,154* (1)
financial assets related to the investment of reserves and provisions	*169*		*-169*	– (1)
Price revaluations	**2,291,739**		**307,407**	**2,599,146**
of which: *foreign currency securities*	*780,245*		*-625,141*	*155,104*
securities denominated in euros	*75,839*		*-17,761*	*58,078*
financial assets related to the investment of reserves and provisions	*1,435,655*		*950,309*	*2,385,964*
Revaluations at 1 January 1999	**11**	**-3**	**–**	**8**
Total	**33,879,592**	**-3**	**11,088,037**	**44,967,626**

(1) Includes net revaluations relating to forward operations.

Capital and reserves (Item 15 on the liability side)

As detailed below:

Table 22.12

Capital and reserves (Item 15)
(thousands of euros)

	31.12.2009	31.12.2008	Changes
15.1 Capital	**156**	**156**	**–**
15.2 Statutory reserves (Article 39)	**12,339,169**	**11,882,707**	**456,462**
Ordinary	6,076,391	5,859,575	216,816
Extraordinary	6,262,778	6,023,132	239,646
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 reserve from the merging of UIC (Law 231/2007)	2,121,931	2,121,931	–
Total	**20,078,836**	**19,622,374**	**456,462**

The movements of the ordinary and extraordinary reserves are detailed below:

Table 22.13

Movements in ordinary and extraordinary reserves (Sub-item 15.2)
(thousands of euros)

	Balance at 31.12.2008	Allocation of 2008 profit under Art. 39 of the Statute	Distribution to shareholders under Art. 40 of the Statute (1)	Transfer of 2009 income under Art. 40	Balance at 31.12.2009
Ordinary	5,859,575	35,042	-29,138	210,912	6,076,391
Extraordinary	6,023,132	35,042	-29,649	234,253	6,262,778
Total	**11,882,707**	**70,084**	**-58,787**	**445,165**	**12,339,169**

(1) From the income earned in 2008.

Table 22.14

Shareholders in the Bank of Italy

	At end 2009				At end 2008			
	Bodies	Shares (1)	%	Votes	Bodies	Shares (1)	%	Votes
With voting rights	58	299,934	100	539	58	299,934	100	539
S.p.A.s engaged in banking, including companies under Article 1, Legislative Decree 356/1990	*51*	*253,434*	*84*	*418*	*51*	*253,434*	*84*	*418*
Social security institutes	*1*	*15,000*	*5*	*34*	*1*	*15,000*	*5*	*34*
Insurance companies	*6*	*31,500*	*11*	*87*	*6*	*31,500*	*11*	*87*
Without voting rights	6	66	..		6	66	..	
S.p.A.s engaged in banking, including companies under Article 1, Legislative Decree 356/1990	*6*	*66*	*..*		*6*	*66*	*..*	
Total	**64**	**300,000**	**100**	**539**	**64**	**300,000**	**100**	**539**

(1) The nominal value of each share is €0.52.

Off-balance-sheet accounts

The off-balance-sheet accounts totalled €255,011 million in 2009.

Table 22.15

Off-balance-sheet accounts
(thousands of euros)

	31.12.2009	31.12.2008 (1)	Changes
Orders in progress	**23,713**	**794,893**	**-771,180**
purchase	20,846	790,105	-769,259
sale	2,867	4,788	-1,921
Forward operations	**626,536**	**9,544,921**	**-8,918,385**
forward sales of foreign currencies	556,536	8,494,108	-7,937,572
forward purchases of foreign currencies	70,000	882,834	-812,834
purchase futures	–	167,979	-167,979
Securities loans to increase liquidity	**–**	**3,053,300**	**-3,053,300**
securities loaned	–	1,439,751	-1,439,751
securities received as collateral	–	1,613,549	-1,613,549
Commitments	**1,141,835**	**824,893**	**316,942**
to the IMF for loans granted	1,141,815	824,450	317,365
other	20	443	-423
Collateral received	**97,446,245**	**109,562,383**	**-12,116,138**
for refinancing operations (2)	76,413,394	108,972,092	-32,558,698
others (3)	21,032,851	590,291	20,442,560
Collateral granted	**29,863**	**30,351**	**-488**
Third-party securities and valuables on deposit with the Bank	**155,676,147**	**151,514,455**	**4,161,692**
Memorandum accounts of the supplementary pension fund	**66,687**	**56,198**	**10,489**
Total	**255,011,026**	**275,381,394**	**-20,370,368**

(1) From 2009 the off-balance-sheet accounts include securities, valuables and goods (€86,877,432,000) formerly entered as balance-sheet assets and securities reverse operations (€57,070,852,000) formerly entered as collateral for refinancing, The amounts for 2008 have been recalculated accordingly for purposes of comparison. – (2) Includes securities and bank loans used as collateral. – (3) Includes collateral provided by counterparties for the collateralized interbank market.

Forward sales of foreign currency include the following commitments:

– €70 million to the ECB in connection with the Swiss franc refinancing programme granted to Eurosystem counterparties through swaps. As with the US dollar Term Auction Facility, the Swiss National Bank provides Swiss francs to the ECB through swaps (see *Gold and assets and liabilities denominated in foreign currency*); at the same time the ECB undertakes analogous operations with the Eurosystem NCBs, which use the francs to provide liquidity to euro-area counterparties;

– €487 million for operations to hedge the exchange risk on foreign currency investments related to investments of reserves and provisions (see *Securities Portfolio*).

Forward purchases of foreign currency relate to the commitment to euro-area counterparties for Swiss franc swaps entered into as part of the aforementioned foreign currency financing programmes.

Commitments to the IMF for loans granted relate to existing IMF initiatives with Italy for financing to be disbursed.

At the end of 2009 there were no securities loans outstanding. The Bank had undertaken such loans at the end of 2008 in relation to extraordinary liquidity support operations.

Comments on the items of the profit and loss account

The net profit for the year was €1,669 million, compared with €175 million in 2008.

Net interest income (Item 1)

Net interest income decreased by €384 million, from €3,384 million to €3,000 million. *Interest income* and *Interest expense* both declined as a result of the lower rate of return on assets, whose effect was only partly offset by the larger average stocks of interest-bearing assets and liabilities.

The net interest income from financial assets representing investments of reserves and provisions is shown in a separate item (see Net income from financial assets representing investments of reserves and provisions*).*

Table 22.16

Interest income (Sub-item 1.1)
(thousands of euros)

	2009	2008	Changes
On assets denominated in euros	3,694,742	5,268,001	-1,573,259
securities	*2,383,256*	*2,373,514*	*9,742*
lending operations	*452,178*	*802,635*	*-350,457*
intra-ESCB balances	*829,591*	*2,040,163*	*-1,210,572*
other	*29,717*	*51,689*	*-21,972*
On assets denominated in foreign currency	468,072	814,270	-346,198
receivables from the IMF	*17,105*	*29,835*	*-12,730*
securities	*424,850*	*550,535*	*-125,685*
other assets denominated in foreign currency	*26,117*	*233,900*	*-207,783*
Total	**4,162,814**	**6,082,271**	**-1,919,457**

Table 22.17

Interest expense (Sub-item 1.2)
(thousands of euros)

	2009	2008	Changes
On liabilities denominated in euros	1,133,409	2,613,003	-1,479,594
Treasury payments account	*660,084*	*1,043,942*	*-383,858*
sinking fund for the redemption of government securities	*588*	*791*	*-203*
current accounts (covering the minimum reserve system)	*324,217*	*934,903*	*-610,686*
intra-ESCB balances	*121,883*	*545,830*	*-423,947*
other	*26,637*	*87,537*	*-60,900*
On liabilities denominated in foreign currency	29,096	84,868	-55,772
counterpart of SDRs allocated by the IMF	*8,558*	*19,374*	*-10,816*
other	*20,538*	*65,494*	*-44,956*
Total	**1,162,505**	**2,697,871**	**-1,535,366**

Net result of financial operations, write-downs and transfers to/from risk provisions (Item 2)

The result for 2009 comprises:

– net profit on trading in securities denominated in euros (€69 million), deriving from sales of government securities;

– net profit on trading in securities denominated in foreign currency (€355 million), deriving primarily from sales of securities denominated in dollars;

– net profit on foreign exchange trading (€112 million), deriving mostly from sales of assets denominated in dollars and sterling;

– net profit on other financial operations, which include the income from securities loans to support market liquidity (€1 million);

– write-downs due to price changes on securities in foreign currency (€64 million, primarily in dollars) and on securities in euros (€13 million);

– the transfer of €700 million to the provision for general risks.

Table 22.18

Net result of financial operations, write-downs and transfers to/from risk provisions (Item 2)
(thousands of euros)

	2009	2008	Changes (1)
Profits (+) and losses (-) on financial operations	536,814	362,029	174,785
foreign exchange trading	*111,829*	*17,851*	*93,978*
trading in securities denominated in euros	*68,547*	*420*	*68,127*
trading in securities denominated in foreign currency	*355,120*	*333,569*	*21,551*
derivative contracts denominated in foreign currency	*-176*	*2,554*	*-2,730*
other transactions	*1,494*	*7,635*	*-6,141*
Write-downs (-) of financial assets and positions	-76,980	-1,245,176	1,168,196
for exchange rate	*–*	*-1,222,163*	*1,222,163*
for price			
– securities denominated in euros	*-13,065*	*-22,435*	*9,370*
– securities denominated in foreign currency	*-63,915*	*-578*	*-63,337*
Transfers to (-) and from (+) the provision for general risks for exchange rate, price and credit risks	-700,000	-176,000	-524,000
Total	**-240,166**	**-1,059,147**	**818,981**

(1) Negative changes indicate smaller profits or larger losses/write-downs; positive changes larger profits or smaller losses/writedowns.

Net income from fees and commissions (Item 3)

The net result for the year (€22 million) is comparable with that for 2008, as *Fee and commission income* rose from €27 million to €28 million while *Fee and commission expense* rose by about the same amount, from €6 million to €7 million. Income under this heading includes: fees for financial services on behalf of general government (€5 million); charges payable by the participants in TARGET2 (€6 million); fees for Correspondent Central Banking Model services (€4 million), those for the use of Central Credit Register information (€3 million) and substitute protest declarations (€4 million). Expenses refer mainly to the centralized securities management service (€5 million).

Income from participating interests (Item 4)

The item *Income from participating interests* decreased by €55 million, from €217 million to €162 million. It comprises:

– the Bank of Italy's share of the ECB profits earned in 2008 and distributed in 2009 (€21 million);

– the Bank of Italy's share of the ECB's seigniorage income on banknotes (€141 million, down from €217 million in 2008).

In 2009 the ECB's entire seigniorage income (€787 million, of which the Bank of Italy's share was €141 million) was distributed to the Eurosystem NCBs as dividend prepayment (see Legal basis, methods of preparation and layout of the accounts*).*

Taking into account the prepayment already made, in March 2010 the Bank of Italy received a further €263 million.

Net result of the pooling of monetary income (Item 5)

The result for 2009 was €683 million, consisting of:

– the receipt of the Bank of Italy's share of the pooling of monetary income (€373 million, compared with €316 million in 2008);

– the reduction of €310 million in the provision in respect of monetary policy operations (see *Comments on the items of the balance sheet: Provisions and provision for general risks*) .

The result for the redistribution of monetary income in 2009 was the difference between the monetary income pooled, €1,661million, and that redistributed, €2,034 million. The monetary income pooled of each NCB is determined by measuring the actual annual income that derives from the earmarkable assets held against its liability base. The liability base of each NCB consists 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 capital key share. Gold is considered to generate no income. The securities held for monetary policy purposes 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 allocated to each NCB according to its subscribed capital key.

Net income from financial assets related to the investment of reserves and provisions (Item 6)

The improvement in the result on this item was due mainly to decreased write-downs on securities, which more than offset the reduction in interest, dividend and trading income.

Transfer of investment income to statutory reserves (Item 9)

As provided for in Article 40 of the Statute, income earned on investments of the ordinary and extraordinary reserves is used to increase these reserves. The amount appropriated in 2009 increased from €143 million to €445 million, owing primarily to a decrease in write-downs due to price changes (for more details, see *Net income from financial assets related to the investment of reserves and provisions*).

Table 22.19

Net income from financial assets related to the investment of reserves and provisions (Item 6)
(thousands of euros)

	2009	2008	Changes
Interest	892,752	956,886	-64,134
Statutory reserves	*299,233*	*311,224*	*-11,991*
other reserves and provisions	*593,519*	*645,662*	*-52,143*
Dividends	255,266	302,115	-46,849
Statutory reserves	*145,236*	*162,583*	*-17,347*
other reserves and provisions	*110,030*	*139,532*	*-29,502*
Profits/losses from trading and disposals	33,768	266,242	-232,474
Statutory reserves	*4,191*	*151,429*	*-147,238*
other reserves and provisions	*29,577*	*114,813*	*-85,236*
Write-downs	-24,785	-700,248	675,463
Statutory reserves	*-15,608*	*-486,837*	*471,229*
other reserves and provisions	*-9,177*	*-213,411*	*204,234*
Other components	21,384	4,625	16,759
Statutory reserves	*12,113*	*4,604*	*7,509*
other reserves and provisions	*9,271*	*21*	*9,250*
Total	**1,178,385**	**829,620**	**348,765**

Expenses and charges (Item 10)

This item comprises:

Table 22.20

Expenses and charges (Item 10)
(thousands of euros)

	2009	2008	Changes
Staff wages and salaries and related costs	715,508	697,282	18,226
Other staff costs	82,574	54,351	28,223
Transfers to provisions for accrued expense and staff severance pay and pensions	174,605	347,139	-172,534
staff severance pay and pensions	*88,769*	*257,607*	*-168,838*
accrued expenses not yet paid	*85,630*	*89,184*	*-3,554*
other	*206*	*348*	*-142*
Pensions and severance payments	333,241	281,072	52,169
Emoluments paid to head and branch office collegial bodies (1)	3,812	3,861	-49
Administrative expenses	450,372	431,739	18,633
Depreciation of tangible and intangible fixed assets	196,067	203,453	-7,386
Banknote production services	18,220	7,075	11,145
Other expenses	30,532	22,633	7,899
Total	**2,004,931**	**2,048,605**	**-43,674**

(1)The item includes the accumulated remuneration due to the General Council and the Board of Auditors, amounting respectively to €1,168,356 (€1,109,014 in 2008) and €130,000 (the same as in 2008), net of value added tax and social security contributions.

The most significant development relating to the sub-item *Transfers to provisions for accrued expense and staff severance pay and pensions* was the decrease in the transfer to *Staff severance pay and pensions* from €258 million to €89 million. In 2008 this item had been affected by the adjustment of the demographic projections used in the actuarial model for calculating the mathematical reserves and by the economic adjustments provided for by collective bargaining agreements.

Table 22.21

The Bank's staff

	Average number of persons in service		Percentage composition	
	2009	2008	2009	2008
Managerial	2,098	2,093	27.6	26.9
Non-executive	4,444	4,599	58.5	59.1
General services and security	572	604	7.5	7.8
Blue-collar	484	482	6.4	6.2
Total	**7,598**	**7,778**	**100.0**	**100.0**
Contract workers	31	31		

Administrative expenses increased overall by €19 million. The main increases were: €10 million for raw and subsidiary materials for banknote production (from €28 million to €38 million); €8 million for building maintenance (from €55 million to €63 million); €2 million for systems assistance (from €29 million to €31 million); external software leasing and maintenance (from €31 million to €33 million); and participation in TARGET2 (from €7 million to €9 million). The decreases involved: €9 million for security services and banknote escort (from €89 million to €80 million); and €3 million for equipment rentals (from €25 million to €22 million). The costs of utilities (€29 million) and electronic transmission (€17 million) remained basically unchanged.

Banknote production services costs, which include costs for banknote production outside the Bank, totalled €18 million in 2009 (€7 million in 2008).

Extraordinary income and expense (Item 12)

Extraordinary income and expense showed a positive balance of €48 million, primarily owing to the recognition of €29 million in tax credits (and interest) more than ten years old and to net income of €9 million deriving from the rectification of the redistribution of monetary income for the years 2007 and 2008.

Taxes on income for the year and on productive activities (Item 13)

Taxes for the year amount to €805 million and comprise both the current taxes due and the change in deferred tax assets and liabilities (see *Comments on the items of the balance sheet: Other assets,* sub-item *Deferred tax assets*).

Tavola 22.22

Taxes on income for the year (Item 13)
(thousand of euros)

	2009	2008
Taxes for the year (-)	-412,300	-432,699
Change in deferred tax assets (+/-)	-392,870	100,330
Change in deferred tax liabilities (+/-)	102	4,641
Tax on income for the year (-)	**-805,068**	**-327,728**

More specifically, corporate income tax for the year included €284.5 million of taxes for the current year and recorded in the tax provision and €284.5 million in relation to the reduction in deferred tax assets in respect of the part of the tax losses offset against 50 per cent of the taxable income for the year. The net change in the other deferred tax components produced additional taxes of €93 million. Overall, corporate income tax for the year, including deferred taxes, amounted to €662 million (€218 million in 2008).

The regional tax on productive activities (Irap) rose from €94 million to €143 million, the result of €128 million of tax for the year, recorded in the tax provision, and a change of €15 million in the deferred component.

PROPOSALS OF THE GENERAL COUNCIL

Pursuant to Articles 38 and 39 of the Statute and after hearing the favourable opinion of the Board of Auditors, the General Council proposes the following allocation of the net profit for 2009 of €1,668,576,514:

	euros
– 20 per cent to the ordinary reserve	333,715,303
– an amount equal to 6 per cent of the share capital to shareholders ...	9,360
– 20 per cent to the extraordinary reserve	333,715,303
– an additional amount equal to 4 per cent of the share capital to shareholders	6,240
– the remaining amount to the State	1,001,130,308
Total	1,668,576,514

Pursuant to Article 40 of the Statute, the General Council has also proposed the distribution to shareholders – drawing on the income earned on the ordinary and extraordinary reserves – of an additional €59,415,000, equal to 0.50 per cent (as in 2008) of the total reserves at 31 December 2008.

If these proposals are approved, the total dividend will be equal to €59,430,600, corresponding to €198,102 per share.

THE GOVERNOR

Mario Draghi

23. DOCUMENTATION ATTACHED TO THE ANNUAL ACCOUNTS

REPORT OF THE BOARD OF AUDITORS

ON THE 116th FINANCIAL YEAR OF THE BANK OF ITALY
AND THE ACCOUNTS FOR THE YEAR ENDED 31 DECEMBER 2009

To the shareholders,

We have examined the annual accounts of the Bank of Italy for the year ended 31 December 2009, drawn up in accordance with the accounting standards and valuation methods decided by the General Council and agreed by us, described in detail in the notes to the accounts.

Our examination of the annual accounts was made in accordance with the principles of conduct for the board of auditors recommended by the *Consigli Nazionali dei Dottori Commercialisti e dei Ragionieri*. Our procedures, in conformity with 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 2009 have been prepared in accordance with the accounting standards and valuation methods indicated in the notes to the accounts. They comply with the law in force and with the harmonized accounting rules laid down by the Governing Council of the ECB and made applicable for the purposes of the annual accounts by Article 8 of Legislative Decree 43/1998.

The accounts were kept properly in conformity with the standards and rules laid down by the law in force. The individual items of the annual accounts, which were also audited by external auditors, were compared by us with the accounting records and found to conform with them.

The inclusion in the balance sheet of deferred tax assets, arising primarily from the carrying forward of residual tax losses deriving 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 €393 million (from €6,413 million to €6,020 million).

The General Council approved the transfer of €700 million to the provision for general risks.

The total amount of the Bank's general and specific risk provisions is deemed prudent. In particular, the provision for severance pay and pensions comprises both the actuarial reserves corresponding to the situation of staff having entitlement and that of pensioners and the severance pay accrued by all the members of the staff in service at the end of the year having entitlement.

The accounts submitted for your approval show the following results:

Assets	€	301,256,318,596
Liabilities	€	279,508,905,685
Capital and reserves	€	20,078,836,397
Net profit for the year (as shown in the income statement)	€	1,668,576,514

The off-balance-sheet accounts, equal to €255,011,026,359, refer to forward transactions, guarantees granted and received, and deposits of securities and sundry valuables, in foreign currencies and euros.

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 General Council proposes the following allocation of the net profit:

– 20 per cent to the ordinary reserve	€	333,715,303
– an amount equal to 6 per cent of the share capital to shareholders	€	9,360
– 20 per cent to the extraordinary reserve	€	333,715,303
– an additional amount equal to 4 per cent of the share capital to shareholders	€	6,240
– the remaining amount to the State	€	1,001,130,308
Total	€	1,668,576,514

Pursuant to Article 40 of the Statute, the General Council also proposes the distribution to shareholders – drawing on the income earned on the ordinary and extraordinary reserves – of an additional €59,415,000, equal to 0.50 per cent of such reserves at 31 December 2008 and within the limits laid down in the above-mentioned article.

During the year ended 31 December 2009 we attended all the meetings of the General Council and made the tests and controls within the scope of our authority, including checks on the quantities of cash and valuables belonging to the Bank and third parties, verifying at all times compliance with the law and the Bank's Statute and General Regulations. We monitored the activity of the Bank's peripheral units, in accordance with Articles 19 and 20 of the Bank's Statute, with the assistance of the examiners at the main and local branches, whom we thank warmly.

To the shareholders,

We recommend that you approve the annual accounts for 2009 that have been submitted to you (the balance sheet, the profit and loss account and the notes to the accounts) and the proposed allocation of the net profit for the year and the additional allocation to capital pursuant to Article 40 of the Statute.

Rome, 29 April 2010

THE BOARD OF AUDITORS
Angelo Provasoli (Chairman)
Giovanni Fiori
Elisabetta Gualandri
Gian Domenico Mosco
Dario Velo

LIST OF ABBREVIATIONS

ABI	–	*Associazione bancaria italiana* Italian Banking Association
BI–COMP	–	*Banca d’Italia Compensazione* Bank of Italy Clearing System
BI–REL	–	*Banca d’Italia Regolamento Lordo* Bank of Italy real-time gross settlement system
BOTs	–	*Buoni ordinari del Tesoro* Treasury bills
BTPs	–	*Buoni del Tesoro poliennali* Treasury bonds
CCTs	–	*Certificati di credito del Tesoro* Treasury credit certificates
CIPA	–	*Convenzione interbancaria per i problemi dell’automazione* Interbank Convention on Automation
Confindustria	–	*Confederazione generale dell’industria italiana* Confederation of Italian Industry
Consob	–	*Commissione nazionale per le società e la borsa* Companies and Stock Exchange Commission
Covip	–	*Commissione di vigilanza sui fondi pensione* Pension fund supervisory authority
CTOs	–	*Certificati del Tesoro con opzione* Treasury option certificates
CTZs	–	*Certificati del Tesoro zero-coupon* Zero-coupon Treasury certificates
EFPD	–	Economic and Financial Planning Document
FIU	–	Financial Intelligence Unit
FPR	–	Forecasting and Planning Report
HICP	–	Harmonized index of consumer prices
ICI	–	*Imposta comunale sugli immobili* Municipal real estate tax
Iciap	–	*Imposta comunale per l’esercizio di imprese e di arti e professioni* Municipal tax on businesses and the self-employed
Ilor	–	*Imposta locale sui redditi* Local income tax
INAIL	–	*Istituto nazionale per l’assicurazione contro gli infortuni sul lavoro* National Industrial Accidents Insurance Institute

INPS – *Istituto nazionale per la previdenza sociale*
National Social Security Institute

Irap – *Imposta regionale sulle attività produttive*
Regional tax on productive activities

Irpef – *Imposta sul reddito delle persone fisiche*
Personal income tax

Ires – *Imposta sul reddito delle società*
Corporate income tax

ISAE – *Istituto di studi e analisi economica*
Institute for Economic Research and Analysis

Istat – *Istituto nazionale di statistica*
National Institute of Statistics

Isvap – *Istituto per la vigilanza sulle assicurazioni private e di interesse collettivo*
Supervisory authority for the insurance industry

MAC – *Mercato Alternativo del Capitale*
Alternative Capital Market

MTS – *Mercato telematico dei titoli di Stato*
Screen-based secondary market in government securities

QRBR – Quarterly Report on the Borrowing Requirement

SACE – *Istituto per i servizi assicurativi per il commercio estero*
Foreign Trade Insurance Services Agency

SIM – *Società di intermediazione mobiliare*
Italian investment firm

TARGET – Trans-European Automated Real-Time Gross Settlement Express Transfer System

UIC – *Ufficio italiano dei cambi*
Italian Foreign Exchange Office

ADMINISTRATION OF THE BANK OF ITALY

AT 31 DECEMBER 2009

GOVERNING BOARD - DIRECTORATE

Mario DRAGHI	Governor - Member of the Governing Board
Fabrizio SACCOMANNI	Director general - Member of the Governing Board
Ignazio VISCO	Deputy director general - Member of the Governing Board
Giovanni CAROSIO	Deputy director general - Member of the Governing Board
Anna Maria TARANTOLA	Deputy director general - Member of the Governing Board

GENERAL COUNCIL

Paolo BLASI
Paolo DE FEO
Giampaolo de FERRA
Lodovico PASSERIN D'ENTREVES
Paolo LATERZA
Rinaldo MARSANO
Cesare MIRABELLI
Giovanni MONTANARI
Ignazio MUSU
Gavino PIRRI
Stefano POSSATI
Nicolò SCAVONE
Giordano ZUCCHI

BOARD OF AUDITORS

Angelo PROVASOLI - Chairman
Giovanni FIORI
Elisabetta GUALANDRI
Gian Domenico MOSCO
Dario VELO

ALTERNATE AUDITORS

Lorenzo DE ANGELIS
Sandro SANDRI

MANAGING DIRECTORS

Paolo PICCIALLI	secretary general
Franco PASSACANTANDO	responsible for central banking, markets and payment systems
Alberto Mario CONTESSA	responsible for service quality
Salvatore ROSSI	responsible for economics, research and international relations
Fabrizio RUDEL	responsible for property and purchasing
Carlo PISANTI	responsible for currency circulation
Olivia BRIZZI	responsible for the reorganization of the bank
Claudio CLEMENTE	accountant general
Giovanni CASTALDI	responsible for the financial intelligence unit
Carlo CHIESA	responsible for information technology resources and statistics
Stefano MIELI	responsible for banking and financial supervision