BANCA D'ITALIA
EUROSISTEMA

Annual Report
Abridged Version

Ordinary Meeting of Shareholders
Rome, 29 May 2009

115th FINANCIAL YEAR

2008

Financial Year 115th

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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. THE FINANCIAL AND FOREIGN EXCHANGE MARKETS

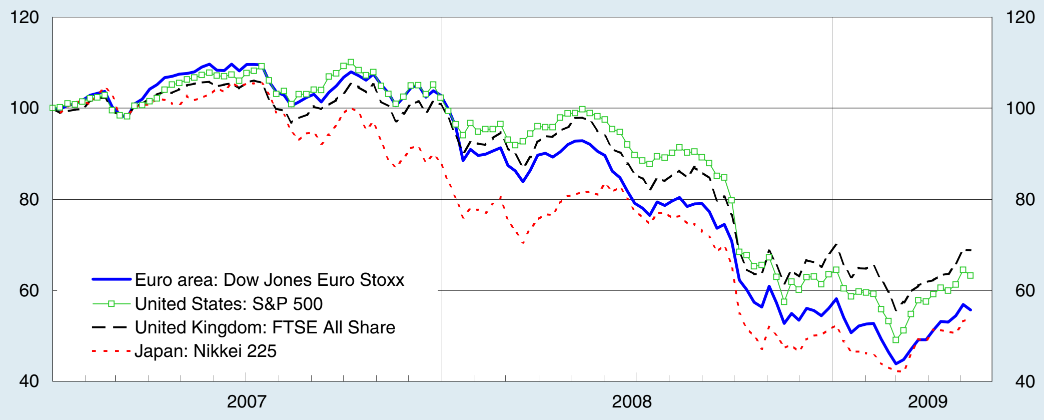
The international financial crisis deepened from September of last year, with severe repercussions on economic activity. The collapse of Lehman Brothers caused a crisis of confidence that drained the money markets of liquidity, aggravating the difficulties of many financial institutions, and led to increased risk aversion. The outcome was a major shift in investors' portfolios towards assets considered to be safer, which caused a slump in share prices, an increase in credit spreads on corporate bonds, and a drop in yields on government securities. The crisis spread rapidly to the financial markets of the emerging countries; those with the largest external deficits were hit hardest by capital outflows. In order to revive confidence in the financial system and restore order in the markets, the authorities of the leading industrial countries introduced measures to overcome the problem of banks' under-capitalization and get credit flowing again to the worst affected markets. Backed by closely coordinated action at international level, these measures succeeded in averting a paralysis of the system; they eased, but did not eliminate, the uncertainty that still weighs on financial institutions and on the prospects for the credit market and for world economic activity.

The financial crisis in the industrial countries and the authorities' response

During the first eight months of 2008 highly volatile conditions still prevailed in the international financial markets. There were growing fears that the banks' losses – their extent and distribution unknown owing to the difficulty of identifying and quantifying the risk attached to less liquid structured credit instruments – might cause the collapse of one or more major financial institutions. The perception of high counterparty risk and heavy demand for liquidity by banks for precautionary motives kept tensions high on the interbank markets: the interest rate spreads between unsecured three-month interbank deposits and three-month overnight index swaps fluctuated around 70 basis points for dollar and sterling deposits and 60 basis points for those in euros, with sharp increases after the Bear Stearns crisis in the middle of March. The share markets continued to fall, losing between January and August around 15 per cent in the United States, Japan and the United Kingdom and 23 per cent in the euro area (Figure 1.1). In the United States, the risk premiums on corporate bonds, measured by the spread with respect to Treasuries, continued to increase: those on BBB-rated securities rose from 2.4 to 3.6 percentage points and those on high-yield securities from 5.6 to 7.9 points.

Figure 1.1

Stock market indices (1)
(average weekly data; first week of January 2007=100)



Source: Thomson Reuters Datastream.
1) Up to the week ended on 15 May 2009.

The crisis worsened in September. At the beginning of that month the US Treasury decided to place Fannie Mae and Freddie Mac into conservatorship; the two federal mortgage agencies, which had incurred heavy losses from the start of the crisis in August 2007 and were hit by the continuous slide of the property market, had begun to encounter difficulty during the summer in placing their bonds. In view of their systemic importance – in 2008 they financed almost three quarters of US residential mortgages – the Treasury undertook to provide them with fresh capital for up to $100 billion each, later raised to $200 billion.

From the middle of September conditions on the international financial markets became critical: the collapse of Lehman Brothers caused a crisis of confidence and a sharp increase in risk aversion; trading on the interbank markets virtually dried up, causing difficulty for other large institutions; and on 16 September the Federal Reserve intervened in support of the insurer American International Group (AIG) with a loan of $85 billion, followed by a further $38 billion at the beginning of October.

In the weeks that followed, the crisis of other important banks triggered a rapid consolidation of the US banking system: the assets of the bankrupt Washington Mutual were taken over by JPMorgan Chase; Merrill Lynch was acquired by Bank of America, and Wachovia by Wells Fargo; Goldman Sachs and Morgan Stanley began their transformation into bank holding companies in order to have access to the liquidity channels offered by the Federal Reserve. The financial market turmoil and crisis of confidence spread swiftly to the European banking systems. A massive portfolio shift ensued towards assets viewed as being safer: against a background of increased volatility, the main share indices fell by around a third during the autumn months, with losses of 40 to 50 per cent in the financial segments, while the spreads on corporate bonds more than doubled.

Towards the end of the year yields on government securities slumped, reflecting the pronounced worsening of the economic situation and the drop in current and expected inflation: yields on ten-year government bonds fell to 2.2 per cent in the United States, 1.2 per cent in Japan and 3.1 per cent in the United Kingdom, from

4, 1.5 and 4.5 per cent respectively at the beginning of the year. In the euro area they declined from 4.3 to 2.9 per cent. Liquidity dried up on the money markets, causing serious financing difficulties for banks and hence also for the non-financial companies that rely on them for credit. In the United States, where money market funds were hit by a wave of requests for redemptions after the value of some fell below par, the stock of outstanding commercial paper decreased by $370 billion in the space of a few weeks to $1,450 billion, matching its decline over the previous twelve months.

The governments and central banks of the major industrial countries responded promptly on several fronts, with strong emphasis on internationally coordinated action (see the boxes "The crisis of some US financial institutions and the support action of the authorities" in *Economic Bulletin* No. 50, 2008 and "The recent measures to support the banking system in the main industrial countries" in *Economic Bulletin* No. 51, 2009). At the summit of G7 finance ministers and central bank governors in Washington on 10 October 2008 and at the summit of Heads of State and Government of the euro-area countries immediately after, with the endorsement of the European Commission and the ECB, agreement was reached on the priorities and underlying principles for the measures to be adopted in each country: reviving the money and credit markets; supporting financial institutions of systemic importance; ensuring continuity of credit flows to banks by providing temporary guarantees on their liabilities; increasing the existing guarantees on bank deposits; strengthening the capital of institutions in difficulty by means of government intervention; and ensuring sufficient flexibility in the application of accounting rules. International cooperation continued within the G20 at the meetings of Heads of State and Government in Washington on 14 and 15 November 2008 and in London on 2 April this year, at which discussions centred on the measures needed to tackle the crisis and reform the international financial system. Regarding action to be taken within the European Union, the Commission issued a set of guidelines designed to ensure that government support would not create a competitive advantage for the banks that benefited from it.

While the measures adopted effectively prevented a paralysis of the financial system, they were only able to mitigate some of the considerable uncertainty and fears of new bankruptcies; the premiums on CDSs for the leading international banks, which had risen sharply in the weeks following the failure of Lehman Brothers, did not drop back even to the previous summer's high level.

After the Obama administration took office, on 10 February the Treasury announced a new scheme, the Financial Stability Plan, designed, among other things, to remove from banks' balance sheets impaired assets, for the most part consisting of portfolios of mortgage loans and securitized products linked to them. The Public-Private Investment Program, or PPIP, provides for the creation of mixed public-private investment funds, for which the Treasury will contribute 50 per cent of capital using a total of between $75 billion and $100 billion of TARP resources. The funds will be able to purchase assets worth about $500 billion, financed by issuing debt instruments guaranteed by the FDIC or loans from the Federal Reserve.

The FSP also aims to create the conditions for banks to continue lending to the economy by strengthening their capital through recourse to the market or new injections of public funds (see the box "The recent measures to support the banking system and stimulate lending: the United States and the United Kingdom", in *Economic Bulletin* No. 52, 2009). In order to assess the possible need for recapitalization the supervisory authorities subjected the nineteen banks with assets in excess of $100 billion at end-2008 to stress-testing for the period 2009-10. They could thus estimate the potential losses, operating results and consequent balance sheet situation of each bank in the event of a worse-than-expected macroeconomic deterioration. It emerged that the banks could incur total losses of $600 billion in the two years. Taking account of capital increases made earlier this year and the need to set aside sufficient funds to cover expected losses in 2011, ten of the banks tested were found to have a capital shortfall of $75 billion, almost half of which pertained to Bank of America. As the crisis deepened, lending conditions became more stringent in the main areas. In the United States gross issues of bonds by non-financial companies were 40 per cent lower in the second half of 2008 than in the same period a year earlier. They picked up in the first quarter of this year, however, increasing by 140 per cent on the preceding period. The authorities have launched a set of measures to provide direct support to credit the worst-hit markets.

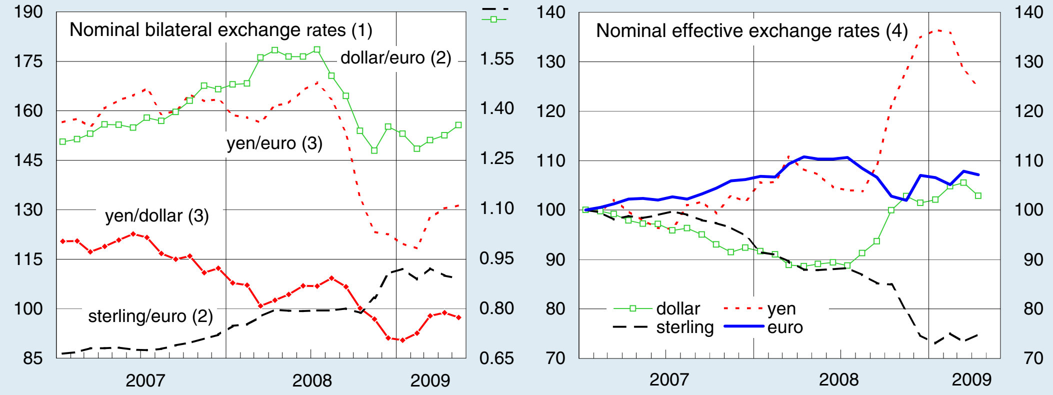
In order to stimulate lending more effectively the US Treasury has stepped up its monitoring of banks, particularly those recapitalized with public funds under the FSP. These banks are also required to submit a plan setting out the conditions that will enable them to maintain or expand their lending to the economy and subsequently to produce a monthly progress report.

Since the middle of March the strains in the financial markets have begun to ease. Share prices have risen significantly, although losses are still very large compared with the beginning of 2008, amounting to around 30 per cent in the United Kingdom, 40 per cent in the United States and 45 per cent in the euro area. The risk premiums on corporate bonds continue to reflect the severity of the recession, but they have fallen from the high point of last December: in the US the spreads are around 5 percentage points for BBB-rated securities and around 11.4 points for high-yield securities. On the interbank market the premiums for counterparty and liquidity risk have returned to levels close to those recorded before the collapse of Lehman Brothers; however, while the premiums on CDSs issued by the leading international banks have narrowed considerably, they still reflect a high perception of risk. As of 20 May of this year the yield on ten-year government securities has risen back to 3.2 per cent in the United States, 3.4 per cent in the euro area, 3.6 per cent in the United Kingdom and 1.4 per cent in Japan, partly indicating an attenuation of the flight to safety and presumably also expectations of an increased supply of public securities in connection with the measures to support the financial system and the economy. Strains also abated in response to the Financial Accounting Standards Board's proposal of 17 March to introduce a number of changes that will ease the rules on marking to market. The changes have been approved and will become operational in mid-June. The markets have also welcomed the publication of the details of the PPIP on 23 March and the announcement of the measures adopted by the G20 at the meeting of 2 April.

On the foreign exchange markets, there has been a reversal of the US dollar's slide against the euro, which fell from a peak of $1.6 in the middle of July 2008 to $1.37 on 20 May of this year; this represents an appreciation of about 8 per cent from the beginning of 2008 (Figure 1.2). Since then the dollar has also made a substantial gain (23 per cent) against sterling. These developments are probably due to the sharp increase in demand for liquidity in dollars by financial operators in the US and to the shift in institutional investors' portfolios towards safer and more liquid assets. The dollar has depreciated by 15 per cent against the yen, which has gained strength owing to the early unwinding of carry trades after the narrowing of the interest rate spread on funds in the other main currencies and the sharp increase in market volatility. The dollar and the yen have appreciated by 8 and 22 per cent respectively in nominal effective terms, while sterling has lost 18 per cent and the euro has held virtually stable.

Figure 1.2

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 2009 are based only on the first 20 days of the month. – (2) Right-hand scale. – (3) Left-hand scale. – (4) Indices, January 2007=100.

Financial markets in the emerging countries

Although financial markets in the emerging countries were affected by the turbulence present since the summer of 2007, conditions remained fairly easy during the first eight months of 2008. However, the sudden increase in risk aversion subsequently caused a sharp deceleration in international credit flows. Growth prospects worsened due to the slowing of exports and the fall in commodity prices, leading to a decline in stock market indices. Growing difficulty in obtaining financing abroad caused credit risk premiums on sovereign and private-sector debt to rise to unprecedented levels. At the same time, the currencies of these countries, which had been appreciating against the dollar until mid-year, came under strong downward pressure which the central banks were able to counter only in part.

International capital flows into the main emerging areas, which had continued steadily throughout most of the year, albeit more slowly than in 2007, almost simultaneously dried up from September. While portfolio investment had already begun to flow out in the previous months (first shares and later bonds), in the last quarter of 2008 credit flows were hard hit by the increasing difficulties of the international banking system.

Although all the emerging economies felt the repercussions of the dearth of international credit, the worst hit were the ones with large current account deficits and reliant on bank capital inflows, first and foremost those in central and eastern Europe. In the last four months of 2008 the premiums on sovereign CDSs, a measurement of the cost of hedging credit risk, rose sharply throughout the region, albeit with wide differences from one country to another.

The pressure lifted briefly at the end of October following the international community's decision to intervene in support of Hungary. Tension began to mount once again from the beginning of this year until mid-March. Afterwards, when Romania's request for financial assistance was well-received by the markets and the nine leading European banks reaffirmed their engagement not to change their exposure to the country, CDS premiums declined, although in most countries in the region their levels are still higher than in the first half of September 2008.

The currencies of the countries with floating exchange rates depreciated sharply in the second half of 2008. The Polish zloty, in particular, lost more than 20 per cent against the euro, while the Czech koruna and Hungarian forint weakened considerably. The trend did not let up until after the first months of 2009 and the situation remains extremely volatile.

The large presence of western-owned banks in central and eastern Europe has helped to limit financial instability in the region. Until the last quarter of 2008 these countries experienced smaller outflows of bank funds than other emerging economies such as Russia, where a smaller share of the banking system is in foreign hands.

2. ECONOMIC DEVELOPMENTS AND POLICIES IN THE MAIN COUNTRIES AND AREAS

World economic activity decelerated sharply in 2008 to an average growth rate of 3.2 per cent from 5.2 per cent in 2007. The slowdown affected the advanced economies (which grew by just 0.9 per cent, down from 2.7 per cent) and also the emerging and developing economies (which slowed from 8.3 to 6.1 per cent).

The advanced economies went through two distinct phases during the year. The first, through August, was marked by weakness due to uncertainty over the severity of the financial turmoil and the housing market crisis in some countries. In the second, from September onwards, the turmoil degenerated into outright financial crisis, which was transmitted to the real economy via a reduction in net household wealth, a tightening of credit conditions and a deterioration in the climate of confidence. In the fourth quarter all the advanced economies recorded a sharp fall in output.

The authorities responded, often in coordinated fashion, by adopting support measures above and beyond those designed to restore the soundness of the financial system. The US Federal Reserve, the Bank of Japan and the Bank of England rapidly cut their policy rates to near zero, and the Eurosystem brought its official rate down to 1 per cent at the beginning of May 2009, the lowest level on record. To sustain economic activity, central banks also undertook a series of unconventional measures. Governments enacted massive fiscal stimulus plans.

The emerging economies, which had been relatively immune to the financial crisis in the first part of the year, felt the repercussions starting in September. However, the intensity and mode of transmission of the crisis differed sharply. The countries of central and eastern Europe, including some new European Union members, proved to be highly vulnerable to the sudden contraction in external finance owing to their large current account deficits. The countries of Asia, especially those specializing in export manufacturing for the advanced countries, suffered above all from the fall in foreign demand. Raw materials exporters, such as Russia and some Latin American countries, although they were generally in much sounder economic and financial condition than at the start of the decade, were affected by the collapse of commodities prices.

The four largest emerging economies (China, India, Brazil and Russia) now account for 22 per cent of world GDP at purchasing power parity and 15 per cent at market exchange rates. Their growth was still very strong in the first part of 2008 but slowed sharply in the fourth quarter. The four countries took budget measures to support demand and credit to the private sector; the amounts were very substantial, especially in China and Russia, thanks to the better state of their public finances.

The discretionary fiscal measures taken by the G20 countries, which account for 75 per cent of world GDP at purchasing power parity, amount to about 2 per cent of GDP in 2009 and 1.5 per cent in 2010.

The United States

American GDP expanded by 1.1 per cent in 2008 compared with 2 per cent in 2007 (Table 2.1), but the growth was concentrated in the first half. In the second half the financial crisis curtailed output, which stagnated in the third quarter and fell at an annual rate of 6.3 per cent in the fourth.

Table 2.1

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

	2006	2007	2008	2008				2009
				Q1	Q2	Q3	Q4	Q1
United States								
GDP (1)	2.8	2.0	1.1	0.9	2.8	-0.5	-6.3	-6.1
Domestic demand (1)	2.6	1.4	-0.3	0.1	-0.1	-1.5	-5.9	-7.8
Inflation (2)	3.2	2.9	3.8	4.1	4.4	5.3	1.6	0.0
Japan								
GDP (1)	2.0	2.3	-0.7	3.4	-3.5	-2.5	-14.4	-15.2
Domestic demand (1)	1.2	1.2	-0.9	3.3	-5.7	-2.3	-2.3	-9.8
Inflation (2)	0.2	0.1	1.4	1.0	1.4	2.2	1.0	-0.1
European Union								
GDP (1)	3.1	2.9	0.9	2.2	-0.5	-1.2	-5.9	-9.6
Domestic demand (1)	3.1	3.0	0.9	1.6	-0.9	0.7	-4.1	....
Inflation (2)	2.3	2.4	3.7	3.5	3.9	4.3	2.9	1.6
United Kingdom								
GDP (1)	2.8	3.0	0.7	1.2	-0.1	-2.8	-6.1	-7.3
Domestic demand (1)	2.6	3.5	0.6	0.4	-0.1	-3.1	-8.5	-7.6
Inflation (2)	2.3	2.3	3.6	2.4	3.4	4.8	3.9	3.0
Canada								
GDP (1)	3.1	2.7	0.5	-0.9	0.6	0.9	-3.4	....
Domestic demand (1)	4.8	4.2	2.5	1.8	1.3	0.5	-4.9	....
Inflation (2)	2.0	2.1	2.4	1.8	2.4	3.4	1.9	1.2
Advanced economies								
GDP (4)	3.0	2.7	0.9	....	....	....	....	....
Memorandum item:								
World output (4)	5.1	5.2	3.2	....	....	....	....	....

Sources: European Commission, 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, final domestic demand. – (4) Weighted average, weighted by GDP at purchasing power parity, of the growth rates of the economies included in the aggregate.

Household consumption expanded by just 0.2 per cent (2.8 per cent in 2007). Spending growth was very modest even in the first half of the year, owing partly to great uncertainty, which led households to save most of the one-off tax rebates they received between April and June. Consumption contracted in the second half as a result of the decline in net wealth, the deterioration in the labour market and the decreased availability of credit.

Private non-residential fixed investment increased by 1.6 per cent on average for the year, but in the fourth quarter it fell at an annual rate of 21.7 per cent in response to the sharp deterioration in the prospects for growth and the restriction in the supply of credit. In part, non-financial corporations offset the reduction in bank lending by making substantial bond issues. Overall net financing flows, while remaining positive, diminished sharply in the course of the year. Residential investment, which had begun to contract in 2006, plunged by 20.8 per cent in 2008, worsening the change in GDP by about 1 percentage point.

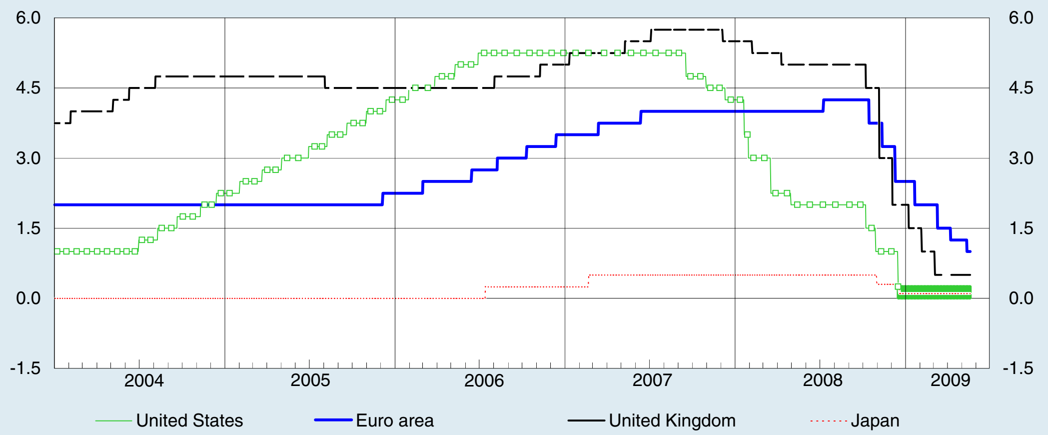
Payroll employment in the non-farm sector decreased overall by 3.1 million in the course of 2008, with nearly 2 million jobs lost in the fourth quarter alone. The unemployment rate rose from 4.9 per cent in January to 7.2 per cent in December.

Preliminary estimates indicate that GDP continued to contract rapidly in the first quarter of 2009 (at an annual rate of 6.1 per cent), owing in part to inventory reduction. The downswing in private non-residential fixed investment and in residential investment gathered momentum. Consumption expanded by 2.2 per cent, driven by the upturn in real available income thanks to the cyclical reduction in taxation and the fall in prices. Payroll employment continued to contract rapidly in the first four months, with a loss of 2.7 million more jobs. In April the unemployment rate rose to 8.9 per cent.

Consumer price inflation broadly reflected trends in raw materials prices during the year, peaking at 5.6 per cent in July and then falling to a rate of 0.1 per cent in December and negative values in the first few months of 2009. The variation in core inflation, net of energy and fresh foods, was much more modest. Ten-year inflation expectations remained unchanged at 2.5 per cent, according to the Philadelphia Federal Reserve's "Survey of Professional Forecasters".

Figure 2.1

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



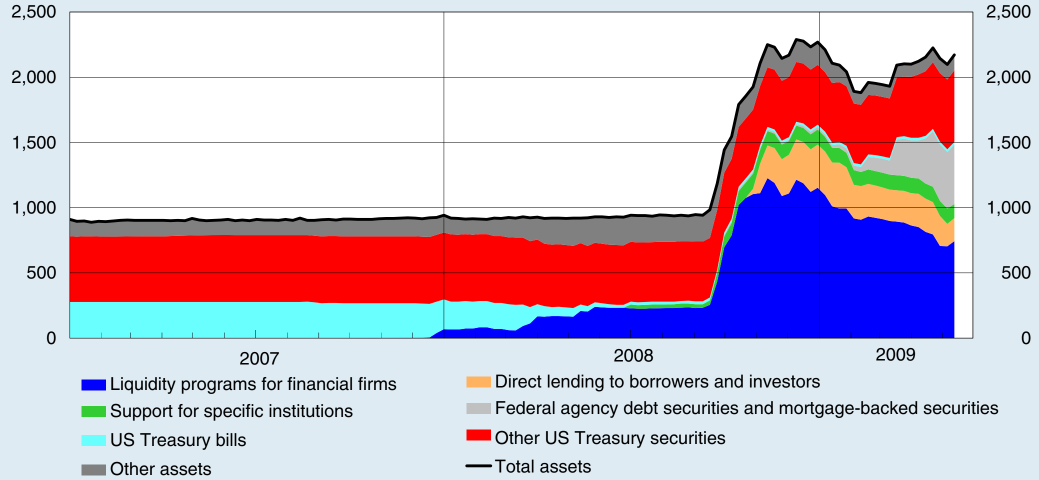
Sources: ECB and national statistics.
(1) For the United States, federal funds target rate; for Japan, target rate on overnight money market funds; for the euro area, interest rate on main refinancing operations; for the United Kingdom, interest rate on commercial banks' reserves with the Bank of England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

The Federal Reserve, which had lowered the federal funds rate from 4.25 to 2.0 per cent in the first four months of 2008, responded to the worsening recession in the last quarter by quickly reducing rates in December, setting a target range for the federal funds rate of 0 to 0.25 per cent (Figure 2.1). The Fed expects cyclical conditions to warrant the maintenance of exceptionally low monetary policy rates for an extended period. In response to this assessment, pronounced repeatedly in the Federal Open Market Committee's press releases, the markets are now discounting unchanged interest rates for all of 2009. From December on, the Fed also announced measures intended to affect the cost of credit to households and firms more directly. In addition to agency mortgage-backed securities, it will buy Treasury securities for up to $300 billion. It is estimated that the announcement and gradual implementation of these measures has already lowered the cost of thirty-year mortgages by about 1 percentage point. Together with the liquidity support programmes they have contributed to a substantial increase in the Federal Reserve's assets. The corresponding entries on the liability side are the sharp increase in banks' reserves and, to a lesser extent, Treasury deposits (Figure 2.2).

Figure 2.2

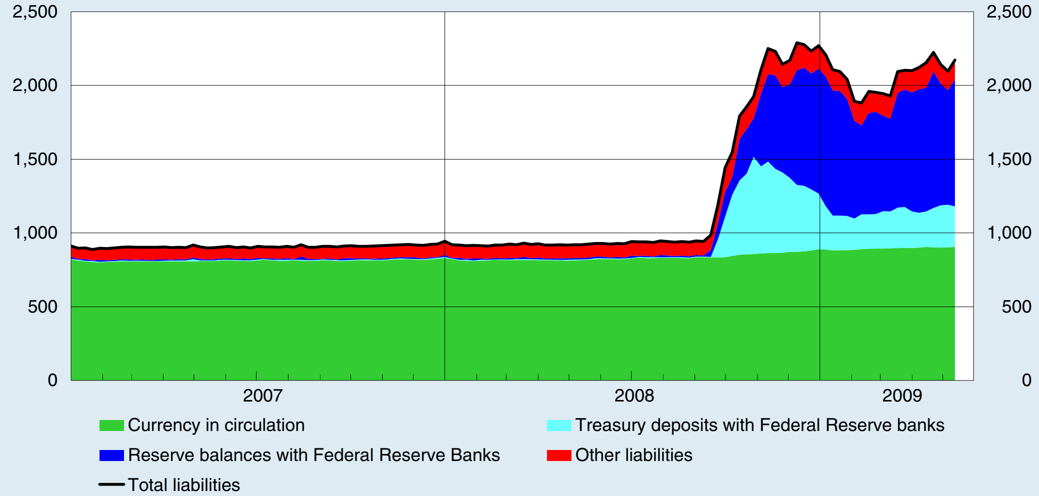
Federal Reserve balance sheet: asset side

(weekly averages; billions of dollars)



Federal Reserve balance sheet: liability side

(weekly averages; billions of dollars)



Source: Federal Reserve.

On 23 March 2009 the Fed and the US Treasury issued a joint press release formally pledging to ensure that the central bank's extraordinary interventions would not jeopardize the ultimate objectives of monetary policy (price stability and maximum sustainable employment). Against this backdrop, in recent months the Supplementary Financing Program whereby the Treasury supplies funds to the Fed has been instituted, and the introduction of new instruments is planned in the months to come in order to allow, as appropriate, the Fed's ready sterilization of the impact of its asset expansion on the growth of bank reserves.

In the 2008 fiscal year, which ended in September, the federal budget deficit rose to 3.2 per cent of GDP, compared with 1.2 per cent in 2007. The outlook for the 2009 and subsequent fiscal years has worsened sharply in recent months, reflecting the recession, government support for the financial system and the approval in February of the American Recovery and Reinvestment Act, a major stimulus package. The Congressional Budget Office estimates that placing the government-sponsored mortgage institutions Fannie Mae and Freddie Mac in conservatorship and implementing the Troubled Asset Relief Program will widen the federal budget by more than $600 billion in 2009 (about 4.5 per cent of GDP). The expansive measures of the American Recovery and Reinvestment Act – around two thirds of it consisting in increases in unemployment benefits, spending on infrastructure, energy saving, public transport, scientific research and the health sector, and grants to state and local government – should increase the deficit by $185 billion this year and about $400 billion in 2010. In the light of these estimates, and not taking the Administration's more recent proposals into account, the CBO forecasts a federal deficit equal to 11.9 per cent of GDP for fiscal 2009 and 7.9 per cent for fiscal 2010.

US federal debt held by the public, whose expansion in recent months has reflected not only the widening budget deficit but also the Treasury's procurement of the resources to finance TARP and provide funds to the Fed, grew by $1.1 trillion between September and April. The CBO estimates that by September 2010 it will have risen to $8,658 billion (60.1 per cent of GDP) from $5,803 billion (40.8 per cent of GDP) in September 2008. The latest estimates of the OECD and the IMF expect gross financial liabilities of general government in the United States to rise to 100 per cent of GDP at the end of 2010, nearly 30 percentage points more than at the end of 2008.

The housing market crisis. – The fall in house prices, which began in 2006, gathered momentum last year. The Case-Shiller index covering the ten main metropolitan areas showed a decline of nearly 20 per cent for the year, nor was there any attenuation in the first two months of 2009; in February the index was 32 per cent below the peak recorded in the first half of 2006. Current prices on Case-Shiller index futures indicate that the downswing is expected to continue throughout 2009. The difference between the observed and the equilibrium price/rent ratio based on the user cost of residential property narrowed sharply towards the end of 2008, indicating a significant attenuation of the overvaluation of houses.

The expectations of a house price decline – together with the diminution in the availability of financing – were a factor in the drastic fall in new home sales in 2008. The ratio of new houses for sale to houses sold remained at historically high levels.

With the fall in house prices, the portion of mortgage holders with negative equity rose to 20 per cent. This, together with the decreased capacity to service the debt due to worsening income prospects, was one of the main factors underlying the increase of foreclosures during the year, mainly in the subprime sector.

In February 2009 the Treasury, estimating the number of households threatened with foreclosure at 6 million, announced a new Homeowner Affordability and Stability Plan. The aim is to help some 7 to 9 million mortgage holders to lower the portion of available income going to repayment instalments. Two mechanisms are envisaged. The conditions for access to refinancing from Fannie Mae and Freddie Mac will be eased, enabling 4-5 million homeowners to renegotiate their mortgages at lower rates. And the design of appropriate economic incentives should enable another 3-4 million to renegotiate with their creditors for a reduction in the debt service burden. If the parties reach an agreement, the Treasury will intervene by taking over part of the residual instalment.

Japan

Japanese GDP declined by 0.7 per cent in 2008. The contraction in economic activity began in the second quarter and intensified in the fourth, when GDP fell at an annual rate of 14.4 per cent, largely because of the exceptional plunge of 47.1 per cent in exports, reflecting the brusque fall in exports of capital goods, digital products and motor vehicles, which account for a large share of Japanese exports.

Economic activity continued to contract in the first quarter of 2009, at an annual rate of 15.2 per cent according to preliminary estimates, as a consequence of falling investment and the collapse of exports (down 70.1 per cent).

For much of 2008 employment was largely unaffected by the trend in economic activity, slipping by just 0.4 per cent year-on-year. In the first few months of 2009 the impact of the recession began to emerge more forcefully, and in March the unemployment rate rose to 4.8 per cent, compared with 4.3 per cent in December.

Consumer price inflation, in response to rising energy prices, rose to 2.3 per cent in July 2008 but then declined rapidly to zero in the early months of 2009 (–0.3 per cent in March). In view of the severe slowdown in economic activity and the emergence of funding problems for firms, the Bank of Japan lowered its policy rate in October and December by a total of 40 basis points, from 0.5 to 0.1 per cent. It also took steps to ease corporate financing difficulties with outright purchases of commercial paper and corporate bonds on the open market.

In the second half of 2008, faced with the worsening recession, the authorities announced a stimulus package consisting mainly of spending increases, amounting to 2 per cent of GDP. In April 2009 this fiscal stimulus was reinforced by measures to sustain employment and to bolster the economy’s growth potential amounting to about 3 per cent of GDP.

The European Union

Growth in the European Union slowed sharply to 0.9 per cent in 2008, from 2.9 per cent in 2007. In the euro area, where GDP began to fall in the second quarter, growth came to 0.8 per cent.

United Kingdom. – British GDP rose by 0.7 per cent in 2008. The growth came mainly in the first quarter, and activity began to slacken in the second owing to a shortage of credit as well as a decline in net wealth. House prices fell by 16 per cent in the course of the year. The real-estate crisis induced a sharp contraction in residential investment, which trimmed GDP growth by about 0.4 percentage points. Businesses' fixed investment stagnated. In the first quarter of 2009, according to preliminary estimates, economic activity diminished significantly (by 7.3 per cent on an annual basis). CPI inflation, which had risen to 5.2 per cent in September, dropped to 2.3 per cent in April 2009.

The Bank of England, which had kept its policy rate at 5 per cent from April to September, lowered it rapidly between then and March 2009 to 0.5 per cent. In order to reinforce the monetary policy impulse, that month the Bank announced its intention to purchase commercial paper, corporate bonds and gilts for a total of £75 billion (around 5 per cent of GDP), financing it by the creation of monetary base. In May the Bank increased its purchasing target to £125 billion and set a three-month deadline for attaining it. As a result of these measures and the provision of liquidity, the Bank's balance-sheet assets more than doubled between mid-September and the end of April. In the 2008-09 fiscal year ending in March, the public sector borrowing requirement increased to 6.3 per cent of GDP (from 2.4 per cent in 2007-08). In the budget presented in April the Treasury projects an increase in the requirement to 12.4 per cent of GDP in 2009-10 (about 1.5 percentage points of which will be due to discretionary stimulus measures), to be followed by a gradual reduction over the next four fiscal years. The borrowing requirement projections do not consider the possible losses due to interventions in support of the financial system, which the Treasury estimates at between 1.5 and 3.5 percentage points of GDP.

The new European Union members. – In the nine new member countries that had not yet adopted the euro in 2008, GDP growth remained strong, on the whole, slowing from 6.2 per cent in 2007 to 4.3 per cent last year (Table 2.2). But in the fourth quarter the drop in demand from the euro area and the deterioration of financial conditions resulted in a sudden slowdown, varying in severity from country to country.

Table 2.2

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

	GDP		Consumer prices (2)		Balance on current account (3)		External debt (3) (4)	Govt. budget balance (3)		Public debt (3)
	2007	2008	2007	2008	2007	2008	2008	2007	2008	2008
Bulgaria	6.2	6.0	7.6	12.0	-22.5	-24.8	114.0	0.1	1.5	14.1
Czech Republic	6.0	3.2	3.0	6.3	-1.5	-3.1	41.8	-0.6	-1.5	29.8
Estonia	6.3	-3.6	6.7	10.6	-18.3	-9.1	131.4	2.7	-3.0	4.8
Hungary	1.2	0.6	7.9	6.0	-6.2	-8.4	157.9	-4.9	-3.4	73.0
Latvia	10.0	-4.6	10.1	15.3	-22.5	-13.6	138.0	-0.4	-4.0	19.5
Lithuania	8.9	3.0	5.8	11.1	-15.1	-12.2	76.2	-1.0	-3.2	15.6
Poland	6.7	4.9	2.6	4.2	-5.1	-5.3	54.7	-1.9	-3.9	47.1
Romania	6.2	7.1	4.9	7.9	-13.5	-12.3	59.1	-2.5	-5.4	13.6
Slovakia	10.4	6.4	1.9	3.9	-5.1	-6.8	59.8	-1.9	-2.2	27.6
Memorandum item:										
Euro area	2.7	0.8	2.1	3.3	0.4	-0.7	….	-0.6	-1.9	69.3

Sources: Based on data from ECB, European Commission, Eurostat, Joint BIS-IMF-OECD-WB External Debt Hub and national statistics.
(1) Including Slovakia, which adopted the euro on 1 January 2009. – (2) Harmonized index of consumer prices. – (3) As a percentage of GDP. – (4) Gross.

The slackening of domestic demand in these countries in the last few months of 2008 and the fall in raw materials prices curbed consumer price inflation, which had been rapid in the first half of the year. The inflation rate rose from 5.6 per cent in 2007 to 8.6 per cent.

The countries with flexible exchange rate regimes (Czech Republic, Hungary, Poland and Romania) adopted a strict monetary policy stance in the first half of 2008 in order to curb the rise in inflation but afterwards had to balance action to sustain economic activity against the need to counter the depreciation of their currencies.

The public finances worsened in 2008 in all nine countries except Bulgaria and Hungary. Generally speaking, policymakers had not taken advantage of the rapid economic growth of previous years to improve the public accounts sufficiently, with a twofold adverse effect. In the short term, there is limited scope for attenuating the impact of the crisis through fiscal stimulus and reinforcing the financial system; and in the medium term, the timetable for adoption of the euro is more uncertain.

The deficit on the current account of the balance of payments was still very large in 2008, around 10 per cent of GDP or more in Bulgaria, Romania, Latvia, Lithuania and Estonia, even though recession had already diminished the deficit in some countries.

In the last few months problems in raising funds on the international markets to finance the current account deficit and maturing external debt have led some countries to ask for international financial assistance.

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

China. – Growth slowed to 9 per cent in 2008, the lowest rate since 2001 (Table 2.3). The deceleration in the first three quarters was due to the restrictive measures taken by the authorities to slow the investment boom, in particular in heavy industry, construction and real-estate services, where expansion was faster than the average. In the fourth quarter the impact of the global crisis was more severe than had been expected, working mainly through the sudden slowdown in exports; the repercussions on the financial system, still not closely integrated with the rest of the world, were quite modest.

Table 2.3

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

	GDP		Consumer prices		Balance on current account (1)		Budget balance (1) (2)	
	2007	2008	2007	2008	2007	2008	2007	2008
China	13.0	9.0	4.8	5.9	10.9	9.8	0.9	-0.3
India	9.3	7.2	6.4	8.3	-1.0	-3.1	-5.2	-8.4
Brazil	5.7	5.1	3.6	5.7	0.1	-1.8	-2.2	-1.5
Russia	8.1	5.6	9.0	14.1	5.9	6.2	6.8	4.3

Sources: IMF and national statistics.
(1) As a percentage of GDP. – (2) General government.

The greatest contribution to GDP growth (4.1 percentage points) again came from domestic investment. That of net exports fell from 2.6 to 0.8 points.

In the fourth quarter, against the backdrop of the worsening outlook for foreign demand and diminishing corporate profitability, investment slowed, especially in real-estate services, low-value-added manufacturing (clothing and textiles) and heavy industry. The negative impact of the export slowdown on growth was partly offset by the decline in imports, especially of intermediate goods.

The contribution of private and public consumption to growth declined from 5.3 percentage points in 2007 to 4.1 in 2008. Household spending proved to be resilient even in the last part of the year, despite the worsening state of the labour market. In the fourth quarter nominal wage growth in the urban areas decelerated, and in the first few months of 2009 the unemployment rate increased, considering both official joblessness and that ascribed to unregistered migrants from rural areas.

Consumer price inflation, after peaking at 8.7 per cent in February, declined sharply owing first to the deceleration in food and energy prices and then to the generalized slackening of demand; since February 2009 it has been slightly negative.

Monetary policy became decisively expansive from September on. The People's Bank of China, after raising the compulsory reserve ratio to 17.5 per cent in August, lowered it to 15 per cent. The reference rate for bank loans was lowered from 7.47 per cent in September to 5.31 per cent in December. As a result of these measures and the suspension of quantitative ceilings on lending to specified sectors, bank credit accelerated to a twelve-month rate of expansion of 30 per cent in March, up from 15 per cent in September.

In November the government announced a massive economic support programme totalling 4 trillion yuan ($580 billion) over the three years 2008-10. Only part of the plan is to be financed by the central government ($173 billion), the rest by local authorities and the largest banks. IMF estimates put the effective amount of new spending under the plan at about $315 billion, to be disbursed over three years: 0.4 per cent of GDP in 2008, 3.2 per cent in 2009 and 2.7 per cent in 2010.

The government also announced additional appropriations for public services and welfare programmes for the most vulnerable groups within the population, including the poorest rural areas. Social service reform is also intended to foster private consumption.

In the first quarter of 2009 Chinese GDP growth came to 6.1 per cent compared with the year-earlier quarter. In April industrial production was up 7.3 per cent over April 2008, and investment accelerated, especially in the sectors enjoying public intervention. Exports continued to contract.

India. – Indian economic growth came to 7.2 per cent in 2008, slower than the 9 per cent average over the previous three years. The fourth quarter saw a sharp slowdown to 5.3 per cent compared with the year-earlier quarter, reflecting the sudden slackening of investment and a drop in exports. The transmission of the crisis was attenuated by the country's still relatively limited international integration.

Inflation rose to a very high twelve-month rate of 12.8 per cent in August based on producer prices but then eased, permitting the Reserve Bank of India to lower its refinance rate by 2.5 percentage points and the reserve ratio by 3.5 points in September.

The consolidation of the public finances begun in 2004 was halted in 2008 as a result of increased current expenditure in the first part of the year, due notably to larger subsidies for purchases of agricultural and energy products. Towards the end of the year and in January the government announced measures to support the economy, centred on a reduction in indirect taxes and an increase in infrastructure spending. The impact on the budget for the fiscal year ending in March 2009 is estimated at 0.6 per cent of GDP.

Brazil. – GDP growth continued at a rapid pace in 2008 (5.1 per cent), even if slightly slower than in 2007. It was led by domestic demand, both consumption (5.4 per cent), thanks to the exceptionally favourable state of the labour market, and investment, which expanded at the fastest rate in over a decade (13.7 per cent).

In the fourth quarter cyclical conditions deteriorated markedly. The fall in the prices of agricultural and metal products, of which Brazil is a net exporter, worsened the terms of trade, while a sudden outflow of foreign capital resulted in a tightening of financial conditions for firms and households. GDP contracted by 3.6 per cent in the quarter, chiefly reflecting the fall in investment.

Inflationary pressures, which had intensified in the first part of 2008, weakened steadily through the rest of the year, and in October the central bank, which has an explicit inflation target, was able to end the monetary tightening initiated during the spring. In January 2009, for the first time in nearly two years, the authorities reduced the official interest rate; this was followed by further cuts in March and April, bringing it to 10.25 per cent compared with 13.75 per cent at the end of October.

In the last few months the Brazilian government has taken measures to support demand, including tax relief for households and firms and a large subsidized loan for investment in the energy sector, while also lending impetus to the infrastructural development plan decided on in 2007. The IMF estimates that the new measures will have a budgetary impact of 0.7 per cent of GDP in the two years 2009 and 2010.

Russia. – The Russian economy grew by 5.6 per cent in 2008, the lowest rate since 2002. GDP growth remained rapid over the first three quarters, but in the fourth the fall in raw materials prices and sizeable outflows of bank capital caused a contraction in economic activity.

Inflation, which had been fueled by the rapid expansion of demand and higher food prices in the first part of the year, remained high at around 14 per cent.

The central bank raised its reference rate from 10 to 13 per cent. Its action became more decisive starting in November, to counter the massive outflow of capital. At the same time the reserve ratio was cut to nearly zero in order to supply liquidity to the banking system. Starting in September the authorities responded to the heavy downward pressure on the ruble with foreign exchange market interventions and a strategy of gradual devaluation.

Russia's external current account surplus remained large, around 6 per cent of GDP, reflecting the rise in oil prices in the first part of the year. However, in the fourth quarter the surplus was halved as a result of the collapse in energy export receipts. The effect on the public finances was substantial. The budget, which ran a surplus of 4.3 per cent of GDP in 2008, is expected to record a large deficit this year.

The government intervened in 2008 with massive measures, worth about 7 per cent of GDP, to support the financial system and credit to the private sector. To increase the liquidity of the banking system, public funds were deposited with the banks and subordinated loans were issued by the leading state development bank, through which a part of the official reserves was also made available to refinance the private sector's foreign currency debt. Economic stimulus measures announced for 2009 total some 4 per cent of GDP, including corporate tax cuts and additional spending.

3. WORLD TRADE AND PAYMENTS BALANCES

World trade in goods and services decelerated sharply in 2008, expanding by only 3.3 per cent, owing to a marked slowdown in the imports of the advanced countries and, in the last quarter, a worldwide reduction in trade.

Trends in raw materials prices changed radically from the first to the second half of the year. Until the summer, upward pressure on oil and other commodities intensified; subsequently, as expectations of a worsening in the global economic outlook gathered strength, prices fell drastically.

In 2008 the US current account deficit narrowed to $673 billion from $731 billion in 2007, even though in the first half the rise in oil prices offset the deficit-reducing effects of the weakening of domestic demand and the depreciation of the dollar. In the face of an expanding surplus of the main oil-exporting countries, which rose to $600 billion, that of the Asian economies was reduced, with the exception of China whose current account surplus rose to $426 billion.

World trade

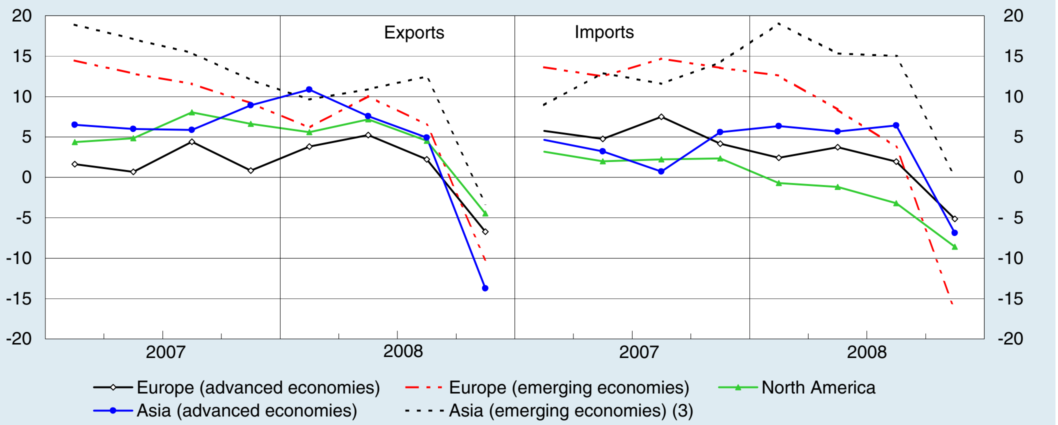
Growth in world trade in goods and services slowed from 7.2 per cent in 2007 to 3.3 per cent in 2008, the lowest since 2001. The imports of the advanced countries had already slowed in the first half of 2008; in the fourth quarter, as the economic and financial crisis intensified, there was a drastic fall in trade flows affecting all the main areas of the world simultaneously (Figure 3.1).

It is estimated that in the fourth quarter of 2008 the global volume of trade in goods fell by around 25 per cent on an annualized basis. As regards exports, the largest reduction came in those Asian countries specialized in producing capital goods and consumer durables which, by their nature, react more quickly to changes in the economic cycle. The sharpest fall in imports was recorded in some of Europe's emerging economies. Provisional data for the first quarter of 2009 show some signs that trade has been more stable since last February. Nevertheless, the fall between November and January will weigh very heavily on the overall results for 2009.

The contraction in trade in the fourth quarter of 2008 was unusually marked, reflecting the extremely sharp fall in economic activity as measured by world industrial production. Another factor was the difficulty, especially after the sharp deterioration of financial conditions last September, in financing trade, particularly for smaller companies working in sectors with low value-added or in countries with less developed banking systems.

Figure 3.1

Growth rates of world trade in goods by volume: main geographical areas (1) (2)
(percentages)



Sources: Based on IMF, the National Bureau of Statistics of China and OECD data.
(1) Growth rates are calculated on the corresponding period of the previous year.– (2) North America: Canada and the United States; Europe (advanced economies): Austria, Belgium, Denmark, France, Germany, Ireland, Italy, Norway, Sweden, Switzerland and the United Kingdom; Europe (emerging economies): Hungary, Poland and Turkey; Asia (advanced economies): Japan and South Korea; Asia (emerging economies): China, India, Indonesia and Thailand. – (3) In the case of China, India and Indonesia, export and import flows by value are deflated with the dollar price index (corresponding period of the previous year = 100) of Chinese exports and imports.

A further element that could weigh on world trade is the risk of protectionist measures in various parts of the world. To date, such initiatives have been fairly reduced in scope, within the limits of the current World Trade Organization rules. Yet, once introduced, protectionist measures are difficult to remove, and their proliferation would be damaging since it would probably trigger reprisals from countries harmed by the restrictions.

Unfortunately, an opportunity was missed last year when the attempt to reach even a provisory and partial agreement failed, thus prolonging the Doha Round multilateral negotiations on trade liberalization.

In order to move forward, governments of the G20 countries must keep to the commitment they solemnly undertook at the April 2009 summit to avoid any measures restricting trade in goods and services or capital movements, especially towards developing countries, before the end of 2010. The decision to strengthen monitoring of the new trade measures and of economic policy actions, assigned to the WTO and the other international institutions and to be carried out quarterly with publicly announced procedures, will increase transparency and thus facilitate this commitment being respected.

Commodities prices

The price of crude oil and that of non-fuel commodities rose by an average of 36.4 per cent and 7.5 per cent respectively in 2008, although there was a dramatic reversal during the course of the year. In the first half of 2008, the prolonged period of rising prices that began in 2002 continued, peaking during the summer, when the prices of oil and metals were respectively about four and three times higher than at the start of the upward trend. The prices of food commodities, less sensitive to the economic cycle, more than doubled under the pressure of structural factors such as the surge in demand for food in developing countries and their increasing use for the production of biofuels.

The last months of rising prices – from end-2007 to mid-2008 – were marked by both an acceleration in dollar prices, in particular of oil, and high price volatility. In the context of slackening consumption in the advanced economies, this may have reflected greater supply-side constraints, which became more stringent after more than five years of strongly increasing demand. Prices may also have been driven up by the easing of monetary conditions in the United States. In the first half of 2008, the fall in US short-term real interest rates accentuated the depreciation of the dollar and caused international investors to adjust their portfolios in favour of financial instruments tied to real assets, including commodities.

In the second half of 2008, as expectations of a sharp deceleration in world economic activity began to consolidate, there was a generalized slump in commodity prices. In the first quarter of this year, world oil consumption was 3.6 per cent lower than in the same period in 2008.

Last September, following a rapid build-up of oil stocks in the industrial countries and the worsening prospects for demand, OPEC decided to reduce supply. After bottoming out at $41.50 a barrel in December, oil prices stabilized in the early months of 2009. Since March there have been signs of a recovery, pushing the price above $55. Reflecting better prospects for global demand, by 20 May the curve for WTI-quality futures, whose spot quotation was around $60, indicated that prices would gradually rise to $64.80 at end-2009 and to $69.40 dollars at end-2010.

Last February the dollar price index for the main metals was almost half the level compared with a year earlier, primarily as a result of the slump in demand for copper and aluminium, the most heavily used metals in the construction and automobile industries. This index has now stabilized. Food prices fell less sharply during the second half of 2008, by around 30 per cent, and recovered slightly in the early months of 2009.

Balance-of-payments disequilibria

In 2008, the US current account deficit was reduced for the second successive year, to 4.7 per cent of GDP, compared with 6.0 per cent in 2006 and 5.3 per cent in 2007. This reflects improvements in the balance on services and on the income account (Table 3.1). For the year as a whole, the trade deficit remained basically unchanged at about $820 billion: the particularly high figure recorded in the first nine months of the year (over $860 on an annualized basis) mainly reflected the rise of about 50 per cent in energy import expenses, which was offset in the last quarter by a sharp decrease due to the drastic fall in oil prices. For the fourth consecutive year, the trend in goods volumes helped to right the trade imbalance: imports fell by 3.4 per cent while exports, despite a sharp fall in the last quarter following the contraction in world trade, grew by more than 6 per cent year-on-year.

Table 3.1

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

	Current account balance (1)						Foreign exchange reserve flows		
	2006		2007		2008		2006	2007	2008 (2)
	billion dollars	% of GDP	billion dollars	% of GDP	billion dollars	% of GDP	billion dollars	billion dollars	billion dollars
United States	**-788.1**	**-6.0**	**-731.2**	**-5.3**	**-673.3**	**-4.7**	**0.8**	**4.7**	**7.1**
Euro area	**-11.9**	**-0.1**	**15.8**	**0.1**	**-137.6**	**-1.0**	**12.3**	**18.6**	**16.5**
Japan	**170.4**	**3.9**	**211.0**	**4.8**	**157.1**	**3.2**	**45.4**	**73.1**	**56.6**
United Kingdom	**-83.1**	**-3.4**	**-80.4**	**-2.8**	**-45.0**	**-1.7**	**2.2**	**8.3**	**-4.6**
Canada	**17.9**	**1.4**	**12.6**	**0.9**	**11.3**	**0.6**	**2.0**	**6.0**	**2.8**
Latin America	**47.7**	**1.5**	**13.4**	**0.4**	**-28.3**	**-0.7**	**55.0**	**134.9**	**51.7**
Asia	**372.5**	**6.2**	**518.0**	**7.1**	**503.8**	**5.9**	**395.2**	**694.5**	**408.9**
Newly industrialized Asian economies	90.0	5.5	103.3	5.7	76.1	4.4	70.4	73.6	1.5
Hong Kong	*22.9*	*12.1*	*25.5*	*12.3*	*30.6*	*14.2*	*8.9*	*19.5*	*29.8*
Singapore	*35.4*	*25.5*	*39.0*	*23.3*	*26.8*	*14.7*	*20.1*	*26.7*	*11.2*
South Korea	*5.4*	*0.6*	*5.9*	*0.6*	*-6.4*	*-0.7*	*28.6*	*23.3*	*-61.0*
Taiwan	*26.3*	*7.2*	*33.0*	*8.6*	*25.0*	*6.4*	*12.9*	*4.2*	*21.4*
ASEAN-4	38.7	4.6	53.8	5.3	39.1	3.3	38.9	62.9	11.2
Indonesia	*10.9*	*3.0*	*10.5*	*2.4*	*0.6*	*0.1*	*8.0*	*13.9*	*-5.4*
Malaysia	*25.5*	*16.3*	*29.2*	*15.6*	*38.7*	*17.4*	*12.3*	*18.9*	*-9.9*
Philippines	*5.3*	*4.5*	*7.1*	*4.9*	*4.2*	*2.5*	*4.1*	*10.2*	*3.0*
Thailand	*2.3*	*1.1*	*14.0*	*5.7*	*-0.2*	*-0.1*	*14.6*	*19.9*	*23.4*
India	-9.5	-1.1	-10.9	-1.0	-37.5	-3.1	38.8	96.3	-19.6
China	253.3	9.5	371.8	10.9	426.1	9.8	247.0	461.8	415.8
Central and Eastern Europe	**-82.5**	**-6.5**	**-122.1**	**-7.7**	**-142.2**	**-7.6**	**47.3**	**59.7**	**-0.6**
Main oil-exporting countries	**484.3**	**12.0**	**456.0**	**9.5**	**600.4**	**10.2**	**212.8**	**320.2**	**-44.3**
OPEC (3)	335.9	19.0	325.2	15.8	430.2	16.2	81.0	134.2	11.8
Algeria	*29.0*	*24.8*	*30.6*	*22.6*	*37.1*	*23.2*	*21.6*	*32.4*	*32.9*
Indonesia	*10.9*	*3.0*	*10.5*	*2.4*	*0.5*	*0.1*	*8.0*	*13.9*	*-5.4*
Iran	*20.4*	*9.2*	*34.1*	*11.9*	*17.8*	*5.2*	….	….	….
Kuwait	*50.6*	*49.8*	*50.0*	*44.7*	*70.6*	*44.7*	*3.7*	*4.1*	*0.4*
Libya	*25.2*	*45.8*	*23.6*	*33.8*	*39.2*	*39.2*	*19.8*	*20.1*	*12.9*
Nigeria	*19.9*	*13.5*	*9.7*	*5.8*	*9.6*	*4.5*	*14.0*	*9.0*	*10.7*
Qatar	*16.1*	*28.3*	*22.0*	*30.9*	*36.1*	*35.3*	*0.8*	*4.0*	*0.2*
Saudi Arabia	*99.6*	*27.9*	*95.8*	*25.1*	*139.0*	*28.9*	*1.0*	*6.2*	*-3.4*
United Arab Emirates	*37.1*	*22.6*	*29.0*	*16.1*	*41.1*	*15.8*	*6.6*	*49.6*	*-45.5*
Venezuela	*27.2*	*14.7*	*20.0*	*8.8*	*39.2*	*12.3*	*5.5*	*-5.2*	*8.9*
Mexico	-4.4	-0.5	-8.2	-0.8	-16.0	-1.5	2.2	10.8	8.0
Norway	58.1	17.2	62.0	15.9	83.8	18.4	9.9	4.0	-9.9
Russia	94.7	9.5	77.0	5.9	102.3	6.2	119.7	171.2	-54.2

Sources: IMF and national statistics.
(1) Due to errors, omissions and differences in international statistics, the world current account balance, instead of being nil, has turned positive (according to IMF estimates, by $176.1 billion in 2006, $243.8 billion in 2007 and $249.5 billion in 2008). – (2) For Nigeria, first nine months. – (3) The OPEC aggregate does not include Angola, Ecuador and Iraq; it includes Indonesia. The flow of foreign exchange reserves does not include Iran.

In 2008, the US deficit was financed by private capital inflows to a much lesser degree than in the preceding four years. In the last quarter, in particular, a significant contribution came from the reduction in residents' external assets, in a context of sharply increasing risk aversion. According to IMF estimates, at the end of 2008 the ratio of the net debtor position to US GDP was much higher than the 12.5 per cent registered a year earlier.

For the Asian economies as a group, the current account surplus fell from $729 billion to $661 billion. This mainly reflects reduced surpluses in Japan and the newly-industrialized Asian countries. By contrast, China's surplus increased, although less quickly than in the previous three years, amounting to $426 billion (9.8 per cent of GDP); it was driven by an increase in the merchandise trade surplus which widened by $30 billion to $296 billion, according to customs data, owing above all to the sharp drop in the value of imports in the fourth quarter, thanks partly to falling energy prices.

The current account surplus of the main oil exporting countries rose sharply in 2008 to $600 billion (10.2 per cent of GDP); the price-induced revenue gains from oil exports were offset to a lesser extent by increased re-spending on imports of consumer and investment goods.

The build-up of foreign exchange reserves by the emerging economies was less than in the preceding years, as a result of the sharp fall in inflows of private capital. Of the economies with current account surpluses, only China increased its reserves significantly, by more than $400 billion, to nearly $2,000 billion at end-2008. In the main OPEC countries, reserves grew by just $12 billion. In Russia, there was a marked fall of more than $50 billion in reserves, reflecting above all large outflows of international capital and the monetary authorities' determination to avoid an excessive weakening of the ruble.

4. REFORM OF THE INTERNATIONAL FINANCIAL SYSTEM

The current crisis has hastened the reform of the international financial system. In November 2008 the Heads of State and Government of the G20 agreed, among other things, to increase the resources of the international financial institutions and to revise their lending instruments in order to meet growing credit demand from countries hit by the crisis; to reactivate the mechanisms for creating international reserve assets; to eliminate distortions and deficiencies in the field of financial regulation and supervision; and to strengthen the mechanisms for discussion among countries within the international financial institutions. In particular, the governance of the IMF and World Bank will be reformed to give more weight and representation to emerging and developing countries.

Increase in the resources and revision of the instruments of the international financial institutions

The demand for IMF financial assistance. – In March 2008, following a prolonged contraction under way since the end of 2003, the stock of IMF non-concessional loans had fallen to a historic low of about 6 billion Special Drawing Rights (SDR), equivalent to €7 billion. In the second half of 2008 and in the first few months of 2009 the worsening of global economic conditions was reflected in a surge of applications from member countries for financial assistance. The IMF approved 19 new credit lines amounting to nearly SDR 100 billion (€115 billion).

Increase in the IMF's lending capacity. – In the light of the increased demand for financial assistance from the IMF, on 2 April of this year the G20 endorsed a tripling, from $250 billion to $750 billion, of the maximum amount of non-concessional loans that the Fund can grant. Besides the quotas of countries with solid balance-of-payment positions, the lending capacity also includes additional resources made available through bilateral loan agreements and the New Arrangements to Borrow (NAB). Nearly half of the amount will initially be made available with bilateral loans, which have been already offered by Japan ($100 billion), the EU countries ($100 billion, contributed on the basis of their respective Fund quotas), Switzerland and Canada ($10 billion each) and Norway ($4.5 billion). Subsequently, these loans will be incorporated into the NAB, extended to new participants and increased with further contributions of up to $250 billion. Recently, the United States committed to finance the increased NAB with up to $100 billion. Lastly, it was decided to bring forward the next General Quota Review to January 2011, so as to ensure that the Fund's resources remain sufficient to meet members' financial needs also in the medium term.

New allocation of Special Drawing Rights. – The G20 pledged to approve a new general allocation of SDR worth $250 billion, of which $100 billion in favour of emerging and developing countries.

Revision of the IMF's lending toolkit. – In response to the worsening of the world economy, the IMF has begun an overhaul of its lending toolkit. The main reforms concern: (a) the conditions that countries must satisfy in order to draw on the Fund's resources (so-called conditionality); (b) the approval of a new facility, the Flexible Credit Line (FCL), and elimination of seldom-used facilities; (c) greater flexibility in the use of the Fund's traditional Stand-by Arrangements; (d) simplification of cost and maturity structures; and (e) the doubling of access limits.

In the past, conditionality consisted in setting up an adjustment programme and conducting periodic reviews of its progress towards given objectives. From now on, instead, the IMF will rely to a greater extent on preventive criteria based on the soundness of underlying economic conditions and the quality of the policies being carried out.

The Flexible Credit Line facility is based on these crisis-prevention criteria. It enables the Fund to disburse, even in the absence of a crisis and for purely precautionary purposes, loans of substantial size for six months or one year to countries with sound economic fundamentals and virtuous policies in place. Once granted, the FCL permits a country to draw the entire amount, possibly all at once, without further conditions. The facility is renewable and, unlike the other ordinary credit lines, does not have access limits. Three member countries – Mexico, Poland and Colombia – have already applied and been approved to use the new instrument. Mexico obtained a credit line of SDR 32 billion ($47 billion), or ten times its Fund quota. Poland and Colombia obtained credit lines of SDR 14 billion and 7 billion ($20 billion and $10 billion) respectively.

The reform has also extended to ordinary loans, with the approval of greater use of the notion of "potential" balance-of-payments need instead of "actual" need, as in traditional stand-by arrangements. In particular, the use of these arrangements on a precautionary basis has been expanded to countries that cannot access the FCL; against this background, credit lines may be granted for substantial amounts and may be drawn upon in instalments or all at once.

The cost and maturity structures for loan repayment have been simplified. In particular, the "time-based repurchase expectations policy", an administrative mechanism intended to induce early repayments, has been replaced by a new time-based surcharge policy, simplifying the repayment schedule.

Lastly, access limits to ordinary resources have been doubled, from 100 to 200 per cent of a country's quota on an annual basis and to 600 per cent on a three-year basis.

Initiatives regarding the Multilateral Development Banks. – To counter the effects of the economic crisis in low-income countries, the G20 decided to strengthen the financing capacity of the Multilateral Development Banks (MDBs) and to encourage the development of new instruments, targeted more closely to those countries' needs and intended to accelerate resource disbursement.

The following are among the measures already or soon to be taken: (a) an increase in planned lending for the three years 2009-11, from $200 billion to $300 billion, 60 per cent of which to be borne by the World Bank; (b) revision of the limits set by the MBDs' articles of agreement on the ratio of lending to own funds; (c) introduction of new instruments such as the World Bank's Vulnerability Financing Facility, aimed at mitigating the impact of the financial crisis and high food prices on the most vulnerable strata of the population, the Inter-American Development Bank's Liquidity Program for Growth Sustainability and the Asian Development Bank's Asian Growth Facility, both designed to buffer the impact of the crisis on banking systems and small and medium-sized enterprises. The G20 also recalled the possibility for World Bank member countries to offer bilateral, voluntary support to the Vulnerability Framework, a diversified set of funds and financing instruments (in part already in existence) to support social assistance, basic infrastructure and the development of the private sector, trade and micro-credit.

To strengthen the MDBs' lending capacity in the medium term as well, the London Summit called for a capital increase at the Asian Development Bank and agreed to reviews of the need for capital increases at the other institutions. To ensure timely implementation of the measures in favour of the poorest countries, it was also decided to front-load the resources of the International Development Association, the World Bank's instrument for grants and concessional financing.

Despite the impact of the crisis on donor countries' budgets, the G20 countries confirmed the commitments made in Monterrey (2002) and Gleneagles (2005) to increase official development assistance. In this connection, the President of the World Bank proposed that in 2009 the developed countries allocate 0.7 per cent of their respective fiscal stimulus packages, or some $15 billion, to the fight against poverty. Preliminary estimates by the Development Assistance Committee of the OECD indicate that global flows of official development assistance grew in real terms by 10.2 per cent in 2008 to a total of $120 billion (0.3 per cent of the donor countries' GDP).

Strengthening the international financial system

The Financial Stability Board. – The G20 decided that the Financial Stability Forum should be expanded and re-established with a stronger institutional basis as the Financial Stability Board (FSB). Participation in the FSB was enlarged to include all the G20 countries, Spain and the European Commission. The FSB's mandate was also broadened significantly. In addition to the tasks assigned to its precursor, the FSB will, among other things, cooperate with the IMF in conducting early warning exercises.

Measures in the field of supervision and financial standards. – The G20 agreed on the need for an effective reform that will strengthen the regulatory framework and supervision of the financial system. In particular, all systemically important financial institutions, markets and instruments will have to be subject to appropriate regulation and supervision. The system of macro-prudential supervision will be improved. Actions will be taken to review banks' minimum capital requirements, improve the quality of capital and harmonize its definition. Standards will have to be developed to promote the creation of capital stocks in excess of the regulatory minima in the expansionary phases of the cycle, to be drawn down when conditions worsen; simple indicators that preclude the possibility of operating with excessive leverage will be introduced. Authorities will also promote the strengthening of liquidity buffers for financial institutions, including cross-border ones. On the issue of executive compensation, the G20 endorsed the principles developed by the Financial Stability Forum to ensure that the compensation systems adopted by major financial institutions are consistent with their long-term goals and prudent risk-taking.

Reform of the structure of representation and governance of the IMF and World Bank. – The G20 endorsed an incisive reform of the governance of the Bretton Woods institutions. The goal is to give greater voice to poor and emerging countries in decision-making, to change the criteria for the selection of top management, and to clarify the division of tasks and responsibilities between the institutions' governing bodies and technical staff. With regard to the IMF, the next general revision of quotas will be moved up to January 2011; the appointment of the Managing Director will be made the outcome of an open, transparent and merit-based process.

The World Bank too has launched a process intended to strengthen the representation of the developing countries. The reform is divided into two phases. The first, already under way, envisages the doubling of basic votes, the assignment of some unallocated shares and the addition of a Board seat for Sub-Saharan Africa. The second phase calls for a revision of the member countries' voting powers according to their relative weight in the world economy and their individual contributions to development financing; it will also tackle some delicate governance issues regarding the effectiveness of the Board's activity, the diversification of World Bank staff by nationality and the procedure for selecting the President. Concrete reform proposals will be discussed at the annual meetings in October 2009; the spring of 2010 is indicated as a deadline for reaching an agreement.

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

5. MACROECONOMIC DEVELOPMENTS

The financial crisis that began during the summer of 2007 impacted on the euro-area economy with increasing severity in the course of 2008, abruptly halting an economic upswing that had been under way for four years.

Since last autumn the situation has deteriorated further. In the first quarter of 2009 industrial production fell to the levels of the end of the 1990s and GDP showed its sharpest quarterly contraction (-2.5 per cent) since official statistics for the euro area first began to be compiled in 1991. Only in recent months have some signs of a possible attenuation of the recessionary momentum emerged. After stabilizing in March at near its all-time low, the €-coin coincident indicator of area-wide GDP growth adjusted for short-term fluctuations improved very slightly in April and May, while remaining substantially negative. The decline in business and household confidence stopped, reflecting slightly less unfavourable short-term expectations.

The fall in world trade in 2008 affected exports and industrial activity, which contracted exceptionally abruptly. Gross fixed investment in instrumental goods decelerated sharply for the year as a whole and fell in the fourth quarter as a consequence of increasing idle capacity, widespread pessimism over the outlook and the reduction in available credit, which the interventions of the monetary authority only attenuated. Investment in construction fell, reversing a five-year expansion.

Consumption again failed to contribute to growth, its stagnation continuing a protracted period of weakness. Only in France did household spending grow appreciably, spurred by a historically robust increase in disposable income; this helped to moderate the slowdown in economic activity.

Driven by higher energy and food prices, inflation rose to a twelve-month rate of 4 per cent in June. It then subsided rapidly in the last part of the year, in response to the sudden reversal in the markets for the main raw materials. In April 2009 the rate fell to 0.6 per cent, the lowest ever recorded in the euro area. Against a backdrop of highly uncertain growth prospects, core inflation held essentially stable, averaging less than 2 per cent in 2008 and falling marginally in early 2009. The risk of a further significant decline in the months to come is not negligible.

The effects of the recession are gradually extending to the labour market. Since January 2008 the unemployment rate in the euro area has risen by around 1.5 percentage points, hitting 8.9 per cent in March 2009, and is expected to continue to rise for the rest of the year.

Economic developments

The gross domestic product of the euro area grew by 0.8 per cent in real terms in 2008, down from 2.7 per cent in 2007 (Table 5.1). This was less than half the growth rate that had been forecast at the start of the year. The slowdown in economic activity, which had begun in the second half of 2007, was dramatically aggravated from the autumn of 2008 onwards as the repercussions of the global economic crisis unfolded in full. In the fourth quarter the drop in output was sharp (-1.6 per cent compared with the third quarter). The main factor was the fall in industrial value added (-5.5 per cent for the quarter, -0.7 per cent for the year as a whole), accompanied by smaller declines in construction (-1.7 per cent) and services (-0.5 per cent); for the entire year these two sectors recorded a 0.7 per cent decline and a 1.5 per cent increase respectively.

Table 5.1

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

	2006	2007	2008	2008				2009
	Year	Year	Year	Q1	Q2	Q3	Q4	Q1
				GDP				
Germany (1)	3.0	2.5	1.3	1.5	-0.5	- 0.5	-2.2	-3.8
France	2.2	2.3	0.4	0.4	-0.4	- 0.2	-1.5	-1.2
Italy (1)	2.0	1.6	-1.0	0.5	-0.6	- 0.8	-2.1	-2.4
Spain	3.9	3.7	….	0.4	0.1	- 0.3	-1.0	-1.9
Euro area (1) (2)	2.9	2.7	0.8	0.6	-0.2	-0.2	-1.6	-2.5
				Imports				
Germany	11.9	5.0	4.0	2.5	-1.4	4.1	-3.6	….
France	5.6	5.4	0.8	1.1	-1.0	0.5	-3.0	-5.3
Italy	5.9	3.8	-4.5	-1.2	-1.1	-0.7	-6.0	….
Spain	10.3	6.2	….	-0.5	0.1	-1.1	-11.9	-10.9
Euro area (2)	8.3	5.4	1.3	1.2	-0.6	1.2	-4.7	….
				Exports				
Germany	12.7	7.5	2.7	2.3	-0.3	-0.2	-7.3	….
France	4.8	2.6	-0.2	2.0	-2.7	0.1	-4.6	-6.0
Italy	6.2	4.6	-3.7	-0.2	-1.0	-2.4	-7.4	….
Spain	6.7	4.9	….	0.2	1.7	0.6	-10.1	-11.9
Euro area (2)	8.4	6.0	1.3	1.5	-0.2	-0.3	- 6.7	….
				Household consumption (3)				
Germany	1.0	- 0.4	-0.1	-0.2	-0.6	0.3	- 0.1	….
France	2.4	2.5	1.0	-0.2	0.1	0.1	0.2	0.2
Italy	1.3	1.2	-0.9	..	-0.9	0.3	-0.8	….
Spain	3.9	3.5	….	0.1	..	-1.0	-1.4	-1.7
Euro area (2)	2.0	1.6	0.5	..	-0.3	0.1	-0.3	….
				Gross fixed investment				
Germany	7.7	4.3	4.4	3.4	-1.4	0.2	-2.7	….
France	4.1	6.5	0.6	1.0	-1.5	-1.0	-2.4	-2.3
Italy	2.9	2.0	-3.0	-0.3	-0.5	-1.8	-6.9	….
Spain	7.1	5.3	….	-0.1	-2.1	-2.2	- 5.2	-4.2
Euro area (2)	5.6	4.4	..	1.0	-1.2	-0.7	-4.0	….
				National demand (4)				
Germany	2.2	1.2	1.8	1.7	-1.0	1.4	-0.1	….
France	2.5	3.1	0.7	0.2	-0.1	0.2	-0.1	….
Italy	2.0	1.3	-1.3	..	-0.7	-0.2	-1.5	….
Spain	5.1	4.2	….	0.2	-0.2	-0.7	-1.9	….
Euro area (2)	2.8	2.4	0.8	0.5	-0.4	0.4	-0.7	….

Sources: Based on national statistics and Eurostat data.
(1) Preliminary estimates for the first quarter of 2009. – (2) The aggregate for the euro area relates to 16 countries. – (3) Consumption of resident households and of non-profit institutions serving households. – (4) Includes changes in stocks and valuables.

The spreading crisis in the main international markets weakened the area's exports, which suffered their worst contraction ever in the fourth quarter (-6.7 per cent from the third quarter, gross of flows within the area). For 2008 as a whole export growth slowed from 6 per cent in 2007 to 1.3 per cent; the deceleration was sharpest in countries where foreign demand had sustained the recent expansion most strongly, such as Germany and Italy; there were also significant export slowdowns in France and Spain. All the main euro-area economies lost world market shares, most notably Germany, partly as a result more unfavourable developments in price competitiveness during the year.

Curbed by the onset of recession, the growth of the area's imports of goods and services slowed to 1.3 per cent.

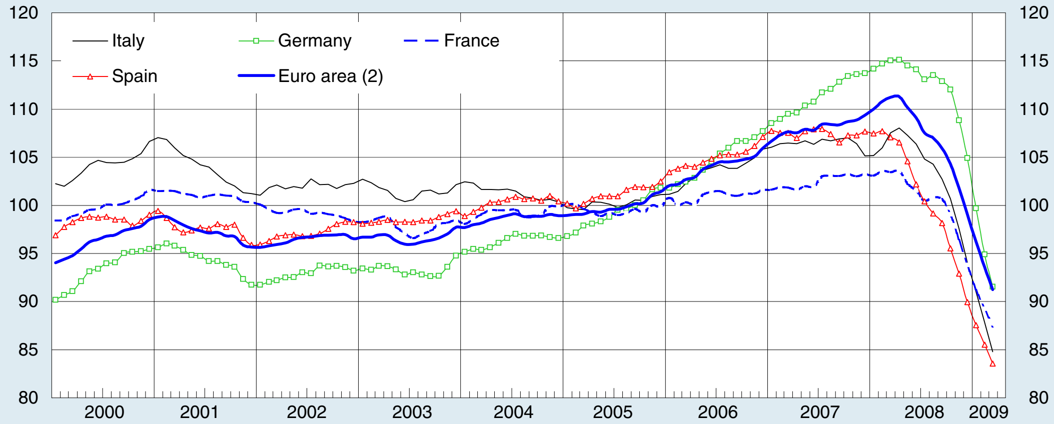
The increase in idle capacity to historical highs and pessimism over future production limited investment in machinery, equipment and transport equipment and intangible assets, which rose by just 0.8 per cent in 2008. The worsening of the recession in the fourth quarter resulted in a sharp fall in investment (-4.6 per cent), perhaps also due to the tightening of credit conditions. After a flurry of activity at the start of the year, concentrated mostly in Germany and favoured by mild weather, the cyclical downturn in construction worsened. For the area as a whole construction investment declined by about 1 per cent, reflecting the fall of 3.4 per cent in residential investment, which was most severe in Spain (-10.9 per cent), putting an end to a series of large annual increases stretching back to 1995.

Consumption recorded a modest increase of 0.5 per cent, even slower than in years past. A major factor was the protracted weakness of households' purchasing power. The rise in nominal incomes, driven by major labour contract renewals in some countries, was largely undercut by the pickup in inflation until the summer months. A second factor was the steady worsening in the climate of confidence among households, which fell below the minimum levels of the early 1990s. Consumers' growing concern about economic developments and the labour market outlook were only partially offset by the reduction in interest rates and the rapid dissipation of inflationary pressures in the last few months of the year. The increased caution in spending was reflected in a rise in the saving rate from 12.8 to 13.1 per cent in 2008, net of changes in households' net pension fund equity. Among the main countries, only France recorded reasonably rapid, if decelerating, growth in consumption at 1 per cent, confirming a characteristic of the French economy found throughout the recent phases of the cycle. A contributing factor was an increase in disposable income, which since the mid-1990s has been growing faster than in the other euro-area economies.

The economy worsened further at the start of this year. Compared with the cyclical peak in the spring of 2008, the volume of industrial production was down by about one fifth in Germany, in France and in the area as a whole and by a quarter in Italy and Spain (Figure 5.1). These unprecedented drops involved practically all parts of industry. According to flash estimates released by Eurostat, area-wide GDP fell by 2.5 per cent in the first quarter; in Germany, Italy and Spain the fall was the sharpest since these data have been collected.

Figure 5.1

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

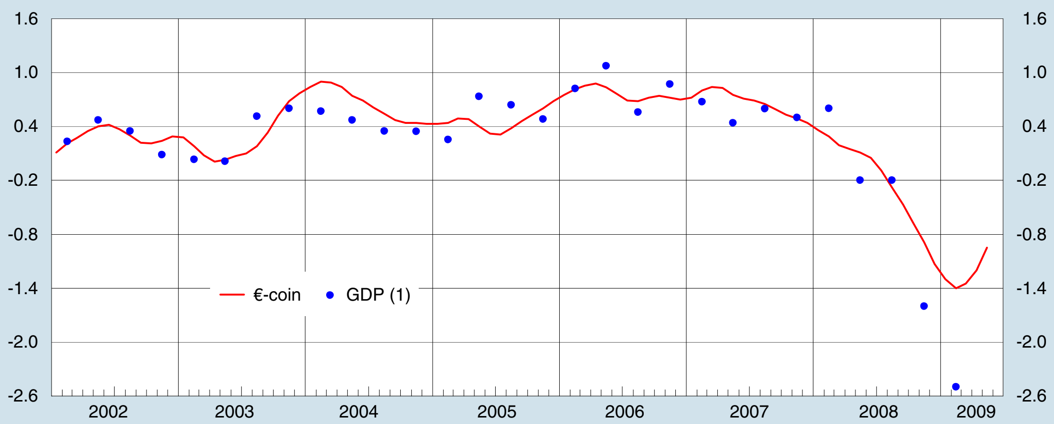


Sources: Based on Istat and Eurostat data.
(1) Indices, 2005=100; seasonally adjusted data. – (2) The aggregate for the euro area relates to 16 countries.

Some qualitative signals indicate a possible moderation in the intensity of the recession in recent months. The €-coin indicator (Figure 5.2), though still substantially negative, turned slightly upwards in April and May. The decline in the confidence of businesses and households stopped.

Figure 5.2

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



Sources: Bank of Italy and Eurostat.
(1) The aggregate for the euro area relates to 16 countries.

Prices and costs

Consumer prices. – Consumer inflation in the euro area rose to a rate of 3.3 per cent on average in 2008, from 2.1 per cent in 2007 (Table 5.2), driven by higher food and energy prices (Figure 5.3). The year saw two distinct phases. The price acceleration under way since the second half of 2007 continued until the summer, peaking at a twelve-month rate of 4 per cent in June. The subsequent fall in the prices of oil and, to a lesser extent, food commodities triggered an abrupt turnaround. The twelve-month increase in the harmonized index of consumer prices recorded an all-time low of 0.6 per cent in April 2009.

Table 5.2

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

	Italy			Germany			France			Spain			Euro area		
	2006	2007	2008	2006	2007	2008	2006	2007	2008	2006	2007	2008	2006	2007	2008
Consumer prices (1)															
General index	2.2	2.0	3.5	1.8	2.3	2.8	1.9	1.6	3.2	3.6	2.8	4.1	2.2	2.1	3.3
Index excluding food and energy products	1.6	1.8	2.2	0.7	1.9	1.3	1.5	1.6	1.8	2.8	2.5	2.4	1.4	1.9	1.8
of which: goods	*1.2*	*1.5*	*1.7*	*0.2*	*1.3*	*0.6*	*0.2*	*0.5*	*0.9*	*1.5*	*0.7*	*0.4*	*0.6*	*1.0*	*0.8*
services	*2.0*	*2.0*	*2.7*	*1.0*	*2.2*	*1.7*	*2.4*	*2.5*	*2.4*	*3.9*	*3.9*	*3.9*	*2.0*	*2.5*	*2.6*
Food products	2.3	3.0	5.2	2.4	3.0	4.3	1.4	1.5	4.8	3.9	4.1	5.7	2.4	2.8	5.1
of which: processed	*2.7*	*2.8*	*6.1*	*2.1*	*3.2*	*5.0*	*0.6*	*1.0*	*5.6*	*3.9*	*3.9*	*7.4*	*2.1*	*2.8*	*6.1*
unprocessed	*1.6*	*3.2*	*3.8*	*3.2*	*2.4*	*2.6*	*2.6*	*2.2*	*3.7*	*3.9*	*4.3*	*3.9*	*2.8*	*3.0*	*3.5*
Energy products	8.0	1.5	10.1	8.4	3.8	9.4	6.4	1.8	10.8	8.0	1.7	11.9	7.7	2.6	10.3
Producer prices (2)	**5.2**	**3.3**	**5.8**	**5.4**	**1.3**	**5.4**	**3.8**	**2.8**	**5.4**	**5.4**	**3.6**	**6.5**	**5.1**	**2.7**	**5.9**
GDP price deflator	**1.8**	**2.4**	**2.8**	**0.5**	**1.9**	**1.5**	**2.5**	**2.5**	**2.2**	**4.0**	**3.2**	**3.1**	**2.0**	**2.3**	**2.3**

Source: Based on Eurostat data.
(1) Harmonized index of consumer prices. – (2) Producer price index for industrial products sold in the domestic market. The aggregate for the euro area relates to 16 countries.

In the first part of 2008 competitive pressures stemming from the rise in the nominal effective exchange rate of the euro, the steady weakening of economic activity, and substantial wage moderation in a framework of inflation expectations anchored to the monetary policy stance all helped to limit the transmission of the raw materials price increases to core inflation (net of food and energy products). The core inflation rate began falling in the autumn, affected increasingly by the slowdown in economic activity. Seasonally adjusted data indicate that the annual rate stabilized in the first few months of 2009 at historically very low levels of around 1 per cent.

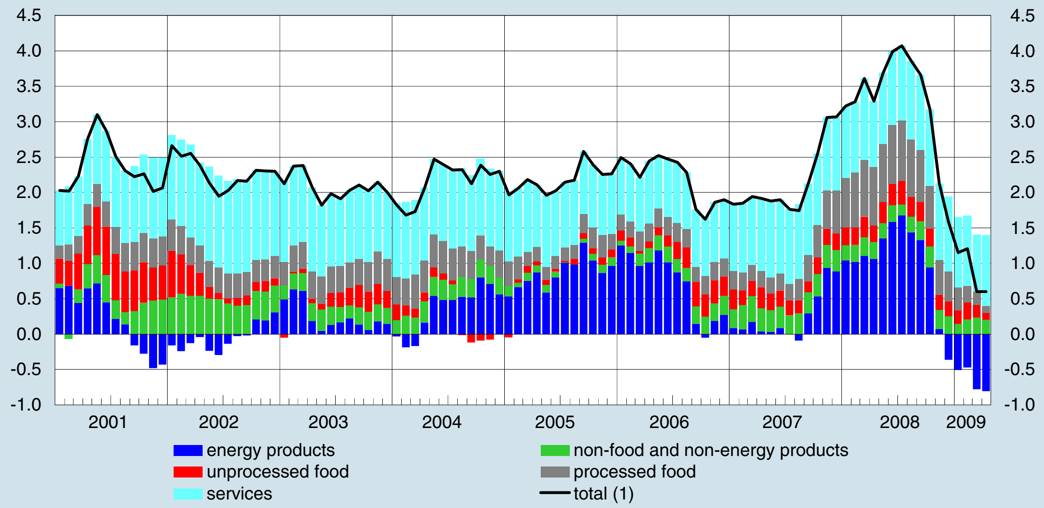
Driven by the past rises in the world prices of grains and oils, the year-on-year increase for food products nearly doubled, from 2.8 per cent in 2007 to 5.1 per cent in 2008, with sharp rises until summer, peaking at a twelve-month rate of 6.1 per cent in July, followed by a steady decline to 1.4 per cent in April 2009.

The surge in world oil prices, offset only in part by the appreciation of the euro, caused the energy component of the index to accelerate to 10.3 per cent year-on-year, up from 2.6 per cent in 2007. The prices of energy products eased sharply starting in August, and over the first four months of 2009 they were 6.8 per cent lower than a year earlier.

The year-on-year rates of increase for services and non-food, non-energy goods in 2008 remained broadly in line with the averages for the last ten years at 2.6 and 0.8 per cent respectively. The fluctuations in the costs of intermediate inputs had a significant impact on the prices of some directly related services, such as air transport and restaurant services.

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. – The producer price index rose by 5.9 per cent on average in 2008, compared with 2.7 per cent in 2007, driven by energy and food prices, which rose by 13.4 and 7.3 per cent respectively. Net of these, producer price inflation held stable at just under 3 per cent.

In the second half of 2008 producer prices reacted immediately to the evaporation of the strains in the world commodities markets. The twelve-month inflation rate declined rapidly, turning negative in early 2009. The rate for final consumption goods held steady through 2008 and fell to 0.5 per cent on average in the first quarter of 2009. The latest manufacturing surveys by the European Commission suggest that in the short term the deceleration should continue, reflecting the low degree of capacity utilization.

Unit labour costs for the entire economy rose by 3 per cent on average in 2008, compared with 1.5 per cent the year before (Table 5.3). The acceleration was due to a slowdown in the growth of output per person employed from 1 to 0.1 per cent and a pickup up in per capita labour costs from 2.5 to 3.1 per cent. The rise in costs was due in part to major contract renewals in public services in Germany and private services in Italy. The result was a loss of competitiveness only partly offset, in the second half, by the nominal effective depreciation of the euro.

The slackening of economic activity led industrial firms, and to a lesser extent service firms, to narrow their profit margins. According to national accounts data, for the euro area as a whole profits' share of value added declined by about 1 percentage point in 2008; in Germany, this was the first such decline in seven years.

The rise in the nominal effective exchange rate of the euro in the first part of the year and the weakening of world demand helped keep the rate of increase in export prices moderate at around 2 per cent, compared with 1.5 per cent in 2007, as against a sharper acceleration in domestic market prices (producer prices net of energy products) from growth of 3.1 to 4.2 per cent. In the fourth quarter, as the global crisis sharpened, there was a marked fall in export prices.

Table 5.3

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

	Labour costs per employee (1)		Labour productivity		of which: Value added (2)		of which: Employment (1)		Unit labour costs	
	2007	2008	2007	2008	2007	2008	2007	2008	2007	2008
Industry excluding construction (3)										
Germany	1.6	1.7	4.0	-1.0	5.2	0.4	1.1	1.4	-2.4	2.7
France	3.1	3.4	2.8	-0.2	1.6	-1.7	-1.2	-1.5	0.3	3.5
Italy	2.8	3.3	0.9	-1.5	1.8	-3.2	0.8	-1.7	1.8	4.8
Spain	3.9	4.6	2.7	-0.8	2.5	-2.0	-0.2	-1.2	1.2	5.4
Euro area (4)	2.8	3.1	3.4	-0.3	3.6	-0.6	0.2	-0.3	-0.5	3.5
Services (5)										
Germany	1.0	2.1	0.2	0.1	2.1	1.6	1.9	1.6	0.8	2.1
France	2.5	2.7	0.3	0.6	2.4	1.4	2.1	0.8	2.2	2.1
Italy	1.8	3.3	0.8	-0.8	1.9	-0.2	1.1	0.6	1.1	4.1
Spain	3.7	5.2	1.0	1.1	4.6	3.1	3.5	2.0	2.7	4.1
Euro area (4)	2.4	3.1	0.6	0.0	2.7	1.5	2.2	1.5	1.9	3.2
Total economy										
Germany	1.1	2.0	1.2	0.0	2.9	1.4	1.7	1.4	0.0	2.0
France	2.6	2.8	0.6	0.3	2.3	0.9	1.7	0.6	1.9	2.5
Italy	2.2	3.3	0.7	-0.8	1.7	-0.9	1.0	-0.1	1.4	4.0
Spain	3.7	5.3	1.1	1.9	4.0	1.3	2.9	-0.6	2.5	3.3
Euro area (4)	2.5	3.1	1.0	0.1	2.9	0.9	1.8	0.8	1.5	3.0

Source: Based on Eurostat data.
(1) For France, Italy and Spain, standard labour units. – (2) Chain-linked volumes. – (3) Manufacturing, mining and quarrying, and electricity generation and distribution. – (4) The aggregate for the euro area relates to 15 countries. – (5) Comprises “wholesale and retail trade, transport and communications”, “financial services and real-estate property” and “other services”.

Inflation expectations. – The inflation expectations for 2009 of the professional forecasters surveyed by Consensus Economics rose steadily until the summer of 2008 and then fell rapidly. In May 2009 they averaged 0.4 per cent. This implies a further fall in inflation during the summer, turning temporarily negative, mainly in connection with the fundamental effects of past trends in energy prices.

So far the five- and ten-year inflation expectations implied by the financial markets have remained at levels which, net of risk premiums, are in line with the Eurosystem’s objective of price stability.

Employment

According to national accounts data, in 2008 the average number of persons in employment in the euro area increased by 0.8 per cent. However, from the summer onwards the labour market was severely affected by the worsening recession, and in the second half there was a fall of 0.2 per cent in employment. The unemployment rate rose steadily from 7.3 per cent in January 2008 to 8.9 per cent in March 2009.

In Germany the cyclical downturn was slow to affect the labour market, and the unemployment rate fell by about 1 percentage point in 2008 to 7.3 per cent. It then turned upwards in the early months of 2009 and reached 7.6 per cent in March. In France employment, measured in standard labour units, expanded in the first part of 2008 before contracting. Year-on-year, employment growth slowed from 1.7 to 0.6 per cent. The unemployment rate has risen by about 2 percentage points in the last fifteen months. In Spain employment decreased in 2008, falling very sharply from the second quarter on. The contraction was worst in construction (a fall of 10.7 per cent in standard labour units), less severe in the rest of industry (-1.2 per cent). In the services sector, employment continued to expand, albeit slowing to 2 per cent from 3.6 per cent in 2007. The overall unemployment rate soared from around 8 per cent in mid-2007 to 17.4 per cent in March 2009.

According to Eurostat, the participation rate for the working age population rose by half a percentage point in 2008 to 66.2 per cent. The rate for women rose from 57.8 to 58.8 per cent, that for men from 73.3 to 73.5 per cent. Though improving, the labour market indicators for the countries of the euro area are still short of the Lisbon Agenda targets for 2010, namely raising the overall participation rate to 70 per cent, that for women to 60 per cent, and that for the population aged 55-64 to 50 per cent.

The balance of payments

The euro area's balance of payments on current account worsened significantly from a surplus of €11.1 billion in 2007 to a deficit of €93.6 billion in 2008 (1 per cent of the area's GDP). About half the deterioration was due to trade in goods, owing chiefly to the rapid rise in raw materials prices; the balance on other items also worsened, notably that on income (Table 5.4). Net inflows on the financial account came to €313.6 billion. Errors and omissions, which since 2002 have been substantial and negative, were again large (-€232.4 billion).

Until the summer, the rise in the raw materials prices resulted in a sharp increase in oil imports by value and a worsening trade balance, which went from a surplus of €46.4 billion in 2007 to approximate balance in 2008. The surplus on services narrowed from €49.2 billion to €41.7 billion, after increasing every year since 2001. The income account, balanced in 2007, recorded a deficit of €32.4 billion in 2008, owing above all to increased outward payments on portfolio liabilities. The deficit on transfers rose from €85.9 billion to €96.8 billion.

The financial turmoil that broke out in 2007 and worsened in 2008 severely curbed cross-border mergers and acquisitions. Real foreign direct investment, which had risen in 2007 to a level exceeded only in 2000, diminished, both outward and above all inward, resulting in an increase in net outflows from €92.5 billion to €251.3 billion.

Table 5.4

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

	2004	2005	2006	2007	2008
Current account	**60.6**	**9.2**	**-10.5**	**11.1**	**-93.6**
Goods	94.3	43.7	12.3	46.4	-6.1
Services	32.0	38.7	43.3	49.2	41.7
Income	-6.3	0.2	13.6	1.4	-32.4
Transfers	-59.5	-73.3	-79.7	-85.9	-96.8
Capital account	**16.5**	**11.4**	**9.2**	**13.7**	**12.4**
Financial account	**-26.2**	**10.2**	**141.4**	**41.2**	**313.6**
Direct investment	-79.6	-205.9	-157.6	-92.5	-251.3
Portfolio investment	72.0	127.1	293.7	159.7	439.2
Financial derivatives	-8.4	-17.3	3.3	-67.0	-30.9
Other investment	-22.6	88.8	2.9	46.0	160.5
of which: monetary financial institutions (2)	*-10.9*	*87.0*	*-27.3*	*86.9*	*-142.3*
Change in official reserves (3)	12.5	17.7	-0.9	-5.1	-3.9
Errors and omissions	**-50.9**	**-30.8**	**-140.2**	**-66.0**	**-232.4**

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.

Portfolio investment was also affected by the financial crisis. For the year as a whole there was net disinvestment in equities by both residents and non-residents, in connection with falling prices on the main stock exchanges and increasing risk aversion, while capital inflows for the purchase of debt securities (four fifths of it public-sector debt) were robust. Given modest outward investment, this produced an increase in net inflows from €159.7 billion to €439.2 billion.

At the end of 2008 the euro area had a net debtor position with respect to the rest of the world of €1,720.9 billion (18.6 per cent of GDP, compared with 13 per cent at the end of 2007). The deterioration reflects the net financial account inflow and, to a lesser extent, value adjustments for changes in market prices and exchange rates.

6. BUDGETARY POLICIES

The cyclical downturn in 2007 and 2008 brought four years of steady improvement in the public finances to an end. In the second half of 2008 the leading euro-area countries began to introduce measures to support aggregate demand, in addition to those to restore stability in the banking and financial system. The expansionary fiscal stance was hampered in the countries whose public accounts had not improved sufficiently before the crisis, at a time of economic growth and rising fiscal revenues. The European Commission expects a further deterioration in budget balances in 2009 in particular and in 2010.

Budgetary policies in 2008. – General government net borrowing in the euro area increased by 1.3 percentage points to 1.9 per cent of GDP (Table 6.1). Between 2003 and 2007 it had instead gradually declined from 3.1 to 0.6 per cent of GDP. According to the stability programme updates submitted in late 2007 and early 2008, the area-wide deficit would increase slightly with respect to the figure estimated for 2007, by just 0.1 points, to 0.9 per cent of GDP. The gap between targets and results was ascribed to much slower economic growth than forecast in the programmes (0.8 against 2.3 per cent) and to discretionary measures to support aggregate demand.

The public accounts deteriorated in most countries. Ireland and Spain went from surpluses of 0.2 and 2.2 per cent of GDP respectively to deficits over the threshold of 3 per cent (7.1 and 3.8 per cent). In both countries the deterioration was caused above all by the contraction in economic activity. In Spain the implementation of tax reductions enacted at the end of 2006 also played a role. The threshold was exceeded by France as well, whose net borrowing rose from 2.7 to 3.4 per cent of GDP, and again by Greece (5 per cent). Germany virtually balanced its budget for the second consecutive year. Only the Netherlands managed an improvement in the public accounts, raising its surplus from 0.3 to 1 per cent of GDP; this was partly due to natural gas prices, which stayed fairly high during a large part of the year.

The area-wide primary surplus declined from 2.3 to 1.1 per cent of GDP. The deterioration was the result of a 0.7 point reduction in revenue to 44.7 per cent of GDP and a 0.6 point rise in primary expenditure to 43.7 per cent. Interest expense was virtually unchanged at 3 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 by 1 percentage point to 2.8 per cent of GDP. The area-wide public debt rose by 3.3 points to 69.3 per cent of GDP, partly as a consequence of measures to support the financial sector.

Stability programmes. – The stability programme updates submitted since October 2008 project that area-wide net borrowing will rise by 1.9 points in 2009, from the 1.6 per cent of GDP estimated for 2008 (Table 6.1) and decline slightly in 2010 as the economic situation improves. In 2011, the last year for which most programmes make projections, the deficit is predicted to be 2.6 per cent of GDP. It should be noted, however, that many of the programmes are based on what now appear to be optimistic macroeconomic scenarios.

Table 6.1

General government net borrowing and debt in the euro area: outturn and forecasts for 2009-10
(as a percentage of GDP)

	Net borrowing				Debt			
	2007	2008	2009	2010	2007	2008	2009	2010
Germany	0.2	0.1	3.9	5.9	65.1	65.9	73.4	78.7
France	2.7	3.4	6.6	7.0	63.8	68.0	79.7	86.0
Italy	1.5	2.7	4.5	4.8	103.5	105.8	113.0	116.1
Spain	-2.2	3.8	8.6	9.8	36.2	39.5	50.8	62.3
Netherlands	-0.3	-1.0	3.4	6.1	45.6	58.2	57.0	63.1
Belgium	0.2	1.2	4.5	6.1	84.0	89.6	95.7	100.9
Austria	0.5	0.4	4.2	5.3	59.4	62.5	70.4	75.2
Greece	3.6	5.0	5.1	5.7	94.8	97.6	103.4	108.0
Finland	-5.2	-4.2	0.8	2.9	35.1	33.4	39.7	45.7
Ireland	-0.2	7.1	12.0	15.6	25.0	43.2	61.2	79.7
Portugal	2.6	2.6	6.5	6.7	63.5	66.4	75.4	81.5
Slovakia	1.9	2.2	4.7	5.4	29.4	27.6	32.2	36.3
Slovenia	-0.5	0.9	5.5	6.5	23.4	22.8	29.3	34.9
Luxembourg	-3.6	-2.6	1.5	2.8	6.9	14.7	16.0	16.4
Cyprus	-3.4	-0.9	1.9	2.6	59.4	49.1	47.5	47.9
Malta	2.2	4.7	3.6	3.2	62.1	64.1	67.0	68.9
Euro area (1)								
European Commission	*0.6*	*1.9*	*5.3*	*6.5*	*66.0*	*69.3*	*77.7*	*83.8*
Stability programmes	–	*1.6*	*3.5*	*3.4*	–	*69.3*	*72.3*	*73.9*
IMF	–	*1.8*	*5.4*	*6.1*	–	*69.1*	*78.9*	*85.0*

Sources: For data on the individual countries, European Commission (*Spring Forecasts*, May 2009). For euro-area averages, European Commission (*Spring Forecasts*, May 2009); based on the updates to national stability programmes and any addenda; IMF (*World Economic Outlook*, April 2009).
(1) Refers to Euro-16.

The EU Commission estimates for 2009-10. – The Commission's May forecasts, based on a substantially less favourable macroeconomic scenario than the stability programmes, indicate an increase in area-wide net borrowing of 3.4 points, to 5.3 per cent of GDP in 2009. The deficit is projected to overshoot the threshold of 3 per cent of GDP in almost all the countries, to widen by more than 4 percentage points in six countries, and to rise by 3.8 points in Germany, 3.2 points in France and 1.8 points in Italy.

Assuming unchanged budgetary policies, the Commission estimates a further increase of 1.2 percentage points in the euro-area deficit for 2010, to 6.5 per cent of

GDP. Under this hypothesis net borrowing would be 3 per cent of GDP or more in all countries.

The area is thus expected to move from a primary surplus of 1.1 per cent of GDP in 2008 to a deficit of 3.3 per cent in 2010: primary expenditure should increase by around 4.1 percentage points of GDP and revenues decline by some 0.3 points. These trends reflect the severity of the recession and the size of the packages of discretionary measures introduced to bolster the economy.

The debt ratio is projected to rise from 69.3 per cent of GDP in 2008 to 83.8 per cent in 2010, ascribable to the large primary deficits, the decline in nominal GDP and the measures to support the financial industry. Very substantial increases will be recorded for Ireland (36.5 points to 79.7 per cent of GDP) and Spain (22.8 points to 62.3 per cent). The debt/GDP ratio is expected to go back over the 100 per cent mark in Greece (108 per cent) and Belgium (100.9 per cent).

The anti-crisis budgetary measures in the leading euro-area countries. – From the second half of 2008 the deepening of the crisis prompted the euro-area countries to introduce expansionary fiscal measures. In December the EU Council approved the European Economic Recovery Plan, which entails measures totalling 1.5 per cent of the Union's GDP, about one fifth of which would come out of the Community budget. According to the estimates released in May by the Commission, the measures taken by the countries of the area will amount overall to 1.1 per cent of GDP in 2009 and 0.8 per cent in 2010.

Spain first intervened to counter the recession in April 2008; the other euro-area countries announced or adopted economic support measures from the end of the same year. There have been substantial differences in the magnitude of the action taken by the leading economies (Germany, France, Italy and Spain). The measures approved by Germany will increase its deficit by around 3.5 percentage points of GDP in 2009-10, divided fairly evenly between the two years. Intervention by France and Spain will concern mainly 2009 and will weigh on the budget balance to the tune of 0.75 and over 2 percentage points of GDP respectively, not including, in the case of Spain, further measures announced in mid-May. According to official estimates the Italian Government's anti-crisis measures will not affect its net borrowing, in consideration of the constraints imposed by the country's large public debt.

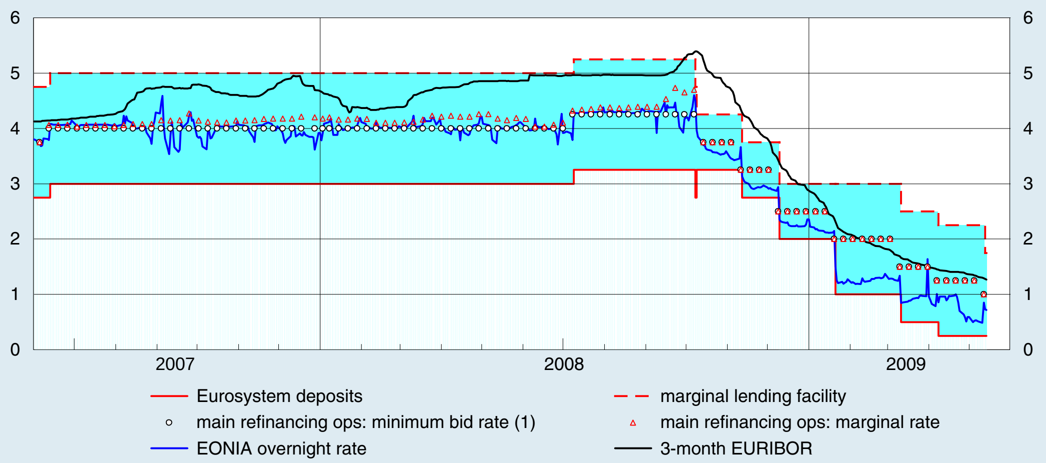
For the long-term sustainability of the public finances it is important that the measures to support the economy be accompanied at the earliest by deficit-reduction plans that rapidly bring each country's public debt back to at least pre-crisis levels. This could be an opportunity to implement structural reforms in line with the Lisbon strategy, to foster economic growth, and to curb the rise in expenditure in the longer run. The latter objective is particularly important given the expected effects of population ageing. The European Commission estimated in April that projected demographic trends will lead to an average increase in public spending of more than 5 percentage points of GDP between 2007 and 2060.

7. THE COMMON MONETARY POLICY

In the first half of 2008, in a context of great uncertainty over the course of the global financial crisis, the Governing Council of the European Central Bank kept its official interest rates unchanged, notwithstanding the inflationary pressures stemming from soaring energy and raw materials prices. At the beginning of July, the Council sought to avert the risk of inflation expectations diverging from levels consistent with price stability by raising the minimum bid rate on main refinancing operations by 25 basis points to 4.25 per cent (Figure 7.1).

Figure 7.1

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



Sources: ECB and Reuters.
(1) Until 14 October 2008, minimum rate; subsequently, fixed rate.

From August onwards the altered world economic outlook triggered an abrupt downturn in raw materials prices and a reduction in inflationary pressures. In September the intensification of the global financial crisis and the consequent heightened volatility in all markets caused a severe deterioration in interbank liquidity conditions, threatening the stability of the financial system. This led to an immediate worsening in the credit conditions for the economy and in the growth outlook and a further decrease in inflationary pressures. Lending to the private sector slowed sharply.

The ECB Governing Council eased monetary conditions considerably. The policy rate was lowered by 0.5 percentage points in October, in a move concerted with the other central banks, and by another 2.75 points over the months that followed, bringing it down to 1 per cent at the beginning of May, the lowest rate ever recorded.

In the autumn the Eurosystem began providing liquidity to the banking system on a totally unprecedented scale in order to keep the money market functioning and credit flowing to the economy. From October operations were conducted via fixed-rate tenders with full allotment, at maturities up to six months. The range of eligible collateral was also extended. At its meeting on 7 May the Governing Council announced that starting in June the Eurosystem would conduct longer-term liquidity-providing refinancing operations with maturities up to 12 months and that it would purchase euro-denominated covered bonds as a further contribution to financing the economy.

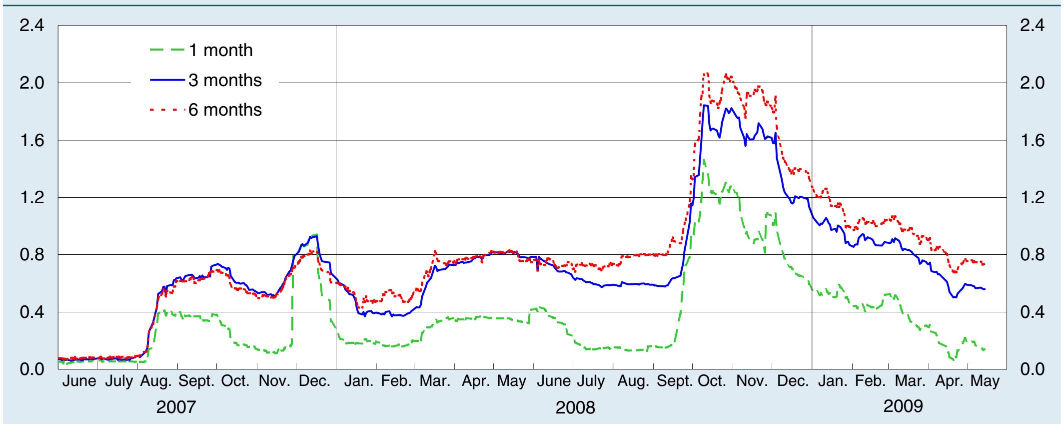
Interest rates and the exchange rate

Short-term rates. – Between January and October money market rates on unsecured loans (Euribor) rose at all maturities (up to 5.4 per cent on three-month funds), reflecting the acute financial tensions (Figure 7.1). After the failure of Lehman Brothers on 15 September, the spreads over secured loans (Eurepo) – a gauge of risk premiums on the interbank market – widened to unprecedented levels, as much as 180 basis points at the three-month maturity (Figure 7.2). They then gradually subsided in the wake of the Eurosystem's extraordinary measures, the reduction in the rates and the announcement by euro-area governments of interventions to support troubled financial institutions (see *Economic Bulletin* No. 50, October 2008). In mid-May 2009 three-month Euribor stood at 1.3 per cent (about 60 basis points higher than Eurepo), in line with the corresponding rates for sterling and just above those in dollars.

Figure 7.2

Spreads between EURIBOR and EUREPO rates by maturity

(daily data; percentage points)



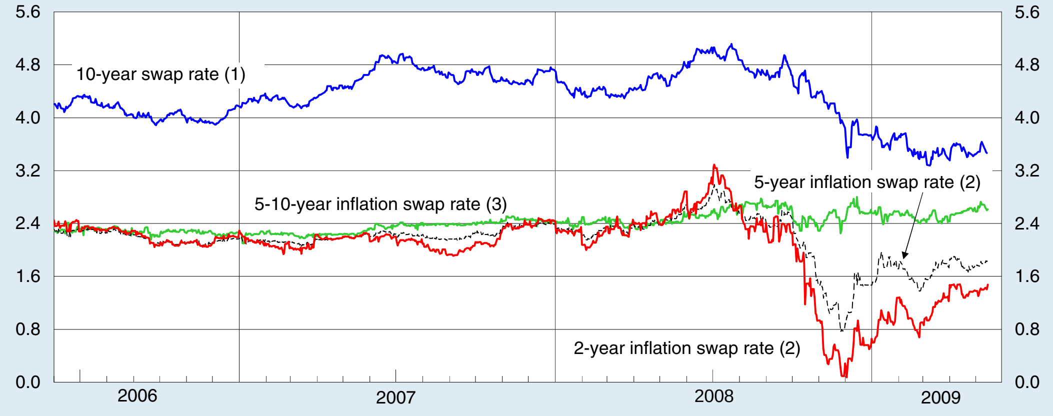
Source: Reuters.

Real short-term rates declined in the first part of 2008 as inflation expectations increased and then turned upwards in the autumn in response to the reversal of those expectations and, to a lesser extent, the widening of interbank risk premiums. The swift reduction in official rates nevertheless allowed real rates to stay low. In mid-May 2009 the real three-month interest rate was 1.2 per cent.

Long-term rates. – Measured on the basis of ten-year swap contracts, long-term interest rates in euros rose to 5 per cent in the first half of 2008 but then fell in response to the sudden worsening of the area's economic outlook, the rapid fall in inflation expectations and the easing of monetary policy. In mid-May 2009 they were down to 3.5 per cent (Figure 7.3). The yields on medium- and long-term government securities in the euro area followed a similar pattern. From October onwards the spreads between the benchmark ten-year bonds of some countries and ten-year German Bunds, which had already widened in the first part of the year, increased further, owing to fears for the future of the public finances and the flight to quality, which favoured German securities with their greater liquidity. The spreads peaked in January and then diminished.

Figure 7.3

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



Sources: Based on Bloomberg and Reuters data.
(1) Yield on ten-year interest rate swap contracts. – (2) Yields on 2-year and 5-year inflation swap contracts for the euro area. – (3) Yield to maturity implicit in 5-year and 10-year inflation swap contracts for the euro area.

Inflation expectations through the medium term, as measured by the yields on euro-area inflation swaps, rose briefly in June before plunging to zero at the end of November for two years forward and to 0.8 per cent for five years forward. They then edged back up to 1.4 per cent in mid-May. However, expectations over a five-to-ten-year horizon, which are less affected by current inflation, held stable at levels which net of risk premiums continue to be consistent with price stability. The Consensus Economics survey and the ECB Survey of Professional Forecasters give similar indications.

The exchange rate of the euro. – The euro appreciated against the dollar in the first part of 2008, owing among others to expectations of a widening interest-rate differential in its favour, as a result of the differing monetary policy stances. This tendency was reversed from the summer onwards as the truly global nature of the economic and financial crisis became apparent and expectations developed that the ECB would therefore ease monetary conditions. Appreciation against sterling, under way since 2007, intensified in the last part of 2008, mainly because of the exceptional slowdown in economic activity and the rapid fall in interest rates in the UK. The nominal effective exchange rate of the euro fluctuated widely in 2008 and early 2009 and in mid-May this year was at about the same level as at the start of 2008. Pronounced uncertainty over the state of the world economy and the deteriorating financial market conditions from the autumn onwards greatly increased exchange market volatility.

Money and credit

The growth in the M3 money supply in the euro area diminished steadily in 2008 and the first three months of 2009 to a twelve-month rate of 5.1 per cent in March 2009 compared with 11.5 per cent in December 2007. The worsening financial crisis significantly affected the aggregate's composition. Investors' increasing liquidity preference and the drastic fall in interbank interest rates resulted in a markedly slower growth of the less liquid instruments; on the other hand, the narrow M1 aggregate returned to expansion after registering zero growth in August. Trends in the monetary instruments held by the various sectors diverged sharply. Households' deposits continued to grow rapidly, while those of non-financial corporations decelerated sharply during the year, reflecting decreased cash flows and confirming the tighter credit conditions.

The growth of bank credit to the private sector slowed considerably during 2008 and the early part of 2009 to a twelve-month rate of 3.2 per cent in March, compared with 11.2 per cent in December 2007 (or 5 and 12.3 per cent net of securitizations). The slowdown was more moderate in the first part of 2008 and then intensified with the aggravation of the financial crisis. Short-term growth in the early months of 2009 was near zero, with annualized quarterly growth of 0.6 per cent in March.

The slowdown in lending to households (the twelve-month rate of increase fell to 1.6 per cent in March 2009), under way since 2007, was most severe for home purchase mortgages. Lending to firms, which was still expanding very rapidly in the first half of 2008, decelerated abruptly in the second half and in early 2009, to a twelve-month increase of 6.3 per cent in March.

Lending to firms and households was affected by demand factors in a context of plunging investment and continued weakening of the real-estate market in a number of euro-area countries, as well as by the tightening of lending conditions, most notably towards the end of the year.

The Eurosystem's Bank Lending Survey found that banks progressively tightened their conditions in the course of 2008 (in particular those for firms, especially the largest ones). In the first part of the year this consisted mainly in raising interest rates; subsequently, it also involved the volume of lending and collateral requirements. The banks reported that the cost of funding and balance-sheet constraints had gained importance as determinants of their more cautious credit policies, in connection with levels of capital adequacy and the capacity to raise funds in the market. As regards credit to households, they reported a reduction in the loan-to-value ratio. The latest Lending Survey found that the tightening of conditions both for firms and for households was attenuated in the first quarter of 2009, and a further easing was forecast for the second quarter. The banks surveyed reported that in the first quarter of 2009 the announcement of recapitalizations and the provision of public guarantees helped to improve funding conditions and to moderate the restriction of credit supply.

The rapid lowering of official interest rates was quickly reflected in bank rates, helping to contain the cost of debt service for households and firms. The cost of short-term credit to firms, including current account overdrafts, diminished by 200 basis points between September and March. The decrease was sharpest for large new loans, presumably granted to the larger firms. The rates on new variable-rate mortgages to households fell by 210 basis points. The fall on fixed-rate mortgages was smaller (80 points) because long-term yields came down less sharply.

Monetary policy operations in the first part of the year

Until the aggravation of the financial strains towards the end of the summer, the ECB used the standard instruments deployed since its foundation to counter the risk that the crisis might paralyse the interbank market and bring about a liquidity crisis. In order to maintain the orderly working of the money market, the volume of longer-term refinancing was increased and the supply of funds was brought forward within the reserve maintenance period. The dollar facility activated in December 2007 was expanded and refinanced. The Eurosystem's interventions kept the strains in the short-term interbank market from becoming too severe (Figure 7.2).

In mid-September, with the failure of Lehman Brothers and the public bail-out of the AIG insurance group, the tensions in the financial markets of the main countries suddenly came to a head. Money market transactions rapidly dried up in a situation of sharply rising counterparty risk premiums among banks (Figure 7.2). There was a growing risk that illiquidity might soon degenerate into systemic crisis.

The unconventional measures

Faced with the drastic deterioration of the economy and serious systemic risk, all the main central banks reacted by lowering their policy rates to near zero and greatly expanding their role as lender on the money market. Given the negligible scope for further interest rate reductions, the need to provide additional stimulus to the economy, to stabilize the financial markets and to facilitate access to credit was served by unconventional monetary policy measures that expanded the balance sheets of central banks and altered their composition.

The particular measures chosen depended on the structure of the financial markets and the differing roles of banks and markets in providing credit to the economy. The Federal Reserve made a number of interventions to ensure the direct provision of credit to final borrowers. Both the Fed and the Bank of England adopted plans to purchase public and private bonds against the creation of money. The Eurosystem concentrated on the banks in order to ensure the continued flow of credit to the economy, in view of their more pre-eminent role in the euro-area than in the other large economies.

In order to sustain access to credit for monetary financial institutions (see *Economic Bulletin* No. 50, October 2008) the ECB held fixed-rate tenders with full allotment. The system was extended to foreign currency refinancing and will remain in place at least until the end of 2009. To ensure the effective expansion of the supply of liquidity, the ECB also broadened the range of eligible collateral for main refinancing operations, lowering the minimum credit rating on securities to BBB-. For asset-backed securities the minimum was kept at A- and raised in January to AAA for new issues. In October the ECB temporarily narrowed the rate corridor on its standing facilities from 200 to 100 basis points around its rate on main financing operations (Figure 7.1) in order to curb the short-run volatility of the Eonia rate.

Thanks to the October measures the average daily volume of liquidity injected by open market operations nearly doubled in the last quarter of the year to over €800 billion, with a slight increase in the portion accounted for by longer-term operations. Between October and January an exceptionally large amount of the liquidity supplied to the system (an average of €210 billion a day) was kept with the Eurosystem's own deposit facility. Reflecting the ample liquidity, the Eonia rate fell regularly below the rate on main refinancing operations. The large-scale recourse to the deposit facility indicated banks' great uncertainty over funding conditions, which induced the precautionary holding of liquidity.

In December, as money market conditions began to improve, the ECB deemed it advisable to reactivate trading and so widened the rate corridor back to 200 basis points as of the January reserve maintenance period. This decision and the gradual easing of the strains reduced the demand for liquidity at the central bank's auctions and marginally increased the volume of interbank market trading, significantly diminishing resort to the deposit facility from an average of €175 billion in the January to €43 billion in the April maintenance period. At the same time the Eonia rate came steadily closer to that on main refinancing operations, the average spread narrowing from 76 basis points in the January maintenance period to 51 points in that beginning in April.

At its meeting in early May, when it lowered the rate on main refinancing operations to 1 per cent, the Governing Council narrowed the corridor to 150 basis points. It also decided that in June it would introduce longer-term refinancing operations with maturities of twelve months and that it would purchase euro-denominated covered bonds, deferring disclosure of the details on this measure to its early June meeting. These interventions are intended to further ease the conditions for the supply of bank credit and provide additional stimulus to the economy.

The measures taken have resulted in an improvement in conditions on the interbank market. Spreads have narrowed, and in May they were lower than before the collapse of Lehman Brothers. The volume of transactions has steadily recovered and the liquidity preference has gradually diminished.

THE ITALIAN ECONOMY

8. DEMAND, SUPPLY AND PRICES

In 2008 economic activity in Italy contracted; from the spring onwards growth turned increasingly negative in real terms and year-on-year GDP fell by 1 per cent. The current recession is likely to be the most severe recorded since the Second World War.

Consumer price inflation reached 4.1 per cent in July, the highest level since the launch of monetary union; it then fell rapidly to around 2 per cent in December, reflecting the exceptional fluctuations in the prices of food and energy products. Last year consumer price inflation averaged 3.3 per cent, as against 1.8 per cent in 2007.

The global nature of the recession has had particularly serious repercussions in countries, such as Italy, Germany and Japan, where exports account for a larger share of aggregate demand. The brusque and substantial drop in Italian exports has added to the problems of industry, which first became apparent in some sectors and then spread to virtually all of manufacturing.

The gap left by the fall in exports has not been filled by domestic demand, whose components have experienced slow growth for several years now.

Gross fixed investment was adversely affected by the decrease in the plant capacity utilization rate, which reached historically high levels, and by firms' pessimism about the global economic outlook. There was a marked decline in purchases of capital goods, partly owing to the widespread uncertainty generated by the intensification of the financial crisis during the last part of the year. Investment in construction contracted, held back in part by the break in the protracted expansionary cycle of the housing sector.

Consumer spending weakened further. The contraction in expenditure on durable goods – a typical feature of all severe crises – was accompanied by a drop in that on non-durable goods. The continuation of the 15-year-long stagnation in households' purchasing power played its part; in 2008 the increase in nominal income was eroded by the rise in inflation. In the final months of the year, growing concern about personal economic prospects, especially developments in the labour market, impaired consumer confidence and strengthened precautionary savings motives.

In the first quarter of 2009, the economic outlook deteriorated further; GDP fell by 2.4 per cent compared with the previous quarter, the steepest drop since statistics began to be collected in 1970. As in the rest of the euro area, in recent weeks several indicators – above all of a qualitative nature – have pointed to an attenuation in the worsening recessionary phase, with signs that the decline in manufacturing activity is slowing.

Since the beginning of 2009 inflation has continued to decrease, reflecting the trends in the energy and food components. In April it stood at 1.2 per cent, the lowest level recorded in the past forty years. Economic agents do not expect a deflationary phase to follow; however, given the uncertainty over the duration of the recession the risk remains that the reductions in prices will spread to the less volatile index components.

Households' consumption

In 2008 Italian households' consumption contracted by 0.9 per cent in real terms (Table 8.1; by 1 per cent excluding residents' expenditure abroad and non-residents' expenditure in Italy), confirming the slower pace of growth in Italy compared with the rest of the euro area since the end of the 1990s. In per capita terms, spending fell to the level recorded at the start of this decade.

Faced with the serious deterioration of the general economic situation and with growing uncertainty over medium-term income prospects, last year households cut back sharply on purchases of durable goods (-7.3 per cent).

Table 8.1

Sources and uses of income

	As a percentage of GDP in 2008 (volumes at previous-year prices)	2007			2008		
		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	–	1.6	2.4	–	-1.0	2.8	–
Imports of goods *fob* and services (1)	28.2	3.8	2.6	-1.1	-4.5	6.9	1.3
of which: goods	*22.4*	*2.4*	*3.1*	*-0.6*	*-5.4*	*8.1*	*1.3*
Uses							
National demand	100.0	1.3	2.0	1.4	-1.3	3.4	-1.3
Consumption of resident households	58.5	1.2	2.2	0.7	-0.9	3.2	-0.5
Consumption of general government and non-profit institutions serving households	20.4	1.0	0.7	0.2	0.6	3.8	0.1
Gross fixed investment	20.8	2.0	2.5	0.4	-3.0	3.2	-0.6
machinery, equipment and transport equipment	*9.1*	*3.1*	*1.6*	*0.3*	*-4.2*	*2.9*	*-0.4*
intangible assets	*0.9*	*3.9*	*0.9*	*..*	*..*	*2.2*	*..*
construction	*10.8*	*1.0*	*3.5*	*0.1*	*-1.8*	*3.6*	*-0.2*
Change in stocks and valuables (2)	–	–	–	..	–	–	-0.3
Exports of goods *fob* and services (3)	28.2	4.6	4.0	1.3	-3.7	5.0	-1.1
of which: goods	*23.0*	*4.9*	*4.7*	*1.1*	*-3.7*	*5.3*	*-0.9*
Net exports	–	–	–	0.2	–	–	0.3

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

Purchases of non-durable goods fell further, by -1.3 per cent. Despite the rapid easing of tensions over the prices of raw materials, the contraction in spending on food products (-2.3 per cent on average in 2008) intensified during the final part of the year. This may reflect the marked impact of the crisis on low-income households, whose propensity to consume is highly concentrated in these product categories.

Expenditure on semi-durable goods also declined, by -1.2 per cent, while that on services grew by just 0.4 per cent.

The general decline in consumption reflects that of disposable income in real terms, which has remained consistently weak for the past 15 years, influencing, perhaps permanently, households' perceptions. The nominal increase of income in 2008 (2.7 per cent; Table 8.2), was entirely eroded by the strong upward pressure on prices, which continued up to the summer. Last year households' purchasing power declined on average by half a percentage point; the contraction is even greater if the effects of the rise in expected inflation on the real value of financial assets are taken into account.

Nominal income was sustained primarily by total wages and salaries (net of employee social security contributions), which grew by 3.7 per cent as in 2007. Given the slowdown – to 0.5 per cent – in standard employee labour units, almost all the increase came from the acceleration in per capita earnings, partly owing to the substantial contract renewals signed at the beginning of 2008. By contrast, self-employed workers' income stagnated, essentially due to the further decline in standard labour units.

Growth in net property income was halved, reflecting, against the backdrop of a pronounced worsening of the economic cycle, the steep decline in dividends and in the other profits distributed by firms (-4.1 per cent, as against an increase of 6 per cent in 2007). Households' net interest inflow grew by 9.6 per cent, compared with 7.3 per cent in 2007. The rise in interest income was accompanied by a marked slowdown in interest expense, which followed the sharp deceleration in loans for house purchases.

Notwithstanding a sharp slowdown, taxes on personal income and wealth continued to grow at a sustained pace; their ratio to household income increased further. Along with social security contributions they subtracted 1.9 percentage points from growth in disposable income at current prices, only partially offset by the slight acceleration in social benefits (1.4 percentage points).

Tumbling financial asset prices and the property prices slowdown cancelled the boost to expenditure provided in the last decade by substantial capital gains. At the end of 2008, household wealth was around eight times gross disposable income; in 2007 it had been about 8.3 per cent.

The greater decline in expenditure compared with income was reflected in the household saving rate, which rose by 0.4 percentage points, to 11.9 per cent (9.2 per cent when measured with reference to income adjusted for expected monetary erosion). As in 2001-02, the increase interrupts a downward trend under way for over twenty years; in the mid-1980s the saving rate stood at around 28 per cent.

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 2008	2006	2007	2008
		Percentage changes		
Earnings net of social contributions charged to workers	42.1	5.6	3.7	3.7
Income from salaried employment per standard labour unit	–	*2.7*	*2.2*	*3.2*
Total social contributions (1)	–	*0.9*	..	..
Standard employee labour units	–	*1.9*	*1.5*	*0.5*
Income from self-employment net of social contributions (2)	21.1	1.4	0.4	..
Income from self-employment per standard labour unit	–	*1.0*	*2.1*	*2.4*
Total social contributions (1)	–	*-0.2*	*-1.3*	*-0.9*
Standard self-employed labour units	–	*0.7*	*-0.4*	*-1.5*
Net property income (3)	26.9	4.8	6.1	3.1
Social benefits and other net transfers	28.0	3.7	4.5	4.6
of which: net social benefits	–	*4.5*	*4.5*	*4.9*
Current taxes on income and wealth (–)	18.1	8.9	7.3	5.0
Households' gross disposable income (4)	**100.0**	**3.4**	**3.2**	**2.7**
in real terms (5)	–	0.7	0.9	-0.5
in real terms, adjusted for expected inflation (5) (6)	–	1.3	0.3	-0.7
in real terms, adjusted for past inflation (5) (7)	–	0.8	0.6	..
Private sector gross disposable income	**–**	**1.5**	**2.9**	**1.8**
in real terms (5)	–	-1.2	0.6	-1.4
in real terms, adjusted for expected inflation (5) (6)	–	-0.9	0.3	-1.4
in real terms, adjusted for past inflation (5) (7)	–	-1.3	0.6	-0.8
		Percentages		
Households' average propensity to save (4) (8)	**–**	**11.7**	**11.5**	**11.9**
calculated on income adjusted for expected inflation	–	9.8	9.0	9.2
calculated on income adjusted for past inflation	–	9.3	8.8	9.6
Private sector average propensity to save (8)	**–**	**23.6**	**23.1**	**22.8**
calculated on income adjusted for expected inflation	–	24.1	23.7	23.3
calculated on income adjusted for past inflation	–	24.2	23.7	23.2

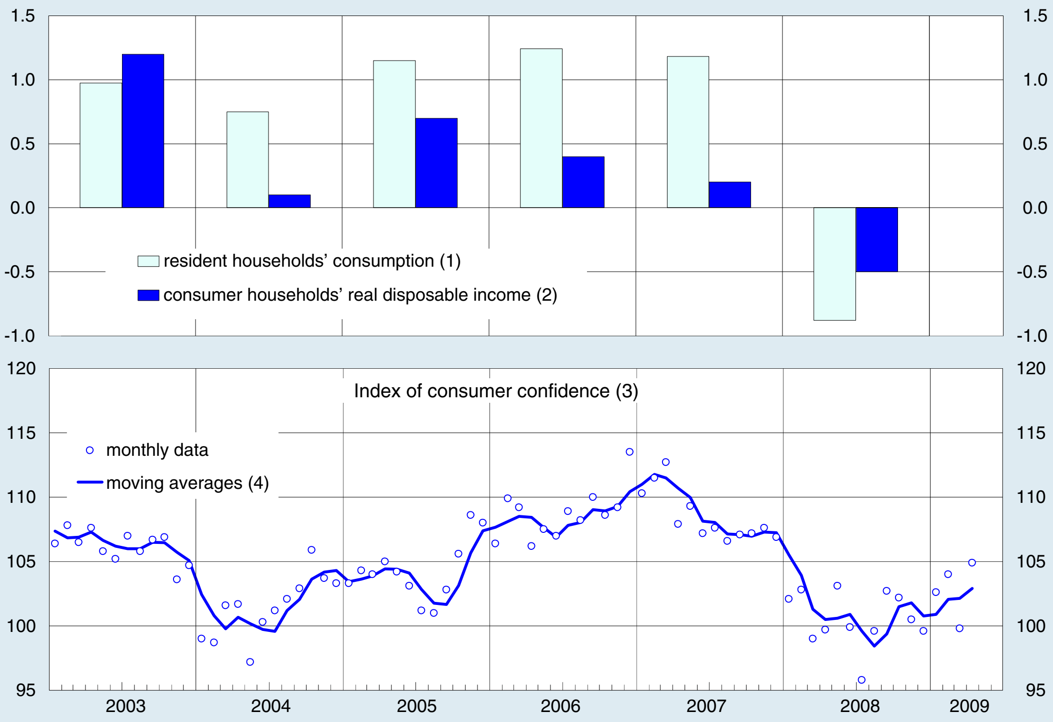
Sources: Based on Bank of Italy and Istat data.
(1) Contribution of social contributions to the change in net income, in percentage points; negative values indicate an increase in social contributions relative to income. – (2) Mixed income and income withdrawn by members of quasi-corporations. – (3) 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 households' consumption deflator. – (6) Gross disposable income net of expected losses on net financial assets due to inflation (estimated on the basis of the Consensus Economics survey). – (7) Gross disposable income net of actual losses on net financial assets owing to inflation. – (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' greater propensity to save reflected stronger precautionary savings motives, which have intensified since last autumn, especially owing to widespread concern over labour market prospects. According to ISAE surveys, in the early months of 2009 the proportion of households expecting unemployment to rise in the short term reached 80 per cent, more than double that of the corresponding period in 2008. This affected the index of consumer confidence, which declined to very low levels, even if still higher than those reported during the other major recessions in the post-war period (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 households' consumption deflator. – (3) Indices, 1980=100; seasonally adjusted data. – (4) For the three months ending in the reference month.

By contrast, the propensity to save in the private sector (households and enterprises) declined slightly, from 23.1 per cent in 2007 to 22.8 per cent (Table 8.2), reflecting the poor performance of firms; if considered for the economy as a whole, the decrease is even more marked (from 20.3 to 18.7 per cent of national income), owing to the considerable deterioration in general government saving.

Investment

In a situation of acute uncertainty over the real effects of the crisis, and growing doubts about the ability of the international economy to return rapidly to a robust growth path, last year gross fixed investment suffered a decline of 3 per cent (Table 8.3), which involved all the main components and above all capital goods. As the year progressed, investment deteriorated rapidly before culminating, in the last quarter, in an exceptional contraction of 6.9 per cent compared with the previous quarter. Overall in 2008 the ratio of investment to GDP declined by 0.4 percentage points to 21 per cent, which was nonetheless in line with the average recorded since the start of this decade. Taking into consideration the lower accumulation of inventories (which in the national accounts include valuables and statistical discrepancies between demand and supply), gross investment contracted by 4.2 per cent.

Table 8.3

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

	Percentage share in 2008 (1) (volumes at previous-year prices)	Percentage change			As a percentage of GDP (1) (volumes at previous-year prices)	
		2006	2007	2008	2000	2008
Construction	52.0	1.0	1.0	-1.8	9.3	10.8
residential	*21.8*	*3.8*	*1.4*	*0.4*	*3.8*	*4.5*
other	*25.4*	*-1.7*	*0.9*	*-2.4*	*4.7*	*5.3*
property transfer costs	*4.7*	*4.0*	*0.4*	*-7.3*	*0.8*	*1.0*
Machinery and equipment	33.9	5.6	3.5	-5.3	7.6	7.1
Transport equipment	9.9	3.2	1.2	-2.1	2.3	2.1
Intangible assets	4.2	4.9	3.9	..	0.9	0.9
Total gross fixed investment	**100.0**	**2.9**	**2.0**	**-3.0**	**20.1**	**20.8**
Total excluding residential buildings	–	2.7	2.2	-3.8	16.4	16.3
Total excluding construction	–	5.0	3.1	-4.2	10.8	10.0
Total net fixed investment (2)	**–**	**5.4**	**2.1**	**-15.8**	**5.6**	**4.7**

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

The sharp decline in economic activity and the rapid decrease in the plant capacity utilization rate, which reached their lowest levels since statistics began to be collected in 1981, coupled with markedly pessimistic expectations about domestic demand and exports, held down spending on machinery, equipment, transport equipment, and intangible assets, which fell by 4.2 per cent. Last year's results were affected primarily by the slowdown in the fourth quarter (-8.9 per cent compared with the previous period), following the widespread uncertainty about international developments that intensified after the collapse of Lehman Brothers, as well as the growing difficulty in obtaining funding connected with the situation in the financial markets.

The contraction of 1.8 per cent in construction investment was concentrated in the non-residential sector, where it fell by 2.4 per cent. During the year the protracted expansionary phase in the real-estate cycle came to a halt. Investment in residential building, which stagnated overall in 2008, fell sharply in the last quarter (-4.9 per cent compared with the previous period). The sector's weakness was confirmed by the volume of housing transactions which, following the record high of 2006, fell for the second consecutive year (-15.1 per cent as against -4.6 per cent in 2007). Probable contributory factors include the gradual tightening of the conditions for taking out mortgages, the worsening outlook for the economy and households' finances.

According to the survey conducted between the months of March and April of this year by the branches of the Bank of Italy on a sample of 3,952 firms with 20 or more workers in industry excluding construction and in private non-financial services, in 2008 the decline in gross fixed investment in real terms was mainly concentrated in the services sector (Table 8.4). Overall, investment in industry showed a slight expansion, driven by firms with 200 workers or more (notwithstanding the scaling back of initial plans), in contrast with the contractions reported in smaller firms.

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 2008 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 2008	*0.3*	*-1.1*	*-5.5*	*4.4*	*4.3*	*-0.6*	*2.2*	*0.9*	*-0.6*
realization rate (4)	*93.4*	*99.0*	*94.6*	*96.4*	*87.1*	*90.0*	*93.7*	*94.1*	*92.3*
plans for 2009	*-22.0*	*-29.5*	*-22.1*	*-23.6*	*-15.3*	*-16.3*	*-23.2*	*-18.6*	*-27.7*
Realized investment in 2008	0.5	-0.9	-4.4	3.1	3.0	0.7	1.1	1.0	-0.5
Realization rate (4)	94.3	99.0	94.7	96.4	91.0	92.5	94.0	95.2	92.4
Plans for 2009	-19.0	-27.5	-21.7	-19.4	-13.2	-13.4	-20.8	-15.6	-26.6
Services (5)									
Realized investment in 2008	-4.7	2.1	-4.0	0.1	-8.1	…	…	-1.8	-8.4
Plans for 2009	-5.1	-15.5	-8.5	-12.0	3.1	…	…	-3.6	-7.4
Total									
Realized investment in 2008	-2.0	0.3	-4.2	2.1	-3.0	0.7	1.1	-0.3	-5.0
Plans for 2009	-12.6	-22.2	-14.8	-16.9	-5.3	-13.4	-20.8	-10.4	-16.6

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 2008. – (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 2007 for 2008, both at current prices. – (5) Private sector non-financial services.

The forecasts for 2009 are decidedly pessimistic. The decline of 18.2 per cent in scheduled investment is exceptional for industry excluding construction (with troughs close to -28 per cent for smaller manufacturing firms and to -24 per cent for those with greater openness to foreign trade); the decline in the services sector is much less pronounced (-4.5 per cent).

Exports and imports

Exports. – The sharp slowdown in international trade was reflected in the decline in exports, depriving the Italian economy of an important source of growth. The contraction, which overall in 2008 reached 3.7 per cent in real terms, worsened in the last quarter (-7.4 per cent compared with the previous quarter), primarily in relation to the goods sector (-8.4 per cent; -3.7 per cent on average in 2008).

From a historical perspective, the most salient features of this economic phase are the global nature of the crisis and the attendant decline in Italian exports. During the main recessionary episodes of the post-war era, Italy's foreign sales had bucked the trend by expanding sharply and contributing to economic recovery (helped by the rapid and robust acceleration in world trade in 1974 and the devaluation of the exchange rate in 1992). Today, instead, the picture for exports is one of sharp decline, and more closely resembles the situation in the 1930s.

In volume terms, Italian exports fared appreciably less well than those of the other main euro-area countries; in value terms, however, Italy is more closely aligned with its European partners (+1.2 per cent). The wide gap between the two measures is the statistical outcome of the sustained pace of the price deflator, which rose by 5 per cent in 2008, over 4 percentage points more than in Germany and 2 percentage points more than in France.

According to the foreign trade data, in 2008 the decline in the volume of merchandise exports (4 per cent; Table 8.5) was almost entirely ascribable to the fall in sales to European Union countries, which account for around 60 per cent of the total. With the sole exception of the food industry, the contraction involved all the manufacturing sectors; traditional products – textiles and clothing, leather and footwear, furniture and wood products – were especially hard hit as was the mechanical engineering industry, affected by the fall in demand for capital goods.

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					
	2007			2008			2007			2008		
	% 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	**60.9**	**4.8**	**4.6**	**58.9**	**4.8**	**-6.3**	**57.7**	**3.8**	**3.1**	**54.6**	**2.5**	**-5.6**
of which: Euro-15	*45.5*	*4.7*	*4.3*	*43.9*	*5.2*	*-7.1*	*46.4*	*3.5*	*3.1*	*43.7*	*2.4*	*-6.0*
France	*11.5*	*4.5*	*3.1*	*11.3*	*4.9*	*-5.1*	*9.1*	*3.5*	*1.2*	*8.6*	*3.8*	*-6.5*
Germany	*13.0*	*4.7*	*3.0*	*12.9*	*3.6*	*-2.9*	*17.1*	*2.6*	*5.8*	*16.1*	*1.4*	*-4.6*
Spain	*7.5*	*4.7*	*7.5*	*6.6*	*7.4*	*-17.1*	*4.3*	*5.8*	*3.7*	*4.0*	*1.4*	*-7.9*
UK	*5.8*	*4.5*	*1.1*	*5.3*	*2.2*	*-9.6*	*3.4*	*5.6*	*-5.1*	*3.0*	*2.6*	*-9.5*
Non-EU countries	**39.1**	**4.8**	**5.5**	**41.1**	**6.9**	**-0.3**	**42.3**	**2.1**	**3.5**	**45.4**	**16.1**	**-5.5**
of which: China	*1.7*	*5.7*	*4.9*	*1.7*	*4.2*	*-1.3*	*5.8*	*3.6*	*16.8*	*6.2*	*6.7*	*2.0*
DAEs (3)	*2.7*	*4.7*	*-1.4*	*2.7*	*3.1*	*-1.7*	*2.3*	*4.3*	*-5.9*	*2.1*	*1.5*	*-8.1*
Japan	*1.2*	*5.1*	*-8.6*	*1.2*	*5.2*	*-6.2*	*1.4*	*1.3*	*-3.0*	*1.3*	*1.0*	*-7.0*
Russia	*2.6*	*5.7*	*18.5*	*2.8*	*5.9*	*3.7*	*3.9*	*-1.1*	*8.8*	*4.2*	*30.4*	*-15.3*
US	*6.6*	*1.4*	*-2.6*	*6.2*	*6.4*	*-10.6*	*2.9*	*3.6*	*-1.6*	*3.1*	*5.7*	*2.7*
Total	**100.0**	**4.8**	**5.0**	**100.0**	**5.7**	**-4.0**	**100.0**	**3.0**	**3.3**	**100.0**	**9.0**	**-6.2**

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 2008 are calculated on the basis of data deflated for AUVs. – (3) Dynamic Asian economies: Hong Kong, Malaysia, Singapore, South Korea, Taiwan and Thailand.

At current prices Italian exports' share of world markets declined from 3.6 per cent in 2007 to 3.4 per cent, as exports lagged behind global demand. This was partly due to the failure, as in the other main euro-area countries, to recoup the heavy losses in competitiveness accumulated since the start of this decade.

Imports. – According to national accounts data, in 2008 imports of goods and services fell by 4.5 per cent in real terms (-5.4 per cent for goods; -0.8 per cent for services).

According to the foreign trade indices, imports of goods declined by 6.2 per cent in real terms; this was mainly due to slackening investment. In fact investment and exports are the two components of demand with the highest share of imported goods. Among the main categories of goods, transport machinery was worst hit. Imports from China slowed sharply, to grow by 2 per cent in volume terms, down from approximately 18 per cent on average since the beginning of the decade; however, in view of the slower trend of imports overall, their share of the total grew further, to over 6 per cent at current prices.

Supply

In 2008 the shrinking of GDP in Italy prompted a further widening of the growth differential compared with the rest of the euro area, to more than 16 percentage points since 1996.

As the year progressed, the decline in output accelerated sharply, in step with the growing tensions in international markets. The deterioration was mostly ascribable to industry excluding construction, which suffered the most severe effects of the drastic slide in demand, and in the foreign component especially. On average last year industrial value added fell by 3.2 per cent, halting the recovery under way since mid-2005. The decline in construction was less marked (-1.2 per cent) while the services sector basically stagnated (-0.3 per cent); only agriculture showed an increase (2.4 per cent).

Industry excluding construction was again the sector most sensitive to the negative shocks of the economic cycle: the fall in value added in 2008 already exceeds the decline of 2.8 per cent accumulated in the severe recession of 1992-93; taking account of the forecasts for 2009, the current reduction appears even more serious than that which occurred in 1975 (-5.6 per cent). So far the services sector, which last year limited the negative effects to a marked deceleration, has – as in the other major crises during the post-war period – reported the softest cyclical landing. History teaches us that the construction sector is the slowest one to exit a recessionary phase: the slumps of 1975 and 1992 lasted three years (-6.1 and -11.6 per cent in cumulative terms); the time it took to return to pre-crisis levels, 6 and 11 years respectively, can be compared with the two years required on average for industry to recover.

In 2008 the reductions in value added in business services provided to enterprises, transport services, insurance, and above all, wholesale and retail trade, were offset by the – albeit slowing – growth in financial intermediation services, real estate services and communications.

By contrast, the recession affected virtually all of industry excluding construction. The sectors that had contributed most to the latest expansionary phase, thanks to their strong export performance (basic metals and metal products, mechanical machinery and equipment, electrical and electronic equipment, and transport equipment) recorded a sharp drop, particularly in the last part of the year, adding to the list of those already lagging behind since 2007 (chemicals and synthetic fibres, paper products and publishing, and wood products). The shift towards higher-quality products continued among the sectors of traditional specialization, as signalled by the ongoing expansion of the clothing sector – one of the few to go against the downward trend, unlike the persistent decline in textiles and leather products.

In the first quarter of 2009 the general economic outlook continued to worsen. Domestic and foreign orders diminished further and business confidence declined close to the historically low levels of 1975; households remained basically pessimistic. The drop in industrial production, to the levels recorded 15 years ago, was reflected in GDP growth, which, according to the flash estimates published by Istat, fell by 2.4 per cent compared with the previous quarter.

A number of more recent indicators, whose significance and duration will have to be assessed carefully in the coming months, presage a possible attenuation of the recessionary phase.

Prices and costs

Consumer prices. – Consumer price inflation in Italy, as measured by the index of consumer prices for the entire resident population, rose in the first part of 2008, reaching a maximum of 4.1 per cent in July, propelled by the surges in food and energy prices; it then declined abruptly, mainly reflecting the sudden fall in oil prices, before reaching 1.2 per cent in April 2009, the lowest level in the past 40 years. Last year the average increase in consumer prices rose to 3.3 per cent from 1.8 per cent in 2007 (3.5 per cent based on the harmonized index; Table 8.6). Excluding the more volatile components, inflation rose by half a percentage point, to 2.1 per cent, driven in the first part of the year by the acceleration in air transport and restaurant services, sectors that are more closely related to raw materials.

The increase in the prices of food products peaked last summer, reaching a twelve-month rate of approximately 6 per cent; it then declined on average to 3.3 per cent in the first four months of 2009, reacting with a few months' delay to the international trends in the prices of the main related raw materials.

Following last summer's spikes, fuel prices have fallen rapidly since the end of 2008; those of electricity and gas reacted to trends in oil prices with the customary time lag, owing to the mechanism for updating prices applied by the competent Authority.

Since the second half of 2008 inflationary pressures have subsided at a slower pace in Italy than in the euro area as a whole: despite falling to 1.3 per cent, on average in the first four months of 2009 harmonized consumer price inflation in Italy was four decimal points higher than in the euro area. This gap may be explained both by the slower reaction of the prices of processed food products to movements in raw materials, and the lower share of energy products in the commodity basket, which favours a broadening of the inflation differential with respect to the rest of the euro area in periods when oil prices are falling.

Table 8.6

Consumer prices

	Percentage changes on previous year		Percentage weights	Contributions to average inflation (percentage points)
	2007	2008	2008	2008
Index of consumer prices for the entire resident population	**1.8**	**3.3**	**100**	**3.3**
Overall index net of food and energy	1.6	2.1	72.4	1.5
Unregulated goods and services	2.1	3.5	82.3	2.9
Unprocessed food	3.4	4.5	7.0	0.3
of which: milk	*2.5*	*9.4*	*0.7*	*0.1*
meat	*3.3*	*3.7*	*3.9*	*0.1*
Processed food	2.4	5.9	10.8	0.6
of which: bread	*5.7*	*10.2*	*1.4*	*0.1*
pasta and rice	*3.7*	*18.4*	*0.7*	*0.1*
milk products	*2.3*	*7.7*	*1.8*	*0.1*
Non-food and non-energy products	1.2	1.4	27.4	0.4
Services	2.6	3.3	32.5	1.1
of which: air transport	*-4.4*	*17.0*	*0.6*	*0.1*
Energy products	0.6	10.6	4.7	0.5
Regulated goods and services	0.6	2.5	17.7	0.4
Public services and utilities	0.9	4.2	10.0	0.4
of which: gas	*0.1*	*9.7*	*2.0*	*0.2*
electricity	*4.8*	*9.7*	*1.2*	*0.1*
Harmonized consumer price index	**2.0**	**3.5**	–	–

Source: Based on Istat data.

The price hikes in essential goods during 2008 weighed more heavily on the purchasing power of the most vulnerable sectors of society, for whom these products represent a larger share of their consumption basket.

In the last quarter of 2008 the national consumer price index recorded the sharpest average reduction seen in the last 40 years, of around half a percentage point compared with the third quarter. However, an analysis of the basic items included in the index continues to show no signs of the beginning of a deflationary phase. There remains, however, the risk of further and more widespread declines, deriving from a possible gradual deterioration in labour market conditions and low rates of plant capacity utilization.

The persistence of oil prices at much lower levels than those in the first part of last year is expected to maintain the twelve-month variation of prices on a downward course until the autumn; in particular, professional forecasters expect inflation to turn temporarily negative during the summer months, before picking up again in the final part of the year.

Producer prices and costs. – In 2008 the twelve-month rate of increase in producer prices of industrial products destined for the domestic market almost doubled, to 5.8

per cent, driven by the acceleration in the first part of the year of the energy and food components, which together make up around one third of the index basket. In the upstream production phases inflationary pressures were curtailed by the slowdown, connected with the deteriorating cyclical conditions, in the prices of non-food and non-energy products for final consumption (from 1.3 per cent in 2007 to 0.4 per cent).

In the first months of 2009, the twelve-month variation in producer prices of products for the domestic market turned strongly negative, averaging -3.2 per cent in the first quarter, following the intensification of the decline in the intermediate components. The conclusions that can be drawn from the latest ISAE surveys on manufacturing and mining and quarrying enterprises suggest this trend will continue in the months with come.

Unit labour costs in the economy as a whole accelerated in 2008, to 4 per cent from 1.4 per cent in 2007. This was due both to the cyclical decline in labour output, which was especially pronounced in industry, and to the acceleration in earnings, which was more marked in the services sector, in part owing to one-off payments made at the start of the year connected with delays in contract renewals. Industry profit margins fell sharply, in contrast with the substantial stability of the services sector.

Inflation expectations. – Analysts surveyed last May by Consensus Economics expect inflation to decline considerably in 2009, to 0.8 per cent on average. At the present time, fears of a deflationary phase are not widespread: in 2010 inflation is expected to increase progressively, reaching a twelve-month average of 1.6 per cent. The expectations of firms in respect of their own selling prices, as reported in the most recent survey conducted by the Bank of Italy in collaboration with *Il Sole 24 Ore*, point to a very sluggish rate of increase for the next twelve months. Likely contributory factors include weak demand and, for industrial enterprises especially, trends in raw materials prices.

9. THE LABOUR MARKET

As the effects of the crisis began to emerge last year, employment growth virtually halted and labour input to the economy – measured in terms of full-time equivalent workers or man-hours worked – diminished. The decline in hours worked was due in part to the further growth of part-time employment and, starting in the autumn, ample recourse to the Wage Supplementation Fund. Earnings per standard payroll labour unit accelerated, following the renewal of many public and private wage agreements. Given the simultaneous rise in inflation, however, purchasing power was unchanged from 2007. This year the slowdown in consumer prices should be greater than that in nominal wages.

Stagnating demand for labour and expanding supply resulted in the first rise in the unemployment rate since it began falling in 1998. In the early months of 2009 the number of Wage Supplementation benefit hours increased further. Firms forecast staff downsizing in 2009 – large firms mainly through hiring freezes and the non-renewal of expiring temporary employment contracts, smaller ones to a greater extent through dismissals. The OECD estimates that the unemployment rate in Italy could rise from 6.7 per cent in 2008 to 9.2 per cent this year.

As the crisis worsened, the central and regional governments temporarily extended the coverage of unemployment benefits and wage supplementation and increased the resources allocated, which are low by international standards. Italy's system of income support for people losing jobs remains fragmented, reflecting the historical genesis of the various component programmes. Protection is consequently segmented by sector, firm size and type of employment contract, and the system is ineffective in fostering mobility between jobs and sectors. Italy remains one of the few developed countries still lacking an income support programme for persons excluded from the labour market. The Government has presented a "white paper" for the reform and rationalization of social policies.

Employment and labour input in 2008 and 2009

The number of persons employed according to the national accounts definition, which includes unreported workers and non-residents, continued to increase in 2008 (by 0.3 per cent), but much more slowly than the 1.2 per cent growth of 2007 (Figure 9.1). The effect of the recession consisted above all in a reduction in labour input; standard labour units diminished by 0.1 per cent and total hours worked by 0.5 per cent (Table 9.1). In the course of the year the economy swung from 0.5 per cent twelve-month growth in hours worked in the first half to a decline of 1.4 per cent in the second.

Table 9.1

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

	Total				Employees				Total hours worked	
	Per cent		Percentage change		Per cent		Percentage change		Percentage change	
	1998	2008	2008/ 1998	2008/ 2007	1998	2008	2008/ 1998	2008/ 2007	2008/ 1998	2008/ 2007
Agriculture, forestry, fishing	**6.9**	**5.2**	**-18.3**	**-2.1**	**3.2**	**2.7**	**-2.8**	**-1.8**	**-16.4**	**-2.8**
Industry excl. construction	**22.6**	**20.0**	**-3.3**	**-1.7**	**27.1**	**23.3**	**-2.4**	**-1.5**	**-5.8**	**-2.7**
of which: manufacturing	*21.7*	*19.3*	*-2.9*	*-1.7*	*26.0*	*22.4*	*-2.0*	*-1.5*	....	....
Construction	**6.7**	**7.9**	**29.5**	**-0.6**	**5.6**	**6.9**	**39.4**	**-0.4**	**31.3**	**-1.7**
Services	**63.9**	**67.0**	**14.6**	**0.6**	**64.1**	**67.1**	**18.9**	**1.4**	**14.4**	**0.5**
Wholesale/retail trade, hotels, transport, communications	26.3	26.7	11.0	-0.3	21.2	23.0	23.4	0.9	7.2	-0.9
Wholesale/retail trade and repairs	*14.7*	*14.2*	*5.9*	*-0.4*	*9.3*	*10.3*	*26.3*	*2.1*	....	....
Hotels and restaurants	*5.2*	*5.8*	*22.4*	*-0.6*	*4.7*	*5.4*	*30.3*	*-0.2*	....	....
Transport, storage and communications	*6.4*	*6.6*	*13.4*	*0.2*	*7.2*	*7.3*	*15.2*	*0.1*	....	....
Monetary and financial intermediation	11.5	14.4	36.4	2.0	10.0	12.4	40.5	3.3	44.1	2.5
Monetary and financial intermediation	*2.6*	*2.5*	*6.1*	*0.5*	*3.2*	*3.0*	*4.8*	*0.8*	....	....
Business services (1)	*8.9*	*11.9*	*45.3*	*2.3*	*6.8*	*9.4*	*57.5*	*4.1*	....	....
Other service activities	26.1	25.9	8.7	0.8	32.9	31.7	9.4	0.9	9.6	0.9
General government (2)	*6.3*	*5.4*	*-6.3*	*0.4*	*9.2*	*7.6*	*-6.3*	*0.4*	....	....
Education	*6.7*	*6.3*	*3.1*	*-1.3*	*8.8*	*7.8*	*1.6*	*-1.1*	....	....
Healthcare	*6.0*	*6.2*	*13.8*	*2.8*	*7.0*	*7.2*	*17.2*	*2.3*	....	....
Other public, social and personal services	*3.9*	*4.2*	*18.7*	*-0.8*	*3.4*	*3.9*	*29.9*	*0.4*	....	....
Domestic services for households and live-in help	*3.2*	*3.7*	*28.3*	*3.4*	*4.6*	*5.2*	*28.3*	*3.4*	....	....
Total	**100.0**	**100.0**	**9.3**	**-0.1**	**100.0**	**100.0**	**13.6**	**0.5**	**8.8**	**-0.5**

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.

The fall in labour demand was sharpest in industry excluding construction, which is more sensitive cyclically and more exposed to contractions in world trade. The decline began in the first half and for the year as a whole came to 1.2 per cent in terms of persons employed and 2.7 per cent in hours worked. Increased recourse to Wage Supplementation resulted in a reduction of 1.5 per cent in hours worked per capita, which moderated the fall in employment. The number of hours of Wage Supplementation authorized rose from 1.5 per cent of total standard labour units in the fourth quarter of 2007 to 2.5 per cent in the fourth quarter of 2008 and about 4 per cent in the first quarter of 2009, the highest level since the recession of 1992-93 (Figure 9.2). In industrial firms with 500 workers or more, the ratio of Wage Supplementation to work hours rose to 10 per cent in February, near the 1993 peak.

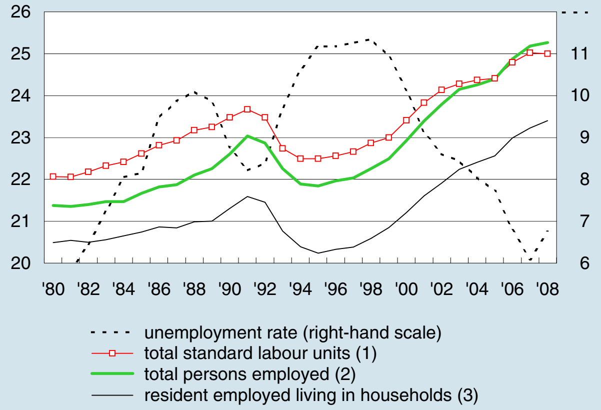
Employment in construction fell by 0.8 per cent after a decade of steady expansion. In agriculture the secular contraction continued, with a loss of 2.2 per cent, bringing the number employed below 1 million for the first time.

The only sector to record a year-on-year increase in employment was services, where the number of people employed rose by 1.1 per cent. Even here, however, the still buoyant growth of 2 per cent in the first half of the year over the corresponding period of 2007 gave way to virtual stagnation in the second half (0.2 per cent on the year-earlier period). The number of hours worked fell by 0.5 per cent in the second half after growing 1.4 per cent in the first.

The deterioration in the labour market will continue in 2009. Firms plan substantial downsizing both through dismissals and through a sharp reduction in hiring, which will make it harder for both the newly unemployed and first-time job-seekers to find work. Dismissal will be more frequent among the smaller firms, while the larger ones will rely mainly on non-renewal of expiring temporary contracts and hiring freezes.

Figure 9.1

Employment and unemployment
(thousands and percentages)



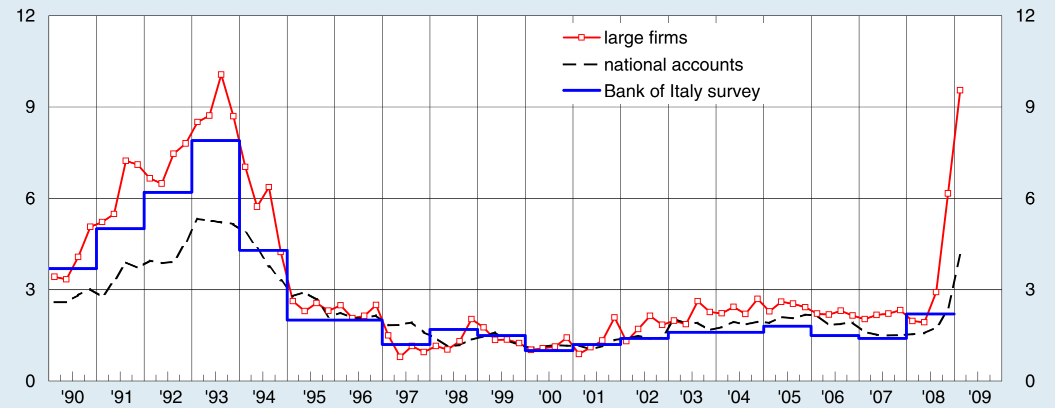
Sources: Istat, national accounts and labour force survey.
(1) Full-time equivalent workers, resident and non-resident, official and unreported (Source: Istat, national accounts). – (2) Number of persons employed – residents and non-residents, official and unreported – in resident firms (Source: Istat, national accounts). – (3) Not in institutions; households are defined as groups of persons cohabiting and bound by marriage, kinship, adoption, guardianship or affection (Source: Istat, labour force survey).

The composition of employment

Istat's labour force survey, which covers only Italian residents, found still rapid growth in employment in 2008, with an increase of 183,000 persons or 0.8 per cent (Table 9.2). However, the growth slowed progressively throughout the year, from 1.4 per cent in the first quarter to 0.1 per cent in the fourth.

Figure 9.2

Wage Supplementation benefit hours and total hours worked
(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 better performance by comparison with the national accounts figures is due to the different reference population. The Istat survey counts only persons officially resident in Italy, and thus reflects the lag with which immigrant workers are entered on civic registers. Immigrant workers present in Italy and employed in 2007 were included in the employment figures for that year by the national accounts. But the labour force survey counts them as newly employed in 2008, not because they found jobs but merely because they were entered that year in the civic register of the official resident population.

The growth in employment is the net balance between an increase of 249,000, or 16.5 per cent, in the number of foreigners employed and a decrease of 66,000 (0.3 per cent) for Italians. The divergence between the two components largely reflects differences in their population of working age; that of Italians fell by 132,000 while that of foreigners increased by 369,000. The foreign component thus rose from 5.7 to 6.6 per cent of the working-age population and from 6.5 to 7.5 per cent of persons employed. The incidence of the foreign workforce is more than 9 per cent in the Centre and North, but just 3 per cent in the South.

Employment increased in the regions of the Centre (1.5 per cent) and the North (1.2 per cent) but declined in the South (0.5 per cent), where the reduction was especially sharp in industry excluding construction (4.9 per cent), compared with a loss of just 1.4 per cent in the North and a gain of 3 per cent in the Centre.

Virtually the entire employment gain was accounted for by the female component, with an increase of 176,000 or 1.9 per cent, while men's employment stagnated (an increase of just 7,000). For the population of working age (15-64), the men's employment rate thus slipped from 70.7 to 70.3 per cent, while the women's rose from 46.6 to 47.2 per cent. The decline in the male employment rate came mainly in the central age group (35-44) and among the less educated workers. The better performance among women was due in part to their proportionately greater presence in service activities, which were less affected by the recession and continued to expand in 2008. In that sector women account for 48.6 per cent of all employed persons, against 21.6 per cent in industry, 30 per cent in agriculture and 39.9 per cent in the economy as a whole.

The overall employment rate held steady at 58.7 per cent, the result of a rise from 62.3 to 62.8 per cent in the Centre and from 66.7 to 66.9 per cent in the North and a decline from 46.5 to 46.1 per cent in the South, due to the fall in the male rate from 62.1 to 61.1 per cent.

Only payroll employment grew (by 279,000 persons or 1.6 per cent), while self-employment declined by 96,000 or 1.6 per cent. The incidence of self-employment thus diminished from 26.1 to 25.5 per cent of the total, still a high figure by international standards.

Among payroll employees, fixed-term positions increased by 55,000 or 2.4 per cent and open-ended jobs by 224,000 or 1.5 per cent. The share of fixed-term contracts rose from 13.2 to 13.3 per cent of the total; their incidence is much greater among formerly unemployed persons who find work. Fixed-term payroll employees, project workers and occasional workers accounted for 47 per cent of all persons finding jobs in 2008, up 1.3 percentage points from 2007. The incidence is higher still among young people and university graduates (59 per cent).

Table 9.2

Structure of employment in Italy in 2008 (1)
(thousands of persons and percentages)

	Centre and North		South		Italy	
	Thousands of persons (2)	Percentage change 2008-07 (3)	Thousands of persons (2)	Percentage change 2008-07 (3)	Thousands of persons (2)	Percentage change 2008-07 (3)
Employees	**12,682**	**2.3**	**4,764**	**-0.2**	**17,446**	**1.6**
Permanent	11,193	2.0	3,930	0.1	15,123	1.5
full-time	*9,577*	*1.4*	*3,509*	*-0.7*	*13,086*	*0.8*
part-time	*1,615*	*5.8*	*421*	*7.3*	*2,037*	*6.1*
Fixed-term and temporary	1,489	4.7	834	-1.4	2,323	2.4
full-time	*1,140*	*3.9*	*644*	*-3.8*	*1,783*	*1.0*
part-time	*350*	*7.2*	*190*	*7.9*	*540*	*7.4*
Self-employed	**4,241**	**-1.6**	**1,718**	**-1.4**	**5,959**	**-1.6**
Entrepreneurs, professionals and self-employed workers	3,566	-0.6	1,491	-1.1	5,056	-0.8
Family workers	293	-6.0	110	..	403	-4.4
Cooperative members	23	-30.3	12	-18.4	35	-26.7
Contingent workers	288	-5.4	82	-6.8	370	-5.7
Occasional workers	72	-5.1	23	5.0	95	-2.8
Full-time	3,675	-2.4	1,514	-2.1	5,189	-2.3
Part-time	566	3.9	204	3.6	770	3.8
Total employment	**16,923**	**1.3**	**6,482**	**-0.5**	**23,405**	**0.8**
women	*7,126*	*2.1*	*2,215*	*1.2*	*9,341*	*1.9*
men	*9,797*	*0.7*	*4,266*	*-1.4*	*14,064*	*..*
Unemployed	**805**	**15.3**	**886**	**9.8**	**1,692**	**12.3**
women	*460*	*14.9*	*412*	*7.3*	*872*	*11.2*
men	*346*	*15.9*	*475*	*11.9*	*820*	*13.6*
Labour force	**17,729**	**1.9**	**7,368**	**0.6**	**25,097**	**1.5**
women	*7,586*	*2.8*	*2,627*	*2.1*	*10,213*	*2.7*
men	*10,143*	*1.1*	*4,741*	*-0.2*	*14,884*	*0.7*
Participation rate (age 15-64)	**68.8**	**0.7**	**52.4**	**0.1**	**63.0**	**0.5**
women	*59.7*	*1.2*	*37.2*	*0.6*	*51.6*	*1.0*
men	*77.9*	*0.3*	*68.0*	*-0.4*	*74.4*	*..*
Employment rate (age 15-64)	**65.7**	**0.3**	**46.1**	**-0.5**	**58.7**	**0.1**
women	*56.1*	*0.7*	*31.3*	*0.2*	*47.2*	*0.6*
men	*75.2*	*-0.1*	*61.1*	*-1.1*	*70.3*	*-0.4*
Unemployment rate	**4.5**	**0.5**	**12.0**	**1.0**	**6.7**	**0.7**
women	*6.1*	*0.6*	*15.7*	*0.8*	*8.5*	*0.7*
men	*3.4*	*0.4*	*10.0*	*1.1*	*5.5*	*0.6*
Youth unemployment rate	**14.5**	**0.8**	**33.6**	**1.3**	**21.3**	**1.0**
women	*17.5*	*1.3*	*39.3*	*1.0*	*24.7*	*1.3*
men	*12.4*	*0.6*	*30.2*	*1.3*	*18.9*	*0.7*

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 totals. – (3) For participation, employment and unemployment rates, change in percentage points.

Unemployment and the labour supply

The average number of job-seekers increased by 186,000 or 12.3 per cent in 2008, ending a decline that had been uninterrupted since 1998. The increase mainly involved people losing jobs and out of work for less than 12 months, evidence that the reversal can be ascribed to the recession.

The unemployment rate, which had come down from 11.3 per cent in 1998 to 6.1 per cent in 2007, climbed back to 6.7 per cent. The increase involved both men and women and all age groups and geographical areas. The sharpest rises were among young people aged 15-24 and in the South. The male unemployment rate rose from 4.9 to 5.5 per cent, the female from 7.9 to 8.5 per cent. In the Centre the rate went up by 0.8 points to 6.1 per cent, in the North by 0.4 points to 3.9 per cent, and in the South by 1 point to 12 per cent.

The rise in the unemployment rate was driven in part by the robust increase in the labour force, which expanded by 369,000 or 1.5 per cent nationwide, after increasing by just 0.3 per cent in 2007. Contributing factors were the strong growth in the foreign population of working age and the upturn in labour market participation by Italians, especially women. The number of foreign workers increased by 274,000 (16.7 per cent), that of Italians by 94,000 (0.4 per cent). The participation rate for the working-age population rose from 62.5 to 63 per cent. Among men it remained unchanged at 74.4 per cent, while rising by 0.9 points among women to 51.6 per cent.

Earnings and labour costs

Actual earnings per full-time equivalent employee in the entire economy rose by 3.3 per cent in 2008, compared with 2.3 per cent in 2007 (Table 9.3). In the private sector the increase slipped from 3.1 per cent in 2007 to 2.9 per cent, while in the public sector, where pay raises under contracts signed in 2007 became effective, it rose from 0.7 to 4.3 per cent. In both sectors nominal wages are expected to slow this year: the effects of the contract renewals of 2007 and the first half of 2008 will wane and no major agreements are pending.

The rise in nominal wages was equal to the 3.3 per cent rise in consumer prices, which was due mainly to higher energy prices. In 2009, thanks above all to a marked reduction in inflation, earnings could increase even in real terms.

Since 2000 average earnings per full-time equivalent employee in the economy, deflated by the consumer price index, have risen by a total of 3.6 per cent in the private sector and 15 per cent in the public sector. Comparing hourly earnings in the three largest euro-area countries, in 2008 the average was €15.30 in Italy, €21.50 in France and €20.50 in Germany; at purchasing power parity, the figures were €14.10, €19.60 and €19.90 respectively. The cumulative increase in real terms between 2000 and 2008, using the harmonized index of consumer prices as deflator, was 4.6 per cent in Italy and 10.5 per cent in France, against a decline of 2.1 per cent in Germany. The differences in wage levels and trends reflect such factors as the differing sectoral composition of employment, education, age, and the incidence of off-the-books work.

Contractual earnings as determined by industry-wide collective bargaining agreements increased by 3.5 per cent in 2008 (2.3 per cent in 2007), outpacing actual earnings. For the private sector the increase was 3.2 per cent. A number of private-sector wage agreements were concluded in 2008 (including metal and engineering workers, retail and wholesale trade and construction). At present, unexpired contracts cover about 90 per cent of the economy-wide wage bill. Many of the agreements further increased work flexibility, and some extended the length of the contract beyond two years.

Table 9.3

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

	Value added at base prices, chain-linked volumes (1)	Total standard labour units	Output per standard labour unit (2)	Compensation per standard employee labour unit	Labour costs per standard employee labour unit (3)	Unit labour costs (3) (4)	Labour's share of value added at base prices (3) (5)	Real labour costs per standard employee labour unit (6)	Real earnings per standard employee labour unit (7)
					Industry excluding construction				
1996-2000	1.1	-0.3	1.4	3.5	2.5	1.1	62.6	0.5	1.0
2001-2005	-0.5	-0.4	-0.1	3.1	3.1	3.2	63.1	1.1	0.6
2006	3.1	1.0	2.2	3.6	2.8	0.6	64.3	1.6	1.4
2007	1.8	0.8	0.9	3.1	2.8	1.8	62.9	-1.2	1.3
2008	-3.2	-1.7	-1.5	3.1	3.3	4.8	64.2	0.6	-0.2
					Construction				
1996-2000	1.0	1.0	..	3.3	2.1	2.1	71.8	-0.1	0.9
2001-2005	2.8	3.3	-0.6	2.6	2.9	3.4	67.8	-1.9	0.2
2006	1.8	1.2	0.5	2.8	2.5	2.0	66.4	0.2	0.7
2007	..	3.2	-3.1	2.6	3.1	6.3	67.5	-1.6	0.8
2008	-1.2	-0.6	-0.6	2.9	3.1	3.7	66.9	-1.5	-0.5
					Private services (8) (9)				
1996-2000	3.1	2.2	0.9	3.2	2.0	1.1	69.7	-0.3	0.7
2001-2005	1.4	1.6	-0.2	2.6	2.6	2.9	68.1	0.2	0.2
2006	2.4	2.0	0.4	3.1	2.7	2.3	71.6	3.8	1.0
2007	3.3	1.4	1.9	3.2	2.9	1.0	71.1	1.1	1.3
2008	-0.9	0.5	-1.4	2.7	2.8	4.3	71.9	-0.2	-0.6
					Private sector (9)				
1996-2000	2.2	0.9	1.3	3.4	2.3	1.0	69.5	0.3	0.9
2001-2005	0.8	0.9	-0.1	2.8	2.8	2.9	68.4	0.4	0.3
2006	2.4	1.6	0.9	3.2	2.6	1.7	70.7	2.6	1.1
2007	2.4	1.1	1.3	3.1	2.9	1.6	69.9	0.2	1.3
2008	-1.6	-0.4	-1.2	2.9	3.0	4.2	70.8	0.1	-0.4
					Total economy (9)				
1996-2000	1.9	0.8	1.1	3.5	2.7	1.5	72.5	0.3	1.0
2001-2005	0.9	0.8	..	3.2	3.2	3.2	71.7	0.6	0.8
2006	2.1	1.5	0.6	3.2	2.7	2.1	73.8	2.0	1.0
2007	2.0	1.0	1.0	2.3	2.2	1.1	72.9	-0.2	0.5
2008	-1.2	-0.1	-1.1	3.3	3.3	4.4	73.7	0.1	-0.1

Source: Based on Istat, national accounts.
(1) Reference year, 2000. – (2) Output is value added at base prices, chain-linked volumes, reference year 2000. – (3) The introduction of the regional tax on productive activities and the simultaneous elimination of some employers' contributions in 1998 caused a break in the series. – (4) Compensation per standard employee labour unit as a percentage of output per standard labour unit; output is value added at base prices, chain-linked volumes, reference year 2000. – (5) Percentages. – (6) Labour income per standard employee labour unit deflated by the value added deflator at base prices. – (7) Compensation per standard employee labour unit deflated by the consumer price index. – (8) Includes wholesale and retail trade, hotel and restaurant services, transport and communications, financial intermediation services and sundry services to businesses and households. – (9) Net of rental of buildings.

In April 2009 the social partners, with the significant exception of the CGIL trade union confederation, signed an agreement for the implementation of the framework agreement on the reform of collective bargaining reached in January. The agreement confirms the two-level bargaining structure, national and supplementary (company-level or provincial), and institutes three-year validity of both the economic and the work-rules parts of the contract. It establishes that wage increases under the nationwide contract will no longer be determined with reference to the government's inflation target but set using a new three-year forecasting index based on the harmonized index of consumer prices net of imported energy products. The new forecasting index will be applied to an average wage level taken as the basis for calculation and composed of contractual minimums, the value of periodic seniority raises and any other fixed allowances under the collective bargaining agreement. Local agreements between the two sides may allow derogations from the industry-wide contract in situations of company crisis or to favour economic growth and employment in selected areas.

Supplementary, second-level bargaining remains relatively rare. The Bank of Italy's Survey of Industrial and Service Firms with at least 20 workers found that in 2008 just 26.1 per cent had signed a supplementary contract since 2000 (30.6 per cent in industry, 20.4 per cent in the services sector). And the incidence of company-level bargaining in industry has decreased over time. The share of industrial firms with at least 50 workers having a company agreement fell from 66 per cent in 1999 to 51 per cent in 2008. For those with 20-49 workers it declined from 34 per cent in 2001 to 21 per cent last year. The share of workers covered by second-level agreements fell from 77 to 68 per cent in firms with 50 or more workers and from 36 to 22 per cent in those with 20-49 workers.

Law 126 of 24 July 2008 enacted tax relief on wage increases linked to productivity and profits and on overtime pay in the second half of 2008. According to the Bank of Italy's survey, 47 per cent of workers benefited; the share was higher among larger firms (59 per cent in those with over 500 workers), lower among the smaller ones (35 per cent in those with fewer than 50). It was higher in the Centre and North than in the South (50 as against 29 per cent). There was no appreciable difference between industrial and service firms. The incidence tends to increase along with the average earnings in the firm.

Unit labour costs, including employers' social security contributions, increased by 3.3 per cent for the entire economy (Table 9.3). Given a fall in labour productivity of 1.1 per cent, unit labour costs rose by 4.4 per cent, compared with 1.1 per cent in 2007. In the private sector productivity fell by 1.2 per cent and unit labour costs grew by 4.2 per cent (1.9 per cent in 2007). Labour's share of value added at base prices net of rentals of buildings gained 0.8 percentage points in the entire economy and 0.9 points in the private sector.

Labour market regulation and social protection

The recession has highlighted some of the shortcomings of Italy's programmes of social protection. Although the increased flexibility of the labour market requires measures to facilitate workers' mobility between jobs and sectors, the funds allocated to unemployment benefit programmes are modest (0.5 per cent of GDP, as against 1.6 per cent in the EU-27 in 2005). Programmes are fragmented, depending on industry, type of employment contract and firm size, which results in a segmentation of protection programmes according to historical origin and does not respond to criteria of efficiency or equity. The employment services are inadequate to help the weakest groups within the labour force to find jobs and do little to verify the correct use of unemployment benefits.

To counter the effects of the crisis the Government temporarily extended the coverage of the programmes already in being and allocated additional resources (Decree Law 185 of 29 November 2008, ratified as Law 2 of 28 January 2009). The resources available for income support programmes in 2009 and 2010 amount to €32 billion, including €8 billion in exceptional measures under a State-Regions derogation agreement. The exceptional appropriation is drawn largely from the Fund for Underutilized Areas and from resources available at regional level financed by the European Social Fund.

The complexity of the legislation, both the ordinary rules and those enacted specifically to cope with the recession, make it very hard to determine the benefits to which various categories of workers would be entitled if they were dismissed or laid off. Using the data from Istat's labour force survey and the EU-SILC survey of household incomes, it can be estimated that in addition to the vast area of unreported workers, roughly 1.6 million employees or quasi-employees would not be eligible for any benefits in the event of a temporary or permanent layoff, even after the Government's recent measures. These are payroll employees lacking the seniority or social security contribution requirements and managers and quasi-employees for whom there is no provision for unemployment benefits or wage supplementation.

The amount and duration of benefits also differ according to type of employment contract. Wage Supplementation can come to as much as 80 per cent of the last paycheck and regular unemployment benefits to 60 per cent. However, both are subject to ceilings which, though revised annually, have lost value over the years by comparison with average earnings. In 2009 employees on Wage Supplementation or ordinary unemployment benefits receive a maximum gross benefit of €886 a month when their monthly earnings are less than €1,917 and €1,065 when they are higher. Between 1995 and 2008, these two maximums fell from 46 to 40 per cent and from 55 to 48 per cent, respectively, of average actual gross earnings in the non-agricultural private sector.

Joblessness and underemployment are significant factors of poverty. The Bank of Italy's Survey of Household Income and Wealth found that in 2006 almost all persons living in households where there were no recipients of labour or pension income were poor; they accounted for nearly 7 per cent of the total low-income population (Table 9.4). In households with only "atypical" workers the poverty rate was 47 per cent (accounting for 20.5 per cent of the low-income population). Italy has no welfare programme for cases in which earnings or public transfers in connection with work status are not enough to provide a minimum standard of income or consumption. The programmes in place, not always well-designed for alleviating the distress of the neediest, provide what by international standards is a very modest amount of resources. The actions undertaken in the last year are intended to prevent the spread of poverty in a period of economic difficulty. Reflection on the state of social policies in Italy has begun and could lead to broader reform.

The measures enacted in the past year include the introduction of a "consumer card" for persons with low income and a temporary "family bonus". The card is for citizens over age 65 and toddlers to age 3 whose households satisfy very stringent means tests.

It consists in a prepaid card, worth €40 a month, designed chiefly for food purchases and the payment of utility bills. The bonus is a money transfer to households whose labour and pension income is below certain thresholds. The two measures are effectively addressed to needy households, but they compound the fragmentation of the income support system and leave a significant portion of the low-income population out. The total financial commitment is modest (0.2 per cent of GDP, based on appropriations), not enough to lower the poverty rate significantly. Additional measures have been taken at regional level.

Table 9.4

Economic condition of individuals and work status of households in 2006
(percentage shares)

EMPLOYMENT STATUS OF HOUSEHOLD MEMBERS (1)	Share of total population	Share of low-income population	Poverty rate
Only traditional employment	52.0	40.4	15.5
1 person employed	28.4	36.1	25.3
2 or more employed	23.6	4.3	3.6
Traditional and atypical employment	15.9	4.8	6.0
Less than 1/3 atypical	8.2	3.0	7.2
1 person employed (2)	–	–	–
2 or more employed	7.8	3.0	7.6
More than 1/3 atypical	7.7	1.8	4.7
1 person employed (2)	–	–	–
2 or more employed	7.6	1.8	4.8
Only atypical employment	8.7	20.5	47.0
Only fixed-term	4.7	14.5	62.1
1 person employed	3.8	12.1	62.9
2 or more employed (2)	–	–	–
Other combinations of atypical employment	4.0	5.9	29.5
1 person employed	2.7	4.1	29.7
2 or more employed (2)	–	–	–
No employment	23.4	34.4	29.2
No pension income	1.4	6.8	95.2
Pension income	22.0	27.6	25.0
Total	100.0	100.0	19.9

Source: Based on data from Banca d'Italia, *Archivio storico dell'Indagine sui bilanci delle famiglie italiane* (version 5.0, February 2008); modified OECD scale of equivalence.
(1) Atypical employment includes fixed-term and temporary positions, collaboration contracts and part-time work, both as employee and self-employed (part-time defined as less than 18 hours a week). All other work is considered to be traditional employment. The various forms of employment are aggregated, for persons with more than one job and for households, on the basis of number of hours worked. – (2) Value not given, as this type of household has less than 100 observations in the sample.

In May 2009 the Ministry of Labour, Health and Social Policies released a white paper on the future of the Italian social model, "The good life in an active society". The reform guidelines include an income protection system resting on two pillars: a public programme offering employees benefits patterned after the present unemployment insurance benefits and so-called quasi-employees a one-off re-employment allowance; and a private programme enjoying tax incentives, to consist in joint agencies created through collective bargaining between unions and employers. Where other solutions, in particular job market access, prove ineffective, the fight against poverty and social exclusion could involve income supplements of last resort, taking account of the characteristics of the household and tied to a plan to get out of poverty. The white paper sets these as long-term objectives, considering them not practicable in today's economic circumstances.

10. THE PRODUCTIVE STRUCTURE AND STRUCTURAL AND TERRITORIAL POLICIES

Value added and labour productivity in the main branches of manufacturing, which had grown significantly in 2006-07 after five years of decline, turned downwards again last year with the onset of the recession. The effects of the crisis were stronger for export-oriented firms and smaller businesses.

The international crisis makes it more urgent to tackle the structural problems that afflict the Italian economy. The small average size of firms constrains their ability to innovate and to penetrate foreign markets, making the productive system more vulnerable to the changes that have been reshaping the world economy for more than a decade. Competition, which has generated significant efficiency gains in manufacturing, is still limited in important sectors such as local public services and professional services. Firms' ownership structure continues to be characterized by a high degree of concentration and limited contestability. In the South, the average quality of public services remains low, the labour market continues to function poorly and public policies are still less effective than in the rest of the country.

Business activity is hindered by defects in the legislative and regulatory framework. Despite the progress made in regulatory simplification, the costs deriving from regulation remain high and differ considerably from region to region; the inadequacy of impact studies is part of the problem. Regulatory measures are frequently opaque, unsystematic and fragmentary. The inefficiency of the civil justice system continues to entail high costs for firms.

Sectoral dynamics

The world financial crisis, which spread to the real economy in the course of 2008, abruptly interrupted a phase of economic recovery in Italy. Manufacturing industry, whose value added had contracted by 0.8 per cent per year in the period 2001-05, went on to record a strong rebound (2.7 per cent) in the following two years; labour productivity, measured by value added at factor cost per unit of labour input, had fallen by 0.4 per cent per year in 2001-05 but risen by 1.7 per cent per year in 2006-07. The improvement had been sharper in the transport equipment and mechanical machinery and equipment sectors but was also evident in the traditional product sectors of clothing, leather and footwear, with a return to slightly positive growth registered from 2006 onwards. In services, where the average annual growth in value added had risen from 1.2 per cent in 2001-05 to 1.8 per cent in 2006-07, the strongest acceleration was recorded in the credit and insurance sector.

For 2006-07 this overview incorporates the revision of the national accounts estimates released by Istat in March of this year. Reinforcing the revisions made in the previous years, the growth in value added, productivity and cost competitiveness in manufacturing now appears decidedly better, though still far short of that seen in France and Germany. The sector's recovery, which appeared hesitant on the basis of the data available up to 2006, is now shown to have begun in 2004 and to have been more robust until the recent economic and financial crisis. Given marginal adjustments in the other sectors, except for construction in 2007, the rate of growth in labour productivity in the whole economy was revised upwards by 0.4 percentage points in 2006 and by 0.1 in 2007.

The intense international crisis caused a brusque cyclical inversion in 2008. Manufacturing was immediately affected by the sharp contraction in world trade: value added declined by 4.6 per cent and labour productivity by 2.9 per cent on average for the year and fell by 9.4 and 7.4 per cent, respectively, in the fourth quarter compared with the same period a year earlier. There were large declines in value added in capital goods sectors, particularly transport equipment (7.3 per cent), electrical machinery and equipment (7.4 per cent) and mechanical machinery and equipment (5.5 per cent); among traditional product sectors, value added fell by about 6 per cent in both the wood and furniture and the leather and footwear industries.

Firms

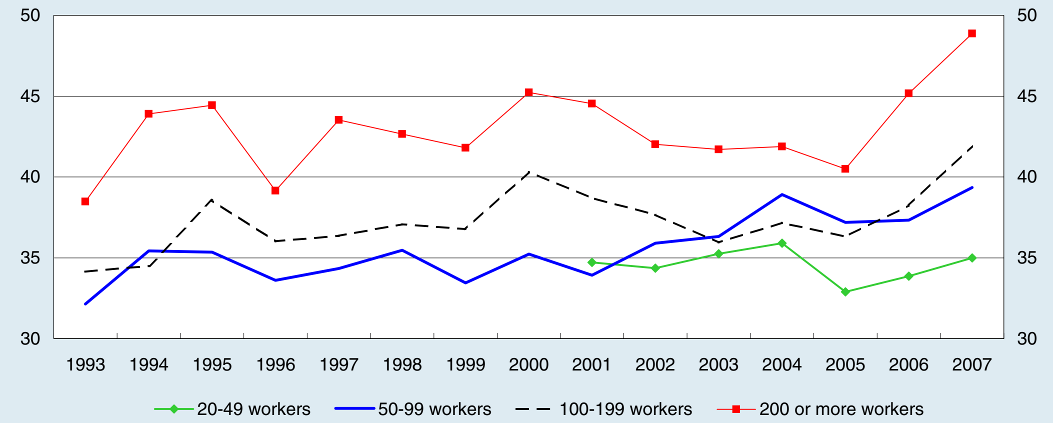
According to Chamber of Commerce data, the number of firms rose by 0.6 per cent in 2008 as a result of more than 374,000 closures and 410,000 start-ups. The slower growth in the number of firms, which fell to a historically low level, appears to be more the continuation of a trend under way since 2006 than the direct effect of the economic and financial crisis. The repercussions of the crisis are discernible instead in the data for the first quarter of 2009, which show firms finding it harder to survive: the number of new bankruptcy procedures (2,600) was more than a third higher than that recorded in all of 2007; this works out to 43 cases for every 1,000 firms, compared with 30 in the year-earlier period and 37 in the fourth quarter of 2008.

The crisis hit the Italian productive system in a phase of intensive restructuring in response to the greater competitive pressure deriving from globalization, European market integration and the technological revolution. Restructuring, which was more intense in the manufacturing sector, was marked by a redistribution of resources in favour of more efficient firms and by changes in corporate strategies, with greater attention paid to brands, product quality and the internationalization of production.

The Bank of Italy's Survey of Industrial and Service Firms indicates that the crisis is most widespread and acute in the manufacturing sector and among export-oriented firms; the difficulties have also spread rapidly to smaller companies, especially subcontractors for larger firms, and more heavily indebted companies, which face tighter borrowing conditions in the markets and from banks. Utility companies, mass retailers and businesses that have public procurement contracts are more sheltered from the slump in demand.

Figure 10.1

Value added per hour worked, by size class of firm
(manufacturing firms with 20 or more workers; euros at 2007 prices)



Sources: Based on Banca d'Italia, *Survey of Industrial and Service Firms*, and Company Accounts Data Service data.

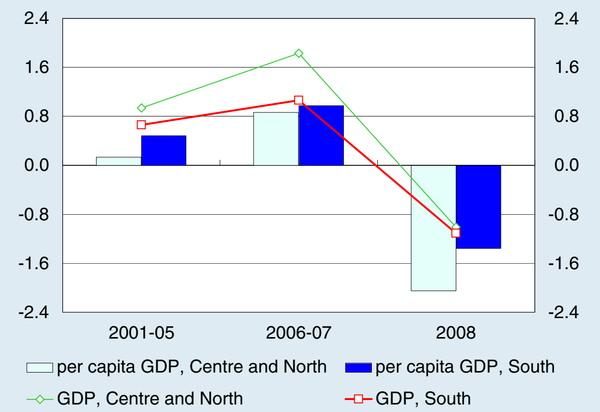
In the past, the size of Italian firms, which is small by international standards, often ensured the requisite flexibility to cope with changes in global demand. Today, however, it is a factor of weakness even in normal cyclical conditions. Extremely small firms find it hard to absorb the high fixed costs connected with export activity and innovation. This results in a positive correlation between firm size and productivity levels and growth (Figure 10.1).

Territorial dynamics

Between 2001 and 2008 real GDP growth averaged 0.8 per cent per year in the North and Centre and 0.4 per cent in the South; the South's growth gap, modest in the five years 2001-05, widened in the next two years (Figure 10.2). In spite of the traditionally greater cyclical sensitivity of the northern economy, according to Svimez estimated output contracted last year by 1 per cent in the Centre and North and by slightly more in the South (1.1 per cent), where the drop in industrial production was steeper (3.2 per cent, compared with 2.6 per cent in the Centre and North). The sharper reduction in domestic final consumption in the South (0.8 per cent, compared with 0.5 per cent) was due to the greater contraction in household consumption, while general govern-

Figure 10.2

GDP growth rates (1)
(percentage changes)



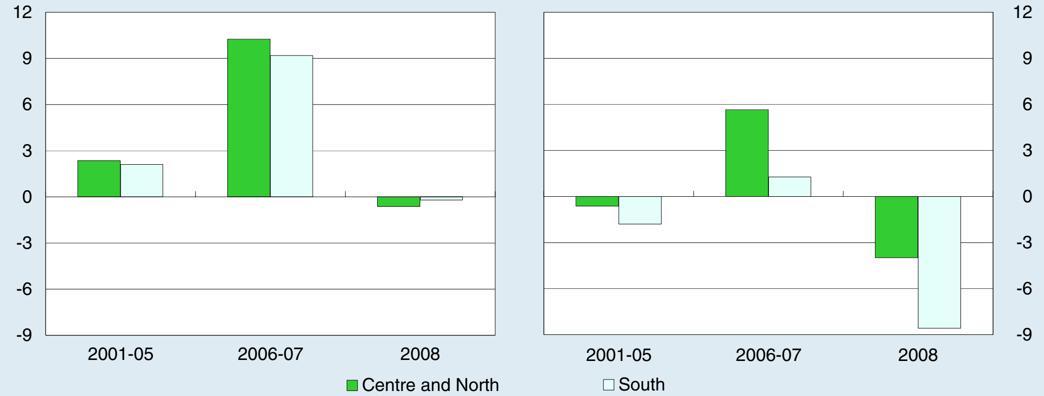
Sources: Istat, *Conti economici territoriali*, for the years from 2001 to 2007; Svimez estimates for 2008.
(1) Chain-linked prices. Annual average growth rates for the periods 2001-05 and 2006-07.

ment consumption showed similar growth in both parts of the country (0.6 per cent). By contrast, the decline in gross fixed investment was slightly greater in the Centre and North than in the South (3 per cent, compared with 2.8 per cent).

The gap between the Centre and North and the South in terms of per capita GDP remained basically unchanged. In the period 2001-08 per capita GDP in the South amounted to about 57 per cent of that of the Centre and North, where the population growth rate was higher (0.8 per cent per year, compared with 0.2 per cent in the South).

Figure 10.3

Growth rates of exports (1)
(percentage changes)



Source: Istat, *Le esportazioni delle regioni italiane*.
(1) At current prices. Average growth rates for the periods 2001-05 and 2006-07. – (2) Excludes refined petroleum products and, to make the data comparable over time, ship's stores. – (3) Includes textiles, clothing, leather, footwear and other products of manufacturing (including furniture).

Between 2001 and 2008 exports at current prices, excluding refined petroleum products, grew at a slightly higher average annual rate in the Centre and North than in the South (3.9 per cent as against 3.4 per cent); the ratio of exports to output of the Centre and North is about three times that of the South. After widening in 2006-07, the export growth gap between the two areas narrowed last year, as exports contracted by 0.5 per cent in the Centre and North and were largely unchanged in the South (Figure 10.3). In the traditional sectors (textiles and clothing, leather and footwear, and "other products of manufacturing", a residual category that includes furniture), which are more exposed to the competition of recently industrialized countries with lower labour costs, southern exports continued to show more unfavourable trends than those of the rest of the country.

Corporate ownership and control structures

Unlisted companies. – The ownership structures of unlisted Italian industrial firms have been essentially stable over time. Ownership is highly concentrated and is often strengthened by the presence of approval clauses in companies' bylaws and by shareholders' agreements (more than 40 per cent in 2008). Some two thirds of unlisted companies describe themselves as family-controlled. This model of control is more common among smaller firms, those that operate in traditional sectors and those located in the South.

Over the last ten years, a change of control occurred in 3 per cent of manufacturing firms each year. About a third of these transfers took place within the same family.

Econometric analyses for the period 1996-2007 show that uncertainty about expected demand leads to a significantly sharper cutback in investment by family-controlled firms than by other firms. The effect is stronger if control is exercised directly by individuals and increases with the size of the controlling stake.

Listed companies. – The governance system of Italian listed companies has undergone major changes in the past few years. From an institutional standpoint, the legislative framework and the forms of self-regulation have approached international best practice. Control structures have become less complex and less opaque. The protection of minority shareholders has improved.

A sign of these changes is the increase in shareholding in Italian companies by institutional investors, particularly those based abroad. Their attendance at shareholders' meetings remains scant, however.

Between 1998 and 2007 the percentage of companies in which foreign institutional investors held an equity interest of 2 per cent or more rose from 25 to 51 per cent (in 2008 it fell to 42 per cent, probably owing to the disinvestment strategies adopted by these investors in response to the financial crisis). The growth concerned non-financial corporations in particular; shareholding in banks, already lower than in other companies, declined.

Analyses for the two years 2007-08 on the participation of some of the largest European institutional investors in shareholders' meetings show considerable differences in their behaviour from country to country. In Italy these investors take part in shareholders' meetings 46 per cent of the time, while in France and Germany the proportion rises to 99 per cent. In the United Kingdom cases of non-participation are rare. Among the obstacles to participation in the Italian companies' shareholders' meetings reported by institutional investors are the lack of timely provision of information to the shareholders, the restrictions that some companies place on the trading of shares registered for the exercise of voting rights and the formalities of proxy voting.

By contrast, the ownership structure continues to be characterized by limited contestability. The concentration of ownership remains generally high and the role of the most important controllers – families and the public sector – is growing. In companies under coalition control, which in theory are more contestable, the control structures are strengthened by interlocking directorships, especially in large-capitalization companies.

Some 90 per cent of the companies included in the S&P-MIB40 index have directors in common. These links reflect interconnected ownership structures: a substantial number of them are associated with coalition control of several companies (Mediobanca, Pirelli & C, Assicurazioni Generali, Telecom Italia) by shareholders that in turn control some of the largest listed companies.

From a regulatory standpoint, the expected transposition of Directive 2007/36/EC, whose main objective is to assist shareholders in the informed exercise of voting rights, is likely to induce institutional investors to further increase their holding of equity and their activism. Additional strengthening of minority shareholders' protection could come from the application of the legislation on related-party transactions, whose implementing regulation is still pending.

Privatizations. – In 2008 the Ministry for the Economy and Finance sold its controlling interest in Alitalia to Compagnia Aerea Italiana (CAI) for €1,052 million. The assets not sold to CAI were transferred to a "bad company", which, placed under special administration, is to dispose of them gradually to the benefit of Alitalia's creditors. In December 2008 AP Holding, a subsidiary of the Toto Group, and CAI reached an agreement for the transfer of ownership of Air One to CAI; CAI proceeded to integrate Air One, which contributed its entire fleet, with the assets taken over from Alitalia, thereby creating a new airline. The joint network of the two companies has been active since 13 January and may operate in derogation of the antitrust rules until 30 June 2009.

The European Court of Justice recently ruled that Italy's legislation on the criteria for exercising the State's special powers in privatized companies (the "golden share") was incompatible with the Community principles of freedom of establishment and the free movement of capital.

Public services and professional services

OECD indicators show that Italy still has one of the highest levels of regulation in some sectors, particularly in services. The inadequate intensity of competition that ensures limits the scope for growth and, by creating monopoly rents, harms consumers and businesses.

Energy. – In 2008 Italy's gross energy requirement (including generation losses) amounted to 192 million tonnes of oil equivalent, 1 per cent less than in 2007. The reduction was due to the fall in productive activity, which led to the first contraction in electricity demand in a quarter of a century. Energy intensity, which measures the amount of energy needed to produce a unit of output, remained unchanged, at 150.5 tonnes of oil equivalent per €1 million. Last year renewable sources satisfied a larger share of energy consumption, to the detriment of oil.

Energy dependence remains high (net imports cover 85 per cent of the gross energy requirement). In 2008 there was a shift in the composition of imports by type of source, with a decrease of 6 per cent in oil imports and an increase of 3.9 per cent in those of natural gas, nearly two thirds of which come from Algeria and Russia.

The Eni group continues to be the dominant player in the gas supply market, accounting for more than 70 per cent of the national total (the sum of net imports and domestic production). According to Eurostat estimates, the costs of supply in Italy before tax are broadly in line with the EU averages for industrial users and higher for households.

The concentration of electricity production has diminished. In 2008 the three largest producers accounted for 53 per cent of gross production (Enel alone for 31.5 per cent), compared with 60 per cent in the two previous years and an EU average of about 70 per cent. The cost of electricity in Italy is higher than the EU average owing to the greater use of fossil fuels in generation and shortcomings in the interregional power grid.

Telecommunications. – In 2008 the volume of business in the Italian telecommunications market recorded weak growth for the second consecutive year (0.8 per cent, compared with 0.4 per cent in 2007). One factor holding back expansion was the reduction in prices, due in 2007 to new rules on the costs of recharging prepaid mobile phones and mobile termination charges, and in 2008 to enhanced competition. Convergence between the land-line and mobile segments and the start-up of virtual mobile operators increased the number of competitors after several years of market consolidation.

Local public services. – The regulation of the sector was revamped in 2008 (Decree Law 112 of 25 June 2008, Article 23-bis). The principle of the competitive tender procedure for awarding services was reaffirmed, but several exceptions were admitted and implementation of key aspects of the legislation was put off to subsequent regulations. The procedure promotes competition provided that technical expertise is available to ensure it is correctly prepared and executed, that the number of potential competitors is adequate and that there is real independence between the regulator, service provider and local authority. The changes introduced do not appear to take these aspects sufficiently into account.

Professional services. – In 2008 professional services were more highly regulated in Italy than in any other OECD country. Only some of the liberalization measures envisaged by Law 248/2006 (the so-called Bersani Law) have been implemented. For the main professions, many of the restrictions regarding such matters as fixed and minimum tariffs, advertising and the provision of multi-disciplinary services that the reform was to eliminate remain in place. The liberalization process would be assisted by the elimination of access restrictions, which were unaffected by Law 248/2008.

Anti-crisis measures and policies for growth

Like the other main European countries, Italy has recently taken measures to contain the repercussions of the global economic and financial crisis on the productive system and employment. Law 33 of 9 April 2009 (ratifying Decree Law 5 of 10 February 2009) granted tax credits for the purchase of furniture and electrical household appliances and offered incentives for the purchase of cars, motorcycles and commercial vehicles. According to official estimates, the support, envisaged only for companies that pledge not to relocate production of the goods covered by the incentives outside the EU, will involve about €1 billion of expenditure in 2009 (less than 0.1 per cent of GDP).

The most recent economic policy measures to support long-term competitiveness are part of the Industry 2015 project, provided for in the Finance Law for 2007. The project's objective is to simplify and rationalize the set of industrial policy measures, in line with recent Community and international trends; it envisages both tax reliefs designed to reduce production costs and encourage firms to invest and expand, and selective sectoral assistance through industrial innovation projects. With respect to the recommendations of the European Commission and European Council on measures to support competitiveness, which Industry 2015 incorporates, there still appear to be shortcomings in the preparation of reliable policy monitoring and assessment mechanisms.

Regional policies. – Further progress was made in 2008 towards implementing the programmes envisaged by the Community Support Framework for 2000-06. By the end of the year payments had risen to 93.6 per cent of the total cost for Objective 1 operational programmes, 103.3 per cent for Objective 2 single programming documents and 95.5 per cent for Objective 3 regional operational programmes (up from 79.9, 88.1 and 86.6 per cent respectively at the end of 2007).

With its Decision No. 1112 of 18 February 2009, the European Commission extended to 30 June 2009 the deadline for the admissibility of expenditures under Objectives 1 and 3 operational programmes, Objective 2 single programming documents and all other Community initiatives.

For the period 2007-13, the National Strategic Reference Framework, approved by European Commission Decision No. 3329 of 13 July 2007, establishes that the three objectives of convergence, regional competitiveness and employment, and European territorial cooperation be assigned respectively 72, 26.1 and 1.9 per cent of the total co-financing resources allocated at national level (about €60.5 billion). As decided at Community level, Italy has allocated 68 per cent of the Community resources for the convergence objective and 82 per cent of those for the regional competitiveness objective to implementing the Lisbon strategy.

According to European Commission data on the financial execution of the Structural Funds for the 2007-13 planning period, as of 23 April 2009 the payments made by the Commission amounted to about 6.9 per cent of the available Community resources. This was somewhat less than the figures for Germany, France and Spain (8.3, 7.5 and 7.4 per cent, respectively).

Measures to promote the development of the most backward parts of Italy not only draw on Community resources and national co-financing but also benefit from the Fund for Underutilized Areas. Resolution 166 of 21 December 2007 of the Interministerial Committee for Economic Planning had allocated €63.3 billion to the Fund for the 2007-13 planning cycle, including €53.8 billion for the South. Subsequent measures reduced the allocation and modified the planned use of the resources, in part reassigning them to priority objectives for economic recovery. In March 2009 the Fund's endowment amounted to nearly €54 billion following reductions of some €10.5 billion and the assignment of about €1.2 billion of resources revoked from the 2000-06 planning cycle because they had not been committed or programmed by 31 May 2008. About €27 billion of that amount was assigned to the regional and interregional operational programmes (of which €21.8 billion to the southern regions and service objectives) and about €25.4 billion went to the national funds, divided between the Fund for Employment and Training (€4 billion), the Infrastructure Fund (€12.4 billion) and the Strategic Fund to Support the Real Economy (€9 billion); the remainder related to pre-allocations and other measures.

In 2008 there were no new financial commitments for the instruments of negotiated development planning. The approval process for new territorial pacts and area contracts was completed; new implementing procedures were put in place for area contracts.

On 8 May 2009 the Interministerial Committee for Economic Planning, in agreement with the regional governments, approved the creation of 22 "urban enterprise zones" (three each in the regions of Sicily, Campania, Sardinia, Calabria and Puglia, two in Lazio and one each in Molise, Abruzzo, Basilicata, Liguria and Tuscany). The measure concerns an aggregate of about 333,000 inhabitants. These special zones are characterized by high levels of social and economic distress and must have between 7,500 and 30,000 inhabitants (but in no case more than 30 per cent of the total municipal population). They can be established only within municipalities with a population of at least 25,000 and where the unemployment rate is higher than the national average. In practical terms, the intervention involves a series of tax reliefs and incentives for small and micro-firms that start a new activity in the zone.

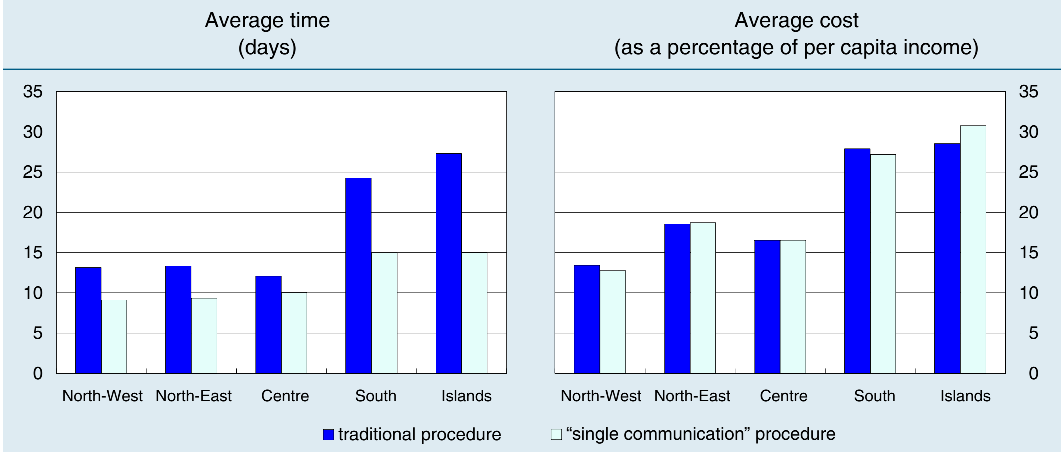
The evolution of the legislative framework

Simplification and quality of the legislative process. – By international standards Italy has a surfeit of legislation and regulation. The burden on enterprises of administrative and bureaucratic costs is heavy and varies considerably from region to region.

This year Italy again stands low in the World Bank ranking of countries according to the ease of doing business: 65th out of 182 countries, compared with an average rank of 27 for the OECD countries. A Bank of Italy exercise, similar to the one conducted by the World Bank and based on five indicators, finds that there is high variance at the regional level and scope for fostering virtuous convergence through simplifying measures. Before the introduction of the single communication procedure – a one-step application for registration with the Company Register, the Revenue Agency, INPS and INAIL – the time needed to start up a business ranged from 12 days in the Centre to 27 in the Islands. The cost ranged from 13 per cent of per capita income in the North-West to 30 per cent in the Islands. The new procedure has shortened the time (it now takes 9 days in the North-West, compared with about 15 in the South and Islands), while the costs have remained about the same (Figure 10.4).

Figure 10.4

Time and cost of procedures for business start-up by geographical area (1)



Source: Based on Banca d'Italia, *Indagine sui tempi e costi della regolazione dell'attività d'impresa.*
(1) Weighted by regional GDP.

The goal of improving the quality of regulation can only be pursued through policies that simultaneously enhance the quality of both existing and future regulation.

Further steps have been taken to simplify the legislative framework and make it easier for citizens to gain access to and know the laws. Measurement of the administrative costs imposed by information obligations has continued, in view of the European objective of reducing them by 25 per cent, as has the monitoring of legislation preparatory to the implementation of the Services Directive (Directive 123/06/EC). The actual reduction in the costs for firms will depend on the way the plans are carried out and the ability to overcome possible resistance on the part of individual administrations.

The quality of new regulation is adversely affected by the limited use and formalistic interpretation of impact analysis. One factor is the shortage of expertise and information needed to conduct quantitative economic assessments of proposed measures. The laws are often opaque and unwieldy, containing highly heterogeneous provisions.

The inefficiency of the public administration has a negative impact on the effectiveness of measures for legislative and administrative simplification and, in general, on business activity. Law 15 of 4 March 2009, an enabling act for an overall reform of the rules governing public employment and of internal controls in general government, aims at improving the quality of administrative action. Its emphasis on measurement of individual administrations' performance and recognition of merit is an important new development. The effects of the reform will depend on the way the principles contained in the legislative mandate are implemented in practice.

The civil justice system. – The slowness of civil justice imposes high costs on firms. According to the Bank of Italy's Survey of Industrial and Service Firms, one third of all industrial firms with 50 or more workers that have brought civil proceedings against a counterparty for non-performance of contract prefer to settle out of court rather than wait for a judgment. In order to reach a settlement, firms forgo an average of 36 per cent of the amount due.

The organization of the courts and the high litigation rate are problems that still must be addressed. Difficulties in the management of the justice system also derive from the lack of information on the courts' endowment of human and financial resources. Without such information, it is not possible to evaluate their adequacy and productivity and to identify the causes of malfunction and suitable remedies.

Company law. – The provisions governing listed companies were affected in recent months by two different legislative measures, both aimed at strengthening the defences available to companies in the event of a hostile takeover bid. This could further reduce the contestability of control of listed Italian companies, which is already limited because of the high concentration of ownership.

The so-called passivity rule prohibiting a target company's board of directors from taking defensive measures without prior approval by the shareholders' meeting has been dropped from the provisions on takeover bids.

An indirect strengthening of the position of controlling shareholders can derive from the measure raising the ceiling on share buybacks from 10 to 20 per cent of a company's capital and that empowering Consob to request, under certain circumstances and for a limited period of time, notification of equity interests in listed companies even below the current threshold of 2 per cent. By international standards, the notification thresholds established in Italian law are among the lowest.

Bankruptcy law. – As a consequence of the crisis, the number of bankruptcy procedures pending in the first quarter of 2009 was 46 per cent higher than in the same period a year earlier. There was also a significant increase in restructuring procedures, particularly compositions with creditors, a recently reformed procedure. To foster wider use of this instrument, especially in the current phase, consideration could be given to legislative measures that would facilitate the granting of loans while the restructuring plan is being prepared. In addition, expeditious action should be taken to coordinate the provisions on bankruptcy crimes with the new provisions of bankruptcy law.

11. IMMIGRATION

Between 2003 and 2008 the number of foreign residents in Italy more than doubled to 3.4 million, around 6 per cent of the population. Compared with the other main European countries, immigrants resident in Italy form a smaller part of the population, are younger and less educated.

Foreigners have higher participation rates in the labour market than Italians. However, as in the other leading economies with large immigration flows, the increase in the supply of labour resulting from immigration does not seem, on average, to have had negative effects on the wages or job prospects of the native population.

The quality of Italy's human capital in the future will be determined to a considerable extent by the skills of the immigrant population. Today, foreign schoolchildren are already lagging behind significantly at primary school and there are high drop-out rates at the subsequent levels of education.

Differences in the socio-economic and demographic structure between the Italian and the foreign populations result in substantial divergences in the economic flows to and from the public finances. On a per capita basis, immigrants pay fewer taxes and receive fewer pension and healthcare benefits.

Immigration in Italy in an international context

The rapid growth in world population, from around 3 billion in 1960 to 6.5 billion in 2005, geo-political changes, the persistence of wide gaps in income and the diverging population trends led to an increase in the number of people migrating from more backward regions to more advanced ones. At the start of this decade, there were around 85 million people living in the OECD countries who had been born abroad, three times as many as forty years earlier.

In 2005-06, it is estimated that about 8.5 million people moved to an OECD country, almost 6.5 million net of flows between countries within the area; about 1.2 million people are estimated to have come from China and India and just under 1 million from Romania, Bulgaria, Russia and Ukraine.

A rapid increase in foreign immigration was also recorded in Italy. Net migration which, on average, was still negative in the 1980s (a loss of about 30,000 people per year), was positive on average in the period 2002-07 (gains of around 450,000 people per year); in 2008, there were 3.4 million resident foreigners, about 6 per cent of the resident population and more than double the figure for 2003. The Fondazione Iniziative e Studi sulla Multietnicità (Ismu) estimates that on 1 January 2008 the total number of foreigners in Italy was around 4.3 million (7.2 per cent of the total population), of whom about 3.7 million were legally present and for the most part recorded as resident at the municipal registry; the number of irregular immigrants is estimated at about 650,000, around 1 per cent of the population.

The rapid growth of the resident foreign population has been due to the regularization measures adopted, the steady increase in the quotas made in the periodic entry-planning provisions (the "flow decrees") and, in the last two years, the enlargement of the European Union to include some eastern European countries. Since 1990 there have been four regularization measures covering a total of about 1.3 million non-EU citizens of whom about half were legalized under the last measure. The "Bossi-Fini" Law (passed on 30 July 2002), covered about 320,000 non-EU domestic workers and the following Law 222/2002 provided for about 330,000 people working in firms. The available evidence shows that of all these non-EU citizens only just over half a million were still legally present in Italy at the beginning of 2007.

On the basis of Istat data, at the start of 2008, almost half the foreigners legally resident in Italy came from central and eastern European countries, mainly Albania and Romania (11.7 per cent and 18.2 per cent respectively); about a quarter came from Africa, mainly from countries on the Mediterranean basin, and 16 per cent came from Asia (Table 11.1). The gender composition of the foreign communities living in Italy would seem to reflect different migration models. There is a high female presence, of more than two thirds, among immigrants from some of the central and eastern European countries and Latin America but a much lower proportion, less than one third, of immigrants from some African and Asian countries.

Table 11.1

Composition of the foreign population in Italy on 1 January 2008
(absolute values and percentages)

ORIGINS	Males		Females		Total	
	Number	Percentage (1)	Number	Percentage (1)	Number	Percentage (1)
Europe	803,901	23.4	981,969	28.6	1,785,870	52.0
EU-15	*61,521*	*1.8*	*96,146*	*2.8*	*157,667*	*4.6*
New EU members (2)	*342,594*	*10.0*	*434,174*	*12.6*	*776,768*	*22.6*
Central and Eastern Europe (3)	*394,159*	*11.5*	*444,745*	*13.0*	*838,904*	*24.4*
Other	*5,627*	*0.2*	*6,904*	*0.2*	*12,531*	*0.4*
Africa	487,028	14.2	310,969	9.1	797,997	23.2
Asia	300,479	8.8	251,506	7.3	551,985	16.1
North America	7,950	0.2	9,499	0.3	17,449	0.5
Central and South America	101,048	2.9	175,053	5.1	276,101	8.0
Oceania	1,009	..	1,518	..	2,527	0.1
Stateless persons	402	..	320	..	722	..
Total	**1,701,817**	**49.6**	**1,730,834**	**50.4**	**3,432,651**	**100.0**

Source: Istat, *Bilancio demografico*, 2008.
(1) As a percentage of the total. – (2) Bulgaria, Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Romania, Slovakia and Slovenia. – (3) Albania, Belarus, Bosnia and Herzegovina, Croatia, Macedonia, Moldavia, Montenegro, Russia, Serbia, Turkey and Ukraine.

Compared with the main European countries, foreigners resident in Italy are younger and less educated. On average, over the three-year period 2005-07, the median age of the legally resident foreign population over the age of 16 was 38 years, similar to that in

Spain and well below the average age of over 50 years recorded in Germany and France. Just under half of the legally resident foreign population aged between 25 and 55 years has, at most, an educational level corresponding to the end of compulsory schooling, a share about 16 points higher than the average EU-15 score; only about 15 per cent have a university qualification, against a European average of around 36 per cent.

The economic condition of immigrants in Italy

In 2008, according to Istat's survey of the labour force, foreigners aged at least 15 years and legally resident in Italy as part of a family (5.2 per cent) accounted for 7.5 per cent of total employment, 8.5 per cent of payroll employment and 4.5 per cent of self-employment. In the 15-64 age group, 67.1 per cent were employed, against 58.1 per cent of Italian citizens (Table 11.2). This difference is mainly due to the different characteristics of the foreign population. In particular, for about half the total this may reflect the higher concentration of foreigners in the wealthier regions of the Centre and North, especially in those with the highest industrial density.

Table 11.2

Composition, participation and employment rates of the working-age population in 2008
(percentages)

AGE GROUP	Educational level	Population		Participation rate		Employment rate	
		Italians	Foreigners (1)	Italians	Foreigners (1)	Italians	Foreigners (1)
				Males			
15-24				34.7	53.0	27.9	46.5
	Up to lower secondary school	8.7	12.6	23.5	47.1	18.4	41.6
	Upper secondary school	6.6	3.7	49.8	73.6	40.7	63.6
	University degree or higher	0.4	..	29.8	0.0	23.8	0.0
25-54				90.7	94.7	86.5	89.7
	Up to lower secondary school	28.8	41.2	88.3	93.3	82.9	87.7
	Upper secondary school	27.7	32.0	92.6	96.3	89.4	91.8
	University degree or higher	9.0	6.6	92.2	95.9	89.0	91.7
55-64				46.6	75.4	45.1	70.7
	Up to lower secondary school	11.5	2.0	38.4	72.4	36.5	66.0
	Upper secondary school	5.3	1.2	53.8	72.4	52.8	69.1
	University degree or higher	1.9	0.7	75.0	88.8	74.8	86.6
Total		**100.0**	**100.0**	**73.6**	**87.1**	**69.5**	**81.9**
				Females			
15-24				25.2	32.7	18.9	25.2
	Up to lower secondary school	7.7	11.0	13.4	24.5	9.2	19.9
	Upper secondary school	6.7	4.7	36.8	50.5	28.7	37.1
	University degree or higher	0.7	0.2	42.1	60.1	31.8	31.7
25-54				65.2	65.5	60.4	58.2
	Up to lower secondary school	25.8	33.4	47.7	56.6	42.4	48.6
	Upper secondary school	28.0	33.9	73.6	70.8	69.0	64.0
	University degree or higher	11.3	12.0	84.6	75.4	79.9	68.7
55-64				24.1	57.3	23.5	53.8
	Up to lower secondary school	13.7	2.3	15.7	49.7	15.0	45.3
	Upper secondary school	4.4	1.7	38.0	60.2	37.4	58.5
	University degree or higher	1.7	0.8	55.5	73.8	55.1	68.8
Total		**100.0**	**100.0**	**51.0**	**59.9**	**46.8**	**52.8**

Source: Istat, labour force survey.
(1) Legally present in a family and resident in Italy.

Foreign workers are concentrated in sectors and jobs with lower professional qualifications: they account for about 16 per cent of production workers, against about 1 per cent of employees, executive and managerial staff (Table 11.3); they comprise 2.3 per cent of entrepreneurs, more than 5 per cent in the company services and hotel and restaurant sectors, and around 12 per cent of own-account workers in the construction industry. The proportion of foreign workers is more than 13 per cent in construction and hotel and restaurant services and 8 per cent in manufacturing industry.

Table 11.3

Proportion of immigrants employed in Italy in 2008
by position and branch of economic activity
(percentages)

	Agricul-ture	Industry			Services					Total
		Total	Manufac-turing industry	Construc-tion	Total	Trade	Hotel and restaurant services	Transport and com-munications services	Business services	
Payroll employess	13.1	10.7	9.3	16.7	7.3	4.4	17.4	6.0	7.3	8.5
Managers	*4.8*	*1.8*	*2.1*	*0.8*	*0.9*	*1.5*	*2.2*	*1.1*	*3.9*	*1.1*
Clerical staff	*1.5*	*1.2*	*1.4*	*1.0*	*1.6*	*1.8*	*7.5*	*1.0*	*1.5*	*1.5*
Production staff	*14.4*	*14.4*	*12.7*	*20.0*	*18.3*	*7.2*	*19.7*	*12.4*	*19.1*	*16.3*
Self-employed workers	0.6	7.1	3.7	10.7	3.9	4.7	5.6	5.0	2.1	4.5
Entrepreneurs	–	*1.9*	*1.3*	*2.8*	*3.0*	*1.7*	*6.4*	*0.9*	*5.5*	*2.3*
Professionals	–	*2.3*	*3.1*	*1.3*	*1.7*	*2.3*	*21.4*	*2.7*	*1.0*	*1.7*
Own-account workers	*0.6*	*8.3*	*3.7*	*12.1*	*5.1*	*5.2*	*5.1*	*4.9*	*5.0*	*5.6*
Total	**6.6**	**10.0**	**8.4**	**14.5**	**6.4**	**4.5**	**13.4**	**5.9**	**5.1**	**7.5**

Source: Istat, labour force survey.

According to INPS data, in 2004 in the non-farm private sector the weekly pay gap between foreign and Italian-born workers was more than 22 per cent on average. About half of this difference was due to concentration in sectors with below-average pay levels (construction, hotel and restaurant services) and to a generally lower position. Besides different levels of educational attainment, the remaining part may also reflect the fact that immigrants' previously acquired human capital is not easily transferable, at least initially. Foreign workers are also more likely to be employed in firms that, on average, have a lower level of productivity.

The rapid growth of the foreign population has also produced an increase in the share of sole proprietorships managed by immigrants: at the end of 2008 they accounted for 9 per cent of all firms in business (7 per cent were managed by non-EU citizens). In the same way as for payroll employees, foreign entrepreneurs also tend to be concentrated in activities with low levels of technology and innovation. This could also reflect initial difficulty in accessing credit as a result of the perception on the part of the banking system that foreign entrepreneurs present a higher level of risk.

Foreigner's household income reflects the pay gap and their greater concentration in low productivity sectors, together with lower levels of real and financial wealth (only 1 per cent of the total wealth held by resident households in Italy). Data from the Bank of Italy's Survey on Household Income and Wealth show that in the period 2002-06, on average, when the head of household was born abroad and was aged between 25 and 54 years (about 5 per cent of all households) the equivalent disposable income was about one third less than in those where the head of household was born in Italy. In the same period, about three quarters of foreign households had an equivalent disposable income that was below the median value of around €16,000; for more than a quarter of such households, income was below half the median value (a conventional measure for the poverty threshold).

Effects of immigration on the host country

The main effect of immigration for an advanced economy is the attenuation of population imbalances caused by the rapid ageing of the existing population; immigrants tend to be younger and they have a higher fertility rate. In 2008, Italy's old-age dependency ratio, measured as the number of persons aged 65 years and over per 100 persons of working age (15-64 years), was equal to 30.4 per cent. Without the resident foreign population, it would have been two percentage points higher.

The effects of the growing presence of foreign residents of working age on the pay and employment conditions of citizens in the host country depend on the characteristics of the immigrant population and on the degree of complementarity in the production process between workers with different skills. In particular, the inflow of foreign workers employed for technical and production work can increase the demand for managerial and administrative staff, requiring higher qualifications which are more readily found among the home population. The most recent assessments indicate that in the advanced economies the sharp increase in immigration in the last few years has had a slightly positive effect on the average remuneration of the resident population. There was a modest fall only for less skilled jobs, where competition from immigrants is stronger. There are similar indications as regards the employment prospects for citizens in the host country.

As in countries with a longer history of immigration, Italy's experience confirms that immigrant workers are complementary to large segments of the home working-age population, in particular as regards the better educated and females. The positive effect overall for Italian workers' employment prospects has not been coupled with negative effects on remuneration levels. The first results based on INPS data suggest that the average remuneration of Italian private payroll employees in the regions most affected by immigration flows has not changed significantly compared with the national average.

The capacity to absorb the supply of foreign labour also depends on adjustments in the productive structure and the demand for labour. These may require moving towards sectors employing more low-skilled workers or an increase, within each sector, in the intensity of labour. As in the United States and Germany, the latter prevailed. According to data in the Bank of Italy's Survey of Industrial and Service Firms, in the period 1996-2007 Italian manufacturing firms in areas with more immigrants steadily increased the proportion of production jobs but company size did not increase. Information from the Chambers of Commerce about new business start-ups indicates that the larger foreign presence is also associated with higher growth in the number of new manufacturing firms, in particular in the more labour-intensive sectors.

Young foreigners and schooling

The increase in the flows of migrants into Italy and the longer time horizon of the existing foreign population have led to rapid growth in the numbers of young people of foreign origin as a result of family reunifications and the higher fertility rate of immigrant women. In 2008, young people of foreign origin constituted over 7 per cent of all resident under-18s and about one tenth of the under-6s, almost double the figure recorded for this age group in 2003.

The foreign component will make a significant contribution to defining the future level and quality of Italy's human capital. According to Ministry of Education surveys, from the academic year 1997-98 to 2006-07, the number of foreign children attending schools up to the upper secondary level increased from about 70,000 to more than half a million (5.6 per cent of the corresponding school population), of whom three fifths in primary and lower secondary schools (about 7 per cent of all students). If suitable provision is not made to integrate these children, such rapid expansion will further widen the large gap in the human capital endowment scores for Italy in international comparisons since the foreign school population is already significantly behind in primary education and the difference is even more marked at the subsequent levels.

The consequences of this lag on foreign students' human capital gains are aggravated by higher school drop-out rates. In 2008, Istat's labour force survey showed that about 10 per cent of foreigners aged between 15 and 17 had left school, double the figure for Italian students. In the 18-21 age group, about 40 per cent of foreigners had left school without a diploma, against 16 per cent of Italians, and only 5 per cent continued their studies following the diploma (more than 25 per cent of Italians continue). Only a minimal part of these gaps results from different family characteristics or the wider social context of reference.

There are also wide gaps in the level of skills acquired by adolescents who decide to continue their studies. The last PISA study conducted by the OECD in 2006 among 15-year-olds showed that foreigners fall behind significantly in acquiring skills – quantifiable on average as about one year's education (two years in the case of non-EU students). With reference to the study of mathematics, the gap would be halved if the lag in text comprehension skills (also measured by the PISA test) were taken into account. As in the case of the school drop-out rates, the gap basically reflects a weaker link between the characteristics of the parents and the results of their children than between the different characteristics of foreign parents and Italian parents.

Immigrants and the public finances

The differences in income and spending between Italians and foreigners and the different population structure of the two groups influence the size and composition of economic flows to and from the public finances. It is estimated that in 2006 foreigners, who comprise around 5 per cent of the resident population, contributed about 4 per cent to revenue from personal income tax, VAT and excise duties, social security contributions, and the regional tax on productive activities (IRAP) of the private sector (overall more than 70 per cent of total revenue) and that they absorbed about 2.5 per cent of spending on education, pensions, health and income-support benefits (equal overall to around 60 per cent of total primary expenditure).

On the basis of the EU survey on income and living conditions (EU-SILC), it is estimated that foreign residents contribute around €4.5 billion in personal income tax and just under €10 billion in social security contributions, equivalent to 3 and 5 per cent respectively of revenue from these two items. Considering the entire population, per capita income tax amounted to about 60 per cent of that paid by Italian citizens, as a result of lower incomes and the progressive taxation system. On average, social security contributions paid by a foreign worker are around 80 per cent of those paid by an Italian worker.

Using the data from the Bank of Italy's Survey on Household Income and Wealth, revenue from VAT and excise duties raised from foreign taxpayers can be estimated at around 3 per cent of the total as a result of lower consumer spending and a smaller share of spending on consumer durables which are taxed more heavily. Around 5 per cent of the IRAP raised from the private sector can be attributed to foreigners. Overall, foreign residents in Italy contribute just under €5 billion in indirect taxes; the per capita amount is more than 60 per cent of that paid by Italians.

In 2006, data from the Ministry of Education and the EU-SILC survey indicate that, overall, foreigners absorbed more than 5 per cent of spending on education, equal to just under €4 billion. The share was greater, around 7 per cent, at the pre-school and primary school levels, reflecting the larger proportion of foreign citizens in the younger age groups. The proportion falls to 2.5 per cent at the post-secondary-school levels (which mainly includes university education), indicating an extremely low participation rate given the higher proportions of foreigners in these age groups compared with the national average.

The younger average age of the foreign population also leads to lower expenditure on healthcare (about 3 per cent of the total, €3 billion) and on pension benefits. Data from INPS for 2006 indicate that, overall, pensioners born abroad absorbed 1 per cent of total spending (equal to €2.3 billion). Foreign workers are accumulating large amounts of contributions which will translate into larger benefits in the future; it is estimated that over a decade the above-mentioned share of expenditure is likely to more than double. Considering beneficiaries only, the average amount of disability, old-age and survivor pensions is about 25 per cent less than for residents; welfare benefits are about 25 per cent higher than those received by residents. Data from INPS and the EU-SILC survey show that income-support benefits, excluding sickness and injury allowances, paid to foreigners account for around 7 per cent of the total (almost €1 billion).

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

After remaining basically stable in 2006-07, Italy's current account deficit began to grow again in 2008, rising to €53.6 billion and from 2.4 to 3.4 per cent of GDP (Table 12.1). The growth in the deficit was due above all to the income deficit, which rose from €19.6 billion to €29.5 billion, primarily owing to the increase in the country's net debt position and the swing in the trade balance from a surplus of €3.2 billion in 2007 to a deficit of €0.7 billion in 2008 due to the rise in the prices of energy products. The deficit on services widened slightly, owing to the stagnation of receipts from foreign tourists and the fall in revenue from international transport as a result of the crisis of Alitalia. The deficit on transfers also widened, from €14.2 billion to €16 billion.

Table 12.1

Balance of payments
(billions of euros)

	2004	2005	2006	2007	2008
Current account	**-13.1**	**-23.6**	**-38.3**	**-37.7**	**-53.6**
Goods	8.9	0.5	-10.2	3.2	-0.7
Non-energy products (1)	*36.9*	*37.5*	*37.5*	*47.9*	*56.6*
Energy products (1)	*-28.0*	*-37.0*	*-47.7*	*-44.7*	*-57.3*
Services	1.2	-0.5	-1.3	-7.1	-7.4
Income	-14.8	-13.6	-13.6	-19.6	-29.5
Transfers	-8.3	-10.0	-13.3	-14.2	-16.0
of which: EU institutions	*-6.5*	*-8.2*	*-8.1*	*-8.4*	*-10.3*
Capital account	**1.7**	**1.3**	**1.8**	**2.3**	**0.8**
Intangible assets	..	0.1	-0.1	-0.1	..
Transfers	1.7	1.3	1.9	2.3	0.8
of which: EU institutions	*2.8*	*3.7*	*3.8*	*3.3*	*2.2*
Financial account	**9.0**	**20.9**	**25.4**	**26.2**	**49.6**
Direct investment	-2.0	-17.6	-2.3	-37.0	-18.3
Outward	*-15.5*	*-33.6*	*-33.5*	*-66.3*	*-29.9*
Inward	*13.5*	*16.1*	*31.3*	*29.4*	*11.6*
Portfolio investment	26.4	43.4	44.3	18.1	118.5
Equities	0.5	-16.0	-8.8	-0.3	70.4
Debt securities	25.9	59.3	53.1	18.4	48.1
Financial derivatives	1.8	2.3	-0.4	0.4	6.8
Other investment	-19.6	-8.1	-16.7	46.2	-51.8
of which: MFIs (2)	*-10.0*	*27.0*	*44.0*	*83.0*	*-18.5*
Change in official reserves (3)	2.3	0.8	0.4	-1.5	-5.6
Errors and omissions	**2.4**	**1.4**	**11.1**	**9.2**	**3.2**

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

The overall deficit of €52.8 billion on current and capital account was offset by a net inflow of €49.6 billion on financial account. Against the background of a generalized decline in international mergers and acquisitions, there was a reduction in net outflows in connection with direct investment, from €37 billion to €18.3 billion. Net inflows for portfolio investment were exceptionally large, rising from €18.1 billion to €118.5 billion, mainly as a result of the huge disposals of shares, above all on the assets side, triggered by the financial crisis. "Other investment" returned to a net outflow, with a deficit of €51.8 billion; in particular, in the last quarter of 2008 the difficulty of raising funds on the international interbank markets reduced the foreign debt of Italian banks with very substantial outflows of funds. The official reserves increased by €5.6 billion.

Italy's net external debt position more than doubled, rising from €81.2 billion to €196.2 billion (12.5 per cent of GDP), above all owing to the fall in share prices, which reduced assets more than liabilities, and the very substantial inflows on financial account.

In 2008 the Bank of Italy began to receive data collected from a sample of firms (about 9,000 in 2009) with a view to compiling the balance of payments. The new system – based mainly on sample surveys and "security-by-security" information provided by depository banks with regard to customers' financial stocks – is expected to come fully into force in 2010. Use of the new sources will lead to the abandonment of the bank reports based on settlements. On the basis of the new data so far collected, a start has already been made on a revision of most of the aggregates of Italy's balance of payments and net international investment position.

The current and capital accounts

Trade in goods. – In 2008 the *fob-fob* trade balance deteriorated by €3.9 billion: the growth in value of imports (2.5 per cent) exceeded that of exports (1.4 per cent). The energy deficit began to increase again in the last part of 2007 owing to the large rise in oil prices, which reached their highest-ever level in nominal terms in July 2008; the substantial fall in prices in the following months curbed the worsening of the balance in 2008 as a whole. The structural surplus on non-energy products increased for the fifth successive year, rising to 3.6 per cent of GDP, but, in contrast with the previous years, this was due only to a fall in the value of imports (2.1 per cent), accompanied by a slight rise in that of exports (0.6 per cent).

The worsening of the *fob-fob* trade balance was entirely due to the doubling, from €6.1 billion to €12.3 billion, of the merchandise trade deficit with the non-EU-27 countries, which include the main suppliers of energy products; by contrast, the surplus with the EU countries continued to grow, rising from €9.3 billion to €11.5 billion, thanks to a larger fall in imports than in exports.

The deficit on merchandise trade with the euro-area countries halved, falling from €6 billion to €3.1 billion: the deficit with Germany fell by €2.5 billion as a result of a fall in imports, especially of electrical machinery and motor vehicles, accompanied by stagnant exports; the surplus with France increased slightly, thanks to a larger fall in imports than in exports; by contrast, there was a decrease in the surplus with Spain – one of first euro-area countries to feel the effects of the international crisis – owing to a brusque fall in Italy's exports. There was also a slight decrease in the surplus with the EU countries not belonging to the euro area, against a background of declining bilateral trade.

The growth in Italy's deficit with the non-EU countries was almost entirely due to its trade with the OPEC countries, the United States and China. The exceptional increase in the oil price in the early part of 2008 caused the deficit with the OPEC countries to widen from €15.2 billion to €19.5 billion, despite the continued rapid growth in exports to these countries, whose demand is driven up by their oil revenues. The growth in goods purchased from China, the country with the third largest market share of Italian imports, slowed sharply but was nonetheless equal to 11.8 per cent; Italian exports to China, which also slowed sharply, grew by only 2.5 per cent, with a consequent further increase in the bilateral deficit. In addition, the surplus with the United States continued to contract: a robust increase in Italy's imports, fostered by the depreciation of the dollar in the early part of the year, was accompanied by an acceleration of the fall in exports, especially traditional Italian products and electrical machinery, owing not only to the fall in US demand but also to exchange rate movements.

After an improvement that began in 2004 and gathered strength in 2006-07, exports of non-energy manufactures on a *cif-fob* basis stagnated, adversely affected by the appreciation of the euro and the sharp fall in world demand in the last part of the year. The largest contributions to the increase in the manufacturing surplus came from metal products and means of transport, where export growth was moderate or nil but was accompanied by a sizeable fall in the value of imports. The surplus on mechanical machinery and equipment – the sector that in the last ten years has contributed most to the growth in the surplus – continued to expand, albeit less fast than in the recent past, as a consequence of moderate export growth accompanied by a slight fall in imports. After an interruption lasting two years, the trade surplus of the traditional sectors contracted again, owing to the fall in the volume of exports.

Trade in services. – For the fourth successive year there was a deficit on services (€7.4 billion and 0.5 per cent of GDP), with a further slight deterioration compared with 2007. The negative contributions of foreign travel and construction were only offset in part by the improvements in the balances for insurance and financial services and communication services.

The reduction of the surplus on foreign travel, which records the receipts and outlays related to international journeys for business and personal reasons, was due to an increase in the expenditure abroad of Italian travellers accompanied by stagnant tourism revenue. Against a background of reduced economic activity both in Italy and abroad, the small deficit on foreign business travel was almost eliminated: revenue was stagnant, while outlays declined.

In a context of reduced inflows and outflows of transport services owing to the international recession, the sector's structural deficit grew slightly compared with 2007. Receipts decreased faster than outlays (5.4 per cent as against 1.4 per cent), primarily owing to the larger deficit on passenger air transport services caused by the crisis of Alitalia: outlays increased by 17.6 per cent, while receipts decreased by 35 per cent.

Income. – The growth of the deficit on income accelerated. As in 2007 the deterioration in the balance can be attributed to the increase in the deficit on investment income, the balance of receipts and outlays in relation to the nominal yields on financial assets but not capital gains, which rose from €19.5 billion to €29.1 billion, and in particular to the large increase in interest and dividends from portfolio investment. The deterioration was primarily due to the growing external debt position; the large increase in payments on portfolio liabilities (22.6 per cent compared with 2007) was also due to the high level of dividends following the good corporate results achieved in 2007 and Italian companies' maintaining their generous dividend policy. Compensation of employees gave rise to a negligible deficit.

Most of the overall deficit (more than four fifths in 2008) was due to the investment income components related to portfolio investment in debt securities and to "Other investment"; income from portfolio investment in equity securities also showed a deficit, while that from direct investment showed a small surplus (€3.3 billion in 2008).

Transfers. – The deficit on current transfers increased from €14.2 billion in 2007 to €16 billion in 2008 as a consequence of the increase in the deficit vis-à-vis the Community institutions (from €8.4 billion to €10.3 billion). The deficit on workers' remittances continued to expand, but at a slower pace than the average for the five previous years, rising from €5.8 billion to €6.2 billion as a result of the increase in the number of foreign workers in Italy.

Investment

Direct investment. – In 2008 world flows of direct investment were powerfully affected by the financial crisis, owing both to the deterioration in the economic outlook and to firms' reduced self-financing capability and access to credit. The inflow of direct investment into Italy fell by 60.4 per cent, from €29.4 billion to €11.6 billion (equal to 0.7 per cent of GDP); about €9 billion of the reduction was due to a single foreign disinvestment: the transfer of the ownership of Banca Antonveneta from Banco Santander to Monte dei Paschi di Siena. The non-bank sectors were dominated by a prudent approach by foreign investors, with a widespread contraction in both investment and disinvestment transactions. One of the most penalized sectors was mechanical engineering, which includes transport equipment, one of the branches of manufacturing hardest hit by the crisis. By contrast, there was an increase in investment in the energy sector, characterized by a phase of intense technological innovation. The decrease in total inflows was in line with that recorded in Germany but in percentage terms twice that recorded in France.

Italian direct investment abroad amounted to €29.9 billion, which was only slightly less than in 2005-06; the large fall with respect to 2007 (-54.9 per cent) was influenced by two large transactions carried out in that year (Enel's acquisition of Endesa and the reorganization of the equity holdings within the UniCredit Banking Group). In the non-bank sectors, direct investment in mechanical machinery and transport equipment decreased by 57 per cent.

Portfolio investment. – In 2008 the worsening of the financial crisis encouraged investors to engage in a "flight to quality" and increased the domestic bias in their portfolio choices, with a consequent expansion in the demand for public-sector securities and re-entry of capital invested abroad in riskier assets. For Italian government securities the first factor was more important than the second: non-residents increased the share of Italian government securities in their portfolios, whereas the large share of Italians' portfolios invested in foreign shares contracted. Total portfolio investment inflows thus rose in 2008 to the historically high level of €118.5 billion, corresponding to 7.5 per cent of GDP. On average for the three preceding years net inflows amounted to €35 billion. Provisional data for the first three months of 2009 indicate that portfolio investment inflows continued at a high level.

The downsizing of the foreign share portfolios held by residents, which had already begun in the summer of 2007 in conjunction with the start of the financial turbulence, accelerated as market tensions accentuated. Sales generated inflows amounting to €90 billion, sharply up from the €11 billion recorded in 2007. Some 61 per cent of these inflows derived from sales of units of foreign investment funds – included by statistics among equity-type securities and widely held in the portfolios of Italian investors – by resident non-bank sectors. The flight from foreign shares was a feature of the whole year and reached a peak of €14.7 billion in October, when there was a generalized fall in stock indices. In the same month there was also a concentration of sales of foreign debt instruments, for a similar amount, probably aimed at meeting residents' liquidity needs. In the year as a whole such residents made €13.3 billion net investments in foreign non-equity securities, in line with the figure for 2007 (€11.7 billion), but much less than in the preceding years.

Symmetrically, although for a smaller amount (€19.6 billion, as against €11.4 billion in 2007), foreign investors reduced the Italian equity component in their portfolios. By contrast, purchases from abroad of Italian debt securities doubled compared with 2007, rising from €30.1 billion to €61.4 billion. The increase involved only government securities, which recorded €76.3 billion of net purchases from abroad, a figure greater than the total net issues for the year. Purchases consisted above all of BTPs and BOTs; they were very substantial in the first quarter, during which large issues were made, and continued at a rapid pace in the fourth quarter, after the explosion of the financial crisis. Foreign investors made net disposals of debt securities of Italian private-sector issuers amounting to €14.5 billion, compared with net purchases amounting to €34.8 billion in 2007.

Other investment. – This item recorded a net outflow of €51.8 billion, compared with a net inflow of €46.2 billion in 2007. Italian banks, which had made net borrowings abroad in the three previous years, reduced both their foreign fund-raising and to a lesser extent their foreign lending and recorded a net outflow of €18.5 billion (as against a net inflow of €83 billion in 2007). The outflows consisted mainly of deposits on the liabilities side and were concentrated in September and October with the freezing up of the interbank markets following the collapse of Lehman Brothers.

The official reserves. – Transactions during the year increased the official reserves by €5.6 billion. The gold reserves recorded a revaluation gain of €4.2 billion as a result of an increase of 9.4 per cent in the price of gold in euros; at the end of the year they amounted to €49 billion. The stock of official reserves rose from €64.1 billion at the end of 2007 to €75.6 billion at the end of last year.

The net international investment position

Italy's year-end net external debt showed a further increase, more than doubling from €81.2 billion and 5.3 per cent of GDP at the end of 2007 to €196.2 billion and 12.5 per cent of GDP at the end of 2008 (Table 12.2). A large part of the growth can be attributed to the net inflow of €49.6 billion on the financial account, but the most important factor was the €69.7 billion negative price adjustment caused by the fall in the prices of securities.

Table 12.2

Net international investment position
(billions of euros)

	Stocks at end-2007 (1)	January-December 2008 Flows (2)	Value adjustments Total	Value adjustments exchange rate	Value adjustments other	Change in stocks	Stocks at end-2007 (2)
	(a)	(b)	(c)=(d)+(e)	(d)	(e)	(f)=(b)+(c)	(a)+(f)
			Resident non-banks				
Assets	1,334.6	-7.2	-99.9	1.5	-101.4	-107.1	1,227.5
Direct investment	290.9	24.5	-10.7	-3.6	-7.0	13.8	304.8
Portfolio investment	739.5	-93.6	-89.8	4.6	-94.4	-183.3	556.2
of which: equities	*365.5*	*-78.0*	*-83.3*	*4.1*	*-87.4*	*-161.3*	*204.2*
Other investment	292.0	59.8	0.5	0.5	..	60.3	352.3
Derivatives	12.2	2.0	..	..	..	2.0	14.2
Liabilities	1,244.5	74.6	-20.4	1.1	-21.6	54.1	1,298.6
Direct investment	222.1	20.6	-4.9	0.1	-4.9	15.7	237.8
Portfolio investment	846.9	35.8	-16.4	0.3	-16.6	19.5	866.3
of which: equities	*35.8*	*-17.3*	*-9.3*	*..*	*-9.3*	*-26.6*	*9.1*
Other investment	144.4	10.5	0.8	0.8	..	11.3	155.7
Derivatives	31.1	7.7	..	..	..	7.7	38.7
Net position	**90.1**	**-81.7**	**-79.5**	**0.4**	**-79.9**	**-161.2**	**-71.1**
			Resident banks				
Assets	455.2	3.1	18.4	8.3	10.1	21.5	476.6
Liabilities	757.1	-36.4	12.6	5.4	7.3	-23.8	733.3
Net position	**-301.9**	**39.5**	**5.8**	**3.0**	**2.8**	**45.3**	**-256.7**
			Central bank				
Assets	130.7	-7.2	8.3	0.9	7.4	1.1	131.8
Liabilities	0.1	0.1	..	..	..	0.1	0.2
Net position	**130.6**	**-7.3**	**8.3**	**0.9**	**7.4**	**1.0**	**131.6**
Total net position	**-81.2**	**-49.6**	**-65.4**	**4.2**	**-69.7**	**-115.0**	**-196.2**

(1) At end-of-period prices and exchange rates. – (2) At the prices and exchange rates obtaining on the transaction date. – (3) In December 2008 the method used to obtain resident banks' stocks of international assets and liabilities was changed. This caused a very large increase in derivative assets and liabilities, of which more than half was due to the reclassification of "Other investment" items. The increase in the stocks of derivatives not due to such reclassifications also appears, in the reconciliation between flows and stocks, under the item "Value adjustments: other" and entirely explains the positive values of this item for resident banks.

Among the liabilities, the large inflows, serving for the purchase of government securities, outweighed the negative price adjustments and led to an increase of €30.4 billion in the total stock at the end of 2008. Among the assets, the fall in the prices of securities and in particular of equities and units of investment funds, held above all by the non-bank private sectors, produced very large reductions in value (€83.9 billion for all the resident sectors and all the instruments), to which must be added the disposals of foreign shares and the decrease in bank loans recorded in the balance of payments. Foreign portfolio assets, marked by a large equity component, were affected by the fall in share prices more than liabilities, consisting mostly of public debt securities.

The Italian banking sector saw its net external debt position decrease by €45.3 billion (from €301.9 billion to €256.7 billion). A major contribution to this reduction came from the halving of the market value of the equity liabilities. On the assets side of the portfolio, purchases of debt securities more than offset the disposals of shares, in a context of less pronounced share price falls than those of the corresponding liabilities.

13. THE PUBLIC FINANCES

The first effects of the economic crisis and an expansionary budget increased net borrowing from 1.5 per cent of GDP in 2007 to 2.7 per cent in 2008. The official forecasts drawn up at the end of 2007, which incorporated a still favourable macroeconomic scenario, had indicated that net borrowing would decline from 2.4 per cent of GDP in 2007, as then estimated, to 2.2 per cent in 2008.

Primary current expenditure grew by 4.5 per cent in 2008, rising by 1.1 percentage points of GDP to a new high. Capital expenditure fell from 4.1 to 3.8 per cent of GDP. The ratio of tax and social security revenue to GDP diminished by 0.3 percentage points, owing to the relief granted in relation to the regional tax on productive activities and the municipal property tax. The ratio of debt to GDP rose by 2.2 percentage points to 105.7 per cent.

In the summer of 2008 – when the outlook for growth was still considered to be relatively promising – the new Government accelerated the timetable with respect to the usual procedures and drew up a three-year adjustment plan intended to achieve budgetary balance in 2011. The objective for 2009 was to reduce net borrowing by half a percentage point, to 2 per cent of GDP.

In the following months, as the crisis grew worse, various measures were enacted to counter the effects on the financial sector, attenuate the social costs and sustain aggregate demand. The latter two objectives were pursued above all by changing the destination of previously allocated funds and speeding up the actual use of resources; the planning of the interventions was constrained by the need to minimize their impact on net borrowing and the debt.

The estimate of the deficit in 2009 was revised upwards several times to take account of the gradual worsening of the growth forecasts. Most recently, the April 2008 Combined Report on the Economy and the Public Finances estimated that net borrowing would amount to 4.6 per cent of GDP. Revenue was expected to be 47.6 per cent, in line with the previous peak recorded in 1997, primary expenditure to rise by another 3.1 percentage points of GDP and the debt to increase by 8 percentage points, to 114.3 per cent.

In the early part of 2009 the general government borrowing requirement was much larger than a year earlier as a result of a generalized fall in revenue.

For 2010 the Combined Report points to net borrowing unchanged with respect to 2009 and a further rise in public debt to 117.1 per cent of GDP. The European Commission expects the deficit to rise to 4.8 per cent of GDP. Both estimates assume a relatively rapid economic recovery, resulting in an upturn, albeit modest, in activity in 2010 and a sharp slowdown in the rate of increase in expenditure.

A consolidation plan providing for budgetary balance in a reasonable period of time and a significant reduction in the debt in relation to GDP will have to include major measures aimed at the structure of expenditure and the functioning of general government. Important contributions can come from further steps to raise the retirement age and reduce tax evasion.

Budgetary policy for 2008: objectives and forecasts

At the end of 2007 a budget was approved that increased the deficit for 2008; according to the official estimates the good performance of the economy was nevertheless expected to bring a small reduction in net borrowing, to 2.2 per cent of GDP. During 2008 this estimate was raised progressively and ended up at 2.5 per cent, reflecting the sharp deterioration in economic conditions on the one hand and the large downward revision of the deficit for 2007 on the other.

The June 2007 Economic and Financial Planning Document forecast GDP growth of 1.9 per cent in 2008 and estimated that net borrowing would be equal to 2.2 per cent of GDP, a decrease of 0.3 percentage points with respect to the result expected at the time for 2007 (Table 13.1).

Table 13.1

Public finance objectives, estimates and outturn for the year 2008
(billions of euros and percentages of GDP)

	General government				*Memorandum items*		
	Net borrowing	General primary surplus	Interest payments	Debt	Real GDP growth rate (%)	Nominal GDP	Estimate of 2007 net borrowing
Objectives							
Economic and Financial Planning Document (June 2007)	35.9	42.5	78.4	….		1,606.1	38.3
as a percentage of GDP	*2.2*	*2.7*	*4.9*	*103.2*	*1.9*		*2.5*
Forecasting and Planning Report (September 2007) (1)	35.4	42.9	78.3	….		1,605.0	36.4
as a percentage of GDP	*2.2*	*2.7*	*4.9*	*103.5*	*1.5*		*2.4*
Stability Programme (November 2007)	….	….	….	….		1,605.0	….
as a percentage of GDP	*2.2*	*2.6*	*4.9*	*103.5*	*1.5*		*2.4*
Estimates released in 2008							
Combined Report on the Economy and the Public Finances (March 2008)	38.7	40.6	79.3	….		1,590.4	29.2
as a percentage of GDP	*2.4*	*2.6*	*5.0*	*103.0*	*0.6*		*1.9*
Economic and Financial Planning Document (June 2008)	39.1	40.7	79.8	….		1,588.8	29.2
as a percentage of GDP	*2.5*	*2.6*	*5.0*	*103.9*	*0.5*		*1.9*
EFPD update (September 2008) (2)	39.7	41.4	81.1	….		1,594.6	29.2
as a percentage of GDP	*2.5*	*2.6*	*5.1*	*103.7*	*0.1*		*1.9*
Stability Programme and Information Note 2009-2011 (February 2009)	40.8	39.7	80.5	….		1,572.5	….
as a percentage of GDP	*2.6*	*2.5*	*5.1*	*105.9*	*-0.6*		*1.6*
Outturn (April 2009) (2)	**43.0**	**37.9**	**80.9**	**1,662.6**		**1,572.2**	**23.2**
as a percentage of GDP	*2.7*	*2.4*	*5.1*	*105.7*	*-1.0*		*1.5*

(1) The primary surplus is taken from Section II of the document. – (2) Sources: Istat; for the debt, Bank of Italy.

In the September Forecasting and Planning Report the Government lowered the figure for net borrowing on a current legislation basis from 2.2 to 1.8 per cent of GDP, despite the reduction to 1.5 per cent in the forecast growth in GDP. The objective nonetheless remained unchanged because at the same time the Government drew up a budget that would increase the deficit by about 0.4 percentage points of GDP. The GDP growth forecast and the objective for net borrowing were confirmed in the November update of the Stability Programme.

In the Combined Report published in March 2008 the Government reduced the GDP growth forecast from 1.5 to 0.6 per cent. The estimate of net borrowing was raised by only 0.2 percentage points (to 2.4 per cent of GDP), in view of the better-than-expected result for 2007.

At the end of May the new Government approved Decree Law 93/2008, which provided, on the one hand, for the abolition of the municipal property tax on main residences and partial tax relief on overtime pay and productivity bonuses and, on the other, for reductions in numerous expenditure appropriations. According to the official evaluation, the decree would not alter net borrowing in 2008 or 2009 but would reduce it by 0.1 percentage points of GDP in 2010.

In the Economic and Financial Planning Document published in June the estimate for the deficit was raised to 2.5 per cent of GDP, with account also taken of the effects of the simultaneously released budget for the years 2009-11. This increased both revenue and expenditure in 2008, while leaving the balance basically unchanged. The September Forecasting and Planning Report confirmed the estimate for net borrowing even though the expected growth in GDP was reduced to 0.1 per cent.

In the Stability Programme update in February 2009 the Government indicated a reduction of GDP in 2008 of 0.6 per cent and raised its estimate of net borrowing by 0.1 percentage points to 2.6 per cent of GDP. The public debt ratio was now expected to have risen by 1.8 percentage points instead of showing a small contraction as still indicated in November 2008.

Net borrowing

In March 2009 Istat announced that net borrowing in 2008 had been equal to 2.7 per cent of GDP and revised the figure for 2007 down to 1.5 per cent (Table 13.2).

Table 13.2

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

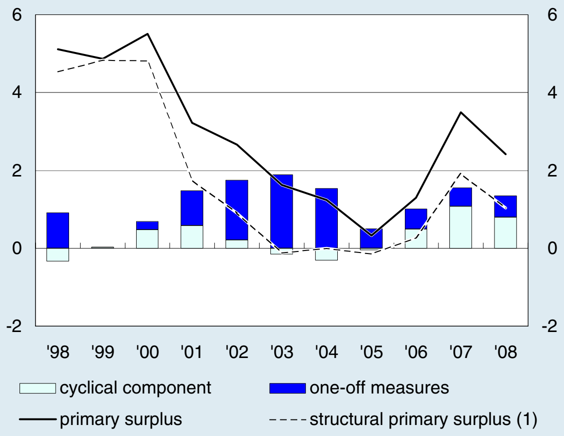
	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Revenue	46.4	45.4	45.0	44.5	45.1	44.5	44.2	45.8	46.9	46.6
Expenditure (2)	48.1	47.4	48.1	47.4	48.6	48.0	48.5	49.2	48.4	49.3
of which: interest payments	*6.6*	*6.3*	*6.3*	*5.5*	*5.1*	*4.7*	*4.6*	*4.6*	*5.0*	*5.1*
Primary surplus (2)	4.9	4.3	3.2	2.7	1.6	1.2	0.3	1.3	3.5	2.4
Net borrowing (2)	1.7	2.0	3.1	2.9	3.5	3.5	4.3	3.3	1.5	2.7
Borrowing requirement net of privatization receipts	3.4	3.5	5.0	3.1	4.2	4.2	5.3	4.0	1.9	3.1
Debt	113.7	109.2	108.8	105.7	104.4	103.8	105.8	106.5	103.5	105.7

Source: Istat for the general government consolidated accounts items.
(1) Rounding may cause discrepancies. – (2) The figure for 2000 does not include the proceeds of the sale of UMTS licences, which were deducted from expenditure in the national accounts.

The estimate of net borrowing for 2007 had already been reduced from 1.9 to 1.6 per cent of GDP in October when the public finance data were notified to the European Commission. The revision was in connection with the reclassification from the private sector to the public sector of the company Equitalia S.p.A. (which entailed the cancellation of the additional expenditure on capital account imputed by Istat in February 2008 to take account of the abolition of the advance payments by tax collection agents) and the change in the statistical treatment of public debt transactions involving derivatives. The further revision carried out in March was due to the normal updating of the statistical sources.

Figure 13.1

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



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

The worsening of the balance between 2007 and 2008 reflects the slowdown in revenue – associated with the first effects of the economic crisis and the tax reductions decided in the last two years – and the increase in primary current expenditure as a percentage of GDP.

On the basis of the methodology adopted by the Bank of Italy, in 2008 the structural primary surplus (cyclically adjusted and net of one-off measures) decreased by 0.9 percentage points to about 1 per cent of GDP, after increasing for two successive years (Figure 13.1). When account is also taken of some temporary factors that sustained revenue in 2007 but not in 2008, the decrease in the structural primary surplus was about half a percentage point of GDP.

One-off measures had virtually no effect on the change in net borrowing; they improved the result by about 0.5 percentage points of GDP in both years. The contribution of the economic cycle to the worsening of the budget balance was equal to about 0.3 points. This assessment takes account of the performance of the main tax bases, which on average was better than that of GDP. It is worth noting the disappearance in 2008 of some temporary factors that had sustained the revenue from direct corporate taxes and indirect taxes in 2006 and 2007. Considering these factors to be associated with the economic cycle but not caught by the evolution of the main tax bases of the national accounts, it can be estimated that in 2008 the contribution of the economic cycle to the increase in the deficit was more than half a percentage point of GDP; accordingly, the worsening of the structural primary surplus was 0.6 points.

Revenue and expenditure

Revenue. – In 2008 general government revenue amounted to €731.9 billion and 46.6 per cent of GDP (Table 13.3). The growth of this aggregate, which had been very rapid in the two preceding years (7.8 per cent in 2006 and 6.4 per cent in 2007), slowed to 1 per cent, reflecting the contraction in GDP and tax reductions.

Table 13.3

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

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Direct taxes	14.9	14.4	14.7	13.9	13.4	13.3	13.3	14.4	15.1	15.4
Indirect taxes	14.9	14.7	14.2	14.3	14.0	14.0	14.2	14.8	14.7	13.7
Capital taxes	0.1	0.1	0.1	0.2	1.3	0.6	0.1	0.0	0.0	0.0
Tax revenue	**29.9**	**29.2**	**29.0**	**28.4**	**28.7**	**28.0**	**27.6**	**29.2**	**29.8**	**29.1**
Social security contributions	12.5	12.4	12.3	12.5	12.6	12.6	12.8	12.8	13.3	13.7
Tax revenue and social security contributions	**42.4**	**41.6**	**41.3**	**40.8**	**41.4**	**40.6**	**40.4**	**42.0**	**43.1**	**42.8**
Other current revenue	3.6	3.4	3.5	3.5	3.4	3.6	3.5	3.6	3.5	3.6
Other capital revenue	0.4	0.3	0.2	0.2	0.3	0.3	0.3	0.3	0.3	0.2
Total revenue	**46.4**	**45.4**	**45.0**	**44.5**	**45.1**	**44.5**	**44.2**	**45.8**	**46.9**	**46.6**

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

The ratio of tax and social security receipts to GDP fell by 0.3 percentage points to 42.8 per cent. The ratio of indirect taxes to GDP fell by one point, partly as a consequence of the Irap and municipal property tax reliefs granted, while social security contributions and direct taxes rose in relation to GDP by respectively 0.4 and 0.3 percentage points.

Discretionary tax measures are estimated to have reduced tax and social security receipts by about half a percentage point of GDP. In 2008 the Irap labour cost relief introduced in 2007 became fully effective; its impact on revenue in respect of 2007 was also felt in 2008 since many firms took advantage of this relief when paying the balance of their self-assessed taxes. Additional relief was introduced in relation to main residences: in particular, the abolition of municipal property tax and an income tax deduction for tenants. The relief referred to above was only marginally offset by the increase in the taxation of the banking sector approved in June 2008 and the increase in some social security contribution rates in the budget for 2007.

Actual social security contributions increased by 4.7 per cent (€9.5 billion). The part related to payroll employment increased by 4.3 per cent, whereas earnings increased by 3.7 per cent. The part paid by self-employed workers grew by 7.7 per cent; one factor contributing to the growth was the increase of 1 percentage point in the rates payable by quasi-employees.

In what follows, receipts entered in the State budget accounts on a cash basis are analysed tax by tax. Receipts of Irap, municipal property tax and local personal income surtax are considered under local government.

It should be noted that the figures for 2008 do not include the receipts of Friuli Venezia Giulia, which began to withhold its share of central government tax receipts as of that year. When the amounts in question are included, the increases in the main taxes are a few tenths of a percentage point higher.

Corporate income tax receipts decreased by 9.3 per cent (€4.7 billion), after the large increases recorded in 2007 (28 per cent) and the two years 2005-06 (more than

17 per cent in each year). In more detail, in 2008 the balance of taxes due on the income of the previous year fell by 21 per cent (€2.8 billion). One factor in this result was the reimbursement, following changes to the deductibility of VAT on company cars, of a part of the corporate income tax paid in 2007. Despite the increase in the taxation of the banking sector decided in June, the payments on account of the tax on 2008 corporate income decreased by 6.1 per cent (€2.2 billion); the performance of the economy and the reduction in the penalties for incorrect payments may have led a larger proportion of companies to calculate their payments on account using the forecasting method (based on an estimate of income for the year) rather than the historical method (based on the actual income for the previous year).

As regards the taxation of households, personal income tax increased by 5.4 per cent (€8.1 billion). More than 2 percentage points of the increase was due to fiscal drag. The part withheld on employee incomes and pensions increased by 6.9 per cent (€7.6 billion). That paid on a self-assessed basis by the self-employed and small enterprises remained virtually unchanged compared with 2007. Empirical evidence suggests that it depends more on regulatory factors, such as sector studies, than on the economic cycle.

Revenue deriving from households' savings increased by 4.1 per cent (€0.6 billion), driven by the increase of 13.9 per cent (€1.5 billion) in the tax on interest payments. The bank deposit component increased by 15.7 per cent (€0.7 billion), partly as a consequence of the increase in interest rates in 2007; the bond component increased by 12.6 per cent (€0.8 billion). The revenue deriving from asset management fell by about half (€0.6 billion) owing to the reduction in holdings of investment fund units in 2007. The revenue deriving from the tax on capital gains decreased by €0.4 billion.

Among consumption taxes, receipts of VAT, which had made a significant contribution to sustaining revenue in recent years (with an average increase of 6 per cent in the last three), decreased by 1.5 per cent (€1.8 billion). The discrepancy between this result and the nominal increase of 2.3 per cent in consumption was only due in part to the fall in purchases of durable goods, which are subject to higher VAT rates. The deterioration in economic conditions made an impact above all in the last part of 2008: after remaining basically stable in the first nine months of the year, VAT receipts contracted by 4.3 per cent (€1.6 billion) in the last quarter.

Revenue deriving from excise taxes also contracted. In particular, receipts from the excise tax on natural gas decreased by nearly 40 per cent (€1.5 billion). The decrease is temporary: the tax paid in 2007 was more than was due and the excess was deducted in 2008.

Expenditure. – In 2008 general government expenditure amounted to €774.9 billion, an increase of 3.6 per cent on 2007. Primary current expenditure increased by 4.5 per cent and in relation to GDP rose from 39.3 to 40.4 per cent, the highest value in the postwar period (Table 13.4). More than half of the increase was due to expenditure on social benefits in cash and the remainder to compensation of employees and intermediate consumption. Capital expenditure decreased from 4.1 to 3.8 per cent of GDP, while interest payments increased from 5 to 5.1 per cent.

Table 13.4

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

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Compensation of employees	10.6	10.4	10.5	10.6	10.8	10.8	11.0	11.0	10.6	10.9
Intermediate consumption	5.0	5.0	5.1	5.2	5.3	5.4	5.5	5.2	5.2	5.4
Market purchases of social benefits in kind	2.1	2.3	2.5	2.6	2.6	2.7	2.8	2.8	2.7	2.7
Social benefits in cash	16.9	16.4	16.2	16.5	16.8	16.9	17.0	17.0	17.1	17.7
Interest payments	6.6	6.3	6.3	5.5	5.1	4.7	4.6	4.6	5.0	5.1
Other current expenditure	3.1	3.1	3.2	3.3	3.6	3.6	3.6	3.6	3.6	3.7
Total current expenditure	**44.2**	**43.6**	**43.9**	**43.8**	**44.2**	**44.0**	**44.4**	**44.1**	**44.3**	**45.5**
of which: expenditure net of interest payments	*37.6*	*37.3*	*37.6*	*38.3*	*39.1*	*39.3*	*39.8*	*39.5*	*39.3*	*40.4*
Gross fixed investment (2)	2.4	2.3	2.4	1.7	2.5	2.4	2.4	2.3	2.3	2.2
Other capital expenditure (3)	1.5	1.4	1.8	1.9	1.9	1.5	1.7	2.7	1.7	1.5
Total capital expenditure (3)	**3.9**	**3.7**	**4.2**	**3.6**	**4.3**	**4.0**	**4.1**	**5.0**	**4.1**	**3.8**
Total expenditure (3)	**48.1**	**47.4**	**48.1**	**47.4**	**48.6**	**48.0**	**48.5**	**49.2**	**48.4**	**49.3**
of which: expenditure net of interest payments (3)	*41.5*	*41.0*	*41.8*	*41.9*	*43.4*	*43.3*	*43.9*	*44.5*	*43.4*	*44.1*

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

Expenditure on social benefits in cash increased by 5.1 per cent to 17.7 per cent of GDP. Pensions increased by 4.2 per cent (4 per cent in 2007), reaching a new peak of 15.6 per cent of GDP (15.2 per cent in 2007). The increase in the non-pension component was again particularly large at 12.1 per cent (12.7 per cent in 2007).

On the basis of Eurostat estimates for 2007, expenditure in Italy on social protection (which includes some minor expenditure items in addition to social benefits in cash) amounted to 18.2 per cent of GDP, basically in line with the average of the other European countries (18.7 per cent for the euro area; 18 per cent for the European Union). By contrast, the proportion of expenditure to protect against the risks associated with old age, 68 per cent of the total, is among the highest, exceeded only by Greece; the proportion of expenditure on households with dependent children is one of the lowest, above only Greece and Spain.

On the basis of the EU-SILC sample survey, Italy's poverty rate is much higher than the average of the euro area (20 per cent against 16 per cent). The difference is more pronounced for minors younger than 16, whose poverty rate is 25 per cent against 18 per cent for the euro area, and less marked for over-65s (22 per cent against 19 per cent). The poverty rate for pensioners (many of whom have a relatively low age) is lower than for the Italian population as a whole.

Expenditure on social benefits in kind grew by 2.4 per cent, that on intermediate consumption by 5.7 per cent (1.7 and 4.1 per cent respectively in 2007). Nearly 90 per cent of social benefits in kind and 30 per cent of intermediate consumption referred to current health expenditure, which rose from 6.6 to 6.9 per cent of GDP.

Compensation of employees rose by 4.3 per cent (0.5 per cent in 2007) to 10.9 per cent of GDP, reflecting the signing of the contracts of the health sector and that of the workers of the regions, provinces and municipalities, which basically completed the contract renewals of the two years 2006-07. According to preliminary data, 2008 saw a renewed widening of the gap between per capita gross earnings in general government and the private sector.

Direct expenditure on investment (excluding the proceeds of real estate disposals, equal to €1.3 billion in 2008 and €1.4 billion in 2007) fell by 3 per cent. In the four years 2005-08 it fell on average by 1.1 per cent per year in nominal terms, reflecting the contraction of the local government component.

The increase of 4.8 per cent in interest payments was due in equal measure to the growth in the average stock of liabilities and the rise in their average cost from 4.8 to 4.9 per cent.

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.

The average gross interest rates on BOTs, which remained about 4 per cent from the second quarter of 2007 to September 2008, subsequently fell sharply to just above 1 per cent at the beginning of May 2009 (Figure 13.2). By contrast, those on longer-term securities have shown very small variations in the last three years.

Local government

The results for 2008. – In 2008 local government recorded a deficit equal to 0.2 percentage points of GDP, compared with a surplus of 0.1 points in 2007. The worsening was due to the large increase in current expenditure.

Local government expenditure grew from 15.1 to 15.6 per cent of GDP (€245.1 billion). The primary current component increased by 6.4 per cent to €203.2 billion. The largest item, the expenditure of the local health units, increased by 6.8 per cent. Compensation of employees increased by 8.6 per cent, boosted by the renewal of local government labour contracts; intermediate consumption increased by 7.4 per cent.

From the early years of this decade the health system has been the object of a series of legislative measures aimed at curbing pharmaceutical expenditure and discouraging deficits in individual regions. As regards the indirect distribution of pharmaceuticals, mechanisms have been adopted for the settlement of the claims of private-sector healthcare operators where the ceiling on expenditure established at national level has been exceeded; after growing by 14.7 per cent per year between 1995 and 2001, this expenditure item grew on average by 1.2 per cent between 2001 and 2006; in the two subsequent years it contracted by 3.9 per cent per year.

Capital expenditure decreased by 2.4 per cent (to €36.7 billion). Gross fixed investment decreased by 2.9 per cent (to €26.8 billion). In relation to GDP this item gradually fell from 2.1 per cent in 2004 to 1.7 per cent last year; municipalities made a particularly large contribution to the fall.

Total local government revenue rose from 15.3 to 15.4 per cent of GDP (€241.6 billion). For the first time since 1999 own revenue, calculated by excluding both public transfers and those from abroad (mainly the European Union), did not increase. In relation to GDP it fell from 8.7 to 8.5 per cent. This result was influenced by the 6.2 per cent decrease in indirect taxes (to €70.5 billion), due to the tax relief granted with respect to Irap and municipal property tax. This contraction more than offset the large increase in direct tax revenue (by 10.4 per cent to €32.3 billion).

Transfers to local government increased by 5.9 per cent. The growth came exclusively from current public transfers, which increased by 12.3 per cent (to €93.3 billion), in part in relation to the offsetting of the tax relief granted with respect to Irap and municipal property tax. Public contributions to investment and transfers from abroad contracted by 20.2 and 30.4 per cent respectively.

The enabling law on fiscal federalism. – Passed on 29 April, this law authorizes the Government to issue decrees to regulate the financial autonomy of local authorities (Article 119 of the Constitution) and lays down some rules of a general nature concerning: a) local tax resources; b) tax equalization; and c) coordination between the various levels of government.

The new system of local government finance is based on the assignment of own taxes to local authorities together with shares of the receipts of central government taxes; for the most part grants from central government are suppressed. Own taxes must be related to the services provided by local authorities and are divided into three categories: own taxes instituted by statutory law, surtaxes levied on the tax bases of central government taxes, and taxes created autonomously by local authorities themselves.

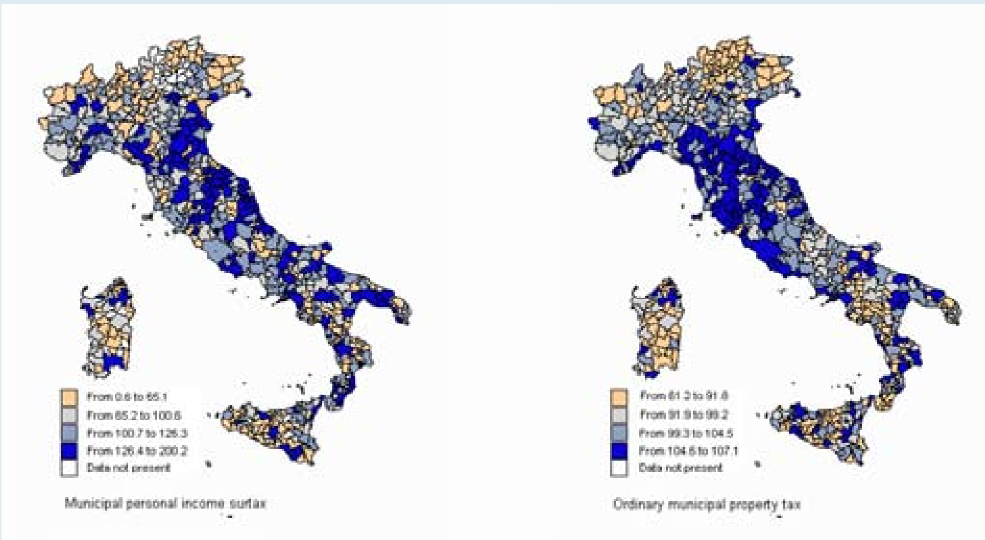
Local authorities will be able to alter the constituent elements of local taxes: for the first two categories of own taxes referred to above, they will be able to vary the rates and introduce tax credits (as well as deductions and allowances in the case of statutory own taxes) within the limits laid down by law. In the case of municipalities the limits to the variation in tax rates can be differentiated according to population.

Sufficiently ample space for autonomous taxation gives effect to the link at the margin between local authorities' expenditure and fund-raising decisions. In the current legal system the freedom to impose taxes is basically restricted to the power to alter, within predetermined limits, the rates of some local taxes. This power has been curtailed by the legislative measures adopted between 2003 and 2006 to suspend increases in Irap and local personal income surtax rates. The freeze on rates was reintroduced in more extensive form by Decree Law 93/2008 (ratified by Law 126/2008) pending the implementation of fiscal federalism.

The recourse made to taxation varies considerably across Italy. Irap and regional personal income surtax rates are higher on average in the Mezzogiorno owing to the automatic increases made in the regions with large healthcare deficits. At municipal level both personal income surtax rates and ordinary municipal property tax rates (which were not affected by the relief granted in 2008) are higher in the municipalities of the ordinary statute regions than in those of the special statute regions (0.45 and 0.66 per cent respectively against 0.35 and 0.62 per cent). Geographically, the rates average 0.52 and 0.69 per cent in the Centre, against 0.49 and 0.65 in the South and 0.38 and 0.64 in the North (Figure 13.3).

Figure 13.3

Rates of municipal property tax and municipal personal income surtax in 2008 (1)
(average values by area; index numbers, Italy = 100)



Sources: Based on data published by the Ministry for the Economy and Finance, the Ministry of the Interior and the Istituto per la Finanza e l'Economia Locale.
(1) The data refer to the average rate for each local labour system, weighted by the tax base of each municipality (for the municipal personal income surtax) and by tax receipts (for the municipal property tax).

The shares of central government tax revenue are assigned according to a geographical criterion: VAT revenue is assigned on the basis of the place of consumption; for personal income tax, which is indicated among the sources of the financing of municipalities, what counts is the place of residence of the receiver of income.

The system of financing local authorities is completed by an equalization fund, which acts in a different way according to the type of function to be financed. In the case of services for which all the regions must guarantee essential levels and the basic functions performed by local authorities, the equalization fund covers the entire financial need (valued on the basis of standard parameters). For all the other functions (except for some interventions for specific purposes) the equalization fund serves to bring about an adequate reduction in differences in fiscal capacity, without penalizing local authorities' efforts to recover tax base.

Among the services provided by the regions for which essential levels must be guaranteed, the law includes healthcare (for which the regions were already responsible), assistance (in part already decentralized at municipal level) and administrative tasks in the education field. For these functions the financial need covered by the equalization fund is to be calculated as the difference between some sources of tax revenue (statutory own taxes, the regional personal income surtax, and a part of the share of VAT) and the standard costs of the essential levels determined by statutory law. The tax rates and the shares are to be fixed at a level sufficient to guarantee the financial equilibrium of the richest region. The equalization fund, to which all the other regions would have access, would be financed by an additional share of VAT revenue. Local transport services are considered in part equivalent to services with essential levels.

As for the regions' non-fundamental functions, the differences in fiscal capacity are assessed with reference to the revenue generated by a personal income surtax with a rate that will generate, in the country as a whole, a revenue equivalent to the transfers suppressed. The law specifies that the equalization fund will take account of the local population but does not quantify the parameter for reducing the differences in fiscal capacity.

Turning to the coordination of the public finances, the law lays down some general principles concerning the tax system (limits to vertical tax competition, safeguarding of progressivity, the territorial nature of own taxes), the harmonization of annual accounts, fiscal regulations (superseding the historical expenditure criterion, rules consistent with the Stability and Growth Pact, and reward and penalty mechanisms). A series of bodies have been created: a Parliamentary Committee to implement fiscal federalism, a Committee of representatives of the local authorities, a Joint Technical Committee and a Standing Committee for the coordination of the public finances.

Among its tasks the Permanent Committee is required to supervise compliance with the Convergence Pact, which is established annually by the Government in the ambit of the Finance Law and lays down a path for the convergence of the costs, standard financial needs and service objectives of the various local authorities. At the same time it fixes, for each level of government, the planned level of the balances to comply with, the manner of having recourse to debt, and the target ratio of tax revenue to GDP.

The enabling law also has a series of articles concerning the provisional regulatory framework for "Roma capitale" and the metropolitan cities (which can be set up in the areas containing the municipalities of Turin, Milan, Venice, Genoa, Bologna, Florence, Bari, Naples and Reggio Calabria at the joint initiative of groups of local authorities).

The law requires that a first decree be issued within one year defining the fundamental principles with regard to public accounts, accompanied by a report on the general framework of local authority finances and hypotheses for the quantitative definition of the relationships between central and local authorities. All the implementing legislation is to be in place within two years. The transition to the new regime for assigning equalization resources is to take place over five years starting from the determination of the financial content of the essential levels of the services.

The borrowing requirement and the debt

The borrowing requirement. – After falling for two successive years, in 2008 the general government borrowing requirement rose by €21.9 billion, from €26.4 billion to €48.3 billion and from 1.7 to 3.1 per cent of GDP (Table 13.5). Equity disposals, which reduced the borrowing requirement in 2007 by €3.5 billion, were virtually nonexistent. The central government borrowing requirement (€52.5 billion) was affected by the thirty-year €8 billion loan made by the state to some regions aimed, as part of the plans for reducing large deficits, at repaying financial and commercial liabilities of the health sector. Local authorities and social security institutions recorded positive balances of €3.9 billion and €0.4 billion respectively.

Table 13.5

General government balances and debt
(millions of euros)

	2004	2005	2006	2007	2008
Net borrowing	48,572	61,432	49,312	23,225	42,979
Total borrowing requirement	49,737	70,668	58,811	26,370	48,282
Borrowing requirement net of privatization receipts	58,052	75,286	58,849	29,870	48,300
Debt	1,444,563	1,512,740	1,581,957	1,598,934	1,662,558
Memorandum item:					
Privatization receipts (-) (1)	-8,316	-4,618	-38	-3,500	-19

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

The disparity between borrowing requirement and net borrowing. – In 2008 the gap between general government's borrowing requirement and net borrowing narrowed from 0.4 percentage points of GDP in 2007 to 0.3 points, the third successive reduction (Table 13.6).

The factors contributing to the gap included the accumulation of financial assets (0.3 points of GDP, as against 0.4 points in 2007), 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 (0.3 per cent of GDP, as against 0.2 per cent in 2007 and an average of zero for the decade 1999-2008). The statistical discrepancies due to the different methods of measuring the borrowing requirement used by the Bank of Italy and the Ministry for the Economy and Finance reduced the gap by 0.2 percentage points of GDP (as against 0.1 points in 2007).

The debt. – In 2008 the ratio of general government debt to GDP rose by 2.2 percentage points to 105.7 per cent. The primary surplus (2.4 percentage points of GDP) was more than offset by the effect (3.3 percentage points) of the difference between the average cost of the debt and the GDP growth rate and by the residual component (1.3 percentage points), which reflects factors that impact on the debt but not on net borrowing.

Table 13.6

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

		1999	2000 (1)	2001	2002	2003	2004	2005	2006	2007	2008 (2)
(a)	**Net borrowing (Istat)**	**1.7**	**2.0**	**3.1**	**2.9**	**3.5**	**3.5**	**4.3**	**3.3**	**1.5**	**2.7**
(b)	Balance of financial items	0.6	2.2	0.5	0.3	0.3	1.0	1.3	0.5	0.4	0.3
(c)	Cash basis minus accrual basis	0.2	-1.1	0.6	-0.2	0.7	-0.4	-0.4	0.2	0.2	0.3
	primary balance	*0.3*	*-0.6*	*0.9*	*0.2*	*0.9*	*-0.2*	*-0.3*	*-0.1*	*0.3*	*0.1*
	interest payments	*-0.1*	*-0.5*	*-0.2*	*-0.4*	*-0.2*	*-0.1*	*-0.1*	*0.3*	*-0.2*	*0.2*
(d)=(a)+(b)+(c)	**Public sector borrowing requirement (MEF)**	**2.6**	**3.1**	**4.2**	**3.0**	**4.4**	**4.1**	**5.2**	**4.0**	**2.1**	**3.3**
(e)=(g)-(d)	Difference between the general government and public sector borrowing requirements	0.8	0.5	0.7	0.1	-0.2	0.1	0.0	-0.1	-0.1	-0.2
(g)	**General government borrowing requirement net of privatization receipts (BI)**	**3.4**	**3.6**	**5.0**	**3.1**	**4.2**	**4.2**	**5.3**	**4.0**	**1.9**	**3.1**
(h)	Privatization receipts (-)	-2.0	-1.3	-0.4	-0.2	-1.3	-0.6	-0.3	0.0	-0.2	0.0
(i)=(g)+(h)	**Total borrowing requirement (BI)**	**1.4**	**2.2**	**4.6**	**2.9**	**3.0**	**3.6**	**4.9**	**4.0**	**1.7**	**3.1**
(l)	Change in Treasury's deposits at the Bank of Italy	0.6	-0.8	0.2	0.0	-0.6	0.2	-0.1	0.6	-0.9	0.7
(m)	Issue discounts	-0.1	0.0	-0.2	-1.9	-0.3	0.0	-0.2	0.2	0.3	0.3
(n)	Change in the euro value of foreign exchange liabilities	0.6	0.1	0.0	-0.3	-0.2	-0.1	0.1	-0.1	0.0	0.0
(o)=(i)+(l)+(m)+(n)	**Change in the debt (BI)**	**2.5**	**1.5**	**4.6**	**0.8**	**1.9**	**3.7**	**4.8**	**4.7**	**1.1**	**4.0**
(p)=(a)-(o)	Difference between net borrowing and the change in debt	-0.7	0.5	-1.6	2.1	1.6	-0.2	-0.5	-1.3	0.4	-1.3
(f)=(a)-(g)	*Difference between general government net borrowing and the general government borrowing requirement*	*-1.6*	*-1.6*	*-1.9*	*-0.2*	*-0.8*	*-0.7*	*-1.0*	*-0.6*	*-0.4*	*-0.3*
(q)=(g)-(o)	*Difference between the general government borrowing requirement and the change in debt*	*0.9*	*2.1*	*0.3*	*2.3*	*2.4*	*0.5*	*0.5*	*-0.7*	*0.8*	*-1.0*

Sources: For net borrowing and interest payments on an accrual basis, Istat; for the public sector borrowing requirement (net of privatization receipts) and interest payments on a cash basis, the Ministry for the Economy and Finance – MEF (Quarterly Report on the Borrowing Requirement and the Combined Report on the Economy and Public Finances, various years); for the general government borrowing requirement and debt, the change in the Treasury's deposits at the Bank of Italy, privatization receipts, issue discounts and the change in the euro value of foreign exchange liabilities, the Bank of Italy – BI; for the balance on financial asset items, based on BI, *Conti finanziari.* The balance on financial asset items includes changes in holdings of the following instruments: cash and deposits, securities and loans; it does not include the change in the Treasury's deposits at the Bank of Italy, privatization receipts, or, for 2006, the change in loans due to the extraordinary cancellation of claims on TAV S.p.A. (€12,950 million). This cancellation reduced the component consisting in the difference between the primary balances on a cash and on an accrual basis, which is obtained as a residual.
(1) For 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) Provisional data.

The portion of the debt consisting of short-term securities increased by 0.9 percentage points (to 8.9 per cent), while that of medium and long-term securities declined slightly (from 74.4 to 74.3 per cent). The debt includes, with a par value of €30.5 billion, post office savings certificates issued up to April 2001, which were assigned to the Ministry for the Economy and Finance when the Cassa Depositi e Prestiti was transformed into a company limited by shares in 2003. At the end of 2008 the redemption value of these securities, which includes capitalized interest, was equal to €93.8 billion.

The ratio of local government debt to GDP fell from 7.2 to 6.8 per cent. The debt of the regions fell from 2.9 to 2.6 per cent of GDP, above all owing to the early closure of some securitizations in the health sector. As a ratio to GDP the debt of the municipalities and that of the provinces remained unchanged at respectively 3 and 0.6 per cent.

Local authorities' use of derivatives. – Since the mid-1990s local authorities have used financial derivatives in the management of their liabilities. Since 2001 legislators have intervened several times to prevent the taking on of excessive risks and the improper use of such instruments.

The Finance Law for 2002 and a subsequent decree issued in December 2003 established that local authorities may subscribe exclusively for plain vanilla derivatives (i.e. for the simplest form available on the market) and only in relation to liabilities that are truly payable. The Finance Law for 2007 made it obligatory to give advance notice to the Ministry for the Economy and Finance; that for 2008 introduced transparency obligations, including in local authorities' annual accounts. Lastly, the three-year adjustment plan approved in June 2008 required local authorities not to enter into new derivative contracts until the relevant regulations had been revised; this provision was reiterated in the Finance Law for 2009.

Local authorities' transactions in derivatives are analysed below on the basis of supervisory statistical reports and Central Credit Register data, which cover only contracts concluded with resident intermediaries. It needs to be stressed that the largest local authorities also use non-resident intermediaries. The notional value of the financial obligations covered by derivative contracts was about €0.1 billion at the end of 2000 and about €26 billion at the end of 2008.

The corresponding gross negative intrinsic values, which indicate the amount that local authorities would have to pay intermediaries if the outstanding transactions had to be closed, rose from about €2 million at the end of 2000 to about €1.1 billion at the end of 2008. The high level of these values and the low correlation with market interest rates may reflect a use of derivatives serving also to meet liquidity needs. The positive intrinsic value in favour of local authorities was equal to about €0.1 billion at the end of 2008.

At the end of 2008 there were more than 450 local authorities that had used financial derivatives with resident counterparties (13 regions, 32 provinces and more than 400 municipalities). On the supply side, the notional value market share of the three top-ranking resident intermediaries was equal to about 70 per cent.

The use of derivatives may provide local authorities with a guarantee against some financial risks (interest rate and exchange rate fluctuations) and make management of the debt easier. Nonetheless, since these financial instruments are complex and difficult to value, especially by smaller authorities, their use can cause a significant increase in financial costs and a reduction in the transparency of the public finances. The legislation that regulates the use of derivatives by local authorities is being revised; at present they cannot conclude new contracts. In view of the difficulty of preventing conduct aimed at shifting budget burdens on to future years, other countries have restricted the use of derivatives, especially by smaller local authorities.

Budgetary policy for 2009 and the medium term

In the summer of 2008, in a still relatively favourable cyclical context, the Government drew up a three-year adjustment plan aimed at achieving net borrowing equal to 2 per cent of GDP in 2009 and close to budgetary balance in 2011. In the months that followed, faced with a worsening of the crisis, various steps were taken to counter the effects on the financial sector and support economic activity. The progressive worsening of the outlook for growth has been reflected in the estimates of the deficit, which have been gradually revised upwards over the whole forecasting horizon.

At the end of June, together with the Economic and Financial Planning Document (EFPD) for 2009-13, the new Government approved a decree law that outlined nearly all the measures needed to achieve the objectives fixed for the three years 2009-11. The decree was ratified as a law at the beginning of August. Until this time it had been standard practice for the measures aimed at achieving the EFPD targets for the following year to be specified in the Finance Law, the examination of which begins at the end of September.

The EFPD of June 2008 laid down a gradual path for the reduction of net borrowing to 2 per cent of GDP in 2009 (Table 13.7), 1 per cent in 2010 and 0.1 per cent in 2011. A continuous reduction of the ratio of debt to GDP was planned, to bring it below 100 per cent in 2011.

The three-year adjustment plan provided, according to the official estimates, an improvement in net borrowing of 0.6 percentage points in 2009, 1 point in 2010 and 1.8 points in 2011. For 2009 the improvement was based prevalently on the net increase in revenue (involving almost exclusively banking, insurance and energy firms), whereas in the next two years a preponderant role was to be played by net expenditure reductions, which would increase from €4.1 billion in 2009 to more than €25 billion in 2011. These reductions derived mainly from financial constraints; achievement of the planned savings required the approval of measures specifying the operational aspects of the adjustment plan and providing for close monitoring of their implementation. The Finance Law approved in December introduced some marginal revisions to the planned revenue and expenditure values, but left the balances unchanged.

In October, November and February, as the financial crisis grew more acute, the Government approved packages to shore up the stability of the financial system and support the economy. The first gave the Government a series of instruments with which to protect savers and allow banks to maintain adequate levels of capitalization and liquidity. The latter two, according to the official estimates, were financed entirely by expenditure reductions and revenue increases, with no effect on the deficit. The November measures to support the economy provided above all for cash transfers to low-income households and, to a lesser extent, for relief for firms. The measures (costing €6.4 billion in 2009, €3.9 billion in 2010 and €4.8 billion in 2011) are to be financed mostly by an increase in revenue, half of which deriving from the introduction of a substitute tax on asset revaluations and in part also by a reduction in expenditure. Subsequently, in February, Legislative Decree 5/2009 introduced incentives for the purchase of durable goods, above all motor vehicles (€1.1 billion in 2009), matched by the elimination of some tax incentives and increased revenue as a consequence of the expected growth in demand.

Table 13.7

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

	General government				*Memorandum items*	
	Net borrowing	Primary surplus	Interest payments	Debt	Real GDP growth rate (%)	Nominal GDP
Estimates on a current legislation basis						
Economic and Financial Planning Document (June 2008)	42.8	40.3	83.1	….		1,637.2
as a percentage of GDP	*2.6*	*2.5*	*5.1*	*103.2*	*0.9*	
Forecasting and Planning Report (September 2008)	34.1	49.7	83.7	….		1,640.2
as a percentage of GDP	*2.1*	*3.0*	*5.1*	*102.9*	*0.5*	
Stability Programme and Information Note 2009-2011 (February 2009)	57.7	20.2	77.9	….	-2.0	1,563.4
as a percentage of GDP	*3.7*	*1.3*	*5.0*	*110.5*		
Combined Report on the Economy and Public Finances (April 2009)	71.0	5.4	76.4	….	-4.2	1,528.9
as a percentage of GDP	*4.6*	*0.4*	*5.0*	*114.3*		
Objectives						
Economic and Financial Planning Document (June 2008)	32.7	50.1	82.8	….		1,637.2
as a percentage of GDP	*2.0*	*3.1*	*5.1*	*102.7*	*0.9*	
Forecasting and Planning Report (September 2008)	34.1	49.7	83.7	….		1,640.2
as a percentage of GDP	*2.1*	*3.0*	*5.1*	*102.9*	*0.5*	

The use of fiscal policy for anti-cyclical purposes has been restricted in Italy by the country's large public debt and the increased risk aversion of Italian and international investors .This caused a considerable widening of the spread between BTPs and German securities with the same maturity, which has only been reabsorbed in part in the last few weeks.

In view of the state of the Italian public finances, the European Commission has judged the economic stimulus measures adopted by the Government to be substantially consistent with the European Economic Recovery Plan approved by the EU Council in December 2008.

When cyclical fluctuations are small, automatic stabilizers and monetary policy can be considered sufficient to curb the deviation of aggregate demand from potential output. As a rule, discretionary expansionary policies are considered inappropriate since they can have negative effects on capital accumulation in the long run (owing to the larger public debt, which would crowd out productive investment) or on the supply of labour (if the return to balance were to be based on higher taxation). In addition, the time taken for fiscal decisions and their implementation has often resulted in the public impulse arriving late and in many cases the assessments in real time of the state of the cycle have proved to be wrong. Nonetheless, in view of the severity of the present crisis, a broad consensus has emerged regarding the desirability for countries without major imbalances in their public finances to adopt discretionary stimulus policies. This indication presupposes that provision is made for expenditure cuts capable, once the crisis has been overcome, of reabsorbing the larger public debt created in order to sustain demand.

In the early months of this year Parliament approved two enabling laws. The law approved in March, known as the Brunetta Law, reforms the public employment relationship with a view to enhancing productivity. The second law, approved at the end of April, sets out a new system for financing local government expenditure, which the Government must regulate with implementing decrees over the next two years.

At the end of April, following the earthquake in Abruzzo, the Government approved Decree Law 39/2009, with measures in favour of the population concerned. The decree, which is currently being discussed in Parliament, refers to implementing provisions for the specification of important operational aspects of the measures.

The latest estimates for the public finances. – Last February's update of the Stability Programme took the estimate of net borrowing for 2009 to 3.7 per cent of GDP. The latest Government estimates, included in the April Combined Report, incorporate a further pronounced worsening of the economic outlook for this year. The document presents a forecasting scenario that is basically in line with that set out by the European Commission at the beginning of May. For 2009 the Government foresees a reduction of 4.2 per cent in GDP accompanied by an increase in net borrowing to 4.6 per cent of GDP. Revenue is seen as amounting to 47.6 per cent of GDP, a level analogous to the historic high recorded in 1997; primary expenditure is seen as amounting to 47.2 per cent of GDP, the highest level of the post-war period; the current component is expected to exceed the average of the 1990s by 5 percentage points of GDP. The ratio of the public debt to GDP is expected to rise by 8.5 percentage points to 114.3 per cent of GDP; this indication takes account of the measures to support the financial sector, estimated at about €10 billion.

In the estimates of the European Commission and the Government, based on a similar methodology, the level of structural net borrowing in 2009 is just under 3 per cent of GDP; the part of the deficit due to cyclical factors this year is equal to almost 2 points.

The estimates of structural net borrowing are subject to a high degree of uncertainty, owing primarily to the difficulty of measuring the cyclical position of the economy in real time. Evidence of this is to be found in the large ex post revisions of the initial estimates of the output gap. Using the calculation methodology usually adopted by the Bank of Italy, the structural balance in 2009 will be around 4 per cent of GDP.

The data on the early months of this year confirm the expected significant worsening of the public finances. The state sector borrowing requirement in the first four months of the year was €48.4 billion, more than €17 billion higher than in the same period of 2008. On the basis of preliminary estimates, the general government borrowing requirement for January-April increased by about €24 billion.

Programmes and prospects for the two years 2010 and 2011

The three-year adjustment plan drawn up in the summer of 2008 was intended to achieve budgetary balance in 2011. This objective was postponed with the February update of the Stability Programme, which took account of the economic crisis, albeit only in part.

The present forecasts are based on an even worse macroeconomic scenario. For 2010 both the European Commission and the Government foresee weak growth of economic activity (respectively 0.1 and 0.3 per cent). While the Commission foresees a slight worsening of general government net borrowing (by 0.3 points to 4.8 per cent of GDP), the Combined Report predicts a stable deficit of 4.6 per cent of GDP and a small increase in the primary surplus (Figure 13.4). The ratio of debt to GDP is expected to rise by about 3 percentage points, both by the Commission (to 116.1 per cent) and by the Government (to 117.1 per cent), Both the forecasting scenarios are based on a relatively rapid recovery of the economy and a sharp deceleration in disbursements.

For 2011 the estimates of the Combined Report point, notwithstanding the sharp fall in the ratio of capital expenditure, to a deficit still in excess of 4 per cent of GDP and a rising public debt ratio.

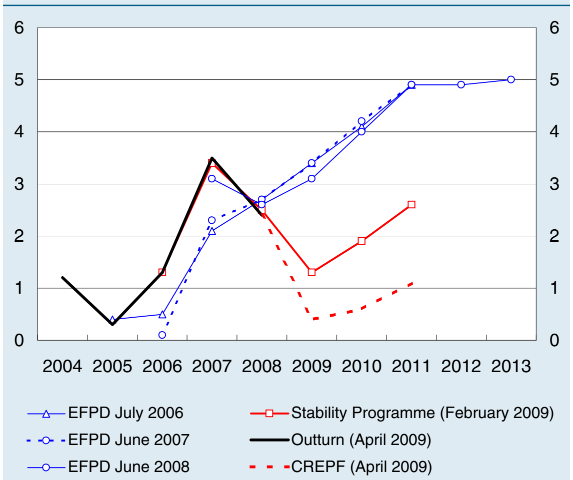
The uncertainty about the cyclical state of the economy and its medium-term prospects is still considerable. In the short term it is necessary to reconcile action to mitigate the severe difficulties of firms and households with the need to contain the growth of the deficit and the debt. It is essential that the measures to support the economy be focused, temporary and accompanied by reductions in non-essential expenditure. There are still ample margins for efficiency improvements in the production of public services. There is also scope for reducing tax evasion, which distorts market mechanisms to the detriment of law-abiding taxpayers.

The scenarios for the coming years point to a large deficits and a rising debt ratio. Looking further ahead, the public finances will also have to cope with the effects of the progressive ageing of the population.

The sustainability of the public finances in the medium and long term requires the budget balance to be brought back – as soon as cyclical conditions permit – towards equilibrium, so as to reabsorb the debt accumulated during the economic crisis and further reduce it as a ratio to GDP. The low level of capital expenditure and the heavy fiscal burden suggest focusing interventions on current expenditure. The size of the adjustment needed makes it necessary to act on all the components of expenditure, including outlays on pensions, which account for a sizeable portion of the budget and are marked

Figure 13.4

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



by rapid growth. An increase in the effective retirement age in the medium term would also make it possible to adjust for the increasing longevity of the population. Rapidly specifying and approving the measures, even if their effects are postponed in time, would have the advantage of increasing economic agents' confidence and make the time needed to reabsorb the disequilibria more certain.

In order for a more effective government of expenditure to be possible, the priority need is for a far-reaching reorganization of general government. It is necessary to raise the public sector's productivity by continuing with the reforms of the last few months. The rapid implementation of the enabling law on fiscal federalism would also make a contribution if it is accompanied by rigorous budgetary laws capable of ensuring balanced accounts and strengthening the incentives to curb expenditure.

14. THE FINANCIAL CONDITION OF HOUSEHOLDS AND FIRMS

In 2008 households' financial saving (the difference between the flows of financial assets and liabilities) remained broadly unchanged, at 2.8 per cent of GDP. Net financial investment decreased and was oriented primarily towards instruments issued by banks; disposals of investment fund units intensified. Households' net financial wealth declined, owing to losses in the value of shares and other equity. The rate of growth in bank loans to households slowed markedly. A decline in demand for financing was accompanied by a modest tightening of credit conditions, in part due to the worsening financial situation of indebted households, which was reflected in an increase in late payments. Nonetheless, the insolvency rate rose only slightly.

Non-financial corporations' operating profitability diminished further, to the levels of the early 1990s. Net interest expense, which rose to 21.7 per cent of gross operating profit, helped curb firms' self-financing capacity: despite a significant fall in fixed investment, the external funding requirement remained very high, at 3.6 per cent of GDP. Firms responded by borrowing more and drawing on liquidity reserves. Bank lending expanded at a progressively slower rate and credit standards became more selective, especially for the more indebted enterprises for which access to credit shrank. The protraction of the recession is generating strong financial tensions in businesses, reflected in growing debt repayment difficulties.

Households' financial saving and debt

Financial balance and wealth. – In 2008 the financial balance of the household sector (consumer households, producer households and non-profit institutions serving households) stood at €44 billion, a similar amount to the previous year's total (Table 14.1).

The sharp contraction in the value of shares and other equity wiped almost €300 billion off the value of Italian households' financial assets, which declined to €3,428 billion (Table 14.2). At the end of the year their total was a little more than three times disposable income, down from 3.5 in 2007. The ratio of net financial wealth to disposable income also declined; in Italy it reached a value of less than 2.5, the lowest this decade; it remains, however, higher than the euro-area average (1.8).

Table 14.1

Financial balances (1) *(millions of euros and percentages)*	2005	2006	2007	2008
Households (2)	64,866	59,999	42,626	43,740
of which: with abroad	*42,141*	*32,559*	*237*	*-20,122*
Non-financial corporations	-30,250	-35,397	-57,820	-56,932
of which: with abroad	*53,445*	*38,516*	*75,435*	*31,735*
General government	-61,600	-48,564	-25,261	-40,353
of which: with abroad	*-91,578*	*-36,967*	*7,268*	*-69,381*
Monetary financial institutions	11,769	-12,801	22,335	3,421
of which: with abroad	*-47,978*	*-62,700*	*-71,611*	*43,459*
Other financial intermediaries (3)	30,736	11,621	16,269	2,616
of which: with abroad	*5,711*	*-26,257*	*-22,057*	*-27,494*
Insurance companies (4)	-26,992	11,488	-18,505	-1,216
of which: with abroad	*26,785*	*41,195*	*-9,631*	*-6,923*
Rest of the world account	11,471	13,653	20,356	48,723
As a percentage of GDP				
Households	4.5	4.0	2.8	2.8
Non-financial corporations	-2.1	-2.4	-3.7	-3.6
General government	-4.3	-3.3	-1.6	-2.6
Financial corporations (5)	1.1	0.7	1.3	0.3
Rest of the world account	0.8	0.9	1.3	3.1
As a percentage of GDP, adjusted for inflation (6)				
Households	2.4	2.8	0.8	1.3
Non-financial corporations	-0.9	-1.7	-2.5	-2.7
General government	-2.4	-2.2	0.2	-1.3

(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.

Investment in financial assets. – In 2008 households' net financial investment fell to €70 billion, down from €103 billion in 2007 (Table 14.2). There was a marked shift in investment preferences and portfolio allocations towards financial instruments issued by banks (sight and term deposits and bonds). Net purchases equalled €93 billion, more than double those recorded in 2007. The increase was particularly high for bonds, whose share in the total stock of financial assets rose from 25 to 31 per cent. This trend is mainly attributable to banks' issuance policies, which were designed to increase fund raising from resident customers to compensate for funding difficulties in the international markets. The yield spread between bonds issued by banks and public sector securities widened. The competition exerted by bank instruments dampened interest in other low-risk assets. Net investment in postal deposits and other postal instruments remained virtually unchanged from 2007, at about €10 billion, while there were net sales of government securities (€3 billion, compared with net purchases of €39 billion in 2007).

Against the backdrop of a sharp contraction in share prices, net share and equity purchases were more than halved in 2008, from €23 billion to €10 billion. Disposals of Italian and foreign investment funds intensified (€66 billion as against €35 billion in 2007) and extended to money market funds. The share of financial assets invested in funds fell by a further 2 percentage points, to 5 per cent, the lowest level since the mid-1990s. Insurance-based financial products included in the technical reserves of the life sector and comparable with other forms of managed savings recorded a net outflow of €11 billion, similar to the previous year's result.

Table 14.2

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

	End-of period stocks			Flows	
	Dec. 2008	Percentage composition		2007	2008
		Dec. 2007	Dec. 2008		
ASSETS					
Cash	103,324	2.4	3.0	5,012	14,298
Instruments issued by banks	1,044,820	25.4	30.5	44,881	92,508
of which: sight deposits	*493,286*	*12.8*	*14.4*	*385*	*16,736*
other deposits	*143,956*	*3.1*	*4.2*	*21,497*	*27,068*
medium and long-term securities	*407,578*	*9.5*	*11.9*	*23,000*	*48,704*
Postal deposits and other savings (2)	295,936	7.7	8.6	9,888	9,584
Government securities	186,094	5.5	5.4	39,048	-3,222
of which: short-term	*20,390*	*0.7*	*0.6*	*12,578*	*-1,021*
medium and long-term	*165,704*	*4.8*	*4.8*	*26,470*	*-2,202*
Other securities	48,622	1.3	1.4	10,439	8,388
of which: short-term	*295*	*0.0*	*0.0*	*118*	*55*
corporate medium and long-term	*48,327*	*1.3*	*1.4*	*10,321*	*8,333*
Investment fund units	165,303	7.2	4.8	-35,468	-66,024
of which: Italian	*128,899*	*5.0*	*3.8*	*-31,937*	*-43,350*
foreign	*36,404*	*2.2*	*1.1*	*-3,531*	*-22,674*
Shares and other equity	721,355	27.2	21.0	22,579	10,231
of which: Italian	*652,316*	*24.6*	*19.0*	*26,109*	*12,208*
foreign	*69,039*	*2.7*	*2.0*	*-3,530*	*-1,976*
Other external assets	154,226	3.9	4.5	7,298	4,529
of which: deposits	*20,595*	*0.5*	*0.6*	*3,121*	*3,023*
short-term securities	*1,971*	*0.0*	*0.1*	*563*	*251*
medium and long-term securities	*131,660*	*3.4*	*3.8*	*3,613*	*1,255*
Insurance and pension fund reserves (3)	586,818	16.3	17.1	-4,181	-5,134
of which: life insurance reserves	*342,262*	*9.8*	*10.0*	*-9,091*	*-10,548*
Other financial assets (4)	121,419	3.1	3.5	3,691	4,664
Total assets	**3,427,917**	**100.0**	**100.0**	**103,188**	**69,821**
LIABILITIES					
Short-term debt (5)	55,640	6.9	6.7	2,302	-632
of which: bank	*52,832*	*6.6*	*6.3*	*1,791*	*-769*
Medium and long-term debt (6)	562,956	67.3	67.3	50,822	17,991
of which: bank	*415,944*	*50.6*	*49.7*	*34,286*	*8,884*
Other financial liabilities (7)	217,620	25.7	26.0	7,438	8,721
Total liabilities	**836,216**	**100.0**	**100.0**	**60,562**	**26,080**
BALANCE	**2,591,701**			**42,626**	**43,741**

(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) Insurance technical reserves of both the life and casualty sectors, pension funds and severance pay entitlements. – (4) Accounts receivable and other minor items. – (5) Includes finance provided by factoring companies. – (6) Includes securitized loans, finance provided by leasing companies, consumer credit from financial companies and other minor items. – (7) Accounts payable, staff pension provisions and other minor items.

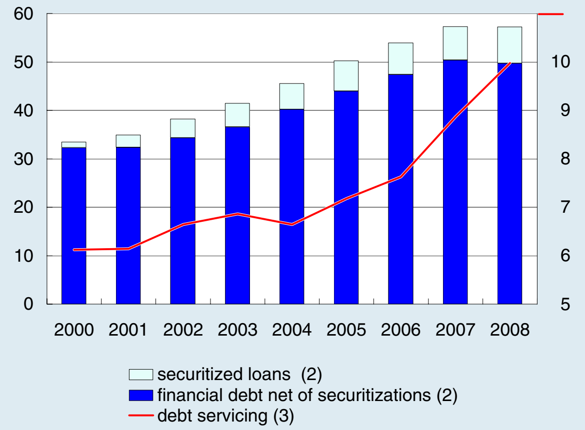
Households' financial debt. – In 2008 lending by banks to consumer and producer households slowed markedly, underscoring a trend already apparent in the previous two years after the strong growth of the first part of the decade. The slowdown reflected lower demand for loans stemming from the slackening of the real-estate cycle and the sharp downturn in expenditure on durable goods. One contributory factor was a slight tightening of the terms and conditions for granting loans, which appear to have eased in the first quarter of 2009. In 2008 lending to households, including securitized loans, expanded by 5.5 per cent (as against 10.4 per cent in 2007). The deceleration was in line with the euro-area average and continued into the first three months of 2009.

At the end of 2008 Italian households' total financial debt, comprising credit from financial companies and securitized bank loans, was equal to just under 60 per cent of disposable income (Figure 14.1). Lending from banks and financial companies to consumer households only, which excludes loans related to productive activities, also slowed in 2008; at the end of the year the rate of increase stood at around 6 per cent, as against 12.5 per cent in December 2007 (Table 14.3). The deceleration in bank lending was more pronounced in Italy's northern regions and in the North-East especially. It was most apparent among banks belonging to the five largest banking groups, where the rate of increase fell from 10 to 1.3 per cent, and among the other large banks (from 11.8 to 6.4 per cent). In 2008 lending by other types of bank increased at a very similar rate to that in 2007, by more than 15 per cent for small banks and branches of foreign banks. The credit supply policies of large banks, which encountered greater fund-raising difficulties, became more stringent.

Figure 14.1

Households' debt (1)

(as a percentage of gross disposable income)



Sources: Bank of Italy, Istat.
(1) Consumer households, producer households and non-profit institutions serving households. The figure for gross disposable income in 2008 is a Bank of Italy estimate. – (2) Left-hand scale. End-of period stocks. – (3) Right-hand scale. The indicator relates only to consumer households. The figure for debt servicing (total payments of interest and principal) is an estimate.

Table 14.3

Lending to consumer households (1)

(twelve-month percentage changes)

	December 2006	December 2007	December 2008	March 2009
	Loans for house purchases			
Banks	15.4	12.0	5.3	4.6
	Consumer credit			
Banks	13.9	7.9	9.1	6.4
Financial companies	*27.6*	25.9	10.7	15.7
Total banks and financial companies	18.8	14.8	9.8	10.2
	Other loans			
Banks	3.6	10.9	5.9	5.1
	Total loans			
Total banks and financial companies	14.3	12.5	6.3	6.0

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; for financial companies only securitized loans still on balance sheets are taken into account. The data for March 2009 are provisional.

Loans for house purchases. – Loans granted for house purchases fell to €56 billion, in 2008, down from €63 billion in 2007, due to the smaller volume of residential property transactions, higher interest rates for most of the year, and stricter lending conditions adopted by banks; the decline steepened in the second half of the year. Compared with recent years the total remains a high one: however, 13 per cent of loans went to subrogation operations and replacement mortgages, as against 4 per cent in 2007. Households sought actively to modify mortgage terms and conditions, either by approaching their own bank directly or changing intermediary. Renegotiations of loans concluded with the originating bank and not entailing any new disbursements were especially frequent, totalling 7.5 per cent of the outstanding stock (3 per cent in 2007).

Between 2006 and 2008 households' preferences began to shift towards fixed-rate loans, owing to the substantial rise in the interest rates applied to variable-rate mortgages. Last year the share of fixed-rate loans granted for terms of over one year (in most cases over ten), amounted to 67 per cent, as against 15 per cent in 2005, when the phase of monetary tightening had not yet begun. For the first time since the statistics were harmonized in 2003, the share was higher in Italy than in the euro area as a whole (62 per cent). In more recent months, in a period when interest rates are falling, demand for variable-rate loans has gradually returned to growth. At the end of 2008 the share of fixed-rate loans reached 36 per cent of the total stock, more than double the minimum recorded in 2005. Households continue to bear most of the interest rate risk.

According to a survey conducted by the Bank of Italy in 2008, both average loan-to-value ratio (65 per cent) and mortgage length (22 years) remained broadly unchanged from 2007, although the share of mortgages with loan-to-value ratios of more than 80 per cent declined from 9 to 7 per cent of new loans.

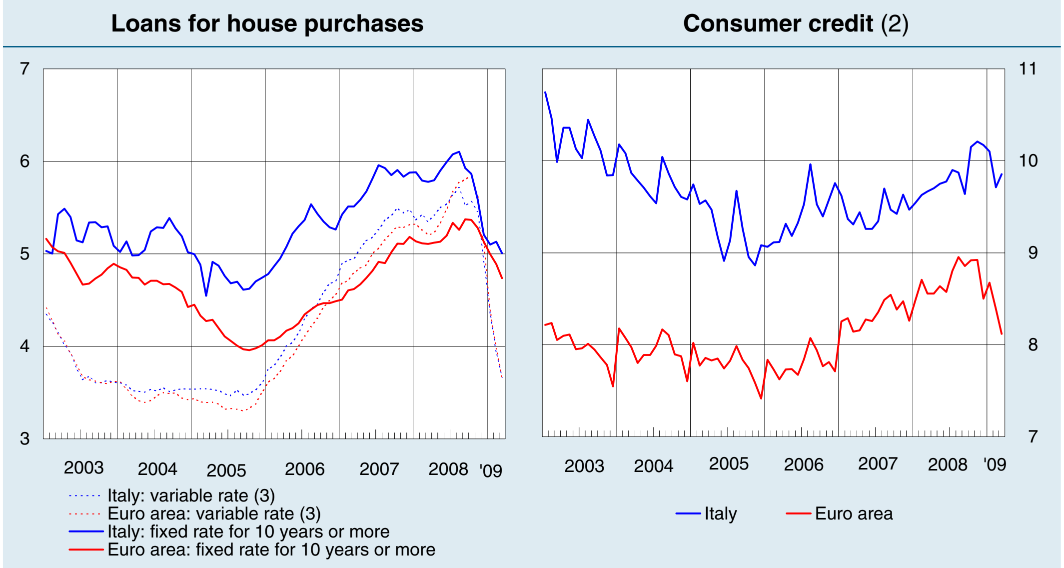
Mortgage interest rates. – Following the high levels reached during the summer, from autumn onwards the cost of new mortgages declined considerably. The rate of interest on new variable-rate loans fell from 5.7 per cent in August to 3.7 per cent in March 2009 (Figure 14.2). Expectations of a cut in official interest rates were reflected in the term structure of forward exchange rates and helped ease the cost of fixed-rate borrowing for terms of at least 10 years, which fell by around one percentage point to 5 per cent in March 2009.

The fall in the cost of fixed-rate loans was more pronounced than in the other euro-area countries: the differential compared with the euro-area average, still high at the beginning of 2008, was almost entirely cancelled (Figure 14.2). This was due to an increase in the spreads applied by banks in several euro-area countries. In Italy the spread between fixed-rate borrowing for terms of 10 years and the reference rate for these contracts (10-year interest rate swaps) remained virtually unchanged over the year as a whole (1.3 percentage points).

For variable-rate mortgages the differential with respect to the reference rate (3-month Euribor) narrowed in Italy for most of 2008; in October, when the banks tried to contain the increase in market interest rates, it reached a minimum of 0.4 percentage points; on average last year the spread was similar to that in the euro area (0.8 points). However, in the first months of 2009, it again widened rapidly, as happened in the area as a whole. In Italy this increase is for the most part attributable to the increased spread between the cost of variable-rate bonds and the Euribor rate, which the banks had to widen in order to boost fund-raising among customers; a more general increase in the risk premium was another contributory factor.

Figure 14.2

Interest rates on bank loans to households (1)
(monthly data referred to new transactions; percentages)



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.

Consumer credit. – Last year the rate of growth in consumer credit to households slowed: in December 2008 the twelve-month rate was slightly less than 10 per cent, compared with almost 15 per cent in December 2007 (Table 14.3). The deceleration is ascribable to loans granted by financial companies, which account for just under half of total consumer credit. The marked slowdown is mostly owing to credit granted for purchases of durable goods, following a substantial drop in expenditure on these products. Consumer credit granted by banks continued to increase at a similar rate to that reported at the end of 2007: personal loans, which account for most of it, maintained a brisk pace during the year as a whole.

The interest rate charged on new consumer credit granted by banks increased throughout all of 2008; it then stabilized at around 10 per cent in the first few months of 2009 (9.5 per cent at the end of 2007).

Indebted households' vulnerability. – Last year households' debt servicing costs reached 10 per cent of disposable income, over 1 percentage point more than in 2007 (Figure 14.1). This reflected both the growth in debt over recent years, and the rise in average interest rates in 2008. The aggregate data refer to all households, both with and without debt.

The Survey on Household Income and Wealth (SHIW), which was last conducted in 2006, indicated at the time that for households with mortgages on their primary residence the median value of debt servicing costs stood at 17 per cent of disposable income. This share is in line with that in the euro-area countries for which sample surveys are available: for households in the lowest income quartile the proportion tends to be higher (more than 30 per cent). Considering all categories of loan, in 2006 the share of households whose repayment instalments accounted for more than 30 per cent of their income was 2.1 per cent of the sample or one indebted household in ten.

Based on an estimate concerning indebted households in the 2006 survey, last year the debt servicing cost of mortgage loans on households' primary residences rose by over 3 percentage points to 20.5 per cent of median household disposable income. The share of households with high debt servicing costs is estimated to have expanded to 3.5 per cent; the increase appears more marked for low-income households, which nonetheless hold a limited share of total debt, equal to around 7 per cent.

The increase in debt servicing costs placed additional financial strain on households, which in 2008 had more difficulty meeting debt repayments. During the year the proportion of impaired loans (when borrowers are in temporary difficulty), rose from 1.5 to 2.2 per cent; the share of loans overdue by at least 90 days rose by over 1 percentage point to 4.3 per cent. However, the ratio of new bad debts to total loans at the beginning of the period increased only slightly and in the first quarter of 2009 stood at 1.2 per cent (0.9 per cent in 2007).

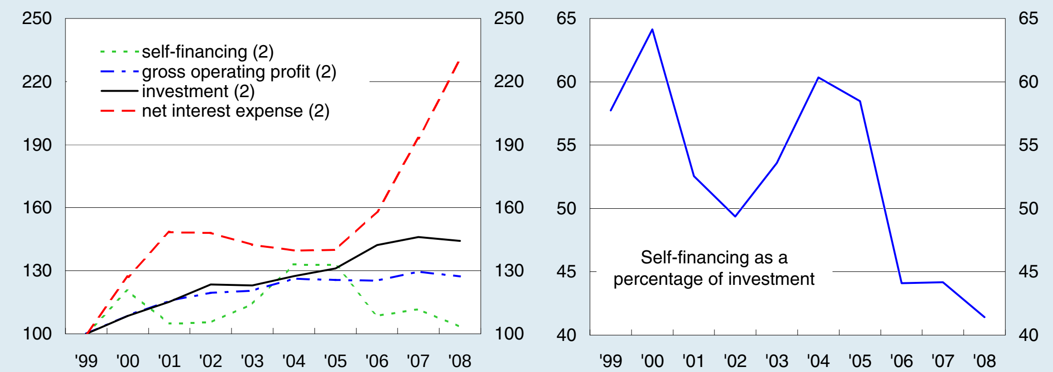
Looking ahead, the vulnerability of Italian households could be affected by worsening labour market conditions, which will have an adverse impact on income growth; some support will come from the recent drop in interest rates.

The conditions and financial choices of firms

Profitability, self-financing and the external funding requirement. – Based on the national accounts data, in 2008 the gross operating profit of non-financial enterprises fell to 34.8 per cent of value added, the lowest level since 1992. Profitability declined in part owing to the strong growth in net interest expense (Figure 14.3), which eroded over one fifth of gross operating profit (17.9 per cent in 2007); this was the highest proportion recorded since the first half of the 1990s when, with interest rates much higher than the current level, it came to exceed 30 per cent.

Figure 14.3

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



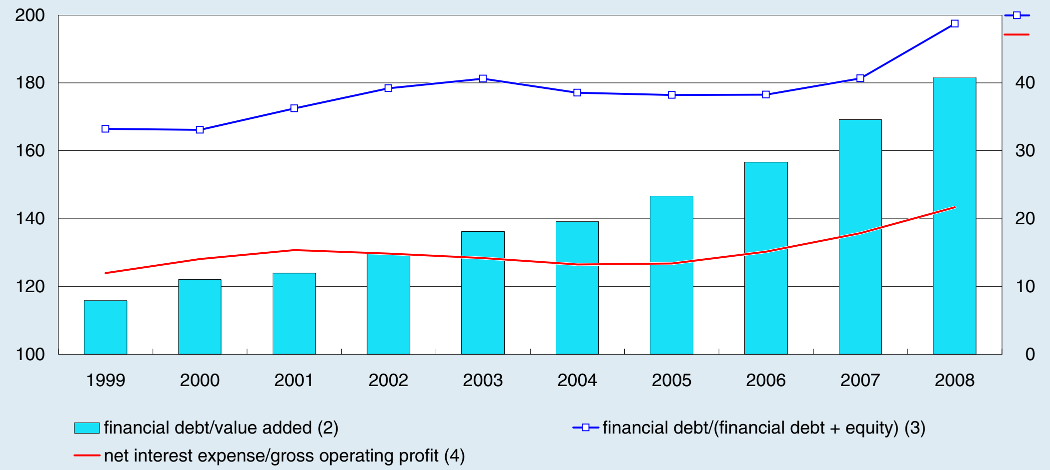
Sources: Bank of Italy, Istat.
(1) Estimates based on the financial accounts and national accounts data for non-financial corporations, 1990-2007. The data for 2008 are estimated on the basis of the national accounts for the year. Investment includes inventories. – (2) Indices, 1999=100.

Notwithstanding the fall in investment, firms' capacity to cover investment expenditure by drawing on internal resources reached historically low levels. The external funding requirement remained very high (€57 billion or 3.6 per cent of GDP; Table 14.1).

Debt and firms' financial structure. – In 2008 the financial debt of firms increased by €103 billion, reaching 182 per cent of value added (Table 14.4 and Figure 14.4). Leverage, calculated as the ratio of financial debt to the sum of financial debt and shareholders' equity at market prices, rose by around 8 percentage points compared with 2007, to 48.7 per cent; the increase is mostly ascribable to the fall in equity value associated with the performance of share prices.

Figure 14.4

Corporate debt (1)
(percentages)



Sources: Bank of Italy, Istat.
(1) The data relate to the non-financial corporations sector and take account of securitizations. – (2) Left-hand scale. Value added for 2008 is estimated from national accounts data. – (3) Right-hand scale. – (4) Right-hand scale. Gross operating profit for 2008 is estimated from national accounts data.

The level of firms' indebtedness appears high compared with the average for the past ten years. Its growth in this decade has been concentrated in larger companies. The data on approximately 50,000 firms compiled by the Company Accounts Data Service show that for those with at least 250 employees, leverage – calculated with shareholders' equity at balance sheet values – rose from 41.4 per cent in 2000 to 47.8 per cent in 2007; for the others it declined from 58.6 to 54.7 per cent.

Lending to firms. – The contraction in economic activity was accompanied by a pronounced deceleration in credit. The twelve-month growth rate of bank loans to firms, calculated taking account of securitizations, was 7.0 per cent in December, around 5 points less than in the same month in 2007; in March this year it fell to 4.2 per cent (Table 14.5). The slowdown was in line with that reported in the euro area.

The slackening pace of growth in credit in part reflected the decline in demand for purposes of investment. During the year the factors affecting supply acquired increasing importance.

Table 14.4

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

	End-of-period stocks			Flows	
	Dec. 2008	Percentage composition		2007	2008
		Dec. 2007	Dec. 2008		
ASSETS					
Domestic assets	**1,246,257**	**73.6**	**70.7**	**25,511**	**2,500**
Cash and sight deposits	175,734	9.0	10.0	-14,061	2,148
Other deposits	16,975	0.6	1.0	1,533	337
Short-term securities	527	0.0	0.0	3	98
Medium and long-term securities	52,648	2.9	3.0	14,664	6,175
of which: government	*31,994*	*1.7*	*1.8*	*21,916*	*899*
corporate	*8,295*	*0.6*	*0.5*	*-6,880*	*5,153*
Shares and other equity	396,026	30.6	22.5	-6,420	-4,809
Investment fund units	1,804	0.1	0.1	-443	-601
Accounts receivable	542,379	27.2	30.8	28,924	1,529
Other financial assets (2)	60,164	3.1	3.4	1,311	-2,377
External assets	517,048	26.4	29.3	94,354	46,775
of which: deposits	*46,037*	*2.6*	*2.6*	*9,361*	*-5,420*
accounts receivable	*57,959*	*2.9*	*3.3*	*-296*	*-385*
short-term loans	*198,129*	*7.5*	*11.2*	*40,727*	*47,221*
securities	*25,366*	*1.4*	*1.4*	*6,217*	*-2,951*
shares and other equity	*177,599*	*11.4*	*10.1*	*38,759*	*9,822*
Total assets	**1,763,305**	**100.0**	**100.0**	**119,864**	**49,275**
LIABILITIES					
Domestic liabilities	**3,036,288**	**90.8**	**91.1**	**158,767**	**91,167**
Short-term debt (3)	420,906	11.1	12.6	39,811	21,607
of which: bank	*365,983*	*9.7*	*11.0*	*34,004*	*17,513*
Medium and long-term debt (4)	650,193	16.4	19.5	71,802	61,017
of which: bank	*503,725*	*12.9*	*15.1*	*60,918*	*43,955*
Securities	48,517	1.5	1.5	5,450	-1,804
of which: medium and long-term	*43,308*	*1.3*	*1.3*	*10,546*	*1,193*
Shares and other equity	1,197,059	41.8	35.9	13,242	12,971
Accounts payable	550,387	15.3	16.5	29,515	-1,488
Other financial liabilities (5)	169,226	4.7	5.1	-1,053	-1,135
External liabilities	298,433	9.2	8.9	18,919	15,040
of which: accounts payable	*29,079*	*0.8*	*0.9*	*-718*	*-115*
financial debt	*137,299*	*3.2*	*4.1*	*13,669*	*22,090*
shares and other equity	*125,679*	*5.1*	*3.8*	*6,287*	*-6,043*
Total liabilities	**3,334,721**	**100.0**	**100.0**	**177,686**	**106,207**
BALANCE	**-1,571,416**			**-57,822**	**-56,932**

(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.

Table 14.5

Lending to firms (1)
(twelve-month percentage changes)

	Total			Cantre and North			South		
	Dec. 07	Dec. 08	Mar. 09	Dec. 07	Dec. 08	Mar. 09	Dec. 07	Dec. 08	Mar. 09
				Banks					
Branches of economic activity									
Manufacturing (2)	6.6	3.9	0.3	6.5	4.4	1.0	7.3	0.2	-4.3
Construction (2)	14.4	8.6	5.7	13.5	8.3	5.3	18.5	9.9	7.3
Services (2)	10.9	7.0	5.4	11.1	7.3	5.4	9.7	5.1	4.9
Other (2)	32.1	11.9	5.3	37.4	12.5	4.9	5.0	8.7	8.1
Technical forms									
Overdrafts	9.1	8.7	6.0	10.3	8.5	5.7	1.0	10.2	7.8
Loans	11.5	7.4	5.6	11.2	7.9	6.0	13.2	5.1	3.7
Other	14.4	4.7	0.9	14.8	5.2	1.0	11.2	1.0	-0.4
Total (2) (3)	**12.1**	**7.0**	**4.2**	**12.4**	**7.3**	**4.3**	**10.6**	**5.3**	**3.6**
				Financial companies					
Leasing (3)	13.0	9.5	10.3	12.3	8.4	8.9	18.8	17.9	21.9
Factoring and other (3)	12.3	13.3	11.0	10.5	14.0	11.4	21.2	9.9	9.2
Total (3)	**12.8**	**10.5**	**10.5**	**11.8**	**9.8**	**9.5**	**19.7**	**15.0**	**17.4**

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 2009 are provisional. – (2) The percentage changes are adjusted for the accounting effect of reclassifications. – (3) The percentage changes are adjusted for the accounting effect of securitizations.

The terms and conditions for granting loans were progressively tightened, especially among the leading banking groups, for which the deceleration in credit had already begun in 2007 and was more intensive compared with the other categories of intermediary: in March 2009 lending by the five largest banking groups was 0.7 per cent less than a year earlier. By contrast, lending by the other banks only started to slow in the last months of 2008 and in March 2009 exceeded the previous year's level by 10.0 per cent. Data on firms in the Company Accounts Data Service indicate that in 2008 the largest banking groups concentrated their lending growth on less risky firms, especially those that at the end of 2007 displayed greater financial equilibrium.

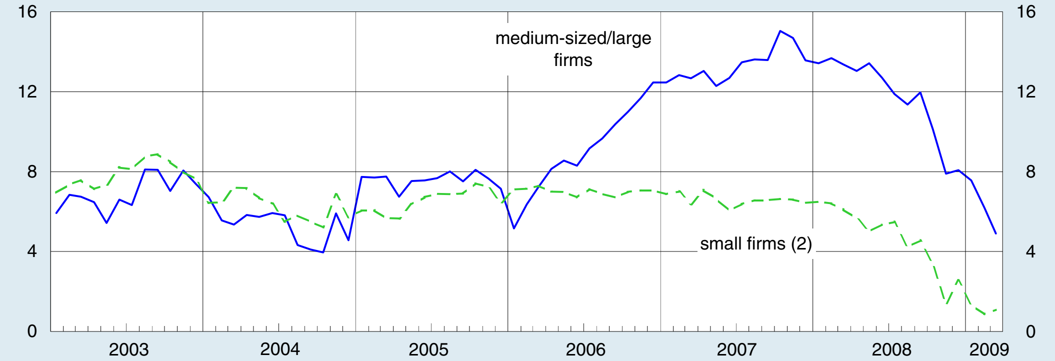
In March 2009 bank lending to manufacturing industry contracted to particularly low levels, above all in the South, where the rate of change turned negative (Table 14.5). Notwithstanding a sharp deceleration, lending to the construction sector is still increasing at an above-average rate. In all branches of economic activity, lending to small firms is experiencing slower growth than that to medium and large firms (twelve-month rates of 1.1 per cent and 4.9 in March, respectively; Figure 14.5).

The survey of industrial firms conducted by the Bank of Italy (Invind) provides evidence of growing difficulties in credit access. A third of the firms interviewed reported a tightening of borrowing conditions from October 2008 onwards: 11 per cent of firms declared they had received a request for early repayment from creditors, while the share of firms reporting to having applied for new loans unsuccessfully rose from 3 per cent in 2007 to 8 per cent, the highest proportion since 1994-95.

Figure 14.5

Bank loans by firm size (1)

(monthly data; 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.

The cost of credit reflected trends in official interest rates, declining significantly from October onwards. In March 2009, the average cost of opening credit lines in current accounts fell to 5.3 per cent; those on new fixed-rate and variable-rate transactions stood at 4.3 and 3.1 per cent respectively (Figure 14.6). The differential with respect to the euro area narrowed. The fall in the cost of credit was more pronounced for new transactions of more than €1 million than for those of lower amounts: the difference, which reflects in part the differential in the cost of accessing credit for small and large firms rose to 1.3 percentage points, from 0.7 in September 2007.

The financial conditions of firms. – In 2008 firms' financial conditions worsened, owing to the increase in debt and the steady deterioration in the business cycle. Above all, there were greater difficulties in collecting payment from customers. Delays in the settlement of transactions between firms was a key channel through which the crisis was transmitted within the productive economy. This was due in part to the high proportion of accounts receivable among firms' balance-sheet assets.

Analyses of commercial paper offered by firms to the financial system for discounting show a sharp acceleration of accounts overdue by more than one month: the rate of change over 12 months rose from around 2 per cent in the first few months of 2008 to over 20 per cent in December, and to 31 per cent in March 2009. Considering only the accounts receivable for which it is possible to identify the final debtor's sector, in March 2009 the share of overdue payables in the total portfolio of invoices with other businesses rose to 16.4 per cent, up from 14.2 per cent twelve months earlier; payment delays were especially acute in the South, in industry and in firms with fewer than 20 employees.

Firms responded to financial tensions by reducing their most liquid assets, currency, deposits, and public sector securities; the fall totalled €5 billion, compared with net investment in the same instruments of €25 billion in 2007 (Table 14.4). Overall net investment in financial assets, which came to €49 billion, was more than halved with respect to the previous year.

Figure 14.6

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

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

The deterioration in firms' financial conditions was reflected in the growing difficulties borrowers had meeting bank loan repayments. In March 2009 impaired loans (when banks report temporary repayment difficulty) rose to 3.0 per cent of total loans, around twice as much as twelve months earlier; the share of payment instalments overdue by at least 90 days increased from 2.8 to 4.3 per cent. Small firms appear to struggle most to meet their obligations, with the share of impaired loans and overdue instalments on mortgages at 4.4 per cent and 6.2 per cent of total loans, respectively. The flow of new bad debts, which responds to the business cycle with a lag, reached €4.6 billion in the first quarter of 2009, 2.0 per cent of the stock of performing loans at the beginning of the same period (compared with €2.9 billion and 1.4 per cent in the first quarter of 2008).

Bonds and syndicated loans. – Gross international bond issues declined: based on Dealogic data, placements by Italian non-financial corporations came to €4.1 billion in 2008, as against €12.7 billion in 2007 (and €15 billion on average between 2003 and 2007). There were no issues of high-yield securities, which are characterized by higher risks and returns.

Mirroring patterns in the other advanced economies, issues in Italy picked up in the first quarter of 2009, thanks to placements by Eni, Telecom Italia and Finmeccanica totalling €3.7 billion. Between 2003 and 2008 bond issues by these three groups accounted for around half those made by Italian non-financial corporations on the international market. In recent months the increased risk aversion of investors led these groups to make substantial changes to the characteristics of the issues: the average maturity was shortened to six years, half as long as in the period 2003-07, and the average spread on the reference rates was increased by around 100 basis points to more than 500.

A substantial share of larger firms' debt (over half of the total for several of the leading industrial groups) is in the form of syndicated loans. The impact of the crisis on this segment of the financial market was striking, especially given the prominent role of the major international banks that were hardest hit by liquidity problems. Data from Dealogic indicate that in 2008 the flow of syndicated loans to Italian firms diminished to €26 billion, around half as much as in 2007; the average between 2003 and 2007 was €40 billion. The contraction was more pronounced for the riskier forms of credit, such as that to highly leveraged firms and especially lending related to leveraged buy-outs, which declined markedly during the year.

In the first three months of 2009 the market for syndicated loans showed signs of recovery. The €18 billion of new loans were for the most part allocated to Enel's acquisition of a minority stake in Endesa.

Consequent to the high volume of past issues, the substantial amounts of high-yield bonds and large syndicated loans that will mature in the coming years may prove difficult to refinance if the supply of funds in international markets continues to contract. Data on a sample of 14 large firms, selected from among the main issuers, show redemptions of bonds and syndicated loans equal to €3.0 and €2.8 billion respectively in the rest of 2009, and €17.1 and €25.9 billion in the two years 2010-11.

Mergers and acquisitions. – According to Thomson Reuters, which monitors the main transactions, in 2008 Italian non-financial corporations announced 189 mergers or acquisitions of majority interests worth about €10 billion, compared with 144 operations and €28 billion in 2007. Enel's acquisition of Endesa in the first half of 2007 affected the year-on-year result, but even excluding it the average value of the transactions diminished. In the first quarter of this year, 38 transactions were announced worth around €230 million, a low amount compared with the same period in 2007.

The greater impact of the financial crisis on the market for corporate control regarded the most risky transactions and leveraged buy-outs, by virtue of the high recourse to debt capital that they imply. The value of transactions by Italian corporations was halved with respect to 2007, to €1.8 billion. From the last quarter of 2008 in particular, and up to March 2009, the few transactions completed were relatively small.

Share issues, venture capital and private equity. – In 2008 firms' net worth increased by €7 billion, €13 billion less than in 2007 (Table 14.4). Negative trends in share prices discouraged the raising of venture capital in the share markets: increases of share capital by Italian non-financial companies totalled €1.8 billion, as against €2.8 billion in 2007 (and an average of €4.3 billion between 2003 and 2007); there were 6 new listings, compared with 26 in 2007. Since September 2008 just one new share issue has been registered, in February 2009.

According to the Italian Private Equity and Venture Capital Association (AIFI), investment by private equity and venture capital companies in Italy expanded by 30 per cent, to €5.5 billion. The increase was larger for transactions relating to companies with more than 250 workers, which absorbed 80 per cent of investment (75 per cent in 2007). Compared with previous years large investments were allocated less towards buy-outs and aimed above all at reducing large corporations' debt levels.

15. THE FINANCIAL MARKETS

In 2008 the effects of the international financial crisis were also felt by Italy's stock and bond markets. The general stock market index fell by half, listed companies revised their profit expectations drastically downwards, and risk premiums on corporate bonds and government securities increased sharply, as did the volatility of share and bond prices. In October, after a further drop in investor confidence following the collapse of Lehman Brothers, the authorities of the developed nations agreed on a series of measures to shore up their financial systems, which they put into effect in the following months.

Prices on the Italian stock exchange fell by a similar amount to those in the other euro-area countries. The share price correction reflected both the sharp drop in current and expected earnings and the rise in share risk premiums in a situation of great uncertainty and investor reluctance to take financial risks. Prices stopped falling in mid-March of this year following signs of improvement at the leading international banks and later in response to indications that the recession was easing.

The yield on Italian ten-year government securities stood at 4.3 per cent at the end of 2008, slightly lower than a year earlier. The yield spread between the ten-year BTP and the corresponding German Bund widened significantly between September 2008 and January of this year, mainly due to a clear investor preference for less risky assets.

Net issuance of bonds by Italian non-financial corporations contracted sharply, and smaller firms made virtually none. The substantial rise in net bond issues in 2008 was due almost entirely to banks and their special purpose vehicle companies.

Public sector securities

Supply and demand. – Net issues of Italian public securities more than doubled from €26 billion in 2007 to €62 billion last year. The increase was largely due to the growth in the general government borrowing requirement in the last four months of the year as the business cycle worsened. The year-end public debt rose to 105.8 per cent of GDP, regaining the level recorded in 2005.

The average residual maturity of government securities decreased slightly to 6 years and 7 months, reflecting a rise in short-term issues. By contrast, the average financial duration lengthened by 2 months to 4 years and 9 months owing to the drop in interest rates on short maturities. There were net redemptions of Republic of Italy bonds and CCTs and substantial net issues of BOTs and BTPs, which rose respectively from €6 billion to €9 billion and from €29 billion to €58 billion. For the first time in over five years there were net issues of CTZs, albeit very limited.

Italian local authorities continued to make modest net redemptions of securities, amounting to €396 million against €155 million in 2007, thanks to the substantial reduction in their overall borrowing requirement. The year-end stock was unchanged at close to €35 billion, or 2.5 per cent of total outstanding Italian public sector securities.

Households and firms made net sales of government securities, with net purchases of BTPs more than offset by net sales of BOTs, CTZs and CCTs. Banks made net purchases of medium and long-term securities. Mutual funds, which again recorded massive net outflows, made net sales of BOTs and CTZs and net purchases of CCTs and BTPs, resulting overall in a disposal of government securities. Foreign investors made substantial net purchases of Italian government securities, notably BOTs and BTPs. At the end of 2008 the stock held abroad amounted to 53.8 per cent of the total, around 3 percentage points more than in 2007.

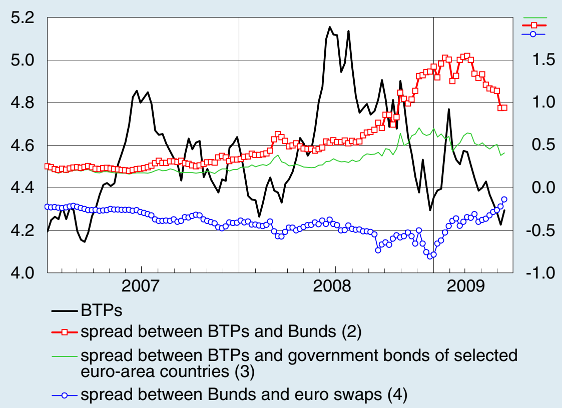
Interest rates. – Interest rates on long-term government securities rose by 0.6 percentage points in the first half of 2008. They then began to decline, mirroring the trend in the euro area, in response to expectations of a reduction of official interest rates and heavy demand for government securities triggered by international financial tensions. At the end of the year the yield on the benchmark ten-year bond was 4.3 per cent, 0.3 percentage points lower than a year earlier (Figure 15.1). The real rate of interest, implicit in the price of the ten-year bond indexed to euro-area consumer prices, fell by a similar amount, to 2 per cent. In the first four months of 2009 interest rates on government securities remained unchanged, on average, albeit with wide fluctuations.

In 2008 the yield spread between the benchmark ten-year BTP and the corresponding German Bund widened by over 1 percentage point, reaching 143 basis points at the end of the year (Figure 15.1). It then widened further in the first weeks of 2009, peaking at 159 basis points before narrowing to under 1 point in mid-May. The premiums on CDSs on Italian government securities, which signal the probability that

Figure 15.1

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

(weekly averages; percentages and percentage points)

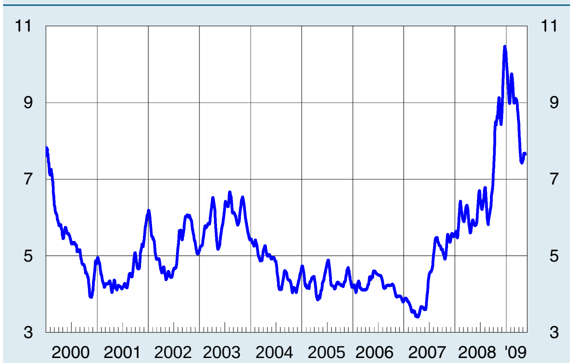


Source: Based on Bloomberg data.
(1) Yields on benchmark ten-year bonds. – (2) Right-hand scale. – (3) Spread between the yield on ten-year BTPs and the simple average of yields on corresponding government securities of three euro-area countries that recorded a budget surplus in 2007 (Finland, the Netherlands and Spain); right-hand scale. – (4) Spread between ten-year Bunds and ten-year euro swaps; right-hand scale.

Figure 15.2

Expected volatility of ten-year Bunds (1)

(20-day moving average ending on the date indicated; percentage points)



Source: Based on Bloomberg data.
(1) Volatility implied by futures options listed on the Eurex market.

markets assign to the issuer's insolvency, as well as their propensity to take such risk, rose sharply between mid-September and the end of January before dropping back to the levels of the middle of October.

The volatility of long-term euro interest rates implicit in the prices of ten-year Bund futures options reflected the tensions on the international financial markets. Having remained steadily high in the first three quarters of 2008, it more than doubled from mid-September, peaking three months later. It subsequently declined in the first four months of this year to a level close to that of last October (Figure 15.2).

Corporate bonds and bank bonds

Issuance. – Despite a downturn in the third quarter at the height of the international financial turmoil, net Italian corporate bond issues more than doubled from €89 billion to €204 billion in the year as a whole (Table 15.1). The increase can be attributed to net issues by banks, which encountered difficulties raising funds on the interbank market in the second half of the year, and by other financial corporations, mainly vehicle companies used by the banks for securitizations in order to obtain securities eligible for Eurosystem refinancing.

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
	2006	2007	2008	2006	2007	2008	2008
Banks	60,371	63,928	123,932	544,742	617,874	741,806	47
Other financial corporations	12,397	15,029	78,985	164,864	170,472	249,082	16
Non-financial corporations	3,446	10,546	1,215	50,505	60,571	60,741	4
Total	76,214	89,503	204,132	760,111	848,917	1,051,629	67
Memorandum item:							
International market (3)	79,791	61,720	104,532	392,628	452,504	553,655	35

(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 bond issues by non-financial corporations were instead extremely small, the market having virtually dried up. They amounted to just €1.2 billion in the year as a whole, compared with €10.5 billion in 2007, and were concentrated in the last quarter of the year. Firms' net bond issues picked up in the first quarter of this year thanks to placements by Eni, Finmeccanica and Telecom Italia.

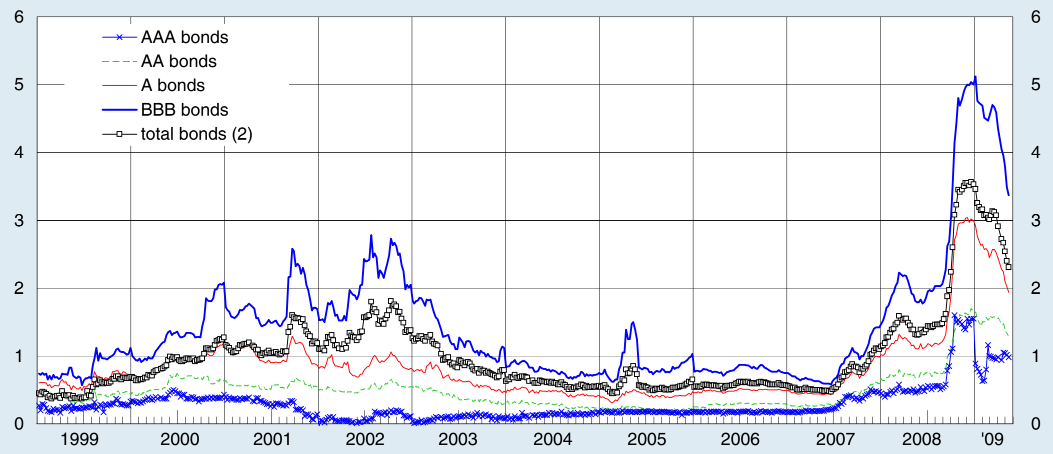
There was a sharp increase in net issues of Italian asset-backed securities (i.e. securities issued by vehicle companies and covered bonds, which are secured by assets that remain on the issuers' balance sheet), which rose from €14 billion in 2007 to €77 billion last year. Issuances was concentrated in the last two months of the year and placed mainly by the UniCredit and Intesa Sanpaolo banking groups, with €24 billion and €18 billion respectively. Virtually all securitizations related to sales of residential mortgage-backed securities. Issues of CDOs decreased to almost nil. Italian banks, which have been allowed to issue covered bonds since May 2007, placed €6.5 billion of them.

Gross issues of commercial paper rose substantially, thanks to the Intesa Sanpaolo and UniCredit groups and Eni and Enel corporations; they totalled €145 billion in 2008 compared with €112 billion in the previous year. Issuance by banks, which accounted for more than three quarters of the total, was driven by persistent difficulties on the interbank market and continued unabated in the first four months of 2009 (€86 billion) thanks to Intesa Sanpaolo.

Yields. – The cost of funds to Italian and foreign corporations on non-financial euro-denominated investment grade bonds (at least BBB- or Baa3) rose by 1 percentage point in 2008 to 6.2 per cent, a level matched only in August 2000. With interest rates on benchmark euro-area government securities down more than 1 percentage point, the increase can be ascribed to the sharp rise in risk premiums, on average from 1.1 to 3.5 percentage points (Figure 15.3). The spread widened further from mid-September following the collapse of Lehman Brothers, reflecting heightened expectations of insolvency caused by the steadily worsening economic scenario and a stronger aversion to risk. There was a particularly large increase in the cost of speculative grade borrowing, with the average bond yield on the secondary market reaching an all-time high of 27 per cent. In the first four months of 2009 the yields on higher-rated bonds came down by 1 percentage point, partly due to a revival of investor demand for such securities.

Figure 15.3

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



Source: Merrill Lynch.
(1) Fixed-rate euro-denominated Eurobonds with a residual term to maturity of no less than one year issued by non-financial corporations resident in countries whose long-term foreign currency debt bears a rating not lower than BBB- or Baa3. The differentials are calculated with reference to French and German government securities of corresponding maturity. – (2) Includes all investment-grade bonds (i.e. rated at least BBB- or Baa3).

Spreads on the issues of high-rated Italian non-financial corporations widened by 2.2 percentage points in 2008, in line with those on issues of other euro-area countries with comparable features. They have since narrowed progressively by about 1 percentage point between the beginning of January and end-April of this year. The premiums on CDSs issued by the leading Italian non-financial corporations followed a similar pattern.

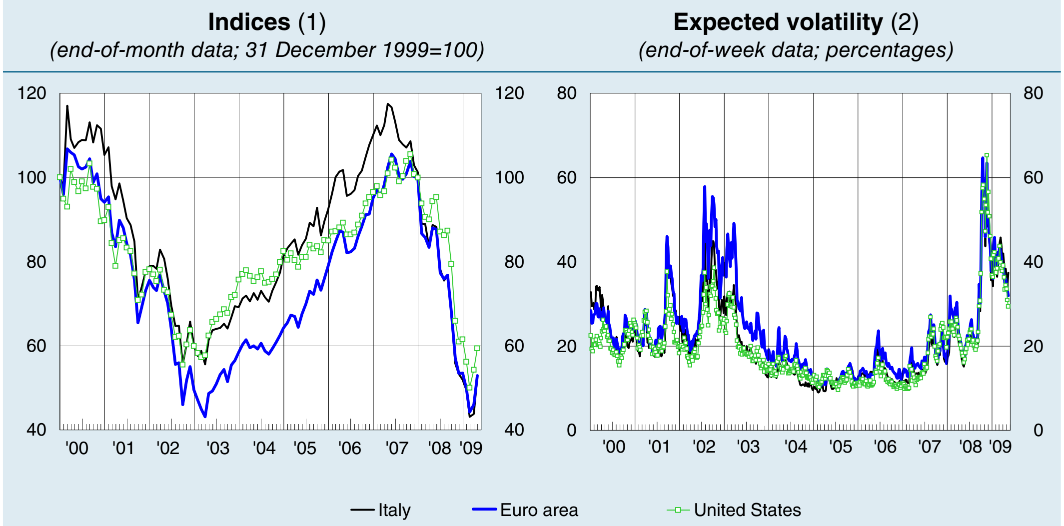
The premiums on CDSs of leading Italian banks fluctuated widely in March and in September 2008 in response to heightened international financial tensions. They rose by 0.8 percentage points on average during the year, which was 0.4 points less than for the other euro-area banks. The first months of 2009 saw a slight drop in the premiums on Italian banks' CDSs as financial market tensions eased; by the end of April they were close to the level recorded last November, in line with the premiums on those of other euro-area banks.

The equity market

Share prices and trading. – In the first eight months of 2008 share prices fell sharply worldwide, plummeting further from mid-September as the financial crisis deepened. In Italy the general index declined by 49 per cent during the year, slightly more than the 46 per cent recorded for the euro area (Figure 15.4). After posting substantial further losses, of around 35 per cent between the beginning of this year and mid-March, prices picked up considerably when international financial market conditions improved; by the middle of May the beginning-of-year losses had been completely recouped.

Figure 15.4

Share markets



Source: Based on Bloomberg data.
(1) Indices: Historical 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.

Prices of bank shares in Italy fell by 56 per cent in 2008, some 10 percentage points more than the rest of the index, mainly because the performance of current and expected earnings was worse than for the other sectors. Among non-financial companies, those most sensitive to the international business cycle fared worse: above-average losses were posted by automobile shares (69 per cent), consumer goods (60 per cent) and basic materials (53 per cent). In all the other main sectors share prices dropped by over 35 per cent.

The drop in share prices was due not only to the sharp increase in the risk premiums demanded by investors but also to the increasingly poor performance of listed companies' current earnings, which fell far short of expectations, and of earnings growth expectations.

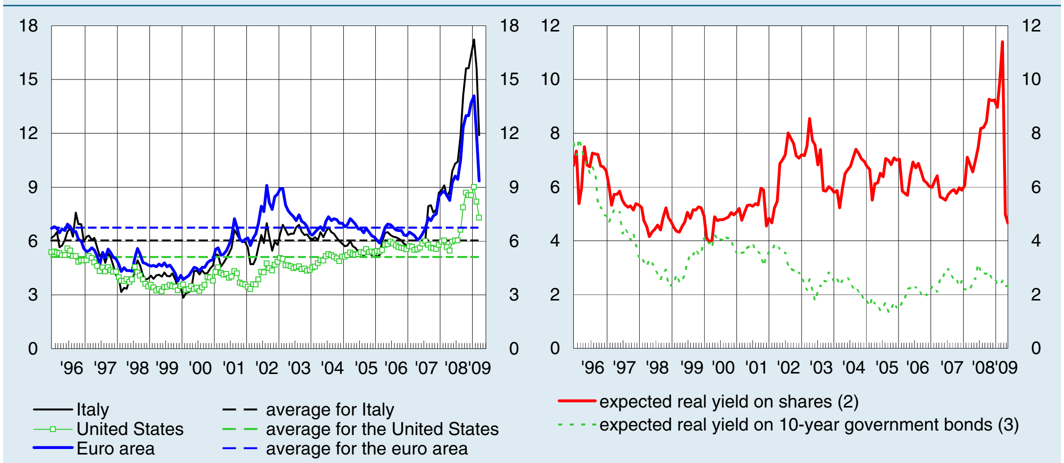
From the middle of September, when Lehman Brothers collapsed, the volatility of Italian equities implicit in option prices increased sharply, reaching an end-year value three times higher than at the beginning of September (Figure 15.4). Although it declined in the following months, it remained nonetheless high by historical standards.

At the end of 2008 the earnings-price ratio of Italian shares was 15.6 per cent, against 7.8 per cent a year earlier (Figure 15.5). This was over twice the average level recorded from the mid-1980s to date and indicated a downward revision of expectations and considerable uncertainty on the part of investors in assessing the earnings prospects of listed companies. During 2008 the expected nominal yield on shares, based on share prices and forecast earnings growth in the short and longer term, was on average at 10.2 per cent, against 7.9 per cent in 2007, while that on ten-year government bonds rose from 4.5 to 4.6 per cent (Figure 15.5).

Figure 15.5

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

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



Sources: Based on IBES, Consensus Economics and Thomson Reuters Datastream.
(1) The averages are calculated from January 1990 onwards. – (2) The expected real yield is estimated as the spread between the rate of return implicitly used by investors to discount expected future dividends and long-term inflation expectations according to Consensus Economics. Stock market variables refer to the Italian MSCI index. – (3) Spread between the interest rate on ten-year government bonds and long-term inflation expectations.

Supply and demand. – The deepening of the financial crisis and the high cost of arm's-length capital discouraged new listings. Only seven new companies made IPOs, compared with 32 in 2007, five of them in the segments for small and medium-sized firms (four in the Expandi Market and one in the MAC – *Mercato Alternativo del Capitale*). Total fund-raising by the newly listed companies amounted to €143 million, against €4.4 billion in 2007, reflecting the paucity of the issues. Companies already listed, however, made substantial additional share issues worth €7.3 billion, compared with €3.9 billion in 2007 (Table 15.2). Most of these were made by banks to strengthen their capital base at a time when investors were rewarding the most highly capitalized institutions. The euro area as a whole also registered a considerably fall in IPOs, from 212 to 45 and from €31 to €4 billion.

Table 15.2

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

	2003	2004	2005	2006	2007	2008
Annual change in prices (1)	14.9	17.5	13.9	19.0	-8.0	-48.7
Listed Italian companies (number at end of year)	271	269	275	284	301	294
of which: in the STAR segment	*40*	*46*	*70*	*75*	*82*	*75*
Total market capitalization (2)	487,446	568,901	676,606	778,501	733,614	374,702
as a percentage of GDP	*37.5*	*43.1*	*49.3*	*52.8*	*48.0*	*24.4*
percentage breakdown: (3)						
industrials	*23*	*23*	*26*	*29*	*31*	*33*
insurance	*12*	*12*	*12*	*10*	*10*	*11*
banking	*26*	*25*	*32*	*33*	*30*	*25*
finance	*4*	*3*	*4*	*4*	*4*	*3*
services	*35*	*37*	*26*	*24*	*26*	*28*
Total	**100**	**100**	**100**	**100**	**100**	**100**
Gross share issues (4)	8,710	3,197	12,599	6,098	5,441	7,700
of which: in the STAR segment	*26*	*89*	*279*	*290*	*409*	*238*
Market value of newly-listed companies (5)	1,412	5,999	6,405	12,919	11,178	464
of which: foreign companies	..	..	..	..	..	..
of which: in the STAR segment	..	..	*797*	*3,620*	*4.243*	..
Dividends distributed (6)	17,030	21,849	22,907	28,317	30,625	28,549
Earnings/price ratio (7)	6.4	6.0	5.2	5.9	7.8	15.6
Dividend yield (7)	3.4	3.4	3.0	3.2	3.7	8.0
Turnover:						
spot market (8)	*580,703*	*641,376*	*893,853*	*1,078,390*	*1,513,634*	*993,511*
S&P/MIB index futures (9)	*527,024*	*467,122*	*585,445*	*761,580*	*954,524*	*698,258*
S&P/MIB index options (9)	*153,998*	*152,839*	*209,526*	*262,312*	*368,966*	*268,264*
Turnover ratio (10)	123	121	144	148	200	179

Sources: Borsa Italiana, Mediobanca and Thomson Reuters Datastream.
(1) Percentage change in the S&P/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 2003, Mediobanca; from 2004, based on Borsa Italiana data. – (7) End-of-period data. Percentages. Current earnings and dividends. – (8) Italian companies. – (9) As of September 2004, replaces the contract on the MIB30 index. – (10) Turnover as a percentage of average market capitalization for the year. Italian companies.

At the end of the year, 294 Italian companies were listed on the Italian stock exchange, down from 301 twelve months earlier, and 42 foreign companies. The fall in share prices led to a decrease in the total capitalization of Italian companies, from €734 billion to €375 billion and from 48 to 24 per cent of GDP. The ratio to GDP was 32 per cent in Germany, 49 per cent in the four European countries of the NYSE Euronext platform (Belgium, France, the Netherlands and Portugal), 82 per cent in the United States and 89 per cent in the United Kingdom.

On 25 September 2008 Borsa Italiana launched AIM Italia, dedicated to small and medium-sized firms. The new exchange, which is patterned after the London exchange of the same name, offers simplified listing procedures and is geared to international investors. It takes over from the Expandi Market, and companies listed on the latter will be transferred to the ordinary segment of the electronic share market (MTA). AIM Italia will coexist with the MAC, which is also dedicated to small and medium-sized firms but reserved to institutional investors.

BANKS AND NON-BANK INTERMEDIARIES

16. BANKS

In 2008 banking activity in all the industrial countries was heavily affected by the evolution of the financial crisis and the onset of the recession. The collapse of the investment bank Lehman Brothers in September marked a turning-point for banks in Italy as in other countries. In the first nine months of the year Italian banks had suffered only moderately from the turmoil, thanks to their low exposure to structured financial products, their specialization in traditional banking activities and the prudence of the regulatory and supervisory framework. During that period, however, the supply of funds evaporated in the wholesale markets, and Italian banks, especially the largest, encountered difficulty raising funds abroad. The expansion in domestic funding, albeit at increasing unit costs, made it possible to maintain a high though gradually diminishing rate of growth in lending to the economy. The ability of Italian banks to absorb the effects of the crisis was reflected in market assessments of their default risk, expressed by the premiums on credit default swaps (CDSs), which were lower than those of the main European banks.

The financial crisis became systemic in September and its direct effects were compounded by the consequences of the economic crisis. The leading international banking groups, especially those most exposed to structured financial products, registered huge losses. The clogging of the interbank markets made the refinancing of maturing positions difficult and reserves of liquidity rapidly dwindled. The governments of many countries had to intervene with massive recapitalizations and other measures to support the stability of the financial system. After an initial phase of purely national interventions, the European governments coordinated their actions, adopting measures to protect depositors and maintain banks' liquidity and the strength of their capital at adequate levels. The European Commission has announced that between October 2008 and March 2009 it received notification of more than fifty public support interventions, including guarantee schemes, recapitalization programmes and specific measures for some intermediaries. The total support for the banking sector is of the order of €3,000 billion, or 24 per cent of the Union's GDP, including €2,300 billion for possible guarantees.

The premiums on the main Italian banks' credit default swaps also rose, coming into line with those of the major European intermediaries. Share prices slumped, reducing the possibility of raising new capital in the markets. Since the end of March of this year, better-than-expected earnings and the statements by some major banking groups of their intention to resort to the instruments of public recapitalization have brought the premiums on credit default swaps back down to low levels.

The fall in productive activity and the decline in transactions on the property market reduced firms' and households' demand for financing. For their part, banks tightened their credit standards. Lending slowed sharply, especially in the last quarter of the year. The riskiness of borrowers rose rapidly: new bad debts in the first quarter of 2009 were equal to 1.6 per cent of total loans, the highest ratio since the end of the last decade, excluding the peak reached in 2003 with the insolvency of the Parmalat group. The increases in borrowers in temporary difficulty and those behind in repayment suggest that the deterioration in loan quality could continue with even greater intensity in the next two years. Additional risks come from the exposure to the economies of some emerging countries, where the main Italian groups hold sizeable market shares.

Although Italian banking groups' return on equity (ROE), calculated on a consolidated basis, remained well above the average for the largest euro-area intermediaries in 2008, it nevertheless came down by about 5 percentage points to 6 per cent. The decline was due primarily to the worsening result on trading activity and to the large increase in provisioning and value adjustments. Positive contributions to profitability, with effect only on 2008 and amounting to more than 2 points of ROE, came from changes to the tax treatment of goodwill and the revision of the international accounting standards for the classification of financial instruments.

The distribution of a smaller percentage of profits and careful management of assets improved the total capital ratio of Italian banks, despite the reduction in earnings. Further strengthening can be achieved with the purchase by the Ministry for the Economy and Finance of financial instruments issued by banks.

Funding and liquidity management

Italian banks' total funding – deposits from resident non-bank customers, bonds not held by other Italian banks and funds raised abroad – slowed markedly in 2008. The twelve-month growth rate fell to 4.7 per cent in December, from 11.3 per cent a year earlier (Table 16.1); in the first quarter of 2009 it declined further, to 4.1 per cent in March.

The higher perception of counterparty risk on the international markets, which also involved Italian banks, caused a large contraction in external interbank liabilities. Deposits and bonds held by non-resident intermediaries fell by €48 billion, or 9.3 per cent; almost all of the decrease came in the liabilities of the five largest banking groups. External interbank liabilities fell to 23 per cent of total funding, a decrease of 4 percentage points.

Disposals of loans on banks' books, which until 2007 had helped to finance the robust expansion in lending, were also affected by the crisis. As a consequence of the seizing up of the secondary loan market, assignments were carried out almost entirely through retained securitizations for the purpose of obtaining assets eligible for refinancing with the Eurosystem.

Banks responded to the reduction in wholesale funding with policies aimed at expanding domestic fund-raising, especially from households.

The share of retail funding, which is less exposed than wholesale funding to financial market turbulence, is high in Italy by international standards. At the end of 2008, the sum of deposits from non-bank customers (excluding financial companies) and bonds held by investors other than euro-area banks and money market funds accounted for 71 per cent of total funding, compared with a euro-area average of 59 per cent. At the end of 2007 the corresponding figures had been 68.7 and 58.4 per cent.

Table 16.1

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 2008
	December 2008	June 2008	December 2007	June 2007	December 2008	June 2008	December 2007	June 2007	
					Assets				
Cash	1,164	712	1,118	500	9.7	8.3	10.3	6.2	13,125
Debt securities (2)	40,836	6,801	7,960	13,631	30.7	5.8	2.9	9.3	184,145
of which: government securities	*11,801*	*-10,228*	*2,891*	*15,414*	*13.5*	*-6.3*	*-1.0*	*8.9*	*126,194*
Loans	83,032	99,647	126,506	133,941	5.6	8.1	10.1	10.8	1,761,199
External assets	-11,411	25,605	44,565	94,110	-2.0	7.5	12.5	30.9	364,087
Shares and other equity	-1,342	21,455	13,532	23,153	14.1	12.3	7.3	18.3	149,954
Claims on resident MFIs									
Loans	*78,433*	*60,672*	*58,247*	*73,099*	*19.0*	*14.0*	*13.8*	*18.4*	*560,841*
Securities	*61,629*	*52,909*	*9,103*	*4,906*	*65.6*	*64.5*	*15.1*	*5.4*	*155,154*
Other assets (3)	44,103	26,963	78,891	79,823	9.3	4.5	13.4	17.7	439,771
					Liabilities				
Total funding	106,652	126,442	173,581	239,288	4.7	8.0	11.3	15.3	2,182,891
Funds raised from residents in Italy	147,153	122,366	89,125	67,774	9.7	10.9	8.5	6.0	1,612,837
Deposits	*82,637*	*46,196*	*33,125*	*46,812*	*7.3*	*6.7*	*4.9*	*6.1*	*1,127,856*
Bonds (4)	*64,516*	*76,170*	*56,000*	*20,962*	*15.6*	*21.3*	*16.8*	*5.9*	*484,981*
Funds raised from non-residents	-40,500	4,076	84,456	171,514	-7.4	2.4	17.8	38.7	570,054
Deposits of non-bank customers	*7,292*	*6,711*	*-6,722*	*-348*	*12.4*	*14.8*	*-8.7*	*0.6*	*61,400*
Liabilities to non-resident MFIs	-47,792	-2,635	91,178	171,862	-9.3	1.2	21.3	44.2	508,655
Deposits	*-44,101*	*14,826*	*92,326*	*132,787*	*-10.7*	*5.7*	*28.3*	*43.6*	*408,281*
Bonds (5)	*-3,691*	*-17,461*	*-1,148*	*39,075*	*-3.3*	*-15.2*	*-2.4*	*46.3*	*100,374*
Capital and reserves	11,705	35,413	63,061	38,893	5.5	11.4	14.1	9.6	276,384
Liabilities to resident MFIs	176,254	105,942	48,572	78,940	34.0	19.9	10.2	16.4	740,033
Deposits	*114,625*	*53,033*	*39,469*	*74,034*	*27.7*	*11.8*	*9.2*	*18.7*	*584,880*
Bonds	*61,629*	*52,909*	*9,103*	*4,906*	*65.5*	*64.5*	*15.1*	*5.4*	*155,154*
Other liabilities	1,834	26,966	54,707	66,042	7.7	9.2	14.0	16.9	428,966

(1) Supervisory returns and calculations based on ECB data. The percentage changes are net of changes due to reclassifications, exchange rate variations, value adjustments and other variations not due to transactions. – (2) Excludes bonds issued by resident monetary financial institutions (MFIs). – (3) Money market fund units, moveable and immoveable assets, and other items of minor importance. Excludes bonds held by MFIs resident in Italy and the euro area. – (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.

Deposits from resident customers expanded by 7.3 per cent, more than two percentage points faster than in 2007. The growth was concentrated in the first nine months of the year and was driven by households' current accounts and longer-term deposits. In the last quarter of the year the reduction in interest rates on bank liabilities, which followed that in monetary policy rates, led to a deceleration in deposits; this trend continued in the first few months of 2009.

Bonds held by resident customers also continued to show rapid growth (15.6 per cent, compared with 16.8 per cent in 2007), though with a decided slowdown in the final months of the year; their share of total funding rose by two percentage points to 22 per cent. The growth in bond funding was assisted by the rise in the yields paid to investors. On average for the year, the spread between the yield on new floating rate issues and CCTs widened from 11 to 37 basis points; that between the yield on new fixed-rate issues and BTPs, which had been negative until mid-2007, increased by 0.4 points to 31 basis points.

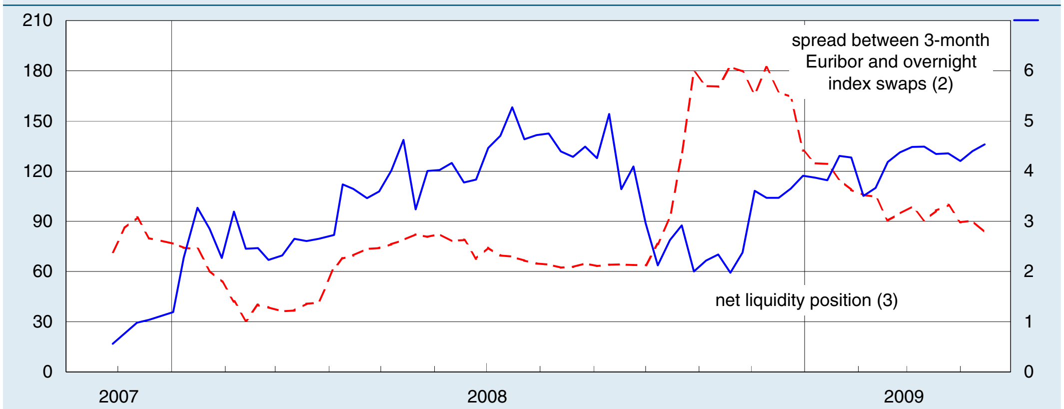
The rise in the yields paid to non-bank customers and that in interbank rates caused the average cost of funds (including those raised from other banks resident in Italy) to increase by an annual average of nearly 40 basis points, to 3.6 per cent. All of the increase was reabsorbed following the reduction in official rates, so that in March of this year the cost of funds was back near the level recorded at the start of 2006 (1.9 per cent).

Liquidity management. – Average daily turnover on the e-Mid market for interbank deposits with maturities ranging from overnight to one year contracted significantly. By contrast, total domestic interbank liabilities, of which only a part are traded on e-Mid, continued to expand at a high rate. This outcome reflected both the growth in intra-group transfers, used in order to enhance the efficiency of liquidity management, and the increase in bilateral trades, mostly backed by collateral, between banks belonging to different groups.

Figure 16.1

Spread between Euribor and overnight index swaps and net liquidity position on maturities up to 1 month (1)

(weekly data; basis points and percentages)



Sources: Based on Bloomberg data and Bank of Italy weekly monitoring procedure of liquidity.
(1) Data for the five largest banking groups. – (2) Left-hand scale. – (3) In relation to total assets; right-hand scale.

The data gathered through the weekly monitoring procedure that the Bank of Italy initiated in September 2007 indicate that for the five largest banking groups the net liquidity position on maturities up to one month grew to reach 5.1 per cent of total assets at the beginning of September (Figure 16.1). A sharp contraction ensued, and in November the net liquidity position was equal to 2 per cent of assets. In the first few months of 2009, as the strains in the market subsided, the net liquidity position of the largest Italian groups improved considerably, returning to the levels observed in the first half of last year.

Assets

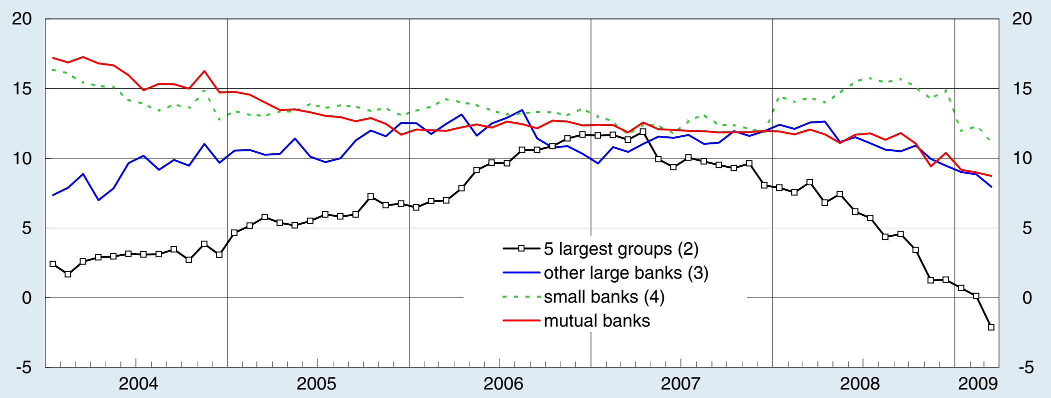
Lending by Italian banks to the private sector slowed markedly in 2008. The growth rate fell by nearly four percentage points to 7.3 per cent, in line with the trend in the euro area. The slowdown involved lending to both households and firms. Compared with the end of 2008, in the first quarter of 2009 lending to the private sector grew at seasonally adjusted annual rates of 0.1 per cent in Italy and 0.6 per cent in the euro area.

The slowdown in credit was gradual in the first nine months of 2008 and then intensified in the last quarter. It was more pronounced for lending by the five largest banking groups, which grew by 1.3 per cent in 2008, compared with 8 per cent in 2007 (Figure 16.2); in the twelve months ended this March, lending by these groups contracted by 2.1 per cent. The slowdown was also sharp for the Italian branches of foreign banks, whose share of the credit market remained about the same in 2008 after growing significantly in the previous ten years. Lending by other banks slowed slightly but continued to show high rates of expansion close to or exceeding 10 per cent.

Figure 16.2

Bank lending by size class of bank (1)

(monthly data; twelve-month percentage changes)



Source: Supervisory returns.
(1) Provisional data for March 2009. Lending excludes repos and bad debts. The division of banks according to size is based on the Bank of Italy's classification and on the composition of banking groups as of March 2009. The percentage changes are calculated net of the effects of securitizations and reclassifications. – (2) Banks belonging to the following groups: Banco Popolare, Intesa Sanpaolo, MPS, UBI Banca and UniCredit. – (3) Banks belonging to groups, other than the five largest, whose parent company is "major", "large" or "medium-sized". – (4) Banks belonging to groups whose parent company is "small" or "minor" and banks not belonging to groups, except for mutual banks (*banche di credito cooperativo*).

The different trends in lending by category of bank primarily reflect the differing intensity of the constraints encountered on the funding side. These were more stringent for the large groups and for the branches of foreign banks, which financed themselves to an appreciable extent in the wholesale markets. Another factor was the strong roots in the local economy of the smaller banks, which gave higher priority to safeguarding long-term relationships with firms, even at the cost of taking on greater risks.

In the first nine months of the year the deceleration in lending mainly reflected the reduction in households' and firms' demand for financing; subsequently, banks' supply policies also contributed. The responses of the Italian banking groups that take part in the Bank Lending Survey for the euro area indicate that banks progressively tightened their terms and conditions for granting loans. Contributing to their greater prudence were the increase in the riskiness of borrowers, the difficulty in procuring funds on the wholesale markets, the rise in funding costs and, especially in the last months of the year, the balance-sheet constraints deriving from the reduced possibility of self-financing and of raising equity capital in the market. In the first quarter of 2009 the number of intermediaries that indicated a further tightening of credit standards fell significantly in connection with the lesser difficulty of raising funds in the wholesale markets.

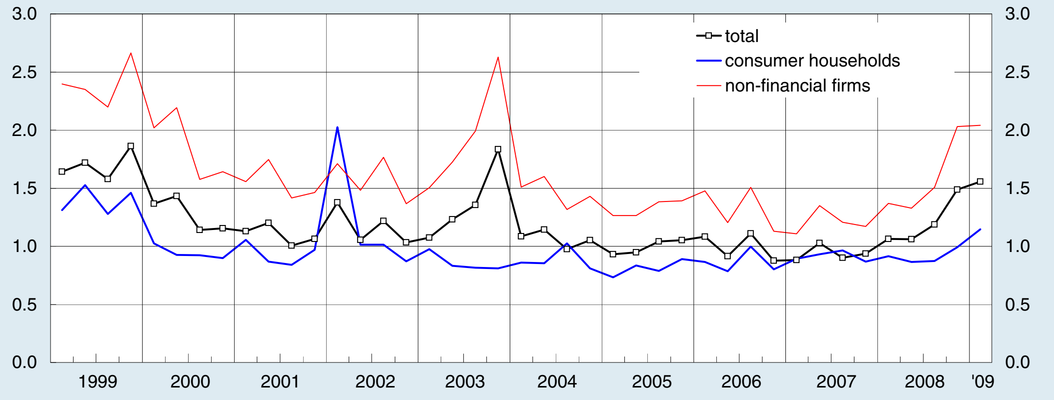
The need to have more eligible assets for refinancing operations with the Eurosystem and to increase the proportion of less risky assets led banks to expand their securities portfolios. Italian banks' holdings of debt securities of issuers resident in Italy (excluding resident monetary financial institutions) grew by €41 billion over the year to €184 billion at the end of 2008. Both retained securitization transactions and government securities contributed to the growth. The ratio of liquid assets (cash and securities other than shares) to the sum of liquid assets and loans rose from 8.5 to 10.1 per cent.

Risks

Credit risk and asset quality. – The recession has begun to have repercussions on credit quality. For banks operating in Italy, the ratio of adjusted new bad debts to total loans rose in the course of 2008, with a significant acceleration in the last two quarters (Figure 16.3). This trend continued in the first quarter of 2009, when adjusted new bad debts amounted to more than €5 billion. On a seasonally adjusted annual basis this was equal to 1.6 per cent of the stock of performing loans at the end of 2008, compared with 1.0 per cent for 2007 as a whole. The increase was greater for banks not belonging to the five largest groups.

Figure 16.3

Ratio of new bad debts to outstanding loans (1)
(seasonally adjusted, annualized quarterly data; percentages)



Sources: Central Credit Register and supervisory returns.
(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. All the time series are adjusted for seasonal effects, where applicable.

On the basis of Italian banking groups' consolidated reports, the amount of non-performing exposures to customers (bad debts, substandard loans, restructured loans, exposures past due or in breach of overdraft ceilings for more than 180 days) rose by 27.6 per cent, driven up mainly by the growth of more than 60 per cent in exposures towards borrowers in temporary difficulty (substandard loans). The ratio of non-performing assets to total exposures to customers rose by more than one percentage point to 5.7 per cent (Table 16.2). The cover ratio (writedowns as a percentage of total exposure) fell to 46.1 per cent (62.8 per cent solely for bad debts).

Table 16.2

Banking groups: quality of assets (1)

(end-of-period data in millions of euros and percentages)

	Exposures (2)	*of which:* % to residents	Share of total balance-sheet exposures to customers		Cover ratio (3)	
	2008 (4)		2007	2008 (4)	2007	2008 (4)
			All groups (5)			
Balance sheet exposures to customers	**2,054,747**	**74.0**	**100.0**	**100.0**	**2.8**	**3.2**
Performing	1,937,311	73.5	95.4	94.3	0.5	0.6
Non-performing	117,436	81.7	4.6	5.7	49.4	46.1
exposures past due and/or in breach of overdraft ceilings for more than 180 days	*9,422*	*95.4*	*0.4*	*0.5*	*8.2*	*8.4*
restructured loans	*3,303*	*65.0*	*0.1*	*0.2*	*25.6*	*27.8*
substandard loans	*35,833*	*86.2*	*1.1*	*1.7*	*26.7*	*25.5*
bad debts	*68,878*	*78.3*	*3.0*	*3.4*	*63.9*	*62.8*
Balance-sheet exposures to banks	**352,045**	**37.7**			**0.1**	**0.4**
Off-balance-sheet exposures	**880,189**	**43.3**			**0.3**	**0.3**
to customers	*523,869*	*48.3*			*0.5*	*0.5*
to banks	*356,321*	*35.9*			..	..

(1) Consolidated supervisory returns of banking groups only. Rounding may cause discrepancies in totals. – (2) Exposures are gross of value adjustments. – (3) Value adjustments as a percentage of total exposure. – (4) Provisional data. – (5) Includes Italian groups controlled by foreign banks.

The increase in substandard and overdue loans indicates that the deterioration in asset quality will continue in 2009. The worsening is also confirmed by estimates of firms' probability of default within the current year, which is higher than that referring to 2008.

An estimate obtained by prorating the total exposures of borrowers who defaulted in the first quarter to the entire year indicates that these loans will exceed €30 billion in 2009, compared with €18 billion in 2008 (of which €6.5 billion in the fourth quarter alone) and €13 billion in 2007. Together with a fall in operating profit, the emergence of bad debts on this scale would significantly reduce banks' self-financing capacity.

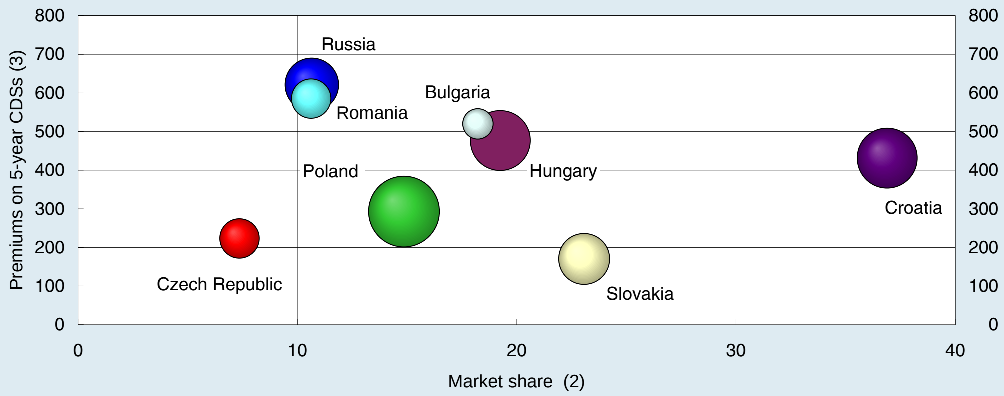
Country risk. – At the end of 2008 the balance-sheet exposure of Italian banks and their foreign subsidiaries to countries defined by the Bank for International Settlements as developing countries amounted to €152 billion, basically unchanged, gross of exchange rate variations, with respect to the end of 2007; it was equal to about 5 per cent of the Italian banking system's total assets.

At the end of 2008 the balance-sheet exposure to the countries of central and eastern Europe (mostly classified as developing countries) amounted to €148 billion, similar to the year-earlier figure. The Italian banking system's overall market share with respect to the total of countries that report to the BIS stood at about 13 per cent, the highest, with Germany's, among those of the industrial countries.

More than 40 per cent of Italian banks' exposure to central and eastern Europe is towards countries such as Poland, the Czech Republic and Slovakia, for which the market's risk assessments (gauged by CDS spreads on sovereign debt) are relatively low (Figure 16.4). The deterioration in credit quality was greater in the economies with flexible exchange rate regimes, where the weakening of the local currencies increased the cost of servicing the debt in foreign currency or that contracted in local currency but indexed to exchange rates with foreign currencies; this increases banks' counterparty risk, since exchange rate risk is generally borne by the borrower.

Figure 16.4

Exposure to country risk (1)



Sources: Based on Thomson Financial Datastream and BIS data and supervisory returns.
(1) The size of the circles is proportional to the exposure of the Italian banking system towards the countries indicated. – (2) Market share with respect to the countries that report to the BIS; percentages. – (3) Average premiums on CDSs on sovereign debt for the first four months of 2009; basis points.

Exposure to products classified as high-risk. – Operations in structured products and other instruments strongly affected by the financial crisis such as securities deriving from other banks' securitizations, derivatives on structured securities and exposures to monoline insurers have traditionally been of limited importance for Italian banks. Faced with the sector's deterioration during the crisis, banks took steps to contain their exposure by setting more stringent operating limits, gradually reducing their portfolio and hedging.

At the end of 2008 the exposure of Italian banking groups to structured securities deriving from securitizations by third parties amounted to €23 billion, €9 billion less than a year earlier. On the basis of information published in financial statements pursuant to the Financial Stability Forum's recommendations and of data collected by the Bank of Italy, more than half the exposure consists of securities with a high rating connected with the securitization of residential or commercial mortgages or with loans of other types mainly to borrowers resident in Europe. The component originated in the United States, hit harder by the crisis, is relatively unimportant. The other types of "high-risk" product have a limited presence in banks' balance sheets.

The risk taken on by Italian banks vis-à-vis hedge funds (loans to Italian hedge fund management companies and portfolio investments in Italian and foreign hedge funds) is limited. The exposure (not counting guarantees) amounted to about €3.6 billion in December 2008, down from €4.3 billion a year earlier. The decline was mainly due to a contraction in lending to hedge fund management companies. The total exposure was highly concentrated, with about 80 per cent attributable to six banking groups; for these groups, the average ratio to regulatory capital was 7.3 per cent. Investments in hedge fund units accounted for about 80 per cent of the total exposure and made up less than 1 per cent of the banks' securities portfolios.

Profitability

In 2008 the profits of Italian banking groups were affected by the international financial crisis and the worsening of the global macroeconomic context, as in other countries.

Profits for the year declined by almost two thirds; return on equity (ROE) fell from 12.8 to 4.8 per cent (Table 16.3). Excluding the non-recurring components connected with some major corporate restructurings, profits dropped by more than 40 per cent and ROE declined from 11.0 to 5.7 per cent.

Table 16.3

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

	All groups			Main groups (2)		
	2007	2008 (3)	Change	2007	2008 (3)	Change
Net interest income (a)	48,657	53,930	10.8	35,323	38,948	10.3
Non-interest income (b)	37,370	27,278	-27.0	27,893	19,533	-29.9
of which: fees	*28,939*	*25,564*	*-11.7*	*21,699*	*18,859*	*-13.1*
Gross income (c=a+b)	86,028	81,208	-5.6	63,217	58,500	-7.5
Operating expenses (d)	51,472	54,006	4.9	37,383	38,800	3.8
of which: staff costs	*29,658*	*30,397*	*2.5*	*21,803*	*21,844*	*0.2*
Operating profit (e=c-d)	34,556	27,203	-21.3	25,832	19,700	-23.7
Allocations to provisions and net value adjustments (f)	10,083	20,253	100.9	7,587	14,990	97.6
of which: in respect of loans	*7,405*	*12,698*	*71.5*	*5,424*	*8,777*	*61.8*
Ordinary profit (g=e-f)	24,474	6,950	-71.6	18,247	4,711	-74.2
Extraordinary profit (h)	1,717	1,568	-8.7	1,394	1,389	-0.4
Gross profit (i=g+h)	26,190	8,518	-67.5	19,639	6,099	-68.9
Taxes (l)	9,224	650	-93.0	6,507	-951	-114.6
Profit from asset classes in the process of being liquidated (after tax) (m)	4,668	1,257	-73.1	4,661	1,245	-73.3
Profit of minority interests (n)	1,360	1,004	-26.2	1,026	764	-25.6
Profit of parent company (o=i-l+m-n)	20,274	8,122	-59.9	16,767	7,532	-55.1
Indicators						
Ratio of non-interest income to gross income	43.4	33.6		44.1	33.4	
Cost/income ratio (4)	59.8	66.5		59.1	66.3	
Value adjustments in respect of loans/Operating profit	21.4	46.7		21.0	44.6	
ROE	12.8	4.8		14.3	5.9	
ROE net of non-recurring components	11.0	5.7		11.8	7.1	

(1) Consolidated supervisory returns of banking groups only. – (2) Five largest groups by total assets. – (3) Provisional data. – (4) Ratio of operating expenses to gross income.

Net of the non-recurring components, the deterioration in the profitability of the five largest banking groups was smaller than average. Their profits fell by two thirds and ROE declined from 11.8 to 7.1 per cent. The ROE of the main euro-area banking groups averaged just over 3 per cent.

The growth in net interest income was substantial but not sufficient to offset the fall in other income. Fee income contracted by 11.7 per cent, mainly reflecting the difficulties in the asset management sector; the net result on trading activity, heavily affected by the performance of the international financial markets, worsened considerably. Gross income declined by 5.6 per cent. The contribution of net interest income to total income rose from 56.6 to 66.4 per cent.

Major Italian banks' losses on structured credit products and other financial instruments affected by the crisis were limited by comparison with those of major foreign banks. Italian and foreign banks that adopt IAS/IFRS were able to benefit from the changes to the classification of financial instruments, which made it possible to transfer some instruments subject to fair-value valuation to portfolios not subject to that valuation standard, attenuating the impact of the losses in the second half of the year. The benefits for the main Italian groups in terms of decreased losses were equivalent to about one fifth of their profits for the year.

Operating profit fell by 21.3 per cent. The large increase in allocations to provisions and value adjustments, which doubled compared with 2007, was due both to writedowns connected with the deterioration in loan quality and adjustments made to the value of goodwill recorded in balance sheets following the mergers and acquisitions of the past years. The portion of operating profit absorbed by writedowns to loans more than doubled, rising from 21.4 to 46.7 per cent.

Profit before tax fell by more than two thirds. The reduction in taxes was proportionally greater as a result of the changes to the tax treatment regarding the revaluation of goodwill. For the largest groups the benefits were equivalent to about two thirds of their profits for the year.

The profitability of banks not belonging to groups (excluding the branches of foreign banks) was hit less hard by the crisis, although their profit after tax declined by nearly a fifth. Their ROE came down by a little more than 2 percentage points, to 6 per cent. The increase in both net interest income and fee income resulted in a 4.3 per cent rise in gross income. In connection with an appreciable increase in operating expenses, operating profit contracted by 6.2 per cent. The decline in the quality of assets entailed an increase in value adjustments to loans similar to that of the banking groups. Profit before tax fell by 23.6 per cent.

Capital

In 2008 the capital of Italian banks and banking groups, taken as a whole, remained well above the regulatory minima in spite of the difficult cyclical situation.

At the end of the year the system's regulatory capital amounted to €204.6 billion, up by 1.4 per cent from the end of 2007 (Table 16.4). Most of the increase of €2.9 billion came from subordinated loans counted in supplementary capital. Tier 1 capital fell by 3 per cent to €145.2 billion: self-financing, which benefited in part from the measures concerning the adjustment of goodwill for tax purposes, was not sufficient to compensate for the effect of valuation losses on available-for-sale securities.

Table 16.4

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

	Banking system		Main groups (2)	
	2007	2008	2007	2008
Allocations to regulatory capital	10,804	10,893	6,841	8,025
Regulatory capital	201,721	204,639	122,672	122,441
Core tier 1 capital ratio (%)	7.2	7.0	5.7	5.8
Tier 1 capital ratio (%)	7.7	7.6	6.4	6.7
Total capital ratio (%)	10.4	10.8	9.5	10.4
Leverage (3) (4)	20	22	25	27
Excess capital	47,550	54,916	19,912	28,857

(1) Consolidated data for banking groups and individual data for banks not belonging to a group. Excludes the Italian branches of foreign banks. – (2) Five largest groups by total assets as of December 2008 – (3) Ratio of total balance sheet assets to tier 1 capital. – (4) Provisional data.

Risk-weighted assets decreased by 2.2 per cent, reflecting a reallocation of portfolios towards less risky assets.

The total capital ratio, consisting in the ratio of regulatory capital (including tier 3 capital) to risk-weighted assets, rose by 0.4 points to 10.8 per cent. The tier 1 capital ratio fell by 0.1 points to 7.6 per cent; the core tier 1 ratio, which refers solely to the components with the highest capacity for absorbing losses, declined by 0.2 points to 7.0 per cent.

For the largest groups, all the capital ratios rose: the total ratio increased by 0.9 points to 10.4 per cent, the tier 1 ratio by 0.3 points to 6.7 per cent and the core tier 1 ratio by 0.1 points to 5.8 per cent. The increase in the ratios was due principally to the decisions by banks to reduce or eliminate the distribution of profits or else to distribute them in the form of shares.

The capital ratios of the largest Italian groups are lower than those of other major international institutions, but the Italian groups, unlike nearly all their competitors in the other main countries, have not yet benefited from public recapitalization measures. The disparity also reflects differences in prudential regulation, which is more severe in Italy in several respects. The possibility of counting hybrid capital instruments in tier 1 capital is generally subject to more stringent limits than in other countries. Furthermore, in the changeover to Basel II, for banks that have adopted internal methods for calculating their capital requirements, stricter limits have sometimes been set on the possible reduction of risk-weighted assets than those envisaged at international level. In addition, the leverage of the largest Italian banking groups is considerably lower than that of their euro-area counterparts: 27 compared with 33.

If the recapitalizations based on Ministry for the Economy and Finance purchases of financial instruments that have been announced went through, the total capital ratio of the five largest groups would increase by about one percentage point with respect to the situation as of December 2008; this would narrow the gap vis-à-vis the main international banks.

The total capital ratio of some of the largest Italian banks increased in the first few months of 2009 as a result of private capital-raising operations.

Stress tests on the Italian banking system

Stress testing provides an assessment of the banking system's ability to withstand very severe but plausible hypothetical shocks. This year the stress tests, conducted in May, concerned credit and liquidity risk.

Credit risk. – The simulations performed on the Italian banking system estimate the impact of the deterioration in credit quality that would occur in the two years 2009-10 under more adverse macroeconomic conditions than those now foreseen; in particular, in one scenario the two-year contraction in GDP in real terms would be nearly 3 percentage points greater than that forecast by the main international organizations (IMF and OECD).

The exercise estimates the loan losses that would occur on the exposure to Italian households and firms. The severe deterioration of the economy would cause the ratio of new bad debts to the stock of loans to rise from 1.4 per cent last year to 3.7 per cent in both 2009 and 2010. Loan losses in the two years would amount to €50 billion. The portion not covered by operating profit, which in the more pessimistic scenario is assumed to be lower than in 2008, would be equal to about one fifth of the system's end-2008 excess capital of €54.9 billion.

Liquidity risk. – The first results of the impact of a liquidity crisis lasting one month are available for the ten largest banking groups. It was hypothesized that severe difficulties arose simultaneously in different supply markets, including the interbank market and the retail funding market. In addition, the scenario envisages an increase in drawings on credit lines by households and firms in connection with the hypothesis of a rise in the need for financial resources.

The number of days of survival (that is to say the period over which the group is able to cope with liquidity strains independently, using its own available liquid assets) would, on average, be slightly greater than the duration of the crisis. The largest groups would show a particularly strong ability to withstand the shocks, thanks in part to the diversification of funding sources, in Italy and abroad, and the availability of eligible assets for operations with the Eurosystem. The Bank of Italy is paying special attention to the need for balanced funding of long-term assets and the adequacy of the stock of marketable assets.

17. ASSET MANAGEMENT AND NON-BANK FINANCIAL INTERMEDIARIES

In 2008 the net outflow of savings from the Italian asset management sector amounted to €137 billion, compared with €75 billion in 2007. As in the previous year, the contraction involved all the main products: investment funds, individually managed portfolios and life insurance policies (Table 17.1). Assets under management declined by 19 per cent to €833 billion, or from 66 to 53 per cent of GDP, partly as a result of the drop in share prices. The portion of households' total financial assets managed by investment companies declined from 27.5 to 24.3 per cent.

Table 17.1

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

	Net flows		End-of-period stocks			
	2007	2008 (1)	2007	2008 (1)	Percentage composition	
					2007	2008 (1)
Investment funds (2)	-50,537	-79,974	349,290	243,766	26.2	22.2
Insurance companies (3)	-13,043	-10,725	423,735	400,520	31.7	36.4
Pension funds (4)	4,028	1,482	39,129	40,611	2.9	3.7
Individually managed portfolios	-24,239	-88,016	522,853	414,111	39.2	37.7
Total	**-83,791**	**-177,233**	**1,335,008**	**1,099,007**	**100.0**	**100.0**
Consolidated total (5)	**-74,709**	**-136,595**	**1,023,839**	**833,376**	**–**	**–**
as a percentage of GDP	*-4.8*	*-8.7*	*66.3*	*53.0*	–	–

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.

Negative returns and investors' increased risk aversion led to a significant shift of Italian households' portfolios from managed assets to other forms of investment, including securities issued by banks. Banks' fund-raising strategy of steering customers to their own products contributed to this.

The outflow of resources from open-end investment funds, under way for several years, gained pace and involved not only Italian funds but also foreign funds controlled by Italian intermediaries. Net fund-raising was also negative for money market funds and hedge funds, which had instead recorded an inflow of resources in 2007. Closed-end real-estate funds continued to grow.

There were also net outflows from individually managed portfolios and life insurance policies. In the life sector, the premiums on unit and index-linked policies declined, while those on with-profits policies increased.

Pension funds turned in negative returns on average; the subfunds weighted most heavily towards shares recorded significant losses. However, the volume of assets under management grew, albeit modestly, thanks to the inflow of new resources.

Non-bank financial intermediaries were hit by the financial crisis and by the rapid downturn in economic activity. Their results for the year reflected the contraction in resources under management, the fall in share prices and the decline in the quality of their assets. Their cost/earnings ratio, a measure of business efficiency, showed either no change or a deterioration. Profits fell sharply. Nonetheless their capital adequacy remained above the prudential requirements.

Investment funds

Fund-raising and net assets. – Italian investment funds recorded net redemptions of €80 billion last year, up from €51 billion in 2007. Foreign funds controlled by Italian intermediaries showed a similar trend, with net outflows rising from €3 billion to €34 billion (Table 17.2).

All the main categories of Italian open-end investment funds had net redemptions; unlike the previous year, net outflows from money market and hedge funds were very substantial, peaking in the last quarter of the year as the economic crisis deepened. In contrast with open-end funds, closed-end real-estate funds enjoyed a significant increase in net inflows of resources, from €2.1 billion to €3.5 billion, thanks to the launch of new initiatives concerning funds reserved to qualified investors. Fund-raising by private equity funds, on the other hand, was virtually nil.

At the end of 2008 the net assets of Italian investment funds totalled €244 billion and those of foreign funds controlled by Italian groups €140 billion, down by around 30 per cent from a year earlier. The decrease was largest for equity funds (57 per cent) and for hedge funds (45 per cent), partly owing to the fall in value of portfolio assets. The net assets of closed-end real-estate funds instead grew by 14 per cent to €24.5 billion, or 10 per cent of the total net assets of Italian funds.

The substantial net outflow of resources from investment funds is ascribable above all to the effect of the financial crisis on households' investment decisions. Falling stock markets and increased aversion to risk led investors to sell units of funds exposed to equities and move into less risky assets. At the same time, the extremely low yield of bond and money market funds pushed investors towards assets offering higher returns for a modest level of perceived risk. As a result of the banks' supply policy aimed at increasing funding from customers, almost all the resources withdrawn from investment funds went into bank products, such as bonds and deposit accounts.

The difficulties of the Italian investment fund industry also have structural and regulatory origins. The report drawn up by the working group on Italian investment funds set up in February 2008 at the initiative of the Bank of Italy cites three main factors at the root of its difficulties: a distributive system that relies mainly on banks and intermediaries controlled by banking groups; asymmetries in the regulation of transparency between its products and other financial products; and the less favourable tax treatment of Italian funds compared with foreign ones.

Table 17.2

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

	Number of funds (2)		Net assets		Net fund-raising (3)	
	2007	2008	2007	2008	2007	2008
Harmonized open-end funds	802	655	260,263	179,387	-51,664	-65,337
Equity	309	232	50,427	21,938	-16,888	-12,031
Balanced	59	74	23,890	14,579	-7,308	-8,097
Bond	281	202	92,157	71,976	-29,260	-26,955
Money-market	37	35	71,068	56,978	2,128	-10,966
Flexible	116	112	22,722	13,915	-336	-7,288
Non-harmonized open-end funds	447	411	63,558	35,019	-1,314	-18,186
Hedge funds	242	249	30,393	16,638	5,354	-6,335
of which: funds of funds	*220*	*217*	*28,392*	*15,081*	*4,837*	*-4,179*
Other	205	162	33,165	18,381	-6,668	-11,851
of which: funds of funds	*115*	*87*	*12,570*	*6,000*	*-5,392*	*-6,247*
Total open-end funds	**1,249**	**1,066**	**323,821**	**214,406**	**-52,978**	**-83,523**
Closed-end securities funds (4)	98	116	3,973	4,894	296	11
of which: reserved to qualified investors	*86*	*100*	*3,478*	*4,598*	*547*	*158*
Closed-end real-estate funds	172	229	21,496	24,466	2,145	3,538
of which: reserved to qualified investors	*143*	*201*	*13,961*	*17,474*	*1,974*	*3,727*
Total closed-end funds	**270**	**345**	**25,469**	**29,360**	**2,441**	**3,549**
Total	**1,519**	**1,411**	**349,290**	**243,766**	**-50,537**	**-79,974**
Memorandum item:						
Foreign funds controlled by Italian intermediaries (5)	784	785	200,947	139,690	-2,888	-33,861
of which: hedge funds	*28*	*28*	*7,143*	*4,862*	*685*	*-814*

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 returns. – (4) Includes seven side pocket accounts. – (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.

The asymmetries in the regulation of transparency between Italian investment funds and other financial products, such as structured bonds and life insurance policies, have essentially been eliminated by Consob Communication 9019104 of 2 March 2009. As part of the legislation implementing the MiFID Directive, the Consob Communication establishes rules that intermediaries must follow in selling products with a low degree of liquidity, so as to give customers correct information on the purchase and sale value of the product distributed and on the costs borne by subscribers.

The financial crisis has underscored the problem of the taxation of investment funds. The system of taxation of profits when accrued has led many equity funds to accumulate enormous tax savings as a result of the substantial unrealized losses registered during the year. These “savings” represent a non-liquid asset item that does not produce revenue, hampering efficient portfolio management.

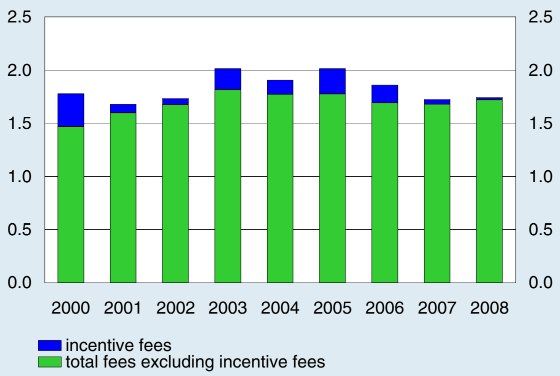
Supply. – The number of open-end funds continued to diminish in Italy in 2008, mainly as a result of mergers between management companies, contracting by 15 per cent. In contrast with previous years, the trend also affected non-harmonized funds, while bond and equity funds decreased further (Table 17.2). Closed-end funds, especially real-estate funds, instead continued to expand.

Yields and fees. – In 2008 the average yield on Italian harmonized investment funds, net of taxes and fees, was negative owing to the fall in prices on the main international stock markets. The general index decreased by 9 per cent, which is close to the losses registered in 2001-02 during the previous stock market crisis. The value of units of equity, balanced and flexible funds plunged 35.9, 13.6 and 9.1 per cent respectively. Instead, returns on bond and money market funds were positive (2 and 2.3 per cent respectively) though low compared with those on comparable investments.

The total fees charged to harmonized investment funds (management fees, incentive fees, fees paid to depositary banks, securities brokerage commissions and other minor items) – which are ultimately borne by subscribers – decreased from €3.8 billion to €2.6 billion. The ratio of total fees to average annual net assets held virtually stable at 1.7 per cent, breaking off the downward trend of recent years (Figure 17.1). The drop in incentive fees from 0.05 to 0.02 per cent was offset by the rise in management fees from 1.07 to 1.12 per cent; other fees were unchanged. According to Borsa Italiana, at the end of April 2009 the total annual fees borne by investors in ETFs averaged 0.43 per cent of net assets.

Figure 17.1

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.

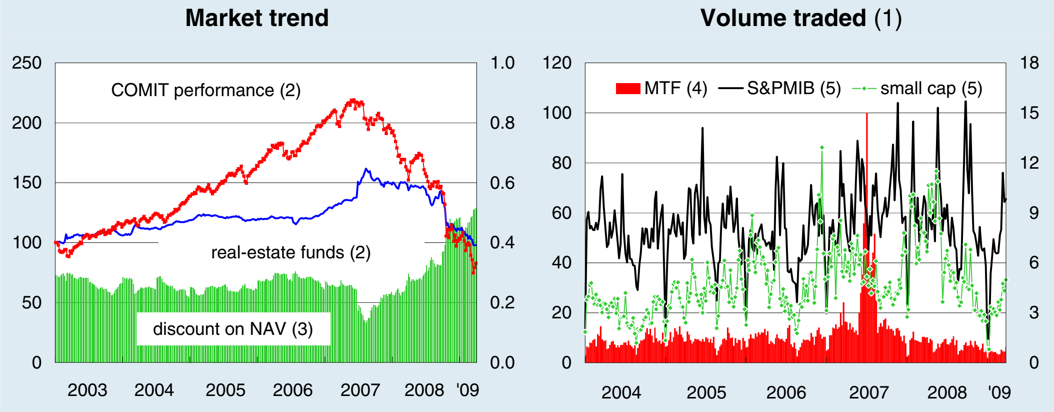
Retail real-estate funds. – At the end of 2008, there were 28 real-estate investment funds in Italy offered to retail investors; they held assets worth €7 billion, equal to 29 per cent of the total net assets of Italian real-estate funds. The capitalization index of the 22 funds listed on the stock exchange fell sharply from mid-2007 onwards, partly as a result of the financial market crisis (Figure 17.2).

Italian listed retail real-estate funds were thinly traded, possibly making it extremely costly for subscribers to sell units under certain market conditions. The market price of real-estate fund units is typically much lower than their net asset value. The discount increased considerably in 2008, and at the end of the year it was 48 per cent of the book value compared with an average of 27 per cent from 2003 to 2008. The gap tends to widen as stock prices fall, the fund's debt increases and the volume of trades contracts.

The risk associated with retail real-estate funds can be heightened by recourse to financial leverage, which is generally modest (1.4). Such funds make limited use of short-term financing or of loans with covenants requiring early repayment when there is a deterioration in given financial indicators. In particular, at the end of 2008 only 2 out of 28 funds (with joint net assets amounting to less than 10 per cent of the total) had resorted to short-term financing and none to loans with covenants. However, without proper programming of disposals, the obligation to redeem maturing units can cause some difficulties.

Figure 17.2

Listed real-estate funds



Source: Based on Bloomberg data.
(1) Ratio of weekly volumes to market capitalization. – (2) Comparison of the trend of the real-estate fund capitalization index and the COMIT Performance. The real-estate fund index has been calculated using the price on the MTF segment of Borsa Italiana, capitalization, dividends and redemptions (left-hand scale). – (3) Capitalization-weighted average of the discount on the funds' stock market price with respect to its net asset value (right-hand scale). – (4) Real-estate funds listed on the MTF (right-hand scale). – (5) Italian listed companies belonging to the S&PMIB index and low-cap companies (left-hand scale).

Retail real-estate funds entail less risk than reserved or hedge real-estate funds. The latter have higher leverage (debt-to-equity ratio of 1.67 and 3.36 respectively), are subject to fewer portfolio diversification constraints, and have recourse to loans with early repayment covenants.

Open-end hedge funds. – At the end of 2008 the net assets of Italian hedge funds amounted to €16.6 billion, equal to 6.8 per cent of the total assets of Italian investment funds.

As a consequence of the enormous volume of redemption requests, Italian hedge funds suffered severe liquidity problems in the last quarter of 2008, as did their international counterparts. In particular, funds of hedge funds were hard-hit by the limits on redemption imposed by the managers of target funds. In order to overcome this problem, in the closing months of 2008 Italian managers were authorized to implement redemption gates or transfer illiquid assets into side pocket accounts.

Individual portfolio management

In 2008 there were net withdrawals of €88 billion from individually managed portfolios, compared with €24 billion in the previous year. Total assets under management fell by 21 per cent to €414 billion. The large outflow of resources involved portfolios managed both by banks and by asset management companies.

Net fund-raising reflected the disappointing financial results, as was the case throughout the asset management industry. The yield, measured as the percentage increase in net assets less net fund-raising, was negative by 4 per cent, against almost nil in 2007. Losses were smaller than those of investment funds thanks to the small proportion of equities held.

In view of the substantial outflow of resources, portfolio managers made net disposals of securities worth €78 billion, mostly units of Italian and foreign investment funds. The share of investment funds in individually managed portfolios fell from 36.8 to 25.3 per cent during the year, while that of bonds rose from 51.3 to 62.5 per cent. The proportion of shares was virtually unchanged at 12 per cent.

Insurance companies

In 2008 the premium income of insurance companies decreased by 7.2 per cent, the same amount as in the previous year. Premium income declined by 11.2 per cent in the life sector and by 0.6 per cent in the non-life sector. Applications for early surrender of life insurance policies were again substantial: fund-raising, net of payments of claims and redemptions, was negative by €10.5 billion, compared with -€12.8 billion in 2007.

As a consequence of the fall of the stock markets, the decline in life premium income was concentrated among the products that entail a greater investment risk for subscribers, such as unit and index-linked policies. Premium income from traditional products, offering broader guarantees of return, returned to growth. Their share of total premium income in the life sector rose from 44 to 57 per cent.

Insurance companies' technical reserves fell by 5.5 per cent to €401 billion. The decline occurred entirely in the life sector and was due mainly to the depreciation of share market investments. Reserves in the non-life sector showed almost no change.

Between the beginning of 2008 and the end of April this year the share prices of Italian insurance companies fell by 48 per cent, compared with 54 per cent for insurance shares in the euro area as a whole. The largest decreases were recorded towards the end of last year, as the financial crisis intensified, and in the first three months of this year. The slide of insurance shares can be put down, in part, to the decline in operating profitability, mainly caused by the smaller inflow of resources. For the life sector, where income from financial operations plays a greater role, share prices also reflected losses on investments in the equity and credit markets.

Pension funds

In 2008 the assets managed by pension funds grew by 3.8 per cent to €41 billion, thanks to the 18 per cent increase in the assets of funds set up after the 1993 reform (Table 17.3). In Italy the assets managed by pension funds amount to about 3 per cent of GDP. Supplementary retirement schemes remain underdeveloped by international standards.

Last year the total number of workers enrolled in supplementary retirement schemes increased by 6.5 per cent to 4.9 million (Table 17.4). Membership of occupational pension funds rose by 3.6 per cent and that of open pension funds by 6.4 per cent, while holders of individual retirement insurance policies instead increased by 15.8 per cent.

Table 17.3

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

	2007				2008 (2)			
	Pension funds			Non-INPS social security institutions (4)	Pension funds			Non-INPS social security institutions (4)
		Set up before the reform of 1993	Set up after the reform of 1993 (3)			Set up before the reform of 1993	Set up after the reform of 1993 (3)	
Liquidity	**3,925**	**2,528**	**1,397**	**2,294**	**4,299**	**2,980**	**1,319**	**2,689**
Securities portfolio	**30,220**	**15,517**	**14,703**	**14,117**	**31,025**	**13,693**	**17,332**	**13,443**
Bonds	19,322	9,540	9,782	9,577	21,895	9,223	12,672	9,228
Shares	5,053	1,645	3,408	1,565	4,326	1,250	3,076	1,240
Investment fund units	5,845	4,332	1,513	2,975	4,804	3,220	1,584	2,975
Mortgage loans and other financial assets	**2,342**	**2,443**	**-101**	**5,515**	**2,663**	**2,455**	**208**	**7,784**
Real estate	**2,642**	**2,642**	**–**	**9,515**	**2,623**	**2,623**	**–**	**9,364**
Total assets	**39,129**	**23,130**	**15,999**	**31,441**	**40,611**	**21,751**	**18,860**	**33,280**

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.

Based on data from the Bank of Italy’s Survey of Industrial and Service Firms, at the end of 2008 an estimated 37 per cent of the total workforce of firms with at least 20 employees were enrolled in a supplementary retirement scheme. The flows of accruing severance pay assigned to supplementary retirement schemes amounted to 2.3 per cent of the total wage bill. The enrolment rate appears to be substantially lower than the overall average for firms with fewer than 50 workers (19 per cent), firms located in the South (22 per cent), and service firms (31 per cent). Probably, in large industrial firms enrolment in retirement schemes is positively affected by the unions’ role in providing information to potential subscribers and by the long-standing presence of occupational pension funds.

In 2008 the financial results of Italian pension funds were negative on average, reflecting the performance of the main international stock exchanges. According to Covip data, the average yield of pension funds (net of taxes and management fees) was -6.3 per cent for occupational funds (2.1 per cent in 2007) and -14 per cent for open funds (-0.4 per cent in 2007). The poor performance of open funds compared with occupational funds was mainly due to the high proportion of equity subfunds. Among the various portfolios offered to pension fund subscribers those with a predominant equity component fared the worst, with occupational funds yielding -24.5 per cent on average and open funds -27.6 per cent. Balanced portfolios did better, although their yield was still negative. By contrast, positive, if modest, returns were achieved by guaranteed subfunds and by subfunds investing only in money market instruments or debt securities. The negative results of many subfunds did not have a significant effect on either subscribers' choices concerning the risk profile of their investments or fund managers' portfolio decisions.

Table 17.4

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

	Number of funds (2)		Number enrolled (3)		Total assets	
	2007	2008 (4)	2007	2008 (4)	2007	2008 (4)
Pension funds set up after the reform of 1993	123	122	2,743,316	2,862,985	15,898	18,758
Occupational funds	42	41	1,996,052	2,067,801	11,599	14,095
Open funds	81	81	747,264	795,184	4,299	4,663
Pension funds set up before the reform of 1993	433	411	680,673	678,000	23,130	21,750
Individual retirement insurance policies	72	75	1,136,102	1,315,983	5,790	6,640
Total	**628**	**608**	**4,560,091**	**4,856,968**	**44,818**	**47,148**

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) Includes possible double-counting. For funds set up before the 1993 reform, estimates. – (4) Provisional data.

Profitability, capital and risk exposure of non-bank financial intermediaries

Asset management companies. – The income statements of asset management companies reflected the negative performance of the markets, particularly in the case of open-end funds. Total net profit fell from €823 million to €563 million, or 31.6 per cent, owing to the contraction in gross operating profit from €2,204 million to €1,805 million. The 2.7 per cent decline in operating costs reflected corporate restructuring (notably following the merger of hedge and traditional companies) and offset only a very small part of the drop in revenue (Table 17.5). ROE, calculated on the basis of shareholders' equity, was 26.7 per cent, compared with 42.3 per cent in 2007.

Companies managing closed-end real-estate and securities funds increased their net profit by 41.1 and 47.5 per cent respectively, while those operating open-end funds and individual portfolios saw their profit drop by 40.3 per cent as a result of the decline in fee income.

About a third of asset management companies closed 2008 with a loss; over 60 per cent of them were either newly formed or in the process of leaving the market.

At the end of 2008 the ratio of regulatory capital to minimum capital requirements of asset management companies was 4.78, compared with 4.08 in 2007. The improvement was due to the increase in regulatory capital as a result of intra-group corporate actions and to the reduction in required capital following the contraction in business volumes.

Investment firms. – The financial market crisis caused a slowdown in the activity of securities firms and a marked deterioration in their profitability. In particular, net operating profit contracted from €174 million to €42 million. ROE, measured on the basis of net assets, declined from 20.5 to 4.3 per cent. Almost half of these firms closed the financial year with a loss.

Table 17.5

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

	2007		2008		Percentage change
	Amount	Percentage (1)	Amount	Percentage (1)	
Fee and commission income	6,594	299.2	4,714	261.2	-28.5
Fee and commission expense	4,390	199.2	2,909	161.2	-33.7
Gross operating profit (2)	**2,204**	**100.0**	**1,805**	**100.0**	**-18.1**
Administrative expenses	1,289	58.5	1,227	68.0	-4.8
of which: staff costs	*638*	*28.9*	*607*	*33.6*	*-4.9*
Other operating expenses	37	1.7	29	1.6	-21.6
Total operating costs (3)	**1,379**	**62.6**	**1,342**	**74.3**	**-2.7**
Other operating income	147	6.7	157	8.7	6.8
Net operating profit	**972**	**44.1**	**620**	**34.3**	**-36.2**
Result on financial operations	307	13.9	211	11.7	-31.3
Result on ordinary activities	**1,279**	**58.0**	**831**	**46.0**	**-35.0**
Taxes	456	20.7	268	14.8	-41.2
Net profit (loss) for the year	**823**	**37.3**	**563**	**31.2**	**-31.6**

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

The deterioration in investment firms' earning capacity reflected the negative results for customer investment services, income from which fell by 40 per cent; in particular, income from the execution of orders fell by almost half. By contrast, portfolio management, including own-account trading, increased by 24 per cent. Operating costs declined by 9 per cent, thanks in part to a sharp reduction in personnel costs, down 17 per cent. The costs/income ratio rose nonetheless, from 62 to 87 per cent.

The effects of the crisis continued to be felt in the first quarter of this year, prompting around ten investment firms to initiate various proceedings to withdraw from the market.

At the end of 2008 investment firms' regulatory capital, consisting almost exclusively of core tier 1 capital (share capital and reserves), declined slightly as a result of operating losses. Total capital charges increased by 14 per cent, mainly owing to the introduction at the beginning of the year of a requirement to cover operating risk. The ratio of regulatory capital to total capital charges decreased from 4.97 in 2007 to 4.24 last year.

Financial companies. – In 2008 lending to financial companies entered in the register set up under Article 107 of the Consolidated Law on Banking decreased by 4.5 per cent. The decline was more marked for companies belonging to foreign banking groups (-8.6 per cent) than Italian groups (-1.2 per cent).

Net profit totalled €1.1 billion, down by 28.5 per cent on 2007. It declined more sharply for leasing companies (-43.7 per cent) and in the consumer credit sector (-29.2

per cent), mainly in connection with losses on loans. In the factoring sector net profit remained virtually unchanged (0.4 per cent).

The growth in gross income of financial companies (21.2 per cent) failed to offset the increase of 58.3 per cent in net losses on loans, equal to 47.9 per cent of net interest income. A total of 39 financial companies made a loss in 2008, compared with 26 in 2007. Most of them (18 companies) specialize in consumer credit or in the issue and management of credit cards.

The quality of credit of these companies showed signs of deterioration: the ratio of new bad debts to total lending went up from 2.7 to 2.8 per cent. This trend is confirmed by Central Credit Register reports, which show that adjusted bad debts and overdrawings of facilities increased respectively by 0.8 and 0.3 percentage points of reported loans (Table 17.6).

Table 17.6

Financial companies: quality of credit
(end-of-period data in millions of euros; percentages)

	Bad debts	Total lending	Bad debts/ lending	Central Credit Register (CCR) (1)			
				Adjusted bad debts (2)	Overdrawings (3)	Adjusted bad debts/CCR lending	Overdrawings/ CCR lending
2006	3,813	137,752	2.8	2,688	1,330	3.3	1.6
2007	4,459	163,704	2.7	2,891	1,274	3.0	1.3
2008	5,798	204,844	2.8	3,843	1,660	3.8	1.6

Sources: Supervisory returns and Central Credit Register.
(1) All financial intermediaries on the special list whose sole or main business is lending belong to the Central Credit Register (CCR), with the exception of those with over 50 per cent of their activity in the consumer credit sector. This table does not include data on intermediaries that manage non-performing loans and securitization vehicle companies. – (2) Difference between the amount drawn on a credit line and the facilities granted (i.e. the amount available to the customer under a valid contract).

For companies specialized in consumer credit bad debts were equal to 4.5 per cent of total lending, almost 1 percentage point more than in 2007. The growth in the ratio was less marked for leasing companies (0.2 points), while the ratio of adjusted bad debts to total loans rose by 0.5 points. In the factoring sector, thanks to the steady expansion in lending and virtual stability of non-performing loans, total and adjusted bad debts declined as a ratio of total lending, respectively by 0.2 and 0.7 percentage points.

At the end of 2008 financial companies' regulatory capital amounted to €17.7 billion, up by 17 per cent on 2007 thanks to capital increases and the allocation to reserves of most of the profits for 2008 (63.2 per cent). The increase was also facilitated by the new prudential regulations (known as equivalent supervision) that came into force on 1 January 2008 establishing specific minimum capital requirements for credit, counterparty, market, exchange rate and operational risk. The solvency ratio of leasing, factoring and consumer credit companies was 8.5 per cent, representing an annual increase of 0.9 percentage points.

18. THE STRUCTURE OF BANKING AND FINANCIAL INTERMEDIARIES

Banks and banking groups

There were 799 banks operating in Italy at the end of 2008, 7 fewer than in 2007 (Table 18.1). Twenty-eight new banks were set up during the year, 21 of which effectively opened for business; 11 were the result of intra-group restructuring. A total of 28 banks left the market, most of them mutual banks (*banche di credito cooperativo*) and banks not belonging to a group. The number of bank branches increased from 33,229 to 34,146 and branch density from 5.6 to 5.7 per 10,000 inhabitants.

Table 18.1

The structure of the Italian financial system

	31 December 2007			31 December 2008		
	Number of intermediaries			Number of intermediaries		
	Group members (1)	Non-group	Total	Group members (1)	Non-group	Total
Banking groups	–	–	82	–	–	81
Banks	224	582	806	223	576	799
of which: limited company banks	*199*	*50*	*249*	*196*	*51*	*247*
cooperative banks (banche popolari)	*15*	*23*	*38*	*16*	*22*	*38*
mutual banks (banche di credito cooperativo)	*10*	*430*	*440*	*10*	*422*	*432*
branches of foreign banks	*–*	*79*	*79*	*1*	*81*	*82*
Investment firms	21	86	107	16	97	113
Asset management companies and SICAVs	63	151	214	54	160	214
Financial companies entered in the register under Article 107 of the Consolidated Law on Banking	100	380	480	101	390	491
Financial companies entered in the register under Article 106 of the Consolidated Law on Banking	–	–	1,239	–	–	1,189
Electronic money institutions	–	3	3	–	3	3
Other supervised intermediaries (2)	–	2	2	–	2	2

Source: Supervisory registers.
(1) Includes parent banks. – (2) Bancoposta and Cassa Depositi e Prestiti.

Nine financial conglomerates are present in Italy; six of them operate mainly in the banking sector and are subject to supplementary supervision coordinated by the Bank of Italy, in addition to the 'sectoral' supervision performed by their respective banking and insurance authorities.

Twenty-six banks were listed on the stock exchange last year, three fewer than in 2007; the reduction reflects the completion of full takeovers. Seven of the top twenty banking groups in terms of consolidated assets were unlisted. Listed groups and banks held 63.1 per cent of system assets, compared with 64.3 per cent in 2007; seven of the listed groups were headed by cooperative banks (*banche popolari*), holding around 80 per cent of the category's total assets.

Ownership of banks and banking groups. – The shareholders of Italian banking groups are predominantly financial entities; banking foundations retain significant holdings, while institutional investors still play only a modest role.

In the last eight years, mergers and reorganizations have re-shaped the ownership structure of the parent companies of the leading banking groups. In 2008 two of the top five groups were headed by listed cooperative banks with a broad shareholder base, while in 2000 they consisted only in public limited companies. On 15 May of this year, the free float of the top five listed groups averaged 67 per cent, higher than the overall average of 58 per cent for listed companies.

At the end of 2008 the subsidiaries of foreign companies and banks numbered 21, including two of the top ten banking groups. Thirty-three foreign shareholders, for the most part from the European Union, held equity interest of more than 5 per cent in 41 banks.

Mergers and acquisitions. – No mergers were carried out among medium-sized and large banks during 2008. Banking groups continued to rationalize their structure in the wake of past mergers.

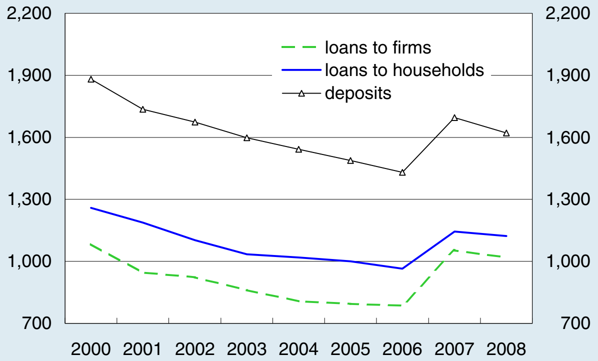
In the early months of 2009 the Banca Popolare dell'Emilia Romagna group acquired control of the Meliorbanca group; its objective was to increase its supply of specialized services for small and medium-sized firms and extend its private banking.

Following the deterioration in Banca Italease's balance-sheet situation, a takeover bid was made by Banco Popolare in May of this year.

Degree of concentration of the Italian banking system. – The numerous mergers and acquisitions of recent years have led to an increase in the degree of concentration of the banking system: the Herfindahl-Hirschman index, calculated on the total assets of the units operating in Italy, increased from 600 to 771 (on a scale of 10,000). The degree of concentration of local credit markets instead decreased in the same period (Figure 18.1), partly thanks to the rise in the average number of banks per province from 25 at the end of 2000 to around 28 at the end of 2008.

Figure 18.1

Herfindahl-Hirschman indices of households' and firms' deposits and loans
(median indices on basis of 10,000)

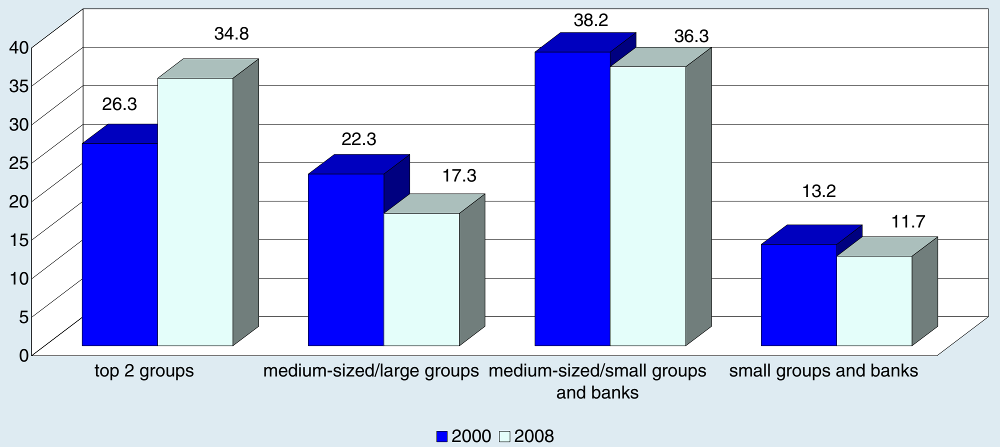


Source: Supervisory returns.
(1) The index for loans to firms is calculated on a regional basis; the indices for households' loans and deposits are calculated on a provincial basis.

Classifying banks according to the size of the group to which they belong produces a first category consisting of two large groups (UniCredit and Intesa Sanpaolo), followed by a category containing three medium-sized/large groups with prevalently domestic operations (Figure 18.2). The third category is made up of 58 medium-sized/small groups and stand-alone banks, including specialized banks and subsidiaries of foreign banking groups. The fourth and last category comprises 594 small, mainly local, intermediaries.

Figure 18.2

Concentration of the Italian banking system (1)
(percentages)



Source: Supervisory returns.
(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 largest groups have grown externally through mergers and acquisitions, entailing internal restructuring that has led to large decreases in market shares. If the composition of the groups is held constant at 2008, the top five banking groups' market share of loans to households and firms has declined by around 13 percentage points over the last eight years. The same period saw an increase in the shares of foreign intermediaries and small banks.

Costs of current accounts. – According to a survey conducted by the Bank of Italy, in 2008 the average annual cost to households of keeping a current account was around €114. Costs differ according to the type of bank with which the account is held: they are close to the average at mutual banks, 3.7 per cent below the average at the banks belonging to the five largest groups and 5 per cent above the average at the remainder.

The internationalization of the system. – For the top five banking groups, foreign business accounted for 35.6 per cent of total financial assets (loans and securities) in 2008, compared with 35.3 per cent in 2007. For all banking groups, the share was 27.1 per cent (25.7 per cent at the end of 2007).

Central and eastern Europe represented a major foreign market for Italian banks at the end of 2008 (Table 18.2). Around 5.4 per cent of total system assets were held in these countries (4.8 per cent in 2007), virtually all with the two largest banking groups. The latter's exposure to residents in the area rose from 8 to more than 9.2 per cent of the total.

Table 18.2

Foreign presence in the banking systems of selected European countries (1) (at 31 December 2008)	Number of banks			Assets		
	Totale	*of which:* foreign-controlled branches and subsidiaries	*of which:* Italian-controlled branches and subsidiaries	Total (billions of euros)	*of which:* % held by foreign-owned banks	*of which:* % held by Italian-owned banks
Austria	827	*58*	*16*	1,069.0	*41.6*	*9.5*
Belgium	56	*....*	*1*	1,422.1	*....*	*0.7*
Bulgaria	30	*22*	*1*	35.6	*83.9*	*15.4*
Croatia	44	*16*	*7*	53.4	*91.1*	*39.9*
Czech Republic	37	*30*	*2*	151.4	*84.7*	*6.1*
Denmark	141	*18*	*0*	615.0	*26.5*	*0.2*
France (1)	401	*161*	*16*	6,375.0	*12.2*	*1.7*
Germany	1,980	*....*	*12*	7,956.4	*....*	*3.3*
Hungary	221	*35*	*4*	121.0	*84.0*	*17.5*
Italy	799	*103*	-	2,581.9	*21.0*	-
Luxembourg	149	*147*	*13*	1,008.0	*95.6*	*3.2*
Netherlands (1)	91	*32*	*1*	2,229.5	*15.6*	..
Poland	649	*60*	*3*	259.6	*72.4*	*11.4*
Portugal	151	*14*	*0*	399.3	*15.0*	*1.0*
Romania	42	*37*	*23*	78.8	*88.3*	*11.8*
Russia (1) (2)	1,092	*86*	*3*	560.1	*17.2*	*2.6*
Slovakia	26	*23*	*2*	62.9	*96.2*	*24.3*
Slovenia	32	*3*	*2*	53.7	*....*	*10.2*
Spain (1)	282	*98*	*3*	2,946.7	*11.6*	*0.1*

Sources: Based on data provided by national central banks and supervisory authorities; individual supervisory returns and Register of Banking Groups. For Croatia, does not include housing savings banks. For Poland, includes cooperative banks. For Hungary, includes savings cooperatives and credit cooperatives.
(1) At 31 December 2007. – (2) At the end of 2008 the assets of Italian-owned banks had increased by around 20 per cent on 2007.

Italian banking groups have six branches and three subsidiaries in countries that the Bank for International Settlements has classified as off-shore centres (seventeen and four respectively in 2004), with assets totalling €13.2 billion, or 0.5 per cent of system assets (see Appendix Table a18.1). The groups hold €157.5 billion worth of assets in countries listed by the OECD among those that do not apply the internationally agreed fiscal transparency standards in full. The largest share of assets (95 per cent) pertains to countries which have endorsed those standards but not yet applied them completely (notably Austria, Belgium, Luxembourg and Switzerland).

At the end of 2008 there were 82 branches of foreign banks in Italy, accounting for 11.7 per cent of system assets, about the same proportion as in 2007. The 21 subsidiaries of foreign banks held 9.3 per cent of system assets.

Non-bank intermediaries

Asset management companies and investment funds. – The number of asset management companies showed no change with respect to the previous year; at the end of 2008 there were 211 and 3 SICAVs (Table 18.1). The growth in companies specialized in innovative sectors continued: of the 17 new companies registered during the year, ten manage real-estate funds, three, private equity funds and four manage open-end funds.

At the end of 2008, the share of assets managed by companies controlled by Italian banks or banking groups amounted to 53 per cent, compared with 52.2 per cent in 2007. More than 20 per cent of net assets were managed by companies belonging to Italian insurance groups (17.5 per cent in 2007). The share ascribable to foreign intermediaries declined from 19.9 to 18 per cent.

Companies belonging to Italian banking and insurance groups dominate the open-end funds sector, managing respectively 53.7 and 25.2 per cent of the market. In the private equity fund sector, bank-controlled companies had an unchanged but relatively small market share, while that controlled by other Italian intermediaries was predominant (42.5 per cent). The market share of foreign intermediaries contracted from 13.8 to 11.4 per cent. Some 39 per cent of real-estate funds are managed by individuals and property groups; the market share of intermediaries belonging to Italian and foreign banks and banking groups fell sharply, from 40 to around 30 per cent. At the end of 2008 hedge funds numbered 249, of which 217 were funds of funds.

Investment firms. – At the end of 2008 there were 113 investment firms operating in Italy, six more that in the previous year. The majority of the new firms, totalling 15 in all, are not controlled by banks and specialize in investment advisory services.

The register of investment firm groups was set up during 2008, in accordance with the Consolidated Law on Finance. At the end of the year, seven groups were listed, joined by a further six at the beginning of 2009.

The investment firm sector remains highly concentrated: the top three firms have a market share of 86 per cent of sales of financial products and 39 per cent of portfolio management.

Financial companies. – At the end of 2008 the number of financial companies entered in the special register instituted under Article 107 of the Consolidated Law on Banking had increased by eleven with respect to the previous year, to a total of 491. The majority of the new entries were securitization vehicles. The number of companies belonging to banking groups remained practically unchanged.

The largest shares of the leasing, factoring and consumer credit markets are held by specialized intermediaries belonging to banking groups. At the end of 2008, 43 specialized financial companies were operating in the leasing market, with a 79.6 per cent share. The sector is fairly highly concentrated, and the top three operators (two financial companies and one bank) have a 38 per cent share of the market. Banks are the principal distribution channel for leasing companies, accounting for 34.6 per cent.

In factoring, 34 financial companies were in operation in December 2008. This sector is also fairly concentrated, with the top three companies – owned by the leading banking groups – holding 47 per cent of the entire market. The factoring companies granted financing mainly through their own units (79.7 per cent).

At the end of 2008, 37 financial companies were specialized in consumer credit, with a market share of around 50 per cent. The share of the three leading operators (two financial companies and one bank) was in the region of 25 per cent. In 2008, 48.1 per cent of consumer credit was disbursed through commercial outlets and 32.2 per cent by the intermediaries' branches.

Intermediaries per Article 106. – Following the merging of the Italian Foreign Exchange Office (UIC), in January 2008 the Bank of Italy took over the management of the general register of financial intermediaries set up under Article 106 of the Consolidated Law on Banking and of the related sections, referred to in Articles 113 and 155 of that law.

At the end of 2008 the register contained the names of 1,189 financial intermediaries engaged in business with the public (acquisition of shareholdings, granting of loans, and payment and foreign exchange services). Also listed, in separate sections, were 19,579 entities not operating with the public and 794 collective loan guarantee consortia.

Loan brokers and financial agents. – As a result of the merging of the Italian Foreign Exchange Office, the Bank of Italy has taken over responsibility for the list of financial agents and the register of loan brokers. At the end of 2008, the loan brokers numbered 107,643, including 9,029 companies. At the same date, 53,650 financial agents were registered, 4,284 of which were companies.

Responsibility for the lists and registers gives the Bank of Italy considerably less power of intervention than in respect of intermediaries subject to banking and financial supervision.

19. SUPERVISION

International cooperation

International cooperation proceeded on two fronts to strengthen the financial system: common principles were established for implementing the measures taken to safeguard stability during the financial crisis; and guidelines were drawn up for reforming the regulatory framework based on the action plan approved by the Group of Twenty (G20) summit in Washington in November 2008 and the implementing measures agreed in London in April 2009.

International coordination to safeguard financial stability. – Starting in October 2008 the governments of the leading industrial countries intensified their action and coordination to cope with the deepening of the international financial crisis in the wake of the failure of the US investment bank Lehman Brothers. Common policies were established at the Group of Seven (G7) summit meeting in Washington on 10 October 2008 and confirmed by the Heads of State and Government of the euro-area countries on 12 October and by the European Council on 15 and 16 October: to provide support to systemically important financial institutions, ensure the continuity of banks' funding flows, to augment depositor protection and to strengthen the balance-sheet position of financial institutions. These bodies also recognized the need to promote transparency and clarity of accounting standards and their greater consistency with prudential requirements, and pledged to improve international cooperation.

The recapitalization measures and the provision of public guarantees on new bank liabilities were carried out by the European governments in accordance with the principle that the restoration of financial stability must be achieved without introducing competitive distortions between countries and intermediaries, in compliance with the rules of the single market.

To allay uncertainty over the quality of banks' portfolios and facilitate financing of the economy, some countries (Belgium, France, Germany, Ireland, the Netherlands, Switzerland, the United Kingdom and the United States) also introduced or announced schemes to support impaired assets. The European Commission and the European Central Bank established common guidelines in this regard. The Ecofin Council meeting of 3 and 4 April 2009 underscored the need for coordinated action to ensure uniform valuations of the assets in banks' balance sheets. At the request of the Economic and Financial Committee, the Committee of European Banking Supervisors (CEBS) is coordinating the stress testing of the European banking system on the basis of common scenarios and guidelines. The procedure is part of the periodic assessment of the financial system's resilience and is not designed to gauge individual banks' recapitalization needs.

The revision of financial regulation and supervision. – The crisis calls for an overhaul of financial regulation and supervision, reconsidering the scope and stringency of supervisory rules and action, improving the valuation rules and transparency standards for balance-sheet assets and bolstering international cooperation. The finding that micro-prudential supervision of individual intermediaries is not sufficient by itself to ensure the overall stability of the system has made it a matter of urgency to intensify macro-prudential supervision and strengthen regulation so that close attention is paid to systemic risks.

A coordinated approach must be taken in drawing the perimeter of regulation, to ensure that significant risks for the financial system cannot arise in jurisdictions or segments of intermediation not subject to adequate supervision (the so-called shadow banking system). The G20 calls for all financial institutions, markets and instruments to be subjected to appropriate regulation and supervision, with rules and controls proportionate to the contribution of each to systemic risk.

According to the recommendations of the Financial Stability Board and the G20, it is necessary to strengthen banks' capital base, improve the quality of capital, accumulate resources in excess of the regulatory minima during cyclical expansions, and limit leverage in the financial system. It will also be necessary to establish guidelines for harmonizing the definition of capital at international level.

In line with these recommendations, in November 2008 the Basel Committee approved an action plan aimed at enhancing the ability of the Basel II regulatory framework to capture risks, improve the quality and increase the quantity of capital, and introduce new measures to curb the possibly pro-cyclical bias of regulation.

Concerning risk control, the Basel Committee has proposed changes to increase the capital requirements for trading book exposures, including illiquid and complex products, on which large losses have been recorded during the crisis. For resecuritizations and credit lines granted to off-balance-sheet vehicles, higher capital requirements than those now in effect are envisaged.

The Committee has also drafted principles to promote more rigorous supervision and management of off-balance-sheet risks, risk concentration and securitizations. As part of the revision of the prudential framework, the Committee has also proposed improvements to the valuation of financial instruments, liquidity risk management and stress testing practices.

In 2008, with the entry into force of Basel II in most of the leading countries, the Basel Committee and the CEBS began monitoring the capital requirements calculated with the advanced methods, to garner indications regarding the adequacy of the stock of capital held by banks and its changes over time. The Basel Committee will review the minimum capital requirement in 2010. As regards the quality of capital, there is agreement on the proposal to increase requirements for tier 1, especially its components of highest quality (core tier 1).

In 2008 and the first few months of 2009 the main international fora worked intensively on an approach to curbing the procyclicality of the financial system, mainly via the introduction of regulatory instruments that would permit banks to build up capital buffers and provisions against losses during economic expansions, for use during recessions. Several regulatory options are being considered. One proposal, developed by the CEBS at the initiative of the Bank of Italy, uses the scope for intervention provided by the Basel II framework's second pillar and envisages the adoption by European supervisors of a common automatic rule, for use alongside the stress tests developed by intermediaries, that would enable them to assess the adequacy of banks' capital buffers and request corrective action where necessary. The international authorities are also evaluating how to supplement capital buffers, designed to cover the unexpected component of credit losses, with countercyclical provisioning against expected losses, along the lines of Spain's "dynamic provisioning".

Also under discussion is a proposal for new instruments based on simplified rules – such as a minimum leverage (capital-to-assets) ratio – in order to limit the excessive growth in intermediaries' borrowing during phases of rapid expansion in financial assets, thereby also protecting against the risk that errors in internal models might induce intermediaries to hold insufficient capital.

In the context of the initiatives promoted by the G7 to strengthen the financial system, in April 2009 the FSB announced a series of principles designed to ensure that compensation and incentive systems take account of the risks assumed and the actual outcomes realized by intermediaries. The principles, similar to those introduced in Italy in March 2008, envisage careful assessment by the board of directors, specific restrictions for employees performing risk-control functions and adequate disclosure to stakeholders. Their efficacy depends on appropriate implementation at national level; their application in practice will have to be checked by the supervisory authorities.

The crisis of the financial markets also prompted consideration of modifying the valuation rules for financial instruments so as to ensure transparency towards the market. The Basel Committee and CEBS worked closely with the international accounting organizations. Concerning the standards on the valuation of financial instruments (IAS 39) and their disclosure (IFRS 7), in October it was made admissible, under particular circumstances, to reclassify as assets valued at amortized cost non-derivative financial instruments previously carried at fair value as held for trading or available for sale. In March 2009 the International Accounting Standards Board requested that information be provided concerning the methods used to measure the fair value of financial instruments, distinguishing between the cases in which it is possible to refer to market prices and those in which it is necessary to use valuation models, whether or not these are based on market data.

Consistent recommendations for the strengthening of international cooperation come from the G20, the FSB, the Ecofin Council and the CEBS. Colleges of supervisors will be established for the main cross-border institutions; the FSB principles defining the procedures for cooperation in case of crisis and for the interaction of colleges of supervisors with central banks and governmental authorities will be put into practice. Within Europe, the Level 3 supervisory committees have worked to enhance the role of colleges of supervisors in the oversight of cross-border financial institutions. At the beginning of 2009 the CEBS released a paper on the practices developed by supervisory authorities that participate in the colleges of major European cross-border banking groups. The study found progress in the exchange of information and in cooperation for regulatory recognition of internal risk measurement models; more needs to be done, however, in the joint assessment of risk and in planning the consequent supervisory activities, including on-site controls.

The structure of financial supervision in Europe. – The report prepared by the high-level working group chaired by Jacques de Larosière under a mandate from the European Commission not only formulates recommendations concerning capital adequacy, transparency, governance and extension of the perimeter of supervision but also proposes a reform of the architecture of European financial supervision aimed at enhancing the effectiveness of macro-prudential analysis and improving coordination between supervisory authorities in the oversight of cross-border institutions. To strengthen macro-prudential oversight, the report proposes the creation of a new body, the European Systemic Risk Council, responsible for identifying risk areas needing special attention and empowered to require the competent authorities to take the necessary measures. The report also recommends creating a European System of Financial Supervision composed of three new European authorities, for different sectors of intermediation that would replace the current Level 3 committees.

EU legislation

An amended version of the European directive on banks' capital requirements was approved in May of this year. It contains provisions to improve the supervision of cross-border groups and inter-authority cooperation, the management of risks deriving from securitizations and the rules on risk concentration, and to harmonize the criteria for counting hybrid instruments in regulatory capital.

The most significant innovation is the obligation for the authority that exercises supervision on a consolidated basis to institute colleges of supervisors for all EU banking groups with establishments abroad. The consolidating supervisor's tasks extend to the assessment of capital adequacy in relation to the second pillar. The legislation strengthens the channels of communication between supervisory authorities and central banks in emergency situations and requires national authorities to take account of the potential impact of their decisions on other member states.

A more stringent treatment is established for exposures connected with securitizations, both by levying heavier capital charges for riskier exposures and by requiring more rigorous organizational and operational safeguards.

Italian legislation

Anti-crisis measures. – Starting in October 2008, in the phase of acute crisis on the financial markets, the Government and Parliament, with the support of the Bank of Italy, enacted measures to restore confidence in the financial system. The measures to recapitalize banks, foster financing of the economy, sustain liquidity and protect depositors were initially passed, using the fast-track procedure, as Decree Law 155/2008 (9 October), 157/2008 (13 October) and 185/2008 (29 November), subsequently converted into Laws 190/2008 and 2/2009.

Two different recapitalization measures were envisaged, one for banks in difficulty, the other targeted to fundamentally sound banks with the aim of ensuring adequate flows of credit to the economy. Decree Law 155/2008 empowers the Ministry for the Economy and Finance until 31 December 2009 to participate in capital increases by Italian banks or banking holding companies whose capital is inadequate. The shares purchased by the Ministry do not carry voting rights, have preference in the distribution of dividends and may be redeemed by the issuer. The public intervention is accompanied by a stabilization and strengthening plan assessed by the Bank of Italy taking account of the dividend distribution policies approved by the applicant bank's shareholders' meeting.

For fundamentally sound banks, Decree Law 185/2008 (Article 12) empowers the Ministry for the Economy and Finance until 31 December 2009 to purchase financial instruments issued by listed Italian banks or bank holding companies that can be counted in regulatory capital and are redeemable or convertible into shares at the issuer's initiative. Access to this measure is evaluated by the Bank of Italy taking account of the capital profile of the bank and the characteristics of the financial instruments. Applicant banks must adopt a code of ethics, particularly for executive compensation policies, and make commitments, on the basis of a memorandum of intent, concerning the volume and terms of lending to households and small and medium-sized enterprises. The measure was made operational in February 2009 by a ministerial implementing decree on which the European Commission passed positive judgment in the light of the rules on state aid (see the box "The instruments for recapitalizing Italian banks" in *Economic Bulletin* No. 52, 2009). In March a framework agreement between the Ministry and the Italian Banking Association laid down guidelines for the individual memoranda of intent. The Ministry is to report periodically to Parliament on trends in lending to the economy; special observatories, instituted at the prefectures in regional capitals, report the information they gather to a national observatory set up at the Ministry. The Bank of Italy contributes to monitoring by transmitting aggregate and regional data to the Ministry.

The strengthening of the Guarantee Fund for Small and Medium-Sized Enterprises (Article 11 of Decree Law 185/2008) is achieved by having the state provide a back-stop guarantee for the Fund's interventions. The consequent more favourable prudential treatment of the direct guarantees issued by the Fund facilitates the financing of SMEs.

To sustain liquidity, Decree Law 157/2008, which was merged into Decree Law 155/2008 during parliamentary ratification, introduced provisions designed to guarantee banks' new liabilities and facilitate refinancing with the central bank (see the box "The measures adopted in Italy for the stability of the financial system", *Economic Bulletin* No. 51, 2009). Up to December 2009 the Ministry for the Economy and Finance may provide a state guarantee on debt instruments issued by banks with a residual maturity of between three months and five years, to the benefit of Italian entities that lend the issuer banks securities eligible for refinancing operations with the Eurosystem. The Ministry may also carry out swaps of government securities for newly issued bank liabilities. Other measures simplify the provision of Bank of Italy financing to intermediaries to cope with liquidity needs and extend the possibility of recourse to crisis management procedures to cases of severe illiquidity of banks.

To strengthen depositor protection, Decree Law 155/2008 authorizes the Ministry for the Economy and Finance to provide a supplementary state guarantee on bank deposits for three years (see the box "The Italian authorities' measures for the stability of the financial system", *Economic Bulletin* No. 50, 2008).

The financial crisis also hit the global asset management industry. Liquidity strains emerged particularly among hedge funds, which in Italy are mostly funds of hedge funds. To attenuate the effects of the crisis, Article 14 of Decree Law 185/2008, implemented with a measure adopted by the Bank of Italy in December 2008, allows hedge fund management companies, until 31 December 2009 and with immediate effect, to introduce redemption gates into fund rules and to transfer illiquid assets into side pocket accounts.

Relations between intermediaries and customers. – In March 2009 the Bank of Italy began a public consultation on new rules for transparency in bank and financial transactions and services and for correctness in intermediary-customer relations. The regulation will simplify transparency documentation and enhance the comparability of information, strengthen customer protection and incorporate the latest changes to legislation.

The rules are graduated according to the type of customer and characteristics of the service, with more stringent rules established for services offered to retail customers and general principles for others. The provision of clear and comparable mandatory information is fostered by the standardization of some documents: the notice of the customer's main rights, the information sheets and summary of terms and conditions for current accounts and mortgage loans to customers. Practical guides are also envisaged for these widely used products. A greater use of composite indicators of cost, extending to current accounts and to credit lines for retail customers, makes costs more readily comparable. The rules facilitate and foster more extensive use of the Internet, as the least costly channel, in all phases of the relationship (pre-contract information, conclusion of the contract, periodic communications). Corporate culture and good organization are also important means of guaranteeing transparent and correct conduct. Accordingly, intermediaries are made subject to organizational obligations to ensure that sufficient attention is paid to the customer in every phase of their activity. Rules for correct, effective complaints-handling are introduced in order to reduce litigation and disputes with customers.

The proposals have been assessed in the light of a preliminary regulatory impact analysis; a final assessment, which will also take account of the information gathered in the public consultation, will be provided when the regulation is issued. Regulatory impact assessment has two phases. The first examines market and regulatory failures, highlighting both the theoretical and the empirical aspects underlying the revision of regulation. The second, consisting in cost-benefit analysis, identifies the economic effects that the different regulatory options could have on the main categories potentially affected. For bank customers, the initiative on transparency could make costs easier to compare and promote consistency between customers' needs and their choices. For intermediaries, more transparency on the characteristics and costs of financial products would help keep down reputational and legal risks. Some of the simplifying measures envisaged could reduce compliance costs. An increase in costs could come from the strengthening of organizational safeguards, but this would be more than offset by the benefits of lower operational, reputational and legal risks.

In July 2008, the Interministerial Committee for Credit and Savings, acting on a proposal from the Bank of Italy pursuant to Article 128-*bis* of the Consolidated Law on Banking, approved a resolution outlining the scope, structure and operational rules of out-of-court settlement systems for disputes between intermediaries and customers regarding banking and financial transactions and services. The Bank of Italy is responsible for drafting the implementing provisions and assigned duties for organizing the new systems, which intermediaries are required to join. In March 2009 the Bank of Italy published a draft implementing regulation for consultation.

A series of legislative measures concerning mortgage loans were adopted in 2008 to help households cope with the change in macroeconomic conditions.

In June 2008 the Ministry for the Economy and Finance and the Italian Banking Association signed an agreement (based on Article 3 of Decree Law 93/2008, ratified by Law 126/2008), open for subscription by intermediaries, which enabled holders of variable-rate mortgages to have their repayment instalments stabilized at the amount paid in 2006. An observatory, in which the Bank of Italy participates, was set up at the Ministry to monitor application.

Decree Law 185/2008 established that for non-fixed-rate mortgage loans for the purchase of one's primary residence the amount of the instalments payable in 2009 was to be calculated by applying the greater of 4 per cent and the rate set at the time the mortgage contract was concluded; the cost of this relief is borne by the state. In addition, for primary residences, intermediaries must offer customers the possibility to take out mortgages indexed to the rate on the ECB's main refinancing operations; the overall rate on these mortgages must be in line with that applied for the other forms of indexation offered. To make sure that banks advertise this product together with the others they offer, the Bank of Italy asked them to prepare a document summarizing the main characteristics of all the mortgages offered. Decree Law 185/2008 also introduced sanctions for non-compliance with the provisions on the portability of loans (Decree Law 7/2007, ratified with amendments by Law 40/2007).

Additional innovations concern the commission on the maximum current account overdraft and other clauses that remunerate banks for making funds available to customers. Decree Law 185/2008 excludes the possibility of applying the commission to drawings in the absence of a credit line; permits it to be applied, under certain conditions, to accounts with a credit line showing a debit balance for 30 or more consecutive days; admits a fee for making funds available proportional to the amount and duration of the credit line, on condition that the fee is determined in advance with an agreement in writing that is not tacitly renewable; and requires the inclusion of these charges in calculating the rate for anti-usury purposes.

Ownership structures and bank-firm relations. – The prohibition on the acquisition by non-financial enterprises of controlling interests or holdings of 15 per cent or more in banks was repealed in November by Decree Law 185/2008, Article 14. The change constitutes partial implementation of Directive 2007/44/EC on the acquisition of qualifying holdings in banks, insurance companies and investment firms. The directive, providing for maximum harmonization, does not allow member states to retain or introduce more stringent rules. The time limit for national transposition expired on 21 March 2009; even in the absence of implementing legislation, the provisions of the directive apply. The Bank of Italy has announced the method it will use to evaluate applications for the approval of acquisitions.

In July 2008 the Interministerial Committee for Credit and Savings, acting on proposals from the Bank of Italy, approved two resolutions. The first concerned banks' equity interests, easing the limits on the acquisition of holdings in non-financial entities, in line with Community legislation and with the approach taken in the other main European countries. The second, concerning banks' risk assets in respect of connected persons, established quantitative limits and procedural rules to control conflicts of interest in related-party transactions.

Governance. – In March 2008 the Bank of Italy issued supervisory provisions concerning banks' organization and corporate governance. They included principles and guidelines for establishing compensation and incentive systems that anticipated approaches subsequently adopted at international level. Banks and banking groups must comply completely and substantively with the provisions by 30 June 2009, verifying the consistency of their own governance structures and making adjustments where necessary.

In February 2009 the Bank of Italy issued guidance to permit correct and homogeneous application of the provisions in regard to some aspects: the time limits, manner of implementation and scope of the provisions; procedures for facilitating participation by shareholders in shareholders' meetings and ensuring their adequate representation in the company's governing bodies; the role of the chairman of the board of directors; and contents of the disclosures to the shareholders' meeting concerning compensation and incentive schemes. Indicators of bank complexity were identified to facilitate application of the regulation according to the criterion of proportionality. In April attention was called to the importance of timely compliance with the rules on compensation and incentives, with reference both to the structure of pay (correct balance between fixed and variable components; anchoring of pay to the performance indicators adjusted for risk and for realized, lasting results; restrictions for persons performing control functions) and to the process of developing and approving proposals (role of the board committee, involvement of the shareholders' meeting). The Bank of Italy asked banks to send it the documents on compensation policies prepared for submission to the shareholders' meeting.

Following discussion with the representative trade associations, in March a favourable assessment was made of a revised version of the "standard bylaws" of mutual banks, with amendments incorporating the new governance rules. Where a mutual bank adopts the standard bylaws, the Bank of Italy will be able to use a simplified procedure to evaluate whether amendments to its bylaws are consistent with sound and prudent management.

Prudential regulation. – Prudential regulation is updated continually to take account of the evolution of the market and products, the need to ensure that national legislation is completely in line with Community legislation, the recommendations of the organizations for international cooperation, and consultations with intermediaries.

In December 2008, in line with the recommendations of the Financial Stability Board, guidance was issued on the use by banks and financial intermediaries registered under Article 107 of the Consolidated Law on Banking of external ratings in order to determine the capital charges for credit risk under the standardized method. The guidance clarified that ratings are one of the components of information on the credit quality of customers but do not exhaust the necessary assessment by intermediaries of their creditworthiness. Indeed, the full set of available information can induce intermediaries to make assessments differ from those produced by ratings. In this sense, intermediaries were asked to conduct periodic checks on the consistency of external ratings with their own analyses of borrowers' quality and to transmit the results of these assessments to the Bank of Italy if significant, frequent disparities were found.

Collective portfolio management. – New regulatory measures expanded the operating autonomy of management companies, making the best use of their operating and risk-control abilities.

The regulation on collective portfolio management was amended in December 2008 to revise the investment rules for harmonized open-end funds. The new rules implement Directive 2007/16/EC (the Eligible Assets Directive) and European Commission Recommendation 2004/383 on the use of financial derivatives by investment funds. They widen the range of eligible assets for investment to include, among others, credit derivatives and units of closed-end funds; and they permit collective investment undertakings to use internal models to calculate the exposure limits for derivatives, subject to verification by the Bank of Italy that specific quantitative ceilings on funds' exposure to derivative instruments are complied with and that the management company satisfies suitable organizational standards. The same regulation also abrogated the ceiling on the number of participants in hedge funds, which had been set at 200.

Financial intermediation. – A start was made at overhauling the legislation in this sector. In connection with transposition of the Community directive on consumer credit, Italy's Community Legislation Implementation Bill for 2008 gives the Government a mandate to revise the provisions of the Consolidated Law on Banking concerning financial intermediaries as well as those on financial agents and loan brokers.

Two regulatory measures have been issued in the course of 2009. One, adopted by the Ministry for the Economy and Finance on 17 February, modifies the criteria for entry in the registers established by the Consolidated Law on Banking. The other, issued by the Bank of Italy in May, comprehensively revises the rules on entry of intermediaries in the general register established by Article 106 of the Consolidated Law on Banking.

Supervision of banks

The process of prudential supervision. – In 2008, with the entry into force of the New Regulations for the Prudential Supervision of Banks (Basel II), the Bank of Italy renewed its model for controls on intermediaries, to focus more on the situation at consolidated level and on risks and increasingly graduate the controls according to banks' differing size, systemic importance and problems. The Supervisory Review and Evaluation Process is based on methods and procedures revised with a new Guide for Supervisory Activity. Under a unitary approach encompassing off-site and on-site supervision and all supervised entities, the new methodologies provide schemes of analysis for each risk profile, capitalizing on the wealth of information available for supervisory purposes and on interaction with intermediaries. The Banking and Financial Supervision Area is preparing to wind up the first cycle of evaluation based on the new supervisory model.

For the main banking groups, analysis of exposure to risks, based primarily on supervisory reports, has been supplemented with the data generated by "recognized internal systems" provided for by the first pillar of Basel II and with reports on the internal capital adequacy assessment process (ICAAP). An examination of the first ICAAP reports, submitted at the end of 2008, found aspects that were susceptible of improvement. Banks' must become more keenly aware of the central role played by the ICAAP in corporate planning and use the results of the analysis for management purposes. On the methodological plane, there is ample scope for optimizing the procedures for the identification, measurement, valuation and management of risks for which regulatory methodologies are not available. Especially for banks with more complex operations, there is a need to strengthen the approach used in conducting stress-testing exercises.

Preventive action continued with a view to promoting stable and reliable organizational structures. Emphasis was placed on the contribution and responsibilities of internal control bodies; special importance was attached to the compliance function, established only quite recently at most banks, whose main responsibility is safeguarding against legal and reputational risk.

For the largest banking groups, more use was made of on-site controls to investigate specific issues and selected risk profiles, check on implementation of corrective measures proposed by the Bank of Italy and make a fuller assessment of the effects of the deterioration in the economic situation. Special attention was paid to capital adequacy and the management of liquidity risk, lending to retail and corporate customers and operations in derivative instruments. Checks on organizational profiles examined the functionality of governance structure and the efficacy of internal control systems, business continuity and the degree of integration achieved following corporate mergers and acquisitions. For groups with cross-border operations, cooperation with the supervisory authorities of the other countries involved has become a regular practice.

Risk measurement systems. – A number of the banking groups that have developed advanced systems for measuring credit and operational risk have asked the Bank of Italy to validate them for calculating capital charges. The validations, which were begun even before the formal submission of the requests, have involved both off-site analysis and on-site inspection. The validation of internal risk measurement systems entails strict verification of compliance with the quantitative, organizational and IT requirements laid down in the regulations. Where misalignments were found in an internal ratings-based method or an advanced measurement approach, but not severe enough to threaten its overall validity, the Bank required corrective action to ensure full compliance and gave the intermediary specific instructions for calculating the capital charges. The continuing reliability of the original systems once validated is carefully monitored. The aim is to institute a set of incentives that will induce better techniques of risk governance, management and control.

Banks' governance. – The Banking Supervision Department took measures concerning the adequacy of banks' corporate governance, designed among other things to facilitate the entry into force of the March 2008 supervisory instructions on organization and corporate governance. Intermediaries were reminded of the importance of the size and qualitative make-up of governing bodies, the protection and representation of the various shareholder interests, and the role of the chairman of the board in guaranteeing internal dialogue and communications and checks and balances. In some cases, after the examination of planned bylaw amendments banks were asked to revise their proposals in order to guarantee the substantive incorporation of the regulatory principles. In keeping with international tendencies, an analysis of executive compensation and incentives schemes was begun.

Supervision of Italian-controlled international groups. – The activity of the supervisory colleges responsible for the two leading Italian-controlled international banking groups was intensified last year in terms both of frequency and of the matters dealt with. There were four plenary meetings and ten meetings of more restricted groups of supervisors. Analysis continued on the first pillar, with the objective of extending the perimeter for the application of already validated internal ratings-based models. As regards the second pillar, coordination of the assessments of group risk measurement and governance systems began.

Banking supervision during the financial crisis. – From the beginning of the financial turmoil the Bank of Italy strengthened its monitoring activity and intensified its supervisory interventions. Analyses were conducted much more frequently, and in many cases the banks were specifically requested to supplement their regular prudential reports with additional data. Further studies in concert with the Ministry for the Economy and Finance and the other Italian supervisory authorities were conducted by the Financial Stability Committee.

Monitoring of banks' capital levels was made more frequent. In July 2008 banks were advised to adopt standards of prudence in capital management and planning. They were invited to seize every possible opportunity to strengthen their capital base in appropriate forms and to preserve its quality. Despite the difficult cyclical situation, at the end of 2008 regulatory capital was greater than a year earlier. Four applications were forwarded for capital strengthening under the public measure whereby the Ministry for the Economy and Finance purchases financial instruments that can be counted in regulatory capital; other important banks have indicated their intention to avail themselves of the same possibility.

The monitoring of liquidity risk, which was initiated on a weekly basis in the autumn of 2007, was extended last year to virtually all Italian banks and the branches of foreign banks in Italy. For the situations of greatest strain and for systemic intermediaries, daily monitoring began. Periodical stress tests were performed. Discussions with corporate officers also concerned the organizational safeguards that ensure the effective control of liquidity risk. Banks were asked to balance their liquidity position each month, taking account of unencumbered eligible assets. Some highly exposed banks were given special warnings. Specifically targeted inspections were carried out. Owing in part to the Bank of Italy's prompting and constant monitoring, the banks increased their holdings of marketable assets and so were in a sounder position to face the period of greatest strain.

The assessment of complex financial instruments, structured credit products in particular, continued. The Italian banking system's already low exposure to these instruments was further reduced in the course of the year. Following the failure of Lehman Brothers a survey of Italian banks' dealings with that investment bank was carried out and continuous monitoring of Italian banks' exposures with major foreign intermediaries, through a special survey, was begun.

In view of the worsening economic picture, the surveillance of asset quality was strengthened still further. Stress tests were conducted to gauge the resilience of Italian banks to adverse economic developments.

The exposure of Italian banks to central and eastern European countries and the evolution of the economic situation in that area are under constant examination, thanks among other things to fruitful cooperation with the local supervisory authorities. The parent companies of the banks with the strongest presence in central and eastern Europe were asked to pay special attention to risk in that area as part of their regular stress testing.

Anti-money-laundering controls. – On 1 January 2008 the Bank of Italy took over the responsibility for action to combat money laundering, formerly the duty of the Italian Foreign Exchange Office (UIC). The Banking and Financial Supervision Area has the power to issue regulations on such matters as customer due diligence ("know your customer"), record-keeping, organization and internal controls and to check banks' and other intermediaries' compliance with the anti-laundering rules, including by on-site inspection. Within the Bank of Italy an independent division has been instituted as Italy's Financial Intelligence Unit, the national agency assigned to collect, analyse and communicate to the competent authorities information concerning possible money laundering or terrorist financing. The FIU's position within the Bank of Italy fosters synergy with the Supervision Area for the common objective of safeguarding the banking and financial system against being used by organized crime. The sharing of databases, the exchange of information and the coordination of operations enhance the effectiveness of their joint action.

The Supervision Area and the FIU, each in its own sphere of responsibility, have drafted a demanding plan of verifications to prevent money laundering. Checks were conducted in the framework of ordinary supervisory inspections, special inspections performed at the head offices of financial intermediaries focusing on anti-laundering compliance, local controls performed at individual branches, and inspections carried out to investigate suspicious-transaction reports. This activity was intense. Cases of failure, or partial failure, to satisfy the anti-laundering obligations were found: incomplete record-keeping, inadequate customer due diligence, unsatisfactory processes for evaluating anomalous transactions, failure to report suspicious transactions, poor staff training, and ineffective control methods. Sanctions were levied for improper conduct, and the necessary corrective action was required. The Supervision Area and the FIU also examine reports from the control bodies of supervised intermediaries concerning infractions they have learned of in the course of their activity.

The Supervision Area and the FIU submitted a good number of reports to the judicial authorities (26 and 31 respectively). Financial analyses relating to more than

13,300 suspicious-transaction reports were forwarded to investigative bodies. Over 300 communications were made to the Finance Police, providing all the information available to assist its plans of anti-laundering controls. These controls brought to light very serious irregularities in dealings between Italian banks and intermediaries in the Republic of San Marino. The Bank of Italy cooperated closely with the judiciary in its investigation of this affair and issued instructions to Italian banks on the proper procedures for fulfilling their anti-laundering obligations in dealings with counterparties in San Marino.

Sanctions. – The Bank of Italy levied sanctions on corporate officers of some 600 banks and financial intermediaries in 2008 for a total of about €9 million. The irregularities, which mostly came to light in the course of inspections, essentially involved shortcomings in organization and internal controls, frequently bearing on the process for loan disbursement, management and control. Sanction procedures were also undertaken for irregularities detected in the finance area and for omitted or insufficient reporting to the Bank of Italy.

Supervision of non-bank intermediaries

Asset management companies. – Analysis, control and intervention on the technical situation of asset management companies and on the risks of their investment funds was intensive last year. The industry's structural problems were compounded by problems originating in the crisis, which unless well managed could have caused a further slump in investor confidence.

In July 2008 the Bank of Italy reminded the management companies of open-end hedge and other non-harmonized funds of the need for appropriate safeguards to guarantee that their assets were sufficiently liquid. These safeguards must comprise investment strategies that are consistent with the redemption schedules and allow the valuation and monitoring of the complex financial instruments in the portfolio. In the second half of the year the worsening financial crisis impacted on the liquidity of the open-end funds, owing in part to the difficulties of some major foreign counterparties. Accordingly, the activity of analysis of the funds' financial situation and risks was intensified, with ad hoc requests to management companies, analysis of supervisory reports and stress tests.

Most open-end hedge funds in Italy are funds of funds that invest in foreign collective investment undertakings. For the Italian funds, the liquidation of assets follows the calendar and procedures laid down in the rules of the target funds, which ordinarily have gates and side pockets allowing for the postponement or suspension of redemptions when requests are exceptionally heavy. In the last quarter of 2008, with the substantial rise in redemption orders and the foreign funds' activation of gates and side pockets, the liquidity problem of Italian hedge funds became pressing. Legislative actions (Article 14 of Decree Law 185/2008 of 29 November and a Bank of Italy regulation of 16 December) enabled Italian management companies to activate the same measures, giving them alternatives to the liquidation of the funds. The abrogation of the ceiling of 200 on the number of investors in any hedge fund favours mergers and should improve operational efficiency and ease strains. Some management companies have already taken advantage of the new rules.

Closed-end funds, real-estate funds in particular, may face strains when they have trouble carrying out their portfolio liquidation plans as the deadlines set in their rules near or when they are heavily indebted. The Bank of Italy again stressed the need for companies to adapt their management plans promptly to changes in market scenarios in order to begin disposals far enough in advance and comply with the objectives and redemption schedules for investors laid down in the fund rules. In order to reduce legal and reputational risks, the Bank also recalled the need to ensure adequate controls on conflicts of interest and to safeguard the management companies' independence in managing the funds.

In December 2008 a special study focused on the exposure of Italian investors to products managed by Bernard L. Madoff Investment Securities, the American brokerage and hedge fund advisor that essentially ran a Ponzi scheme. The study found that 30 Italian investment funds, mostly hedge funds, had exposures to Madoff. The total exposure amounted to 4.8 per cent of those funds' net worth and was concentrated mostly at two management companies. One of these, following an inspection by Consob in accord with the Bank of Italy, was subjected to sanctions in 2009. The exposure to Madoff was equivalent to 0.07 per cent of the total assets managed by Italian open-end investment funds.

The misappropriation of funds was apparently facilitated by the fact that the Madoff group management company was also responsible for asset custody and by the fact that the tasks of the "custodian" bank were limited to handling the flows of subscriptions and redemptions. Under Italian law, in keeping with European directives, such an arrangement is impossible, because every investment fund must use the services of a depositary bank responsible for the safekeeping of its assets and assigned to verify that the transactions ordered by the management company comply with the law and with the fund's rules. The funds' accounts are subject to outside auditing by an audit firm entered in a special register kept by Consob.

Investment firms. – The market crisis affected the business and the technical situation of investment firms. The fall in equities and investors' mounting liquidity preference, both of which intensified in the second half of the year, undermined earnings and resulted in negative results for more than half of the firms. The Bank of Italy conducted analyses directed to anticipating the impact on capital adequacy and where necessary called on the firm to take appropriate corrective measures. The poor state of the markets also induced some firms to begin the exit process (voluntary liquidation, merger or transformation into subsidiary of a foreign firm). Supervisory action is directed to making sure that these processes are orderly and do not damage customers.

Financial intermediaries in the special register. – The economic downturn had differing repercussions on the intermediaries entered in the special register referred to in Article 107 of the Consolidated Law on Banking. While the factoring industry – traditionally counter-cyclical – continued to grow, the leasing and especially the consumer credit sectors required decisive supervisory intervention for the recapitalization of intermediaries whose asset quality had deteriorated. For companies not belonging to banking groups, supervisory action also involved initiatives to ensure compliance with capital requirements. Use of the advanced methods of calculating the requirements was favoured.

Financial intermediaries in the general register. – Among the intermediaries in the register referred to in Article 106 of the Consolidated Law on Banking, and among financial agents and loan brokers, there are some enterprises characterized by modest scale of business, relatively weak capital, and dubious professional fitness. Controls on the Article 106 intermediaries were stepped up in 2008 and the early months of 2009, and the violations detected were subjected to sanction or deletion from the register. Checks on loan brokers and financial agents were conducted to verify their actual fulfilment of the requirements that they had self-certified upon entry in the register.

Recognition of ECAIs. – Prudential regulations allow banks to determine the weighting coefficients for calculating capital requirements for credit risk by recourse to rating agencies (External Credit Assessment Institutions) recognized by the Bank of Italy. The Bank is intensifying its verification of the requirements for recognition: an objective methodology, independence, periodic review of assessments, market reputation, and transparency.

Consumer protection

In the area of consumer protection the Bank of Italy intensified its checks on intermediaries, revised the regulations, and heightened its attention to the users of banking and financial services, including financial literacy initiatives. Checks on transparency, undertaken in part on the basis of complaints received, were extensive and found shortcomings. The assessment of the findings resulted in supervisory interventions appropriate to the significance and seriousness of the irregularities.

For the most part, the irregularities involved: the obligations of disclosure to customers (updating of announcements and information sheets, pre-contract information); contracts themselves, i.e. the inclusion of charges of which customers were not properly informed; lack of adequate information on loan portability and early repayment possibilities. The investigations also found widespread non-compliance with the transparency obligations for door-to-door selling. Sanction proceedings were begun against 43 intermediaries for violation of the rules on the publicizing of contract terms. In 52 cases in which the basis for formal sanctions was lacking, intermediaries were urged to comply more closely with the rules, to revise their contract models, and to institute organizational arrangements and internal controls such as to improve customer relations. Where necessary, they were asked to refund charges debited to customers but not disclosed in advance.

The Bank of Italy received more than 5,000 complaints last year, mostly relating to credit business (current accounts, mortgages and other loans), investment services, payment instruments (debit cards, credit cards, cheques), and alleged violations of transparency requirements. For the intermediaries entered in the general register under Article 106 and loan brokers, the complaints also bore on the business of issuing guarantees and on excessively large brokerage fees.

Financial education. – The greater complexity and sophistication of today's financial products, households' increased borrowing, the increase in life expectancy and changes in pension systems are the main factors demanding improved knowledge and understanding of financial matters. Raising the level of financial education can increase the demand for products of high quality, bring the more disadvantaged social groups closer to banking and financial products, stimulate efficiency, innovation and competition among banks, and enhance the fiduciary relationship between banks and customers. Under the 2007 Memorandum of Understanding between the Bank and the Ministry of Education, Universities and Research, the experimental programme of economic and financial education advanced to the practical application stage at a sample of Italian schools.

THE PAYMENT SYSTEM, THE MARKETS AND THEIR INFRASTRUCTURES

20. LARGE-VALUE PAYMENT SYSTEM, MONEY MARKET AND FINANCIAL MARKET INFRASTRUCTURES

The financial crisis of 2008 was accompanied by mounting deterioration in financial market liquidity conditions. Following the failure of Lehman Brothers in September, interbank market risk premiums rose and the yield spreads widened on government securities markets between issues of less creditworthy countries and benchmark bonds.

Notwithstanding the turmoil, payment and settlement systems and the guarantee systems for transactions in financial instruments continued to function smoothly, thanks among other things to the abundant liquidity supplied by central banks. Central counterparties made higher and more frequent margin calls, but the market participants met them without serious difficulty. Only in the days immediately following the Lehman Brothers collapse was there an increase in securities trades awaiting settlement.

In Italy the trading structures for government securities (MTS) and for interbank deposits (e-MID), the central securities depository (Monte Titoli) and the central counterparty (Cassa di Compensazione e Garanzia, CC&G) all suffered a decline in volumes because of the contraction of financial market activity. Perception of counterparty and liquidity risk affected the interbank market above all, especially for the longer maturities, where trading nearly dried up. In view of the importance of the interbank market to the conduct of monetary policy and to financial stability, the Bank of Italy promoted the creation of a new interbank market segment with characteristics designed to overcome the factors currently hindering smooth trading.

On 19 May 2008, as scheduled, the third and last group of countries, Italy among them, completed their migration to TARGET2, the new gross settlement system created and operated on behalf of the Eurosystem jointly by the Bank of France, the Deutsche Bundesbank and the Bank of Italy. With the migration of the Italian banking system to TARGET2, the old BI-REL gross settlement system was supplanted by the Italian component of the new system, TARGET2-Banca d'Italia (TARGET2-BI).

The assessment conducted by the ECB and the other Eurosystem central banks in connection with payment system oversight and endorsed by the Governing Council in December has confirmed the full compliance of TARGET2 with the Eurosystem's oversight standards (the BIS's Core Principles for Systemically Important Payment Systems and the ECB's Business Continuity Oversight Expectations).

For better integration of the European payment system, in 2009 the Eurosystem began the implementation phase of two projects: TARGET2 Securities (T2S), for the settlement in euro of securities transactions in central bank money, and Collateral Central Bank Management (CCBM2), for a single platform for collateral management for Eurosystem credit operations. Thanks in part to synergies with TARGET2, T2S will improve efficiency and heighten competition in post-trading services, lowering costs and making available advanced solutions for business continuity. CCBM2 will provide harmonized services to banks for collateral management, with gains in efficiency in liquidity management as well. The two projects, finally, will enable market participants to conduct integrated management within the euro area of liquidity, securities positions and collateral for Eurosystem operations.

Cooperation agreements between authorities within the European Union were strengthened. In June 2008, with a view to handling cross-border crises, a Memorandum of Understanding on Co-operation between the Financial Supervisory Authorities, Central Banks and Finance Ministries of the European Union on Cross-border Financial Stability was finalized.

Settlement in central bank money

In 2008 TARGET2 settled a daily average of nearly 370,000 payments worth €2,670 billion, respectively 59 and 90 per cent of funds transfers via the main EU payment systems. The number of payments settled in TARGET2 rose by 1 per cent and their value by 10 per cent. Transactions settled in Euro1, the largest alternative system, increased by 26 per cent to €287 billion a day. The growth of these two systems was due in part to the closing of the Paris Net Settlement system, two thirds of whose payment flows went into Euro1 and one third into TARGET2.

The flows handled by the Italian clearing and settlement systems operated by the Bank of Italy, including the new TARGET2-BI system, amounted to just over €54 trillion in 2008, down more than 4 per cent compared with 2007. These flows were equivalent to 34.4 times GDP (Table 20.1).

Table 20.1

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

	Clearing system (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

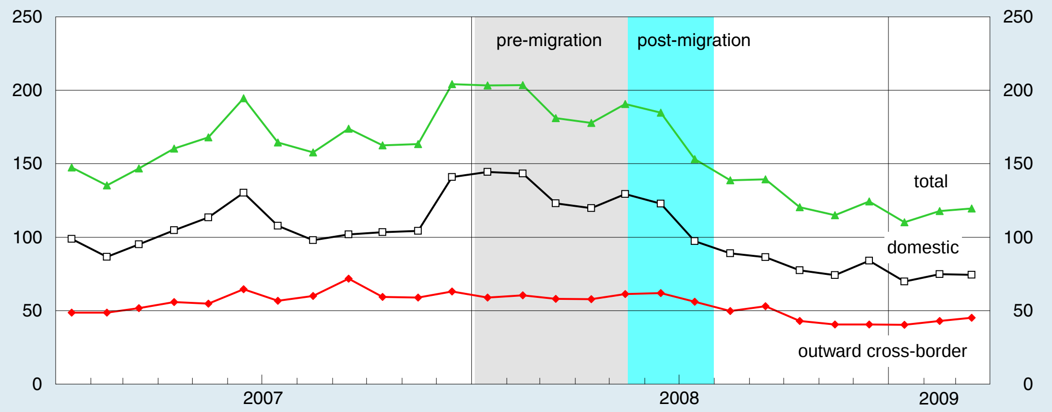
Sources: Based on SIA-SSB, Istat and Bank of Italy data.
(1) Including transactions of the Bank of Italy, provincial treasury sections and Poste Italiane S.p.A. From 19 May 2008, with the migration to TARGET2, the balances from the provincial treasury sections are included in those of the Bank of Italy. 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 reduction of payment flows was reflected in the 9.1 per cent diminution in traffic via SWIFT; the drop was sharper in Italy than in the other main countries. In the first quarter of 2009 the contraction came to 36.8 per cent by comparison with the first quarter of 2008.

The average daily flow of payments handled by the Italian gross settlement system diminished by some €7 billion compared with 2007. The reduction involved interbank payments only, which declined by 11.9 per cent, while payments ordered by non-bank customers increased by 17.8 per cent. The contraction was due in part to the migration to TARGET2-Banca d'Italia and in part to the aggravation of the crisis in the fourth quarter. The migration fostered a centralization of treasury management by Italian branches of foreign banks at their parent banks abroad. Comparing settlement flows in the period before the migration (2 January-16 May) with those in TARGET2-BI's first few months of operation (19 May-31 July), the average daily value of domestic and outward cross-border payments fell from €192 billion to €171 billion; the entire decrease was accounted for by domestic payments (from €133 billion to €112 billion), while cross-border flows remained practically unchanged (Figure 20.1).

Figure 20.1

Value of transactions settled through BI-REL and TARGET2-Banca d'Italia, January 2007-March 2009
(average daily values in billions of euros)



Source: Based on Bank of Italy data.

The use of intraday credit averaged €6.4 billion a day, nearly €2 billion more than in 2007. The peak drawings (averaging €12.6 billion a day, up from €9.8 billion) continued to come in the first few hours of the day, when e-MID transactions falling due are settled. The recourse to intraday credit was concentrated among a handful of participants; just three intermediaries accounted for nearly 85 per cent of the credit drawn and 35 per cent of the collateral deposited.

The value of the assets deposited during the day as collateral rose significantly, from €16 billion to about €28 billion. This trend concerned all the main banks and reflected stepped-up precautions during the financial crisis. The increase in collateral came from negotiable instruments, whose average daily value rose from €9.1 billion in 2007 to €13.9 billion last year, and from bank loans, which rose progressively from €1.9 billion in 2007 to over €12 billion a day in the first quarter of 2009 (three quarters of it deposited by a single bank). The significant rise in domestic securities in the first quarter, however, stemmed from the deposit by some intermediaries of collateral deriving from the securitization of their own loans, which the Eurosystem had recently made eligible.

Table 20.2

Collateral assets deposited with the Bank of Italy
(average stocks in millions of euros)

	Intraday credit					Monetary policy repos					Italian securities as collateral with foreign NCBs via CCBM
	Securities			Total	Bank loans	Securities			Total	Bank loans	
	Italian	CCBM	Links			Italian	CCBM	Links			
2007	4,739	2,682	1,729	9,150	1,932	6,786	–	8,973	15,758	4,002	47,176
2008	7,051	3,208	3,720	13,979	9,059	11,431	8	5,507	16,947	5,535	58,373
2008 – Q1	4,279	2,676	2,382	9,336	6,957	4,646	–	5,925	10,572	6,304	50,145
Q2	5,855	3,004	3,295	12,154	7,928	4,683	–	3,708	8,391	5,424	50,851
Q3	9,877	3,565	4,509	17,951	9,455	6,975	–	3,315	10,290	3,169	59,231
Q4	8,149	3,579	4,676	16,404	8,865	29,274	31	9,065	38,370	4,985	73,095
2009 – Q1	12,715	3,345	5,300	21,360	12,089	29,576	37	8,222	37,834	7,793	63,678

Rounding may cause discrepancies in totals.

The effects of the crisis on flows in payment systems. – The intensification of the financial crisis in the fourth quarter of 2008 is still affecting payment flows. The availability of advanced treasury management functions favoured the effective handling of payments despite the severe liquidity strains and thus helped to safeguard the stability of the financial system as a whole. TARGET2 had 100 per cent operational availability in the fourth quarter of 2008, so there were no repercussions on the use of the services provided by the Eurosystem.

The TARGET2-BI system registered a further contraction of payment flows of more than €50 billion a day in the fourth quarter, from €171 billion to €120 billion; domestic flows fell by €35 billion a day and outward cross-border flows by €15 billion (Figure 20.1). The decrease reflected the diminution in financial market activity. The significant decline in payments settled was mainly due to the reduced activity of the Express II securities settlement system, whose participants include some large foreign intermediaries. In the fourth quarter the average daily value of the payment flows from Express II fell from €75 billion to €40 billion.

In the days immediately following the failure of Lehman Brothers on 15 September, there was no remarkable change in the behaviour of TARGET2-BI participants. Between 15 and 30 September the average waiting time to settle queued payments was about 1 minute, in line with the previous period. The average daily value of transactions settled declined slightly (by about €5 billion) compared with the first half of the month. Recourse to overnight deposits was extremely limited, but became significant starting in October (a daily average of €8 billion).

The e-MID interbank deposit market

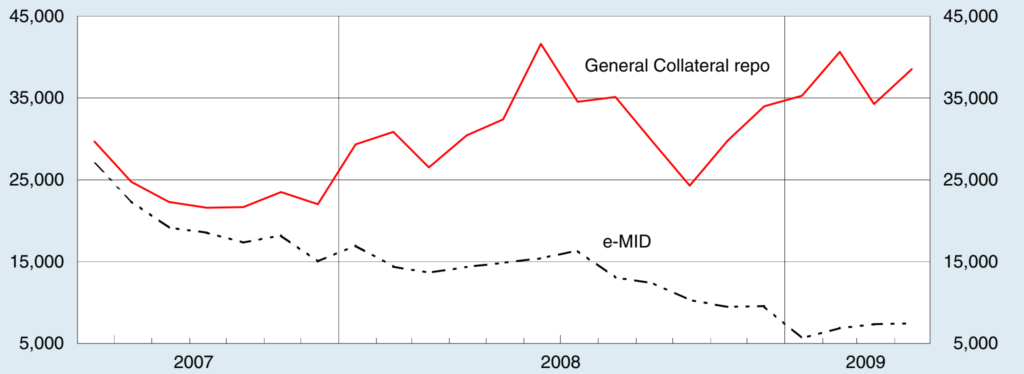
The volume of interbank deposits traded on the e-MID electronic platform fell by around 40 per cent in 2008 and remained low in the first quarter of 2009 as well. The fall occurred in the most acute phase of the financial crisis, when risk perceptions grew and intermediaries became fearful of showing bids for funds on the e-MID platform.

There was a consequent impetus to over-the-counter trading, which allows banks to choose their counterparty in advance and to keep transactions confidential.

The contraction in trading on the unsecured interbank market was accompanied by an expansion of business in the General Collateral segment of the repo market in government securities, thanks to the guarantee against counterparty risk on securities purchases, which is strengthened beyond the overnight maturity by the interposition of the central counterparty (Figure 20.2).

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.

Average daily turnover on e-MID fell from €22.4 billion in 2007 to €13.4 billion in 2008 and continued to decline to €6.6 billion in the first quarter of 2009. The share accounted for by overnight deposits remained at about 90 per cent, much as in previous years. The average transaction size fell from €51 million in 2007 to €37 million last year. Cross-border deposits accounted for 42 per cent of the total, compared with 53 per cent in 2007; the share fell further in the first three months of 2009 to 36 per cent.

The great volatility and discontinuity of overnight deposit rates rendered the market's bid-ask spread next to meaningless. The intraday trading pattern changed after the Lehman Brothers failure, with a substantial increase in transactions in the first hour after opening, owing to participants' propensity to procure needed funds as promptly as possible. The decline in the number of participants owing to bank mergers ceased. At the end of the year there were 239 members of e-MID, including 113 Italian banks. The number of active traders was 179 (104 Italian institutions). The ten most active traders accounted for 30 per cent of the contracts traded, up from 27.5 per cent in 2007; that share rose to 39 per cent in the first quarter of 2009.

In an effort to attract a part of the growing over-the-counter business, in November the market operator, e-MID SIM S.p.A., introduced a bilateral segment (request for quote) in which banks exchange information on the proposed contract in advance, without disclosure on-screen. In the segment's first few months trading averaged €680 million a day.

The collateralized interbank market. – A continuing flow of interbank transactions at all maturities facilitates the prompt, effective transmission of monetary policy impulses, contributes to orderly securities and foreign exchange markets, and makes the pricing of fund-raising and lending more efficient.

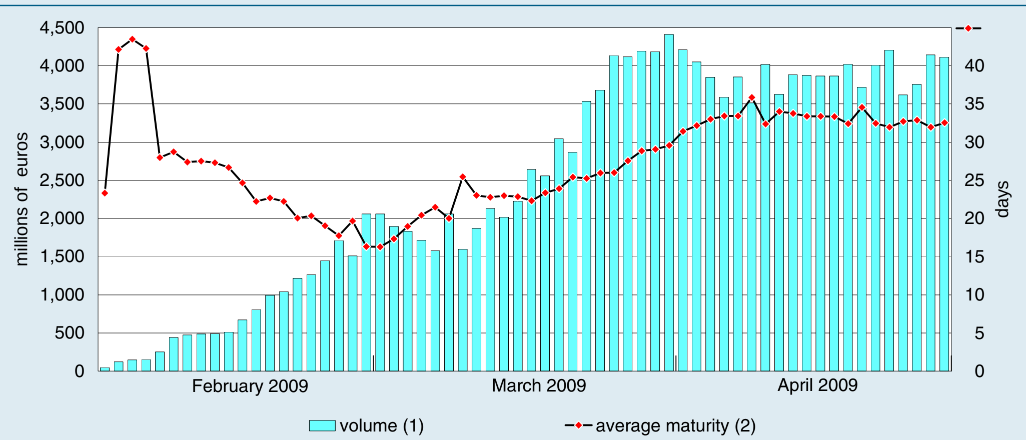
The Bank of Italy viewed the evaporation of trading on e-MID from September onwards with concern. Accordingly, in cooperation with the market operating company and the associations of banks and bank treasury managers, it constituted a new interbank market segment on which interbank deposits could be traded with much lower liquidity and counterparty risk. On 2 February, the new Collateralized Interbank Market went operational, using the e-MID SIM trading platform and settling via TARGET2. Transactions are anonymous and collateralized, with maturities of one week to six months. Each participant's potential maximum net exposure is proportional to the value of the assets posted as collateral. There is also a risk-sharing component of collateral equal to 10 per cent of the assets provided by each participant. The Bank of Italy's function is to guarantee the complete anonymity of transactions, to value, manage and provide custody of the collateral provided by banks, and to ensure execution of contracts should a participant default.

Fifty-two banking groups, including four foreign-controlled groups, joined the market; they account for more than 80 per cent of bank assets in Italy. Foreign banks can also participate at a distance with the agreement of their home central bank and the Bank of Italy.

Figure 20.3

Collateralized Interbank Market: volume and average maturity of contracts

(daily data; volume in millions of euros, maturity in days)



Source: Based on e-MID SIM S.p.A. data.
(1) Left-hand scale. – (2) Right-hand scale. The average maturity is weighted by the size of the deposits.

Through 30 April contracts worth a total of €13 billion were traded, concentrated at the one-week, two-week and one-month maturities (34, 26 and 23 per cent respectively). All the maturities allowed were quoted continuously. The average daily bid-ask spread stabilized at about 10 basis points for one-week funds. Over the same period the volume of trading on the open e-MID segment for the collateralized market maturities was roughly equivalent (€12 billion). After its launch, market volume increased steadily over the first few weeks to stabilize, from the end of March onwards, at around €4.1 billion. The average original maturity of contracts stabilized at 32 days (Figure 20.3). The weighted average rate for one-week deposits was about 14 basis points lower than on the unsecured segment of e-MID. On 15 May the stock outstanding had diminished to €3.3 billion and the average maturity of contracts had lengthened to 38 days.

The wholesale market in government securities

The money and financial market turmoil also affected the Italian government securities market. Liquidity on MTS was severely curtailed, with a smaller volume of trading and wider bid-ask spreads. In order to maintain orderly quotes and trading, in March 2008 MTS relaxed its quoting obligations, thus making this less costly for primary dealers. The pan-European EuroMTS platform also registered scanty liquidity.

Average daily turnover on MTS fell from €6.5 billion in 2007 to €3.4 billion last year; and the contraction continued in the first quarter of 2009 to a volume of about €2 billion a day. The share of short-term paper diminished to the benefit of inflation-indexed BTPs, which rose from 4 to 8 per cent of the total. BTPs constituted 54 per cent of total turnover in long-term securities. The share of trading accounted for by the top five dealers remained unchanged at 26 per cent, but that of the top ten rose from 44.5 to 49 per cent. The average bid-ask spread widened significantly, from 5 basis points in 2007 to 16 in 2008. The spread has nevertheless narrowed from 29 points at the height of the crisis, between October and December, to 24 points in recent months. The number of MTS participants fell further, from 108 to 101. The market's two central counterparties – Cassa di Compensazione e Garanzia (CC&G) and LCH.Clearnet SA – guaranteed trades amounting to some 80 per cent of the total, up from 75 per cent in 2007.

The repo segment of MTS was relatively little affected by the international crisis. Volume shrank by about 4 per cent, to €61 billion a day. The contraction of trading, largely offset by the increased role of the General Collateral segment, came in the Special Repo segment, continuing a tendency that began in 2007 and that has been favoured by the difficult situation in the spot market.

The Continuous Linked Settlement system

At the end of 2007 the CLS system, a payment versus payment scheme in business since 2002 for the settlement of foreign-exchange transactions, extended its operations to OTC derivatives. It operated in orderly fashion during the phase of market turmoil. Numerous Italian banks participate directly or indirectly, thus enjoying the protection against foreign exchange settlement risk that CLS offers. CLS coped effectively with exceptionally large volumes. In the week following the failure of Lehman Brothers, its daily turnover rose to about $5.4 trillion. Two more currencies were added last year to the 15 already handled by CLS. Its average daily turnover in 2008 was the equivalent of some $3.9 trillion, up nearly 10 per cent from 2007. The system's growing importance and its global activity have led the G10 central banks and the others whose currencies are traded on CLS to strengthen their cooperative oversight of it. A protocol defining the oversight mechanisms more clearly went into effect in December, with primary responsibility assigned to the Federal Reserve, since CLS Bank International is located in the United States. Some central banks and the Eurosystem also laid down specific standards for the CLS activities that involve their currencies.

Central depository, settlement and guarantee systems

The market in central securities depository, settlement and guarantee services is the scene of a number of initiatives. In Europe the most important is TARGET2-Securities, undertaken at the initiative of the Eurosystem based on a decision by the ECB Governing Council in July 2008. The Italian post-trading companies, CC&G and Monte Titoli, are engaged in reorganization following the London Stock Exchange's acquisition of Borsa Italiana.

Work is proceeding at global and European level on the harmonization of the regulations governing post-trading services. In the second half of 2008 the ESCB worked together with the Committee of European Securities Regulators (CESR) on a set of recommendations for authorities to include in their supervisory activities, designed to enhance the security and efficiency of securities settlement systems and central counterparties. As regards custodian banks, at the request of the Ecofin Council the Committee of European Banking Supervisors was consulted and gave the opinion that banking regulations already provided sufficient safeguards against their clearing and settlement risk. The recommendations, which have already gone through a public consultation procedure, are scheduled for publication before the summer, after their approval by the ECB Governing Council and the CESR.

Central depository services. – Monte Titoli's central depository activity expanded in 2008. The face value of financial instruments in custody rose by 12.4 per cent to €2.3 trillion at the end of the year, while securities transfer orders increased by 7.5 per cent and the number of issuers went up by 64 to 2,161. However, the financial crisis resulted in a 4.2 per cent decrease in the market value of the instruments in custody. Monte Titoli remains the third largest depository in Europe in terms of value of securities under management, behind the international depositories Euroclear, with €18 trillion in securities in custody, and Clearstream, with €11 trillion.

Securities settlement. – The Express II securities settlement system, which is divided into a net and a gross component, registered a decline in both the number and the value of the transactions handled in 2008. The number of payments fell by 15 per cent to just over 94,000 a day and their value by 9 per cent to €182 billion. However, net and gross settlements through the system moved divergently. The number of transactions entered for net settlement, used mainly to settle trades on regulated markets, declined from 108,000 to 90,000 a day, and their value from €163 billion to €139 billion. But the gross component, used mainly for OTC transactions and monetary policy operations, gained both in number (from 6,800 to 7,400 a day) and in value (from €38 billion to €43 billion).

The number of participants fell again in 2008, from 122 to 115, mainly because of the industry's growing specialization. By contrast, two additional central counterparties began to use the system last year.

Despite the financial market turmoil, the portion of transactions entered in the net component of Express II that were settled on the same day remained at 99 per cent in 2008; it rose to 99.5 per cent in the first quarter of 2009, owing in part to Consob's ban on the short-selling of shares. In the days following the Lehman Brothers bankruptcy Italy, like other countries, saw a temporary increase in the number of securities transactions awaiting settlement.

The overnight clearing cycle continued to benefit from the Bank of Italy's automatic intraday credit procedure for participants. The volume of credit granted rose from €4.6 billion to €6.2 billion a day, covering 58 per cent of the participants' debit balances. The share of transactions coming from regulated Italian markets remained stable at about 70 per cent, while the portion guaranteed by central counterparties rose again, from 36 to 41 per cent. In the gross settlement component, MTS repos increased from 29.3 to 41.7 per cent of settlement value, while the share of business consisting in settlement of queued transactions from the net component continued to diminish (from 29.6 to 18.1 per cent).

Concentration increased still further: the three largest participants accounted for 56.5 per cent of the settlement flow, up from 53.2 per cent in 2007, and the share of the top five rose from 70.4 to 75.2 per cent. The share of turnover produced by foreign intermediaries (Italian branches of foreign banks and Italian subsidiaries of foreign groups) rose again from 62.9 to 65.4 per cent.

Clearing and guarantee services. – The Lehman Brothers failure involved CC&G only indirectly. Lehman's British subsidiary belonged to the Italian central counterparty through two clearing participants, which discharged the failed investment bank's obligations without loss to CC&G.

The number of participants rose from 130 to 137 in the course of the year. Activity in the equity and derivatives markets was flanked in 2008 by electricity futures in the IDEX market launched in November, which has 16 members.

Reflecting market trends, the daily value of equity cash market trades handled by CC&G fell from €6.3 billion to €4.1 billion. For the IDEM equity derivatives market, CC&G's activity contracted for the first time ever, slipping to 35.9 million contracts (down 3.2 per cent) and falling 26.5 per cent in value. The value of government securities market transactions guaranteed decreased by 3.3 per cent. The contraction continued in the first quarter of 2009. The daily value of equity market transactions, both cash and derivative, was down more than 60 per cent by comparison with the first quarter of 2008. In its first two months 634 standard contracts worth nearly €129 million were executed in the new IDEX segment.

The pronounced volatility of the markets brought an increase in the average margin required by CC&G. The central counterparty service for MTS, provided jointly with LCH.Clearnet SA, contributed about 14 per cent of total margins deposited. The margins required by CC&G in 2008 amounted to €2.7 billion, up from €2.6 billion. The market crisis led to repeated revisions of the parameters for margin calculation, based on estimates of the daily volatility of the instruments guaranteed. In the first quarter of 2009 daily margins deposited by participants averaged €3.1 billion, 71 per cent more than a year earlier.

21. RETAIL PAYMENT SERVICES AND THE STATE TREASURY SERVICE

SEPA and the integration of European retail payment services and systems

In January 2008 the Single Euro Payments Area advanced from the planning to the implementation phase. The pan-European SEPA credit transfer became operational and the regulatory framework designed by the Eurosystem for payment cards went into effect, mandating the migration of cards and equipment to smart card technology. SEPA direct debits are scheduled to become operational on 1 November 2009, with the entry into force of the Payment Services Directive (Directive 2007/64/EC).

Nevertheless, the migration to SEPA is proceeding slowly throughout the Eurosystem. In the entire area SEPA-standard credit transfers constituted just 1.8 per cent of the total in the second half of 2008. In Italy, the share was 0.7 per cent, which was higher than in France or Germany. As to payment cards, 60 per cent of the cards in circulation in Italy at the end of 2008 met the security standards, as did 70 per cent of ATMs and 80 per cent of POS terminals. Italy is catching up with the other large European countries, but a special effort is needed for debit cards in particular.

In addition to the banks, which are called on to adapt their services to pan-European standards, the migration also involves retail clearing and settlement mechanisms, which must be capable of handling SEPA instruments. Europe has two infrastructure models for communication between all banks: one based on direct participation in a central system (represented at present by the STEP2 system operated by the Euro Banking Association) and one requiring agreements between systems for interoperability, developed by the European Automated Clearing House Association (EACHA).

The 14 payment system operators that have announced their intention to comply with SEPA standards include two Italian clearing and settlement mechanisms (ICBPI-BI-COMP and SIA/SSB-BI-COMP). Accordingly, in agreement with these two private operators, the Bank of Italy has made the necessary adjustments to its BI-COMP clearing system, and in the course of 2008 ICBPI/BI-COMP concluded interoperability agreements with its Dutch and Austrian counterparts.

In order to increase the number of reachable intermediaries, the Bank of Italy offers its BI-COMP participants an intermediation service to counterparties belonging to the European STEP2 system. ICBPI and SIA/SSB offer banks a link to STEP2.

In Italy a key part of the work of the national SEPA migration committee involved the definition of specific additional optional services (AOS), so as to ensure service levels at least as good as those already achieved domestically while also guaranteeing full compatibility with the basic SEPA payment procedures.

Payment instruments

Economic developments. – The use of the various retail payment instruments was influenced by the slowdown in economic activity and consumer spending last year. The hardest hit by cyclical developments were cheques and credit transfers, along with some types of collection order used principally for business-to-business payments. The use of cheques was also curtailed by the legislative measures of 2007 and 2008 for stepped-up action against money laundering (Legislative Decree 231/2007 and its successive amendments). The structural upward trend in direct debits (to pay utility bills, for instance) and in the use of payment cards continued.

There were some 3.8 billion cashless payments in Italy in 2008, up 1.4 per cent from 2007. Payments via cheque decreased by 9.7 per cent in number and 6.3 per cent in value, while the number of credit transfers declined by 2.9 per cent. Invoice collections (automated bank receipts and notified payments) came down both in number (by about 2 per cent) and in value (by over 5 per cent), while direct debits increased by some 9 per cent in number.

POS transactions using credit, debit and prepaid cards increased in number by 6.5 per cent, continuing the trend of the previous three years. The fastest growth – 46.4 per cent in number of transactions – again involved prepaid cards, but they still account for no more than 5 per cent of total card payments.

The average handling time for personal and cashier's cheques before funds become available, according to data from PattiChiari, remained unchanged at 6.4 working days. The Bank of Italy proceeded with its assessment of the technical and legal feasibility of the project for electronic transmission of digital images of cheques. The plan is to cut the operational costs of handling paper instruments and shorten the time to collection and funds availability.

Greater and greater importance is being attached, internationally as well as in Italy, to the development of circuits for immigrants' remittances, which are growing constantly. In Italy there were 32 specialized intermediaries last year; they transferred some €6 billion out of the country, about one third more than in 2006. The leading receiving countries include China, the Philippines and Romania.

The interbank database on irregular cheques and payment cards. – The number of persons and of cheques registered in the database for lack of funds or authorization fell by 5.7 and 14.3 per cent respectively in 2008, reversing the upward trend of recent years. The total value of the cheques registered was stable at €1.2 billion (Table 21.1). Although the number of bad cheques registered diminished, their ratio to those regularly debited to the account-holder increased slightly. Geographically, as in years past, the South and Islands accounted for the majority of unpaid cheques. There was an increase in the number of persons whose payment cards were revoked for failure to pay or to constitute funds against payment. At the end of 2008 the payment card section of the database covered some 209,000 persons, nearly 17 per cent more than a year earlier, and once again two thirds of the newly registered were domiciled in the Centre, South and Islands.

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	14,887	44,558	15.6	221.9	17.8	4,981
North-East	6,910	21,549	7.5	130.4	10.4	6,051
Centre	16,059	56,991	19.9	250.1	20.0	4,388
South	42,238	161,324	56.5	638.1	51.1	3,955
Foreign	365	1,282	0.4	7.6	0.6	5,928
Total	**80,459**	**285,704**	**100.0**	**1,248.1**	**100.0**	**4,369**

Rounding may cause discrepancies in totals.
(1) At 31 December 2008.

BI-COMP operations. – The value of the transactions handled by the BI-COMP clearing system increased by 2 per cent and their number by 1.6 per cent, from 1,992 to 2,024 million (Table 20.1). The shift towards fewer paper-based and more electronic payments continued.

Since the launch of the Single Euro Payments Area, SEPA credit transfers settled in BI-COMP have increased steadily, and last December they accounted for 43 per cent of all Italian SEPA credit transfers. Overall, BI-COMP settled some 668,000 SEPA credit transfers, 0.2 per cent of all the credit transfers processed by the system; 50,000 of them were SEPA cross-border payments having as counterparty the Dutch Equens system, with which interoperability began in April 2008.

In February 2009 BI-COMP established a link with the Austrian STEP.AT system, which immediately began to handle a substantial flow of retail payments between the two countries.

Retail payment services. – The use of non-cash instruments remains quite limited in Italy by international standards, with 64 transactions per inhabitant in 2008 compared with 161 for the Eurosystem countries as a group in 2007 (Table 21.2). Moreover, a full 60 per cent of bank card transactions (including POS purchases) consists of ATM cash withdrawals, even though Italy's infrastructure endowment in this field is on a par with the rest of Europe at 1.3 cards per inhabitant and 20 POS terminals for every 1,000 inhabitants.

In the area of innovative products and payment channels, the number of Internet payments via credit card or credit transfer again rose significantly in 2008. The number of online credit transfers was 70 million, up 16.5 per cent, while online credit card payments increased by 12.6 per cent to over 30 million. The use of automated postal payment instruments increased sharply: the number of credit transfers and collection orders by 19 per cent, that of pre-paid and debit card transactions by 15 per cent. At the end of 2008 the 5.4 million postal current account holders, almost all of them households, had more than 11 million postal payment cards, almost 19 per cent more than a year earlier.

Table 21.2

Non-cash payment instruments in Italy and other countries

	Number of non-cash transactions per capita in year (1)				
	Total	Cheques	Credit transfers	Direct debits	Payment cards
Italy	**64**	**6.4**	**17.7**	**15.1**	**24.5**
Euro area	**161**	**14.6**	**44.4**	**49.0**	**53.3**
Belgium	198	1.0	84.5	22.6	89.6
France	243	57.4	41.1	47.6	97.1
Germany	174	1.0	62.9	83.9	25.9
Netherlands	272	–	86.5	71.9	113.3
Spain	114	3.4	16.3	51.1	43.4
EU-25	**149**	**12.7**	**41.6**	**38.9**	**55.9**
United Kingdom	245	26.3	51.3	48.8	118.5

Sources: Based on ECB, BIS, Poste Italiane S.p.A. and Bank of Italy data.
(1) For Italy, 2008; for the other countries, 2007.

The growing use of information and communications technology for making payments and for online business activities in general was confirmed last year by the Bank of Italy's third survey of service firms, which has now been extended to manufacturing enterprises. Virtually all businesses used the Internet for collections and payments. The more innovative firms seem to follow one of two distinct models in the introduction of the technology: one group uses innovations mainly to improve operating efficiency (the product chain) while the other innovates mainly for the benefits to marketing. In either case, the online collection and payment procedures, combined with electronic invoicing, offer new opportunities to rationalize internal processes and gain access to foreign markets, in keeping with the SEPA philosophy.

The state treasury service and public payments

The reform of general government was given stronger impetus by the Government's plans for e-government and by a series of legislative measures. The use of ICT and the project for the digitalization of relations between government bodies and citizens have already produced significant renovation of the state treasury service, which now uses automated procedures for almost all public payments and collections.

About 95 per cent of the 53 million purchase transactions ordered by general government bodies in 2008 (almost all of them via the dedicated network) were handled in ICT mode. On the revenue side, the full effects of taxpayers' steadily increasing use of credit transfers (in lieu of direct payments at the Post Office, the Treasury and tax concessionaries) and those of the new procedure for single payment of tax receipts by public bodies are beginning to unfold.

The achievements already made have laid the foundations for the further online evolution of the public payments system. Last year the project for online payments to central government departments using electronic instruments (credit and prepaid cards, direct debits) went into the execution phase.

Initiatives were undertaken to integrate into the Bank of Italy's procedures payment and collection operations on behalf of public bodies to and from non-euro-area countries in euros and foreign currency. Such transactions numbered 56,000 in 2008, with a total value of over €2.5 billion. The achievements of the General Government Payments Information System were consolidated in the course of 2008. Its electronic database records the collections and payments of all general government entities as defined in the national accounts (which number more than 12,900, including social security and national health bodies). The System permits constant monitoring of local government accounts by the Ministry of the Economy and Finance. The objective as specified in the Finance Law for 2009 is to eliminate paper-based data, which should greatly improve data quality and reduce costs.

THE GOVERNOR'S CONCLUDING REMARKS

The reorganization of the Bank is going ahead as scheduled. Eighteen branches have already been closed and others will cease operations over the coming months. By the end of this year, 58 of the original 97 branches will still be operational, including 6 specializing in banking and financial supervision and 25 assigned, with a streamlined structure, to the State treasury service and to providing information services to the public. Banknote production will be reorganized, with the agreement of the trade unions, in order to expand output and increase efficiency.

Following the absorption of the Italian Foreign Exchange Office, for more than a year the Bank of Italy has had the function of combating money laundering through a Financial Intelligence Unit that operates within the Bank but with special autonomy. It has been endowed with substantial resources and expertise. In carrying out its tasks, the FIU has developed fruitful synergies with the banking and financial supervision area. This benefits the stability and the reputation of the banking system. The Unit cooperates closely with the judiciary and with the Finance Police, to which a constantly growing stream of complaints and reports are submitted.

This January Antonio Finocchiaro left the Governing Board to assume the office of chairman of the Pension Fund Supervisory Authority. In the course of a long career, Mr Finocchiaro served the Bank of Italy with rigour and dedication, making important contributions in a diversity of fields ranging from the original development of the Bank's IT system to the management of human resources and trade union relations, to operational organization and management. Let me offer him my most affectionate and grateful salutation. His place on the Governing Board has been filled by Anna Maria Tarantola, former Managing Director for Banking and Financial Supervision.

The Bank's staff last year faced an extraordinary commitment, commensurate with the difficulties of the economic and financial crisis we are experiencing and the exceptional response required at every level. The earthquake in Abruzzo has posed a painful additional challenge. All are responding with self-sacrifice, putting the great professional and human qualities that distinguish our team to the best possible use. I thank all of them on behalf of the General Council and the Governing Board.

The question of the Bank's ownership structure remains to be dealt with. For over seventy years now the present arrangements have ensured the independence and decision-making autonomy of the central bank. However, the evolution of the structure of the banking system has brought to light a formal anomaly that it is advisable to remove. We are prepared to design, together with our shareholders and with the Government, a solution that will work to the benefit of the entire system.

The global crisis

Since mid-March tensions in the financial markets have eased and share prices, despite fluctuations, have recovered, returning to the levels recorded at the beginning of the year; the qualitative indicators of the real economy point to a subsidence of recessionary pressures.

These are encouraging signs. The likelihood of deflation, in the sense of a protracted decline in the general price level, now appears slight, also because longer-term inflation expectations remain close to 2 per cent. However, in view of their seriousness, the persistent risks to the unfolding economic scenario require that the economy continue to be supported decisively using all available instruments. There is awareness of the need to prepare in advance strategies to reabsorb the large budget deficits and exceptional liquidity creation that characterize the current situation.

It is not yet possible to point with certainty to a definitive cyclical inversion: the forecast is for a return to growth in 2010. The general expectation is for falling levels of employment and revenue, accompanied by continuing volatility in the financial markets, with adverse effects on consumption and investment.

The task of economic policies is to attenuate the negative spiral of unemployment and consumption. The response has been prompt, vigorous and coordinated at the international level. Up to now there has been no sign of a significant resumption of protectionism.

Official interest rates have been cut drastically in all the main economies. Between October 2008 and the beginning of May, the Governing Council of the European Central Bank lowered the rate on main refinancing operations by 3.25 percentage points, to 1 per cent, the lowest level ever reached in the euro-area countries.

The reduction was reflected in market rates: the three-month Euribor rate is currently 1.3 per cent, over 4 percentage points lower than in the first ten days of October. Twelve-month interest rates in euro are aligned with those in dollars and slightly lower than the sterling rates.

The expansionary measures taken by all the central banks significantly enlarged their balance sheets in ways that reflect differing national financial structures. Bank credit in the euro area is relatively more important than in the United States (around 140 per cent of GDP compared with 60 per cent). Accordingly the Eurosystem has so far focused on banks.

The introduction in October last year of a system of bank funding at a fixed rate, limited only by the availability of collateral, was a highly important development; this, along with other measures, enabled banks to meet their liquidity requirements in a situation of money market paralysis. It also provided certainty regarding the rate they would have to pay for a much longer period than in the past: the maturities of longer-term refinancing operations were extended up to six months and, from next June, to twelve months. Against these loans banks can now post as collateral a much broader range of securities than were previously eligible.

A global systemic collapse was averted, but neither monetary expansion nor the effect of built-in stabilizers in government budgets could fully counter the fall in aggregate demand and the social costs of the recession.

Since last autumn international organizations have been emphasizing the need for decisive discretionary budgetary measures, coordinated internationally and involving all the main countries. The Council of the European Union called for stimulus interventions totalling 1.5 per cent of the euro-area GDP in 2009.

In all the industrial countries and in many emerging economies, first and foremost China, the fiscal policy response has been markedly expansive. The size, duration and makeup of the interventions have varied, reflecting in particular the uneven impact of the crisis, the initial state of the public finances and the scale of built-in stabilizers. The simultaneity of the stimulus measures adopted enhances their effectiveness.

According to recent estimates by the International Monetary Fund, in 2009 the fiscal deficits of advanced countries will reach almost 9 per cent of GDP, then fall by 1 percentage point in 2010. Between 2008 and 2010 government gross debt is forecast to increase by 27 percentage points of GDP in the United States, to almost 100 per cent, and by 16 percentage points in the euro area, to 85 per cent.

The need to place massive volumes of government securities on the market in the next two years puts upward pressure on interest rates; these will intensify with the easing of the recession and attendant rise in demand for private debt securities, checking the recovery of the economies. Once the crisis has passed, the public debt must be reduced sharply.

However, history teaches us that without the restoration of the banks to health and without the resumption of credit flows, the recession will be more drawn out and the recovery slower, despite the exceptional expansion of budget deficits.

After the failure of Lehman Brothers last September, government interventions to guarantee bank deposits and liabilities and to support recapitalization prevented additional collapses; they were insufficient to avert a contraction of credit. Financial markets are still struggling to become fully functional again. Risk aversion remains high.

Worldwide, in the past two years banks have recorded losses of over $1,000 billion in their balance sheets. Just under half of the funds used to rebuild their capital base came from government intervention.

Looking ahead, banks' capital requirements must be met by reactivating the market. This depends on the total transparency of banking assets. The cloud of uncertainty that continues to hang over banks' balance sheets limits the inflow of private capital, increases the level of capital ratios demanded by the market and makes the incentives to reduce assets more stringent.

Action must be taken to re-establish the certainty and credibility of the asset side of bank balance sheets. The measures announced by a number of countries to insure or transfer to separate entities part of their assets can prompt the emergence of the most problematic securities. But to restore confidence in the major international financial institutions, there remains the need for a full, internationally coordinated, consistent, rigorous and transparent stress testing of banks' balance sheets, which has already been launched in the United States and is being prepared in Europe.

Promoting financial stability

The crisis is rooted in distortions in the markets' functioning, regulatory and supervisory shortcomings and the conduct of intermediaries in the world's leading financial centres. The exceptional liquidity that flowed into those centres as a result of the prolonged disequilibria in savings rates and payments balances contributed to keeping interest rates, volatility and the cost of protection against insolvency at abnormally low levels. This led to a general underestimation of risk with a consequent overvaluation of financial assets and real estate. The defects in regulation and the management of risk by the world's largest banks were concealed. An accommodating monetary policy contributed to the artificial dilation of financial volumes and permitted the continuation of a situation rendered fundamentally unstable by the distortions and shortcomings mentioned above. The market rejected economic policy interventions despite their timidity; blinded, it lost its diagnostic capacity, its self-correction mechanisms were paralysed.

A financial system that combines innovation and solidity, profit and support for households and firms will have to have more rules, more capital and less debt. The global strategy that is emerging is based on three pillars: the international financial institutions, the regulatory authorities and the central banks.

The International Monetary Fund has taken on a crucial role; its resources have been more than doubled and its ability to intervene has been enhanced. Today the IMF can support countries in difficulty, especially the emerging economies that are suffering most from the adverse economic cycle; the Fund's assistance in managing imbalances is preventing the systemic propagation of the crisis. The IMF, together with the Financial Stability Board, has been entrusted with analysing and signalling threats to the stability of the global financial system. It is encouraging that the leading countries have at last accepted periodic IMF examination of the soundness of their financial systems.

More rigorous multilateral surveillance than in the past will contribute to the global consistency of national economic policies. But the orderly correction of current account imbalances will have to hinge on a world capital market that is fully functioning and free from defects in regulation and control.

This belief underlies the establishment by the G20 Heads of State and Government of the Financial Stability Board. The new body has a broadened membership and mandate by comparison with the Financial Stability Forum; in April 2008 the latter had produced the first report on the steps to be taken to overcome the shortcomings of regulation. The Board is now responsible for monitoring national authorities in the application of those recommendations, coordinating the many committees of regulators and accountants that determine the standards for banks, and proceeding with the establishment of international colleges of supervisors for the largest financial institutions. More rigorous capital and liquidity requirements, the extension of the scope of regulation to non-bank institutions, the completion of Basel II and amendment of the accounting rules in order to reduce their procyclicality, and more demanding supervision and regulation for institutions whose size makes them a systemic risk; these are the measures describing the path of the Financial Stability Board's work in the coming months.

The Italian presidency of the G8 is conducting the work to set global standards for the transparency, propriety and integrity of international economic and financial activity.

The crisis has considerably broadened the consensus on the need for central banks to expressly include financial stability among their objectives; restricting their task to taking corrective action after a crisis is no longer deemed sufficient. The idea is gaining ground that the functions of monetary policy and supervision reinforce each other. The debate on these issues is complex and far from over.

In Europe the revision of large parts of the system of banking and financial supervision is already under way. The fundamental aspects of this process appear correct; in some points it needs to be strengthened.

The assignment of supervisory tasks aimed at systemic stability to a European council is a good idea if it has real powers of intervention and operates in close coordination with the national supervisory authorities.

In at least some areas the common supervisory standards should be binding and directly applicable at national level. It is necessary to harmonize deposit guarantee systems and the mechanisms for crisis management.

The repercussions of the crisis in Italy

According to the latest forecasts, the world crisis will cause GDP to fall in Italy by about 5 per cent this year, after decreasing by one per cent in 2008.

The collapse of foreign demand has triggered a sharp contraction in industrial production and investment. The reaction of firms, especially those most exposed to the international cycle, was immediate: the temporary closure of entire factories and production lines; temporary and permanent reductions in the workforce; postponement of purchases of intermediate and capital goods; and unusually long delays in paying suppliers. In the six months from October 2008 to March 2009 GDP fell by more than 7 per cent on an annual basis compared with the previous six months.

The recent signs of an easing of the most acute phase of the recession come from the financial markets and opinion surveys, more than from the statistics available to date on the real economy. For a return to sustained growth there must be a stable recovery of the world economy, the weakness of the labour market must not have an even more severe impact on domestic consumption, and the structure of our productive system must be strengthened.

Employment and consumption

Among the prudential measures that firms have taken to cope with the recession, those involving labour have been of three types: a reorganization of shifts and working hours and a freeze on hiring; recourse to the Wage Supplementation Fund; and non-renewal of fixed-term contracts and layoffs of permanent employees. Nearly all firms have used measures of the first type. Ordinary wage supplementation was also used extensively, quickly reaching the peak levels recorded in the 1992-93 recession; the cover it potentially provides is nonetheless limited – one third of payroll workers in the private sector – and it provides workers with a maximum monthly benefit that is less than half the average gross earnings in industry. It is estimated that two fifths of the industrial and service firms with 20 or more workers will reduce their staff this year; the reduction will probably be most pronounced among the smallest firms. More than 2 million fixed-term workers will see their contracts expire this year; more than 40 per cent work in private services, nearly 20 per cent in the public sector; 38 per cent work in the South.

Workers on wage supplementation and job seekers already amount to about 8.5 per cent of the labour force, a share that could rise above 10 per cent. Households' disposable income and consumption are expected to go on falling, despite the substantial decrease in inflation. The governmental measures in favour of less well-off households and the incentives for the purchase of durable goods are providing temporary support.

A first risk of the current cyclical phase is a sharp reduction in domestic consumption, to which firms could react by further restricting their purchases of capital goods and inputs.

Firms and the crisis

Thanks to the commitment of our regional branches, we have conducted a particularly thorough survey of the state of the Italian economy, the difficulties that firms are encountering and how they are reacting to the crisis.

Expectations of a sharp fall in turnover (of more than 20 per cent according to many firms) and great uncertainty as to the duration of the crisis have caused investment plans for this year to be reduced by 12 per cent in industry and services overall and by more than 20 per cent in the manufacturing sector – exceptionally high figures by historical standards.

Restructuring in large parts of the economy began in the first half of this decade. Prior to the crisis, some positive results were already visible in terms of productivity and competitive strength on foreign markets, but these difficult times jeopardize the process.

According to our survey, about half of the 65,000 industrial and service firms with 20 or more employees are engaged in restructuring. They expect a much smaller than average drop in turnover in 2009. At one extreme, the more financially solid among them are now buffering the impact of the recession by consolidating their technological edge and diversifying their outlet markets. There are a fair number of such firms, we estimate more than five thousand, employing nearly a million people. Some appear ready to take advantage of the crisis by repositioning themselves in the market. At the other extreme lie the firms that, having decided to grow in size and technological intensity, and to open up internationally, had taken on debt. Now, with the crisis, they are faced with the drying up of cash flows, more rigid bank credit, and considerable problems in accessing capital markets. At least six thousand companies, once again with almost a million workers, are affected in this way.

The effects of the crisis are being felt above all by firms with fewer than 20 workers. In manufacturing alone there are nearly 500,000 such firms, employing just under two million workers. The very survival of those subcontracting for larger firms that are cutting orders and deferring payments is sometimes at stake.

The coming months will be decisive; excessive mortality due to financial strangulation of too many companies that have the potential to prosper after the crisis has passed is a second, serious, risk for the Italian economy.

Financing the economy

The deterioration of the economy tends to curb bank lending. In April the quarterly rate of growth of credit to non-financial firms was nil; it had been 12 per cent a year earlier. Lending to households has also continued to slow.

A part of the deceleration can be explained by a decline in manufacturing and real estate investment and in the consumption of durable goods. But the supply of bank lending has also been curtailed, mainly owing to difficulties in raising medium and long-term funds and to the increase in credit risk.

Our survey found that the loan applications of 8 per cent of firms were rejected – the highest figure since the mid-1990s; it was less than 3 per cent a year ago. Over 10 per cent of firms state that since last October they have been asked for early repayment. This happens more frequently in the South of Italy but affects the whole country and even some larger companies.

Banks cannot be asked to be less prudent in granting credit; a banking system that risked the integrity of its balance sheets and the confidence of those who entrust their savings to it would not serve the interests of the economy. What can, and must, be asked of our banks is to improve their ability to recognize creditworthiness in the present, exceptional circumstances. Special attention must be paid to the longer-term prospects of the firms that apply for financial assistance. When evaluating and making decisions, banks must take account of technology, organization and the dynamics of firms' main markets.

The Government's recent initiatives to increase the Guarantee Fund for small and medium-sized firms can strengthen banks' support to smaller companies.

Consideration should also be given to the possibility of making a public loan guarantee scheme available to a broader range of firms, as in other countries, for a limited period of time and with safeguards to reduce distortions in resource allocation.

However, it is also important to reactivate the Italian securitization market; if properly structured these instruments will remain a key channel for financing. The less risky *tranches* backed by portfolios of mainly newly-granted loans could be covered by government guarantee. The State would not be required to make an immediate outlay of funds and its guarantee would be adequately remunerated.

Anti-crisis measures

Economic policy currently presents more difficulties in Italy than in other countries. Action to bolster demand is restricted by government debt from the past. Measures taken to date to mitigate the social costs of the recession have relied mainly on funds allocated to other purposes.

But firm and credible action to set the public finances right within an agreed time frame can provide scope for a more incisive economic policy.

The first concern is the danger of a further deterioration of labour market conditions. The crisis has highlighted long-standing deficiencies in our system of social protection, which continues to be fragmented. Otherwise identical workers are treated differently only because they are employed in a craft firm rather than in a larger company. It is estimated that 1.6 million employees and quasi-employees have no right to any assistance if they are dismissed. More than 800,000 full-time workers in the private sector, that is 8 per cent of potential beneficiaries, are entitled to an allowance of less than €500 a month.

A good system of social buffers for the unemployed that balances out financially over the economic cycle lifts some anxiety from workers, supports consumption, improves mobility between firms and sectors, and helps re-direct individual skills into more productive employment. Well-defined, non-discretionary assistance, conditional upon engaging actively in a job search – stronger controls being essential here – increases people's sense of security, gives their life-plans substance, and makes it less necessary to save for a rainy day; it narrows the disparities between workers with and without safeguards.

In a welcome move, the Government has already included temporary income support among its anti-crisis measures, including in the case of shut-downs in companies not covered by the Wage Supplementation Fund. It has also made provision for experimental measures in favour of some quasi-employees.

The time is ripe for a rigorous, comprehensive reform that will rationalize the current system of social buffers and provide more universal benefits. There is no need to overturn the existing system. It can be re-designed around the two traditional instruments of the ordinary Wage Supplementation Fund and unemployment benefits, suitably adjusted and graduated. These should be accompanied by income support for the cases they do not cover, as happens almost everywhere else in Europe and as proposed in the Government White Paper. A form of tax credit could be considered for those on low wages: this system has been successfully adopted in many countries and could help to regularize informal employment.

Among the anti-crisis measures for the productive system, priority must go to action to ease firms' financial problems, such as the plan of intervention being drawn up with the assistance of Cassa Depositi e Prestiti and SACE, the export credit insurance agency. Additional and more direct support could be provided by cutting payment times for general government trade payables, which amount to about 2.5 per cent of GDP. A further move would be made in this direction by temporarily suspending the requirement to pay into the National Social Security Institute, INPS, the part of contributions to severance pay not allocated to a pension fund, amounting annually to 0.3 percentage points of GDP. While both actions would entail greater recourse to the financial markets, neither would worsen the central government's net financial position.

Measures to stimulate private investment in residential property, which it is hoped will be introduced in suitable form very shortly, will assist the recovery of capital accumulation. Existing building work should be completed at the earliest opportunity and encouragement should be given to local projects, many of which are fairly small and could be launched without delay.

The adjustment of the public finances and structural policies

The recession is slowly producing an effect on the tax yield: having decelerated for most of 2008, it fell during the last two months. VAT receipts decreased by 1.5 per cent in the year as a whole, compared with an increase of 2.3 per cent in consumption, partly due to the shift towards essential goods carrying a lower rate. In the first four months of this year, VAT receipts were down 10 per cent on the same period of 2008. Revenue from corporate income tax, which dropped by more than 9 per cent in 2008, could fall by a still larger amount this year. Only the revenue from personal income tax is holding up.

The action of built-in stabilizers is likely to raise the public deficit by around 2 percentage points this year, to more than 4.5 per cent of GDP. In 2010 the deficit could exceed 5 per cent.

Even without additional measures to support the economy, by the end of the crisis the public debt will have increased considerably in terms of GDP, back to the levels of the early 1990s. The ratio of primary current expenditure to GDP, which in 2008 reached the highest value recorded since the Second World War, will rise by 3 percentage points in 2009. Total public expenditure will be well over 50 per cent of GDP, and unless steps are taken it will tend to stay at that level in the years to come. There is a danger that the economy will have to bear the burden of extremely heavy taxation for many years.

After the crisis has been overcome, Italy will find itself not only with more public debt but also with an endowment of private capital – physical and human – impoverished by the sharp drop in investment and the rise in unemployment. If we were to do no more than return to a low growth path like that of the past 15 years – starting, moreover, from decidedly worsened conditions – it would be difficult to pay down the debt, while the necessity for restrictive policies to ensure its sustainability would become more stringent. We must aim, immediately, at achieving faster growth in the medium term. It is necessary to act on two fronts: to ensure the consolidation of the public finances and to implement the long-awaited reforms that will enable our economy to be an active partner in the world economic recovery.

The measures reducing current expenditure must be introduced into legislation immediately, even if the effects are deferred, not put off to further legislative acts or administrative decisions. In many cases this simply means proceeding more resolutely on the courses already embarked upon.

The gradual raising of the average age at retirement will guarantee adequate pensions. A higher employment rate among those between the ages of 55 and 65 will increase both households' disposable income and the economy's potential output.

In 2008 occupational pension funds recorded negative yields of 6 per cent and open funds lost 14 per cent. These results must not induce us to modify the process launched in the early 1990s to foster the development of a second, funded retirement pillar. In the long run a mixed system is preferable to a straight pay-as-you-go system. Nevertheless, some adjustments and additions may be advisable. It is necessary to encourage the introduction of products that automatically diminish the riskiness of portfolios as retirement nears and to offer securities allowing for better management of risks over the long term.

The implementation of fiscal federalism must make a contribution to curbing government expenditure. By strictly linking spending and taxation decisions, without forgoing the principle of solidarity, it can lead to more efficient use of public resources. A crucial feature of the reform enacted by Parliament is the replacement of historical expenditure by standard costs as the criterion for the assignment of resources to local authorities. Until now the reference to historical expenditure has made public budgets more rigid, institutionalizing inertial mechanisms in expenditure trends.

Much is expected from the planned reform of the public administration. The breadth of the plan, the emphasis it places on transparency and on the measurement of government performance and the recognition of merit are all important elements of change. The efficacy of the reform will depend on the design of evaluation systems and on the organizational rules adopted.

Progress has been made in simplifying and reordering regulations and in reducing red tape, in particular for business start-ups. Yet new regulatory provisions continue to be both complex and opaque. The bureaucratic costs for business activity remain high, with substantial differences from region to region.

Regulatory simplification and effective public action are necessary conditions for reducing the incidence of the underground economy, which is estimated to account for more than 15 per cent of overall economic activity in Italy. The concealment of a considerable proportion of the tax base increases the burden on law-abiding taxpayers. It undermines the competitiveness of the majority of firms, creates inequities and disrupts the social fabric. Progress in fighting underground economic activity would make it possible to lower official tax rates, attenuating distortions and unfairness.

It is necessary to improve the quality and increase the quantity of human capital and physical infrastructure. Last year on this occasion I dwelt on the urgent need to elevate educational attainment in our schools and universities. The drive for reform in this area must proceed and intensify. Physical infrastructure is a crucial factor in competitiveness. In the last twenty years the gap between Italy's infrastructural endowment and that of the other leading EU countries has more than tripled. As regards major public works, the failure to set long-term priorities has resulted in discontinuity and the dissipation of funds on a multitude of projects. The list of high-priority strategic infrastructures, originally 21, has now swollen to over 200. The time and the costs for high-speed rail lines and motorway network extensions, and even for short road links and bypasses, are far greater than in other European countries. A kilometre of motorway can cost over twice as much as in France or Spain. The causes are the uncertain attribution of powers and jurisdiction between national and regional government, poor initial cost estimation and shortcomings in reporting and continual project alterations. Regulatory defects limit recourse to project financing.

The process of liberalization undertaken in years past must not halt or retreat. In the countries where services are less liberalized, the growth problems of technologically advanced industries are more severe. Local public services are an example of the way in which the absence of regulation entrusted to bodies that are competent and independent of the service providers can engender inefficiency and higher costs for consumers.

The crisis and the banks

In the recent past the Italian banking system underwent a major transformation, spurred by heightened competition. A large number of mergers and acquisitions, by increasing the average size and efficiency of Italian banks, helped to improve their resilience in the face of the crisis.

The crisis caught the Italian banking system at a time when reorganizations were being completed, new forms of governance were being tested and the presence in foreign markets was being expanded. The system remains characterized by the clear prevalence of credit intermediation activity in favour of households and firms, strong local roots and a generally balanced structure of assets and liabilities.

The impact of the crisis on the banks has been less traumatic in Italy than in other countries, thanks above all to a limited exposure to structured finance products and lesser reliance on wholesale funding. At the end of 2008 structured credit instruments represented just under 2 per cent of the assets of the main banking groups. Wholesale funding made up 29 per cent of total funding for our system, against an average of 41 per cent in the euro area.

A fundamentally sound model of intermediation, together with a particularly prudent regulatory framework and supervisory approach, has shielded Italian banks from the most devastating effects of the market turbulence. Taxpayers have not been saddled with the costs of losses and bankruptcies seen in other countries.

The banking system is not immune to the consequences of the crisis, however. Italian banks' profits contracted sharply in 2008. The return on equity of the largest groups fell by 5 percentage points.

Lending rates have come down rapidly since October. The average initial rate on new variable-rate mortgage loans to households declined from 5.6 per cent to stand at 3.7 per cent in March. Interest rates for fixed-rate mortgages have also fallen swiftly; the differential that still existed at the beginning of last year between Italy and the euro-area average has narrowed considerably. For short-term loans to firms, the reduction in rates between October and March averaged about 2 percentage points. But it is also true that the risk and rate differentials between borrowers have widened: the difference between the cost of new loans of limited amount and that of high-value transactions has grown; the disparity in borrowing costs between small and large firms has increased. Those now in greatest need of credit suffer from this.

Bad debts and loans classified as "substandard", that is to say in temporary repayment difficulty, are growing rapidly. The lesson of experience is that the recession will continue to affect loan quality even two or three years after the cyclical upturn.

In Italy, unlike other large countries, writedowns to loans are immediately tax deductible only up to 0.3 per cent of the amount of total lending; the portion exceeding that amount is deductible over 18 years. The rule becomes especially stringent in this recessionary phase, in which the pressure to curtail lending in order to satisfy capital requirements is mounting.

Banks' capital

Despite the decline in profitability, banks have maintained capital above the minimum standards. The average ratio of capital to risk-weighted assets was 10.4 per cent for the largest groups at the end of last year. The higher ratios found abroad often reflect massive injections of public capital. By international standards, leverage, measured by the ratio of total assets to core capital, is lower in Italy.

The Bank of Italy assesses capital adequacy with stringent criteria. Instruments of lesser quality make up 13 per cent of the core capital of the five largest Italian banking groups, compared with 22 per cent for the 15 largest euro-area banking groups.

Stress tests, which evaluate resilience in the face of markedly unfavourable economic developments, have become a practice in supervisory action since 2005, when the International Monetary Fund conducted its Financial System Stability Assessment for Italy.

We have just completed an aggregated exercise to estimate the impact on banks' balance sheets of a deterioration in the quality of credit exposures to Italian households and firms in the two years 2009-10 under assumptions of more adverse macroeconomic conditions than those foreseen for Italy by the main international organizations.

The results of the exercise indicate our banking system's ability to hold up, even under more adverse scenarios.

But I have already let it be known on several occasions that capital strengthening is a priority for the banking system. It is not only a question of increasing the buffers safeguarding stability. Capital strengthening is essential in order to compete with the leading intermediaries; it is also a necessary although not sufficient condition to maintain the flows of credit to the economy.

This is why in the present phase it is also necessary to limit the distribution of profits. Many banks have done so. The sacrifice shareholders are being asked to make today is compensated for by the greater solidity of their investment.

The markets have reacted positively. Compared with mid-March, the premiums on the credit default swaps of the largest Italian banks have fallen by more than half, a significantly greater decline than the average reduction recorded in Europe.

The effort must continue. The public instruments for capital strengthening envisaged by law are now available. The intervention of the state is temporary; the private shareholders will have to replace the public funds as soon as market conditions permit.

* * *

These concluding remarks were written in the throes of a general crisis that has catapulted the world into perhaps its gravest difficulties since the middle of the last century. The wound that has been inflicted upon the public confidence – confidence in the markets and their protagonists, in the future of millions of people, in the social compact that binds us together – has to be healed.

Overcoming the crisis means rebuilding that confidence. Not by means of artifices but with the patient, laborious effort to understand what has happened and what future scenarios are possible; and with the consequent action. Much has been done. It is not the work of a day. Much remains to be done: to create jobs again, to restore vitality to firms, to repair the financial markets, to earn the citizens' trust.

The Bank of Italy, both at home and in international fora, is engaged in improving the regulatory framework and detecting the vulnerabilities and risks of banking and financial business. We shall continue to improve supervision. We must progress in our action to safeguard a system that so far – thanks in part to that action – has withstood the crisis better than others.

Every country faces the crisis with its own special strengths and its weaknesses, its own history. There is a national aspect to the response: for Italians, the repercussions will be more or less severe depending on our own choices. In the last twenty years our story has been one of stagnant productivity, low investment, low wages, low consumption and high taxes. We must lift our gaze from the present woes to take the longer view. An effective response to today's emergency is possible only if it is accompanied by the sort of conduct and reforms that can raise our growth above the low path of recent decades.

Italian banks' balance sheets are not weighed down by a legacy of impaired assets. Let them exploit this advantage over their competitors to face a present and a future that will not be easy; show foresight in assessing their customers' creditworthiness; follow the example of the bankers who financed the reconstruction and the economic boom of the 1950s and 1960s. Let firms strive to continue the rationalization they began just a few years ago; safeguard the accumulated skills of their workers, which will be invaluable again in what we hope is a not too distant future. The completion of the country's social buffers, the resumption of public investment and the actions to sustain demand and credit that have been outlined today will have the desired effects if they are coupled with structural reforms – not just in order to be able to tell the markets that the deficit is under control, but because these reforms are the foundation for future growth.

Confidence cannot be rebuilt with false hopes. But neither can it be restored without hope. Surely we can emerge from this crisis stronger than before.

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 income statement and the notes to the accounts. Amounts are presented in euros in the accounts and in thousands of euros in the tables of the notes to the accounts.

In February the Bank sends the balance sheet to the European Central Bank for consolidation with the accounts of the other Eurosystem central banks.

The draft annual accounts are transmitted to the 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 2008 that influenced the Bank's operations and had an impact on the accounts. In addition to the Annual Report, the instruments used by the Bank to report on its activity are: the *Relazione al Parlamento e al Governo*, the *Bollettino di Vigilanza*, and periodic and occasional testimony before Parliament by the Bank's highest officers.

[1] This abridged English version of the Bank's annual accounts does not contain all the information required by law in the Italian version, 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 2008 – which saw the merger of the UIC pursuant to Legislative Decree 231/2007 – closed with a net profit of €175 million (€95 million in 2007). The gross profit before tax and the allocation of €176 million to the provision for general risks was equal to €679 million (€422 million in 2007). Direct taxes for the year amounted to €328 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, comprising 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

On 1 January 2008 the UIC was merged into the Bank of Italy pursuant to Legislative Decree 231/2007, with the transfer of the related functions and human, instrumental and financial resources.

The Bank of Italy took the place of the UIC in performing controls and keeping the registers of financial intermediaries referred to in Article 106 of the Consolidated Law on Banking and of other intermediaries. The UIC's statistical tasks were taken over without a break, as was the management of the external collection and payment services in euros and foreign currency with non-EMU countries on behalf of government departments and other public entities. The UIC's mandate to manage a part of the Bank's foreign exchange reserves had already been revoked at the end of 2007.

Legislative Decree 231/2007 also provided for the creation of Italy's Financial Intelligence Unit at the Bank with the duty of preventing and countering money laundering and terrorist financing; the decree provides for the Unit to enjoy autonomy and independence in the exercise of its tasks.

Last year saw further progress in the restructuring of the Bank's organizational arrangements.

A start was made on the plan for pruning the branch network, which provides for the closing by the end of 2009 of 39 branches, of which 6 will be turned into specialized supervision units. Between the second half of 2008 and the early months of 2009 a total of 18 branches closed.

The fundamental criteria upon which the new territorial model is based are: the concentration of activity at the branches located in regional capitals; attention to specific local features by keeping a second full-service branch in regions with special economic, financial, social and territorial features; the satisfaction of specific functional needs in terms of "demand for services", with the establishment of units specialized in handling notes and coins or supervision; and the maintenance of a balanced territorial distribution of the Bank's structures.

Last year also saw further significant interventions at the Bank's Head Office. The reorganization of the supervision function took effect, aimed at improving its ability to oversee the banking system in the face of new risks, providing more effective forms of protection of savings, increasing the effectiveness of controls, strengthening collaboration with foreign authorities and the coordination of controls.

The reorganization of the central banking and markets area and the payment system and treasury services area was carried out, with the creation of a single area – called Central Banking, Markets and Payment Systems – in view of the high degree of integration between the various functions and the growing need for domestic and international coordination.

The plan for the reform of the IT function was drawn up and a start made on its implementation at the beginning of 2009. The new organizational solutions are intended to keep abreast of innovation and to meet the needs of the various categories of users with solutions more closely focused on the type of demand.

Human and IT resources

In the field of human resources the objective of efficient corporate management continued to be accompanied by that of making good use of the existing endowment of skills. At 31 December 2008 the Bank had 7,755 employees: 4,433 assigned to the Head Office and 3,322 to the branch network. Managers and officers made up, respectively, 8.6 and 18.7 per cent of total personnel. The staff's average age was 48.7 years. About one third of all employees were women.

The increase of 355 in the total number of staff compared with the end of 2007 was due to the addition of the employees of the UIC, 450 at 1 January 2008, and the hirings and terminations during the year. In fact in 2008 there were 113 new appointments (77 men and 36 women, of whom 7 were employees reappointed after taking a competitive exam), 61.9 per cent of which served to meet technical or specialist requirements. Of the 201 terminations, about 15 per cent refer to branch employees who accepted early retirement in the first closures.

The implementation of the Bank's reorganization plans is likely to alter the size and distribution of its staff. It is expected that when it is completed there will be a further reduction in the number of employees and a shift in their distribution in favour of functions of an institutional nature.

Table 22.1

Composition of the Bank's staff

	At 31 December 2008					At 31 December 2007				
	Men	Women	**Total**	At branches	At Hed Office (1)	Men	Women	**Total**	At branches	At Hed Office (1)
Managers	534	131	**665**	181	484	485	117	**602**	197	405
Officers	974	472	**1,446**	407	1,039	900	413	**1,313**	429	884
Coadjutors	777	509	**1,286**	557	729	747	449	**1,196**	590	606
Other	2,916	1,442	**4,358**	2,177	2,181	2,918	1,371	**4,289**	2,293	1,996
Total	**5,201**	**2,554**	**7,755**	**3,322**	**4,433**	**5,050**	**2,350**	**7,400**	**3,509**	**3,891**

(1) Includes personnel assigned to representative offices abroad and seconded to other organizations. For 2008 includes former UIC staff.

The measures in the agreements signed on 26 June 2008 with the trade unions for staff involved in the reorganization of the branch network provide for eligible employees who wish to retire early (337) to receive incentives and for those who opt to be transferred to other branches to receive relocation allowances.

Training involved 4,920 employees in 2008 (63.4 per cent of the staff), of which 3,126 men and 1,794 women. Overall there were 12,502 participations in courses and 166,174 hours of training, corresponding to 33.8 hours per participant. Distance training methods were used for 26.3 per cent of the total hours of training.

Information technology plays a particularly important role in support of the Bank's institutional activity. Last year was marked by important projects at European and national level and numerous special initiatives related to the Bank's reorganization plan.

As part of the development of the infrastructure of the European payment system, the Bank's IT function played an active role in Italy's migration to the new centralized Single Shared Platform (SSP). After the launch of the Single Euro Payments Area (SEPA), designed to harmonize the electronic payment instruments in the participating countries, applications were built to provide access to the banks participating in the Italian BI-Comp system to the STEP2 retail settlement platform.

In 2009 work has continued on strategic projects in support of both institutional and corporate activities. At European level, special importance attaches to the commitments in relation to: a) the design of the new securities settlement system, TARGET2-Securities, in conjunction with the central banks of France, Germany and Spain; and b) the creation of new application functionalities for the new TARGET2 system. Another especially important plan is that for the upgrading of the national procedures with a view to the Bank's joining the Collateral Central Bank Management (CCBM2) common platform for the management of assets conferred to guarantee Eurosystem credit operations. As regards corporate activities, a new document management procedure will shortly be launched that will allow information of interest to the Bank to be handled in conformity with the Digital Administration Code.

Pursuant to Article 128-*bis* of the Consolidated Law on Banking and the Credit Committee Resolution of 29 July 2008, an IT system is under construction to support the out-of-court settlement of disputes between banks and financial intermediaries and their customers.

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. The Bank is committed to improving the expenditure process and raising its effectiveness and efficiency. In this context the Bank of Italy issued a measure on 11 February 2009 (published in *Gazzetta Ufficiale* no. 47 of 26 February 2009) that regulates controls on the acts involved in its administrative procedures for the award of contracts for works, supplies and services and the functioning of the internal bodies charged with carrying out the controls.

The amount of commitments for goods and services was considerably affected in 2008 by IT projects (in the first place the launch of TARGET2), the decisions taken at European level on the share of banknote production entrusted to the Bank of Italy, which entailed the purchase of some banknotes, and real-estate projects.

The budget for 2009 approved by the General Council shows an increase in allocations compared with the previous year. The overall trend of expenditure is affected by the reorganization of the branch network and some factors of an extraordinary nature, such as the increase in the production of banknotes on the basis of the share entrusted by the Eurosystem to the Bank of Italy and the implementation of the plans for the complete automation of the handling of notes and coins at branches.

Note issue

The Bank participates in the activity of the Eurosystem aimed at preparing a second series of euro notes and in the drafting of common guidelines for the quality of the banknotes in circulation and measures against counterfeiting.

The management of notes and coins continues to be affected by the action implementing the policies adopted by the Eurosystem and intended to achieve a greater degree of convergence in the activity of the national central banks. The reorganization of the Bank's territorial configuration, with the creation of branches specialized in handling notes and coins, is an innovation that will produce benefits in terms of the system's overall efficiency.

In 2008 the Bank of Italy produced 1.1 billion banknotes in €20, €50 and €100 denominations. It put 2.3 billion banknotes into circulation, for a total value of €89.2 billion. The return flow to the Bank amounted to 2.1 billion banknotes worth €78.2 billion; most of these notes were selected automatically at the Bank's branches.

The level of demand for euro banknotes typical of the last few years has attained a structural nature, in view of the widespread use of the Community currency and the considerable need to replace worn notes; it has been confirmed by the even larger quantities expected for 2009. The production of banknotes is set to increase in the coming years as well, in relation to the demand deriving from the issue of the second series of euro notes. In order to meet the growing demand, a plan has been drawn up to bring the Bank's production capacity into line with the expected requirement. Pending the implementation of the plan – which in some respects has called for negotiations with trade unions – it became necessary in 2008 to acquire a limited quantity of notes from the printing works of the Austrian central bank in order to fulfil the Bank's obligations vis-à-vis the Eurosystem.

The value of the banknotes in circulation at the end of 2008 amounted to €139.5 billion (18.3 per cent of the Eurosystem total) and was up by 8.6 per cent from €128.5 billion at the end of 2007; the amount recorded in the accounts (€126.2 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 is assigned by law to the Bank of Italy. The reserves make it possible to service the Italian Republic's foreign currency debt and meet its commitments to international organizations such as the International Monetary Fund. In addition, since the nation's official reserves are an integral part of the Eurosystem's reserves, their overall level and proper management contribute to safeguarding the credibility of the European System of Central Banks. The Bank also manages a part of the reserves transferred to the ECB; in this activity it refers to guidelines laid down by the Governing Council. 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.

Table 22.2

Composition of the reserves (1) *(millions of euros)*	31.12.2008	31.12.2007 (2)
US dollars	22,192 (3)	14,214
Pounds sterling	4,234	5,129
Japanese yen	4,739	3,593
Swiss francs	229	241
Other currencies	2	4
Gold	48,995	44,793
Net assets vis-à-vis the IMF (includes SDRs)	1,014	410
Total	**81,405**	**68,384**

(1) The reserves, valued at market exchange rates and prices, include the official reserves (gold and claims on non-euro-area residents denominated in foreign currency) and claims on euro-area residents denominated in foreign currency; foreign currency claims are shown net of foreign currency liabilities. The reserves do not include financial assets (shares of ETFs and units of collective investment undertakings) denominated in foreign currency representing the investment of ordinary and extraordinary reserves, provisions and other capital funds, as they constitute a separate foreign currency item. – (2) For the sake of comparison, the data for 2007 include the balances of the UIC. The reserves coming from the UIC included €9 million of US dollars, €3 million of pounds sterling, Swiss francs for €2 million, yen for €1 million and other currencies for €3 million. – (3) Includes reverse operations in US dollars, carried out under the US dollar Term Auction Facility programme, for €6,141 million (€94 million in 2007).

At 31 December 2008 the gold and foreign currency reserves were worth €81.4 billion, compared with €68.4 billion a year earlier (including the net foreign currency assets of the UIC, equal to €18 million). The increase mainly reflected the 9.4 per cent rise in the price of gold, which increased the value of the stock by €4,202 million, and reverse foreign currency operations with Eurosystem counterparties as part of the US dollar Term Auction Facility programme (+€6,047 million compared with the end of 2007). The appreciation of the dollar and the yen had a positive effect, while the depreciation of the pound sterling had a negative effect. 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. The composition of the reserves is approved by the Governing Board.

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 severance pay and pension provisions for staff hired before 28 April 1993. 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 2008 the book value of the portfolio was €88 billion, compared with €91.7 billion at the end of 2007 (including the portfolio of the UIC, equal to €2.4 billion). The decrease, concentrated in the equity component, was primarily due to the fall in share prices owing to the financial crisis. The portfolio was invested mainly in bonds (especially Italian and other euro-area country government securities) and equities (primarily listed in the euro area).

The General Council decides whether securities are to be booked as held to maturity or as held for trading. The bulk of the portfolio (89 per cent) consists of securities held to maturity and therefore is valued at cost. If all marketable financial instruments were valued at market prices, the value of the portfolio would be €90 billion.

Table 22.3

Composition of the financial portfolio
(millions of euros)

Items	31.12.2008	31.12.2007 (1)
Government securities	82,281	82,958
Shares and participating interests	4,573	7,726
Convertible bonds and warrants	23	25
Other bonds	231	396
ETF shares and units of collective investment undertakings	845	603
Total	**87,953**	**91,708**

(1) For the sake of comparison, the data for 2007 include the balances of the UIC. The portfolio coming from the UIC included €2,430 million of government securities and €11 million of other bonds.

Further progress was made in 2008 on the geographical diversification of the equity portfolio by reducing the domestic component to the benefit of foreign shares.

The Bank also manages the investments of the defined-contribution pension fund for staff hired since 28 April 1993. Its investments and earmarked estate are included in the Bank's books. The fund constitutes a separate estate for administrative and accounting purposes. Investments are made observing benchmarks. At 31 December 2008 the fund's net assets in the Bank's balance sheet amounted to €106 million. Returns on assets and exposure to risk are measured daily.

Financial risks

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 assigned to the national central banks under Eurosystem regulations, and of the assets offered as collateral for any extraordinary financing operations.

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. The effects of the latter on the prices of portfolio securities are monitored on a daily basis, with limits set on the duration of the portfolio with respect to the tactical and the strategic benchmarks. The Value at Risk (VaR), computed in both euros and foreign currency, is also monitored daily. Credit risk is controlled by means of a prior assessment of the soundness of eligible counterparties, which include sovereign states (the United States, Japan, the United Kingdom and Switzerland), agencies, supranational bodies and banking counterparties. For the last three categories there exist individual limits, which are checked daily. The liquidity of the reserves is guaranteed by limits on maturity and category. Regarding the former, instruments issued by commercial banks may have a maximum maturity of one month in the case of deposits and of three months in the case of commercial paper. Regarding the latter, which are also monitored daily, there are investment ceilings that limit the amount of deposits and investments with supranational counterparties and agencies. The financial position is determined by setting strategic and tactical benchmarks and limits on the deviation of the portfolios' duration with respect to that of the benchmarks.

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. Various measurements of risk are employed and 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. 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 on capital (conditional loss).

Market developments and investments made in 2008 partially altered the composition of the Bank's portfolio of financial assets. The reduction in the proportion of shares and the increased diversification of the bond component helped to reduce its implicit riskiness. However, the indicators still point to an increase in risk due to the present phase of pronounced financial market volatility and uncertainty.

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 General Documentation. 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.

The difficult situation of the money and credit markets during 2008, particularly from September on, induced the Eurosystem to make significant changes in the operational framework of monetary policy. Swaps in dollars and Swiss francs were introduced, in coordination with the Federal Reserve and the Swiss National Bank. Financing in dollars through the US dollar Term Auction Facility increased, as operations were conducted having overnight, one-week and three-month maturities as well as the original 28-day maturity. Both the frequency and the maturity of financing operations in euros increased and the maturity of longer-term operations was diversified: a one-month maturity (coinciding with each maintenance period) and a six-month maturity were added to the existing three-month maturity. Changes were made to the methods of tender allotment: from October 2008 variable rate tenders, with a pre-specified allotment amount, were replaced by fixed rate tenders with full allotment. Moreover, variable rate tenders were introduced for fine-tuning deposits, replacing the previous system of fixed rate tenders. The total volume of ECB refinancing increased significantly in the course of 2008, initially as a result of the policy of allotting liquidity far in excess of the "reference" amounts and subsequently with the changeover to full allotment tenders. Italian banks stepped up their participation in Eurosystem operations, in terms of both number of tenders and volume of liquidity requested. As a result of the ECB's increased use of longer-term facilities, the average maturity of refinancing operations also changed: in the second half of 2008, 63 per cent of total refinancing in euros had a maturity of more than one week, compared with 56 per cent at the beginning of the year (and just 35 per cent in the second quarter of 2007). In Italy, main refinancing operations are still preferred, although recourse to longer-term facilities has increased markedly compared with the pre-crisis period.

According to Article 18.1 of the ESCB Statute, every financing operation by the Eurosystem must be secured by eligible collateral. The increase in refinancing to the banking system during 2008 led to a sharp rise in the volume of collateral provided. As the financial market turmoil grew, the ECB Governing Council decided, on 15 October to extend temporarily the list of eligible assets. The eligibility of the collateral is verified by the risk control measures set out in the General Documentation and in the case of temporarily eligible assets by the measures decided by the Governing Council. 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 risk exposure of the Eurosystem, and hence also of the Bank of Italy, grew significantly during 2008 as a result of combined quantitative and qualitative effects.

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 in the closing months of 2008, although the latter began operating in 2009. Under the securities loan facility 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 transactions: 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. The Collateralized Interbank Market 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. 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.

Internal control and operational risk

The Bank of Italy's internal control 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 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

Against the background of growing international attention to environmental problems, the Bank of Italy has studied and implemented measures to reduce the environmental impact of its activity. A further objective has been to reduce costs in some sectors, notably by rationalizing the consumption of energy and natural resources. The Bank has identified five priority areas of action within its global strategy: rational use of resources, efficient waste management, sustainable mobility, "green" purchases, and promotion of environmental awareness, including among those with whom the Bank has dealings.

A number of initiatives were launched during 2008, particularly with regard to energy saving, reduced paper consumption, waste sorting, insertion of ecological clauses in contracts, and personnel training in environmental issues.

In the field of health and safety, with the continuous evolution of regulations, rapid scientific and technological progress, and organizational changes in production processes there is a need for permanent monitoring and constant amendment of workers' safeguards, particularly measures relating to health protection. Safety plans are drawn up periodically for this purpose, using a risk evaluation system designed to ensure completeness, measurable results, and flexible and efficient communication and to support transparent and joint decision-making in the management of workplace safety.

In addition to the ordinary activities of prevention and protection, detailed studies were made in 2008 of the rules introduced by Legislative Decree 81/2008 concerning occupational health and safety and of the new types of risk identified by the decree. Internal instructions were also issued concerning the safety requirements associated with contracts for the supply of works and services, with particular regard to the drafting of the "interference risk evaluation document" and to the quantification of costs for safety.

Balance-sheet highlights

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 2008 profit before tax and the change in the provision for general risks came to €679 million (€422 million in 2007). The result does not include the return on investments of the ordinary and extraordinary reserves (€143 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 profit on ordinary operations, consisting of interest and dividends, increased by €494 million (from €3,893 million to €4,387 million), as a result both of the improvement in net interest income (+€287 million), due mainly to the increase in the average stock of earning assets, and of the increase in ECB dividends (+€204 million) as a consequence of the restitution to the Bank, in the form of a dividend prepayment, of a part of the seignorage earned on the share of the note issue conventionally assigned to the ECB (in 2007 the ECB retained all this seignorage).

The contribution from trading and the valuation of financial positions in euros and foreign currency was again negative (-€982 million), but better than that recorded in 2007 (-€1,938 million). The result for 2008 reflected the depreciation of the pound sterling, which resulted in a €1,222 million foreign currency valuation loss and reductions in the prices of securities, especially equities, that gave rise to €237 million of valuation losses. A net positive contribution of €477 million came, by contrast, from financial transactions, especially trading in dollar-denominated securities and in equities.

Profit before tax was adversely affected by the transfer, in accordance with the decision of the Governing Council of the ECB, to a provision against counterparty risks in Eurosystem monetary policy operations. On the basis of the principle of prudence and pursuant to Article 32.4 of the Statute of the ESCB, the Governing Council has deemed it appropriate to establish a buffer totalling €5,736 million, with the participation of all the euro-area national central banks according to their share of the ECB's capital. The share of the Bank of Italy, amounting to 17.9776 per cent of the total, was €1,031 million.

Table 22.4

Summary of the annual accounts - Reclassified (1)
(millions of euros)

VOCI	Balance-sheet aggregates	Income statement			
		Interest and dividends	*Results and writedowns*	*Other components of income*	*Contribution to net profit*
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 banks	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 income, net		*-22*		*415*	*393*
Operating expense and other costs				*-2,049*	*-2,049*
Transfer to a provision in respect of monetary policy operations				*-1,031*	*-1,031*
Extraordinary income and expense				*-61*	*-61*
Appropriation of investment income to reserves under Article 40 of the Statute		*-478*	*335*		*-143*
GROSS PROFIT		**4,387**	**-982**	**-2,726**	**679**
Allocation 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**
2007 FINANCIAL YEAR					
Gold	44,793				
Position in foreign currency	23,572	*1,123*	*-1,945*		*-822*
Portfolio of financial assets	90,247	*3,676*	*43*		*3,719*
Lending to euro-area banks	28,070	*772*			*772*
Net intra-Eurosystem claims	26,777	*693*			*693*
Banknotes in circulation	-112,213				
Deposits for minimum reserve system	-35,071	*-844*			*-844*
General government deposit	-9,716	*-1,027*			*-1,027*
Revaluation accounts	-29,976				
Capital, reserves and provisions	-30,187				
Other income, net		*-8*		*118*	*110*
Operating expense and other costs				*-1,687*	*-1,687*
Extraordinary income and expense				*36*	*36*
Appropriation of investment income to reserves under Article 40 of the Statute		*-492*	*-36*		*-528*
GROSS PROFIT		**3,893**	**-1,938**	**-1,533**	**422**
Transfer from the provision for general risks				*1,284*	*1,284*
Taxes on income for the year and productive activities				*-1,610.5*	*-1,610.5*
NET PROFIT		**3,893**	**-1,938**	**-1,860**	**95**

(1) The balance sheet data refer to the end of the year. The data are reclassified as follows: the position in foreign currency includes the securities and other assets denominated in foreign currency (Items 2 and 3 on the assets side) net of the corresponding liabilities (Items 6, 7 and 8 on the liabilities side); the 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 11.3. It also includes the participating interest in the ECB (Item 9.1) and the UIC endowment fund (Item 11.2); the intra-Eurosystem claims (Items 9.2 and 9.4 on the assets side) are shown net of the debt related to the adjustment of the circulation (Item 9.2 on the liabilities side); with reference to balance-sheet aggregates that include shares and other equity, the column *Interest and dividends* includes income from ETF shares and units of collective investment undertakings; net income from fees and commissions, the pooling of monetary income and other withdrawals from provisions are included under *Other income, net.*

Other net income increased by €283 million, basically owing to the better net result of the pooling of monetary income; operating expense and other costs grew by €362 million, owing to the increase in the staff following the merger with the UIC, the larger transfer to the severance pay and pensions provisions as a consequence of the updating of the mortality tables used to calculate the mathematical provisions and the pay increases deriving from the renewal of the staff labour contract.

Extraordinary income and expense showed a negative balance of €61 million and included the transfer of €59 million to a provision for early retirement incentives connected with the reorganization of the branch network.

The General Council approved the transfer of €176 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 €328 million (€1,610 million in 2007). Consequently net profit for 2008 amounted to €175 million (€95 million for 2007).

The year-end balance-sheet total rose by €23,054 million to €267,431 million. On the assets side, in particular, there were increases in the refinancing of credit institutions and foreign currency assets, the latter largely owing to temporary transactions in dollars under the US dollar Term Auction Facility; by contrast, intra-Eurosystem claims contracted. On the liabilities side the deposits of banks decreased while liabilities to general government and banknotes in circulation increased. The UIC merger resulted in an increase of €2,196 million in reserves.

Post-balance-sheet events

As of 1 January 2009, following the five-year revision and the entry of Slovakia into the euro area, the Bank of Italy's share of the capital of the ECB, considering only the Eurosystem national central banks, has declined from 17.9776 to 17.9056 per cent. This percentage is used in financial transactions between the Bank of Italy and the other Eurosystem central banks, such as the distribution of the ECB's net profit.

In March 2009 the Bank completed the ninth 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 2009 the exchange rates of the US dollar and the pound sterling against the euro stood at $1.3275 and £0.8934 respectively, an appreciation compared with the values obtaining at the end of 2008 ($1.3917 and £0.9525). By contrast the yen depreciated, its exchange rate against the euro falling from ¥126.14 to ¥130.34.

The earthquake in Abruzzo on 6 April 2009 led to the suspension of activity at the Bank's branch in L'Aquila. The premises of the branch suffered only minor damage. The other buildings owned by the Bank in the city and rented out are being surveyed to estimate the amount of damage they have suffered. The total balance-sheet value of the above-mentioned buildings is €31 million.

BALANCE SHEET AND INCOME STATEMENT
for the year ended 31 December 2008

BALANCE SHEET

ASSETS	Amounts in euros 31.12.2008	Amounts in euros 31.12.2007	
1 GOLD AND GOLD RECEIVABLES	**48,995,407,036**	**44,793,359,278**	
2 CLAIMS ON NON-EURO-AREA RESIDENTS DENOMINATED IN FOREIGN CURRENCY	**26,646,915,328**	**19,276,461,391**	
2.1 Receivables from the IMF	1,790,146,957	1,163,950,124	
2.2 Securities (other than shares)	22,875,908,700	14,661,776,735	
2.3 Current accounts and deposits	1,938,236,284	3,352,466,453	
2.4 Reverse operations	39,234,949	95,177,954	
2.5 Other claims	3,388,438	3,090,125	
3 CLAIMS ON EURO-AREA RESIDENTS DENOMINATED IN FOREIGN CURRENCY	**6,952,216,251**	**5,052,179,843**	
3.1 Financial counterparties	6,952,216,251	5,052,179,843	
3.1.1 Securities (other than shares)	*321,818,532*	*425,939,892*	
3.1.2 Reverse operations	*6,140,968,671*	*93,846,118*	
3.1.3 Other claims	*489,429,048*	*4,532,393,833*	
3.2 General government	–	–	
3.3 Other counterparties	–	–	
4 CLAIMS ON NON-EURO-AREA RESIDENTS	**8,519,610**	**1,000,000**	
4.1 Claims on non-euro-area EU central banks	–	1,000,000	
4.2 Securities (other than shares)	–	–	
4.3 Other claims	8,519,610	–	
5 LENDING TO EURO-AREA BANKS RELATED TO MONETARY POLICY OPERATIONS	**50,344,218,525**	**28,070,383,588**	
5.1 Main refinancing operations	12,979,778,198	22,222,181,834	
5.2 Longer-term refinancing operations	36,975,612,330	5,848,201,754	
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	6,218,380	–	
6 OTHER CLAIMS ON EURO-AREA BANKS	**154,259,813**	**10,244,660**	
7 SECURITIES ISSUED BY EURO-AREA RESIDENTS (other than shares)	**41,227,623,953**	**38,868,175,415**	(1)
8 GENERAL GOVERNMENT DEBT	**17,945,631,742**	**18,098,403,732**	
9 INTRA-EUROSYSTEM CLAIMS	**31,392,000,673**	**43,743,527,387**	
9.1 Participating interest in the ECB	721,792,464	721,792,464	
9.2 Claims deriving from the transfer of foreign reserves to the ECB	7,217,924,641	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)	23,452,283,568	35,803,810,282	
10 ITEMS TO BE SETTLED	**1,878,465**	**788,583**	
11 OTHER ASSETS	**43,761,958,630**	**46,461,901,734**	(1)
11.1 Euro-area coins	35,621,922	28,161,819	
11.2 UIC endowment fund	–	258,228,450	
11.3 Financial assets related to investments of reserves and provisions	28,813,592,336	32,334,146,779	
11.4 Other financial assets	–	–	(1)
11.5 Intangible fixed assets	36,034,194	27,613,610	
11.6 Tangible fixed assets	3,570,053,947	3,677,274,966	
11.7 Accrued income and prepaid expenses	1,484,285,165	1,374,387,959	
11.8 Deferred tax assets	6,412,807,316	6,310,856,695	
11.9 Sundry	3,409,563,750	2,451,231,456	
TOTAL	**267,430,630,026**	**244,376,425,611**	
MEMORANDUM ACCOUNTS	**419,329,234,853**	**324,200,245,943**	

(1) The amounts for 2007 have been reclassified on the basis of the changes made in 2008 to the rules on the inclusion in the balance sheet of securities held as fixed assets, now called securities held to maturity.

THE ACCOUNTANT GENERAL: Claudio Clemente

THE GOVERNOR: Mario Draghi

Audited and found correct - 31 March 2009

THE BOARD OF AUDITORS: Giovanni Fiori, Elisabetta Gualandri, Gian Domenico Mosco, Angelo Provasoli, Dario Velo

BALANCE SHEET

LIABILITIES	Amounts in euros 31.12.2008	31.12.2007
1 **BANKNOTES IN CIRCULATION**	**126,159,171,125**	**112,213,480,080**
2 **LIABILITIES TO EURO-AREA BANKS RELATED TO MONETARY POLICY OPERATIONS**	**35,441,362,984**	**42,622,806,292**
2.1 Current accounts (covering the minimum reserve system)	28,434,547,371	35,071,182,091
2.2 Deposit facility	6,966,292,052	1,624,201
2.3 Fixed-term deposits	–	7,550,000,000
2.4 Fine-tuning reverse operations	–	–
2.5 Deposits related to margin calls	40,523,561	–
3 **OTHER LIABILITIES TO EURO-AREA BANKS**	**–**	**–**
4 **LIABILITIES TO EURO-AREA RESIDENTS**	**19,413,226,051**	**9,881,376,565**
4.1 General government	19,412,943,302	9,715,516,047
4.1.1 Treasury payments account	*19,095,319,108*	*9,672,252,995*
4.1.2 Sinking fund for the redemption of government securities	*19,793,408*	*19,042,752*
4.1.3 Other liabilities	*297,830,786*	*24,220,300*
4.2 Other counterparties	282,749	165,860,518
5 **LIABILITIES TO NON-EURO-AREA RESIDENTS**	**200,744,792**	**88,074,509**
5.1 Current accounts (covering the minimum reserve system)	41,973	63,555,345
5.2 Deposit facility	200,702,819	24,519,164
6 **LIABILITIES TO EURO-AREA RESIDENTS DENOMINATED IN FOREIGN CURRENCY**	**411,281,150**	**6,911**
6.1 Financial sector counterparties	–	6,911
6.2 General government	411,281,150	–
6.3 Other liabilities	–	–
7 **LIABILITIES TO NON-EURO-AREA RESIDENTS DENOMINATED IN FOREIGN CURRENCY**	**2,329,622**	**1,827,308**
7.1 Deposits and balances	2,329,622	1,827,308
7.2 Other liabilities	–	–
8 **COUNTERPART OF SDRs ALLOCATED BY THE IMF**	**776,011,520**	**754,377,600**
9 **INTRA-EUROSYSTEM LIABILITIES**	**13,313,088,780**	**16,244,516,710**
9.1 Promissory notes covering debt certificates issued by the ECB	–	–
9.2 Net liabilities related to the allocation of euro banknotes within the Eurosystem	13,313,088,780	16,244,516,710
9.3 Other liabilities within the Eurosystem (net)	–	–
10 **ITEMS TO BE SETTLED**	**50,764,574**	**25,944,024**
11 **OTHER LIABILITIES**	**2,643,870,990**	**2,285,730,067**
11.1 Bank of Italy drafts	509,460,949	756,236,790
11.2 Accrued expenses and deferred income	80,949,431	85,280,730
11.3 Sundry	2,053,460,610	1,444,212,547
12 **PROVISIONS**	**8,245,924,958**	**6,239,998,691**
12.1 Provisions for specific risks	1,775,411,272	543,255,280
12.2 Sundry staff-related provisions	6,470,513,686	5,696,743,411
13 **REVALUATION ACCOUNTS**	**33,879,592,386**	**29,975,834,755**
14 **PROVISION FOR GENERAL RISKS**	**7,095,675,075**	**6,647,281,997**
15 **CAPITAL AND RESERVES**	**19,622,374,328**	**17,300,013,298**
15.1 Capital	156,000	156,000
15.2 Ordinary and extraordinary reserves	11,882,707,407	11,757,789,279
15.3 Other reserves	7,739,510,921	5,542,068,019
16 **NET PROFITS FOR DISTRIBUTION**	**175,211,691**	**95,156,804**
TOTAL	**267,430,630,026**	**244,376,425,611**
MEMORANDUM ACCOUNTS	**419,329,234,853**	**324,200,245,943**

THE ACCOUNTANT GENERAL: Claudio Clemente

THE GOVERNOR: Mario Draghi

Audited and found correct - 31 March 2009

THE BOARD OF AUDITORS: Giovanni Fiori, Elisabetta Gualandri, Gian Domenico Mosco, Angelo Provasoli, Dario Velo

INCOME STATEMENT

		2008	2007
		Amounts in euros	
1.1	Interest income	6,082,271,202	5,555,123,458
1.2	Interest expense	-2,697,870,694	-2,482,653,362
1	**Net interest income**	**3,384,400,508**	**3,072,470,096**
2.1	Profits and losses on financial operations	362,029,442	-33,769,902
2.2	Writedowns of financial assets and positions	-1,245,175,896	-1,910,093,729
2.3	Transfers to/from the provision for general risks for exchange rate and price risks	-176,000,000	1,284,000,000
2	**Net result of financial operations, writedowns and transfers to/from risk provisions**	**-1,059,146,454**	**-659,863,631**
3.1	Fee and commission income	27,216,185	23,922,732
3.2	Fee and commission expense	-5,632,303	-20,092,696
3	**Net income from fees and commissions**	**21,583,882**	**3,830,036**
4	**Income from participating interests**	**216,751,123**	**12,724,565**
5	**Net result of the pooling of monetary income**	**-715,013,081**	**48,482,765**
6.1	Interest income	956,886,118	991,121,023
6.2	Dividends from equity shares and participating interests	302,114,983	305,435,758
6.3	Profits, losses and writedowns	-434,006,073	42,394,186
6.4	Other components	4,625,331	2,270,850
6	**Net income from financial assets representing investments of reserves and provisions**	**829,620,359**	**1,341,221,817**
7	**Other withdrawals from provisions**	**8,817**	**3,945,005**
8	**Other income**	**76,890,892**	**61,744,483**
	TOTAL NET INCOME	**2,755,096,046**	**3,884,555,136**
9	**Appropriation of investment income to reserves provided for in the Statute** (1)	**-143,003,405**	**-528,262,230**
10.1	Staff wages and salaries and related costs (2)	-697,282,152	-629,873,328
10.2	Other staff costs	-54,351,489	-40,495,991
10.3	Transfers to provisions for accrued expense and staff severance pay and pensions	-347,139,545	-97,496,268
10.4	Pensions and severance payments	-281,071,566	-292,440,524
10.5	Emoluments paid to head and branch office collegial bodies	-3,860,760	-2,889,078
10.6	Administrative costs	-431,739,114	-400,569,206
10.7	Depreciation of tangible and intangible fixed assets	-203,452,913	-195,756,041
10.8	Banknote production services	-7,074,951	–
10.9	Other costs	-22,632,931	-27,423,359
10	**Sundry expenses and charges**	**-2,048,605,421**	**-1,686,943,795**
11	**Other allocations to provisions**	**–**	**–**
12.1	Extraordinary income	5,726,248	42,951,690
12.2	Extraordinary expense	-66,274,213	-6,654,154
12	**Extraordinary income and expense**	**-60,547,965**	**36,297,536**
	PROFIT BEFORE TAX	**502,939,255**	**1,705,646,647**
13	**Taxes on income for the year and productive activities**	**-327,727,564**	**-1,610,489,843**
	NET PROFIT FOR THE YEAR	**175,211,691**	**95,156,804**

(1) Made in accordance with Article 40 of the Statute. – (2) The average number of employees in 2008 was 7,809, compared with 7,488 in 2007.

THE ACCOUNTANT GENERAL: Claudio Clemente　　**THE GOVERNOR:** Mario Draghi

Audited and found correct - 31 March 2009

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 contained 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 Guideline ECB/2008/21.

  On the basis of the authority granted by Article 8 of Legislative Decree 43/1998, the Bank of Italy has applied in full the accounting rules and recommendations issued by the ECB, including those on the layout of the income statement in report form and that of the balance sheet. The latter is the same as that used for the monthly statement approved, pursuant to Article 8.2 of Legislative Decree 43/1998, by the Minister for the Economy and Finance;

- the Bank's Statute (approved by a Presidential Decree of 12 December 2006), which lays down special rules for the allocation of the net profit for the year, the creation of special reserves and provisions, and the allocation of the income arising from the investment of the reserves.

As regards the matters concerning the preparation of the accounts not covered by the foregoing rules, the following provisions apply:

- Legislative Decree 127/1991 ("Implementation of Directives 78/660/EEC on the annual accounts of certain types of companies and 83/349/EEC on consolidated accounts pursuant to Article 1.1 of Law 69/1990"), as amended;
- Legislative Decree 87/1992 ("Implementation of Directive 86/635/EEC on the annual accounts and consolidated accounts of banks and other financial institutions and 89/117/EEC on the obligations of branches established in a member state of credit institutions and financial institutions having their head offices outside that member state regarding the publication of annual accounting documents"), as amended;
- Article 65 (transactions involving government bonds) of Law 289/2002, as amended by Decree Law 203/2005, ratified by Law 248/2005.

Main innovations in the annual accounts for 2008. – With Guideline ECB/2008/21 the Governing Council of the ECB amended Guideline ECB/2006/16. The amendments focused in particular on the rules on bonds held as fixed assets, now called securities held to maturity.

The application of the new rules to the annual accounts for 2008 entailed the transfer of bonds held as fixed assets unrelated to reserves or provisions from the subitem 11.4, "Other financial assets", to item 7, "Securities issued by euro-area residents".

For the sake of comparison, the balance-sheet data for 2007 have been appropriately reclassified.

At 1 January 2008, following the merger of the UIC into the Bank of Italy pursuant to Legislative Decree 231/2007, the former's assets and liabilities were allocated at their historical cost to the accounts of the Bank of Italy on the basis of its classification of the different items. In particular, the specific risk provisions and the provision for legal disputes were included in the Bank's provision for general risks, considering that this serves to protect against risks involved in the Bank's overall activity.

For the sake of balance-sheet comparison, the amounts of assets and liabilities at 31 December 2007 shown in the tables in the notes to the accounts have been restated to take account of the merger of the UIC into the Bank of Italy.

Accounting policies. – The accounting policies applied in preparing the annual accounts for 2008 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 income statement on a pro rata basis in the event of disposals, redemptions and writedowns.*

For gold, the capital gains still existing at 30 December 2002 were used in connection with the government bond conversion pursuant to Article 65.3 of Law 289/2002; the cost of gold, for tax purposes as well, is equal to the value stated in the accounts net of the pertinent revaluation account.

Gold and foreign currency assets/liabilities

- *stocks, including those represented by foreign currency securities, are valued by applying, for each currency and for gold, the method of the "average-daily-net-cost", determined in the manner established by the ECB, which at the end of the year 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 income statement;*
- *the International Monetary Fund quota is translated on the basis of the euro/SDR exchange rate communicated by the IMF on the occasion of the last transaction undertaken for the part in national currency and at the euro/SDR exchange rate communicated by the ECB for the remaining part.*

Securities

- *each type of security is valued by applying the method of the "average-daily-cost", determined in the manner established by the ECB. In the case of bonds, account is taken of the amount of the amortization of the premium/discount, 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 income statement. Foreign currency ETFs and units of collective investment undertakings stated in the balance-sheet item "Financial assets related to investments in reserves and provisions" are not included in the net foreign exchange position but shown as a separate item;*
     b) *non-marketable bonds, 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 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 accrued income and prepaid expenses and accrued expenses and deferred income. Interest accrued on foreign exchange assets and liabilities is recorded on a daily basis and included in the net foreign exchange position.

BANKNOTES IN CIRCULATION

The ECB and the euro-area NCBs, which together comprise the Eurosystem, have issued euro banknotes since 1 January 2002 (ECB Decision no. 15 of 6 December 2001 on the issue of euro banknotes, in Official Journal of the European Communities, *L337 of 20 December 2001, pp. 52-54, as amended).*

The total value of euro banknotes in circulation is allocated within the Eurosystem on the last working day of each month on the basis of the criteria set out hereinafter.

As of 2002 the ECB has been allocated a share of 8 per cent of the total value of euro banknotes in circulation, while the remaining 92 per cent has been allocated to each NCB according to its weighting in the capital key of the ECB. The share of banknotes allocated to each NCB is disclosed under the balance-sheet liability item "Banknotes in circulation". On the basis of the banknote allocation key the difference between the value of the banknotes allocated to each NCB and that of the banknotes it actually puts into circulation gives rise to remunerated intra-Eurosystem balances. From the year of the cash changeover of each member state that has adopted the euro and for the five subsequent years the intra-system balances arising from the allocation of euro banknotes will be adjusted in order to avoid significant changes in NCBs' relative income positions as compared with previous years. The adjustment period for the Bank of Italy ended on 31 December 2007. The adjustments are effected by taking into account the differences between the average value of banknotes in circulation of each NCB in the *reference period established by law and the average value of banknotes that would have been allocated to them during that period under the ECB's capital key. The adjustments are reduced in annual steps for five years starting from the year of the cash changeover, after which income on banknotes is allocated fully in proportion to the NCBs' paid-up shares in the ECB's capital (ECB Decision no. 16 of 6 December 2001 on the allocation of monetary income of the national central banks of participating member states from the financial year 2002, in* Official Journal of the European Communities, *L337 of 20 December 2001, pp. 55-61, as amended).*

The interest income and expense on 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 and gold price risks. The seigniorage income distributed by the ECB is recorded on an accrual basis in the year to which the income refers, by way of derogation from the cash policy applied in general to dividends and profits from participating interests. For 2008 the Governing Council decided that part of the seigniorage income should be retained by the ECB.*

INTRA-EUROSYSTEM ASSETS AND LIABILITIES

For each NCB the intra-Eurosystem balance arising from the allocation of euro banknotes is included under "Net claim/liability related to the allocation of euro banknotes within the Eurosystem".

PROVISIONS FOR RISKS

In determining the provisions for risks account is taken of the riskiness of the various sectors of the Bank's operations in an overall evaluation of adequacy. The riskiness of the Bank's foreign exchange positions and securities portfolio is evaluated on a value-at-risk basis, with consideration also given to the size of the revaluation accounts.

The provision for general risks is also for risks in connection with the Bank's overall activity that cannot be determined individually or allocated objectively.

Transfers to and withdrawals from the provisions are decided by the General Council.

TAX PROVISION

The provision for taxation is equal to the amount of taxes to be paid (including deferred tax liabilities), determined on the basis of a realistic estimate of the foreseeable liability under the tax rules in force and of amounts arising from possible disputes with the tax authorities.

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.

SUNDRY STAFF-RELATED PROVISIONS

- *transfers to the provision for severance pay and pensions of staff hired before 28 April 1993 are included in the annual accounts under Article 3 of the related Rules for an amount that comprises the severance pay accrued at the end of the year, the mathematical reserves for the disbursements to pensioners and those corresponding to the situation of staff having entitlement;*
- *the provision for staff costs includes the estimated amount of costs that had accrued but not been paid at year-end;*
- *transfers to the provision for early retirement incentives connected with the reorganization of the Bank's branch network are entered for the amounts determined on the basis of reliable estimates;*

– *transfers to the provision for grants to BI pensioners and their surviving dependents are made in accordance with Article 24 of the Rules governing staff severance pay and pensions;*
– *transfers to the provision for severance pay of contract staff, who do not participate in pension funds or who pay only a part of the contributions for retirement benefits, are determined in accordance with Law 297/1982.*

For staff hired from 28 April 1993 onwards a defined-contribution supplementary pension fund has been created (for more details see below under Other assets and liabilities).

OTHER ASSETS AND LIABILITIES ITEMS

Receivables are stated at their 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 patrimony of the defined-contribution supplementary pension fund created for staff hired from 28 April 1993 onwards. The fund is invested in financial instruments, which are valued at year-end market prices. The resulting revaluation gains (losses) are treated as revenues (expenses) and, in the same way as for other operating revenues (expenses), added to (subtracted from) the fund's patrimony.

The item "Other liabilities" includes the lira banknotes that have not yet been presented for conversion, net of the payments on account made to the tax authorities under Article 87 of Law 289/2002.

The other components are stated at their nominal value.

OFF-BALANCE-SHEET TRANSACTIONS AND MEMORANDUM ACCOUNTS

Forward purchases and sales of foreign currency

– *forward purchases and sales are recorded in the memorandum accounts at the trade date at the spot exchange rate of the transaction. The difference between the values at the spot and forward exchange rates is recorded, on a pro rata temporis basis, under interest in the income statement.*

Foreign currency swaps

– *forward and spot purchases and sales are recorded in the memorandum accounts at the trade date at the spot exchange rate of the transaction. The difference between the values at the spot and forward exchange rates is recorded, on a pro rata temporis basis, under interest in the income statement. The forward position is valued in conjunction with the corresponding spot position.*

At the time of the settlement of forward purchases and sales of foreign currency and foreign currency swaps, the entries in the memorandum accounts are transferred to the appropriate items of the balance sheet.

Interest rate futures denominated in foreign currency

– *are recorded in the memorandum accounts at the trade date at their notional value and translated at the end of the year at the exchange rate communicated by the ECB. Initial margins in cash are recorded in the balance sheet among foreign currency claims, those in securities are recorded in the memorandum accounts. Positive and negative daily variation margins are communicated by the clearer and taken to the profit and loss account, converted at the exchange rate of the day.*

Other cases with the amount entered in the memorandum accounts

– *securities denominated in euros held on deposit are stated at their nominal value; shares are stated on a quantity basis; those of other kinds at face value or at conventional value;*
– *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;*
– *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.*

Table 22.5

Reconciliation of the comparative data with the balance sheet at 31 December 2007

Amounts in euros

ASSETS	Bank of Italy at 31.12.2007	Reclas-sification	Bank of Italy at 31.12.2007 (comparative)	UIC at 31.12.2007	Consolidation	Bank of Italy at 31.12.2007 (restated balance sheet)
1 GOLD AND GOLD RECEIVABLES	**44,793,359**		**44,793,359**	**–**		**44,793,359**
2 CLAIMS ON NON-EURO-AREA RESIDENTS DENOMINATED IN FOREIGN CURRENCY	**19,276,461**		**19,276,461**	**401,456**		**19,677,917**
2.1 Receivables from the IMF	1,163,950		1,163,950	–		1,163,950
2.2 Securities (other than shares)	14,661,777		14,661,777	–		14,661,777
2.3 Current accounts and deposits	3,352,466		3,352,466	401,456		3,753,922
2.4 Reverse operations	95,178		95,178	–		95,178
2.5 Other claims	3,090		3,090	–		3,090
3 CLAIMS ON EURO-AREA RESIDENTS DENOMINATED IN FOREIGN CURRENCY	**5,052,180**		**5,052,180**	**59**		**5,052,239**
3.1 Financial counterparties	5,052,180		5,052,180	59		5,052,239
3.1.1 Securities (other than shares)	*425,940*		*425,940*	–		*425,940*
3.1.2 Reverse operations	*93,846*		*93,846*	–		*93,846*
3.1.3 Other claims	*4,532,394*		*4,532,394*	*59*		*4,532,453*
3.2 General government	–		–	–		–
3.3 Other counterparties	–		–	–		–
4 CLAIMS ON NON-EURO-AREA RESIDENTS	**1,000**		**1,000**	**12,022**		**13,022**
4.1 Claims on non-euro-area EU central banks	1,000		1,000	–		1,000
4.2 Securities (other than shares)	–		–	–		–
4.3 Other claims	–		–	12,022		12,022
5 LENDING TO EURO-AREA BANKS RELATED TO MONETARY POLICY OPERATIONS	**28,070,384**		**28,070,384**	**–**		**28,070,384**
5.1 Main refinancing operations	22,222,182		22,222,182	–		22,222,182
5.2 Longer-term refinancing operations	5,848,202		5,848,202	–		5,848,202
5.3 Fine-tuning reverse operations	–		–	–		–
5.4 Structural reverse operations	–		–	–		–
5.5 Marginal lending facility	–		–	–		–
5.6 Credits related to margin calls	–		–	–		–
6 OTHER CLAIMS ON EURO-AREA BANKS	**10,245**		**10,245**	**257,296**	**-165,263**	**102,278**
7 SECURITIES ISSUED BY EURO-AREA RESIDENTS (OTHER THAN SHARES)	**–**	**38,868,175**	**38,868,175**	**1,276,398**		**40,144,573**
8 GENERAL GOVERNMENT DEBT	**18,098,404**		**18,098,404**	**–**		**18,098,404**
9 INTRA-EUROSYSTEM CLAIMS	**43,743,527**		**43,743,527**	**827**		**43,744,354**
9.1 Participating interest in the ECB	721,792		721,792	–		721,792
9.2 Claims deriving from the transfer of foreign reserves to the ECB	7,217,925		7,217,925	–		7,217,925
9.3 Net claims related to the allocation of euro banknotes within the Eurosystem	–		–	–		–
9.4 Other claims within the Eurosystem (net)	35,803,810		35,803,810	827		35,804,637
10 ITEMS TO BE SETTLED	**789**		**789**	**–**		**789**
11 OTHER ASSETS	**85,330,077**	**-38,868,175**	**46,461,902**	**1,899,804**	**-259,594**	**48,102,112**
11.1 Euro-area coins	28,162		28,162	–		28,162
11.2 UIC endowment fund	258,228		258,228	–	-258,228	–
11.3 Financial assets related to investments of reserves and provisions	32,334,147		32,334,147	1,164,398		33,498,545
11.4 Other financial assets	38,868,175	-38,868,175	–	–		–
11.5 Intangible fixed assets	27,614		27,614	633		28,247
11.6 Tangible fixed assets	3,677,275		3,677,275	48,608		3,725,883
11.7 Accrued income and prepaid expenses	1,374,388		1,374,388	36,167		1,410,555
11.8 Deferred tax assets	6,310,857		6,310,857	1,620		6,312,477
11.9 Sundry	2,451,231		2,451,231	648,378	-1,366	3,098,243
TOTAL	**244,376,426**	**–**	**244,376,426**	**3,847,862**	**-424,857**	**247,799,431**

cont.

Table 22.5 *cont.*

Reconciliation of the comparative data with the balance sheet at 31 December 2007

LIABILITIES	Amounts in euros					
	Bank of Italy at 31.12.2007	Reclas-sification	Bank of Italy at 31.12.2007 (comparative)	UIC at 31.12.2007	Consolidation	Bank of Italy at 31.12.2007 (restated balance sheet)
1 BANKNOTES IN CIRCULATION	**112,213,480**		**112,213,480**	**–**		**112,213,480**
2 LIABILITIES TO EURO-AREA BANKS RELATED TO MONETARY POLICY OPERATIONS	**42,622,806**		**42,622,806**	**–**		**42,622,806**
2.1 Current accounts (covering the minimum reserve system)	35,071,182		35,071,182	–		35,071,182
2.2 Deposit facility	1,624		1,624	–		1,624
2.3 Fixed-term deposits	7,550,000		7,550,000	–		7,550,000
2.4 Fine-tuning reverse operations	–		–	–		–
2.5 Deposits related to margin calls	–		–	–		–
3 OTHER LIABILITIES TO EURO-AREA BANKS	**–**		**–**	**–**		**–**
4 LIABILITIES TO EURO-AREA RESIDENTS	**9,881,377**		**9,881,377**	**67,784**	**-165,263**	**9,783,898**
4.1 General government	9,715,516		9,715,516	67,784		9,783,300
4.1.1 Treasury payments account	*9,672,253*		*9,672,253*	–		*9,672,253*
4.1.2 Sinking fund for the redemption of government securities	*19,043*		*19,043*	–		*19,043*
4.1.3 Other liabilities	*24,220*		*24,220*	*67,784*		*92,004*
4.2 Other counterparties	165,861		165,861	–	-165,263	598
5 LIABILITIES TO NON-EURO-AREA RESIDENTS	**88,074**		**88,074**	**–**		**88,074**
5.1 Current accounts (covering the minimum reserve system)	63,555		63,555	–		63,555
5.2 Deposit facility	24,519		24,519	–		24,519
6 LIABILITIES TO EURO-AREA RESIDENTS DENOMINATED IN FOREIGN CURRENCY	**7**		**7**	**382,804**		**382,811**
6.1 Financial sector counterparties	7		7	–		7
6.2 General government	–		–	382,804		382,804
6.3 Other liabilities	–		–	–		–
7 LIABILITIES TO NON-EURO-AREA RESIDENTS DENOMINATED IN FOREIGN CURRENCY	**1,827**		**1,827**	**1,094**		**2,921**
7.1 Deposits and balances	1,827		1,827	1,094		2,921
7.2 Other liabilities	–		–	–		–
8 COUNTERPART OF SDRS ALLOCATED BY THE IMF	**754,378**		**754,378**	**–**		**754,378**
9 INTRA-EUROSYSTEM LIABILITIES	**16,244,517**		**16,244,517**	**–**		**16,244,517**
9.1 Promissory notes covering debt certificates issued by the ECB	–		–	–		–
9.2 Net liabilities related to the allocation of euro banknotes within the Eurosystem	16,244,517		16,244,517	–		16,244,517
9.3 Other liabilities within the Eurosystem (net)	–		–	–		–
10 ITEMS TO BE SETTLED	**25,944**		**25,944**	**2,190**		**28,134**
11 OTHER LIABILITIES	**2,285,730**		**2,285,730**	**198,277**	**-1,366**	**2,482,641**
11.1 Bank of Italy drafts	756,237		756,237	–		756,237
11.2 Accrued expenses and deferred income	85,281		85,281	2		85,283
11.3 Sundry	1,444,212		1,444,212	198,275	-1,366	1,641,121
12 PROVISIONS	**6,239,999**		**6,239,999**	**517,912**	**–50,102**	**6,707,809**
12.1 Provisions for specific risks	543,255		543,255	73,004	–50,102	566,157
12.2 Sundry staff-related provisions	5,696,744		5,696,744	444,908		6,141,652
13 REVALUATION ACCOUNTS	**29,975,835**		**29,975,835**	**1,504**		**29,977,339**
14 PROVISION FOR GENERAL RISKS	**6,647,282**		**6,647,282**	**222,291**	**50,102**	**6,919,675**
15 CAPITAL AND RESERVES	**17,300,013**		**17,300,013**	**2,453,840**	**-258,062**	**19,495,791**
15.1 Capital	156		156	258,228	-258,228	156
15.2 Ordinary and extraordinary reserves	11,757,789		11,757,789	–		11,757,789
15.3 Other reserves	5,542,068		5,542,068	2,195,612	166	7,737,846
16 NET PROFITS FOR DISTRIBUTION	**95,157**		**95,157**	**166**	**-166**	**95,157**
TOTAL	**244,376,426**	**–**	**244,376,426**	**3,847,862**	**-424,857**	**247,799,431**

Gold and assets and liabilities denominated in foreign currency (Items 1, 2 and 3 on the assets side and Items 6, 7 and 8 on the liabilities side)

The increase in the value of gold – the quantity of which remained unchanged compared with 2007 (79 million ounces or 2,452 tons) – was entirely due to the rise in the metal's price. The amount of net assets denominated in foreign currency also reflected reverse operations in dollars as part of the US dollar Term Auction Facility launched at the end of 2007 between the Federal Reserve and the ECB; the general performance of exchange rates also boosted net foreign currency assets.

Table 22.6

Gold and assets and liabilities denominated in foreign currency
(thousands of euros)

	31.12.2008	31.12.2007 (1)	Changes
Gold (Item 1)	**48,995,407**	**44,793,359**	**4,202,048**
Net assets denominated in foreign currency	**32,409,508**	**23,590,046**	**8,819,462**
Assets denominated in foreign currency	**33,599,131**	**24,730,156**	**8,868,975**
claims on the IMF (Subitem 2.1)	*1,790,147*	*1,163,950*	*626,197*
bonds other than those held to maturity (Subitems 2.2 and 3.1.1)	*23,197,727*	*15,087,717*	*8,110,010*
current accounts and deposits (Subitems 2.3 and 3.1.3.)	2,427,665	8,286,375	-5,858,710
reverse operations (Subitems 2.4 and 3.1.2)	*6,180,204*	*189,024*	*5,991,180*
other assets (Subitem 2.5)	*3,388*	*3,090*	*298*
Liabilities denominated in foreign currency	**1,189,623**	**1,140,110**	**49,513**
counterpart of SDRs allocated by the IMF (Item 8)	*776,012*	*754,378*	*21,634*
advances of general government departments (Subitem 6.2)	*411,281*	*382,804*	*28,477*
current accounts and deposits (Subitem 7.1)	*2,330*	*2,921*	*-591*
other liabilities (Subitem 6.1)	*–*	*7*	*-7*

(1) For comparison, data for 2007 include the balances of the UIC (Table 22.5).

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 2008 using that day's exchange rate of the euro against the dollar. Compared with end-2007, gold appreciated by 9.4 per cent (from 568.236 to 621.542 euros per ounce). The exchange rates of the main currencies against the euro showed appreciations of the US dollar (from 1.4721 to 1.3917 dollars per euro), the yen (from 164.93 to 126.14), the Swiss franc (from 1.6547 to 1.4850) and the SDR (from 1.0740 to 1.1048 euros per SDR). The pound sterling instead depreciated (from 0.7334 to 0.9525 pounds per euro).

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 a total of €6,215 million (€4,202 million in respect of gold and €2,013 million in respect of assets denominated predominantly in dollars and yen). In respect of sterling there were unrealized losses of €1,222 million, which were charged entirely to the income statement.

After the above-mentioned movements, the revaluation accounts amounted at the end of 2008 to €31,588 million, of which €29,575 million was in respect of gold, €1,110 million the yen, €831 million the dollar, €50 million the SDR and €22 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.

Table 22.7

Accounts with the International Monetary Fund *(thousands of euros)*	31.12.2008	31.12.2007	Changes
Assets			
Receivables from the IMF (Subitem 2.1)	**1,790,147**	**1,163,950**	**626,197**
a) Italy's net position vis-à-vis the IMF	1,090,828	493,880	596,948
quota in the IMF	*7,790,981*	*7,601,357*	*189,624*
IMF holdings	*-6,700,153*	*-7,107,477*	*407,324*
b) participation in the PRGF	511,783	445,156	66,627
c) Special Drawing Rights	187,536	224,914	-37,378
Liabilities			
Counterpart of SDRs allocated by the IMF (Item 8)	**776,012**	**754,378**	**21,634**

The portfolio of securities denominated in foreign currency consists primarily of bonds issued by government bodies and international organizations. Of the total portfolio 64 per cent consisted of securities denominated in US dollars, 20 per cent of securities denominated in yen and 16 per cent of securities denominated in pounds sterling. During the year net purchases consisted mainly of securities denominated in dollars.

The other foreign currency assets, denominated primarily in US dollars, consist mainly of reverse operations (€6,180 million), current accounts (€1,939 million), time deposits (€489 million) and foreign banknotes (€3 million).

*Subitem 3.1.2 (*Claims on euro-area residents denominated in foreign currency: reverse operations*) includes claims in respect of reverse operations with Eurosystem counterparties guaranteed by securities (€6,141 million) in connection with the Term Auction Facility. 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 Eurosystem 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*).*

*Subitem 11.3 (*Financial assets related to investments of reserves and provisions*) includes foreign currency investments that constitute a separate position with respect to the foreign assets and liabilities previously described (see Securities portfolio).*

Monetary policy operations (Item 5 on the assets side and Item 2 on the liabilities side)

Operations carried out by the Bank of Italy in connection with the single monetary policy of the Eurosystem.

On the assets side, the stock of *main refinancing operations* decreased, both the year-end value and the average stock (from €17,466 million to €11,879 million). The stock of *longer-term refinancing operations* instead rose substantially at year-end and the average stock grew from €1,697 million to €7,988 million. The stocks of *fine-tuning reverse operations* were equal to zero at year-end, while the average stocks fell from €78 million to €18 million. The average stock of the *marginal lending facility* rose from €2 million to €76 million. As in 2007, no recourse was made to *structural reverse operations* during the year.

Table 22.8

Monetary policy operations
(thousands of euros)

		31.12.2008	31.12.2007	Changes
Lending to euro-area banks (Item 5)				
5.1	Main refinancing operations	12,979,778	22,222,182	-9,242,404
5.2	Longer-term refinancing operations	36,975,612	5,848,202	31,127,410
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	6,218	–	6,218
Total		**50,344,218**	**28,070,384**	**22,273,834**
Liabilities to euro-area banks (Item 2)				
2.1	Current accounts (covering the minimum reserve system)	28,434,547	35,071,182	-6,636,635
2.2	Deposit facility	6,966,292	1,624	6,964,668
2.3	Fixed-term deposits	–	7,550,000	-7,550,000
2.4	Fine-tuning reverse operations	–	–	–
2.5	Deposits related to margin calls	40,524	–	40,524
Total		**35,441,363**	**42,622,806**	**-7,181,443**

On the liabilities side the deposits held by banks to fulfil their minimum reserve obligations decreased at year-end while the average stocks rose slightly (from €21,185 million to €22,882 million). *Overnight deposits* increased substantially, both at year-end and in terms of average stock (from €51 million to €1,731 million). The average stock of *fixed-term deposits* decreased from €865 million to €277 million. As in 2007, no recourse was made to *fine-tuning reverse operations* in 2008.

Securities portfolio (Items 7 and 8 and Subitem 11.3 on the assets side)

The bulk of the Bank's securities portfolio consists of bonds denominated in euros and shares, participating interests, EFTs and units of collective undertakings denominated in euros and foreign currency. Securities making up part of the foreign exchange reserves are commented under *Gold and assets and liabilities denominated in foreign currency*.

The ECB's guideline (ECB/2008/21) of 11 December 2008 amends the rules on securities held to maturity in the balance sheet. In application of the new rules, bonds denominated in euros not related to investments of reserves and provisions, previously entered under Subitem 11.4 "Other financial assets", now appear under Item 7 "Securities issued by euro-area residents". In addition, the term "Securities held as fixed assets" has been changed to "Securities held to maturity".

Table 22.9

Securities portfolio – stocks
(thousands of euros)

	31.12.2008	31.12.2007 (1)	Changes
A) SECURITIES RELATED TO INVESTMENTS OF RESERVES AND PROVISIONS (SUBITEM 11.3)			
1. Securities held to maturity and held as permanent investments	**23,393,824**	**25,269,061**	**-1,875,237**
a) Government securities	23,052,211	24,772,916	-1,720,705
b) Other bonds	176,920	327,338	-150,418
c) Shares and participating interests	164,693	168,807	-4,114
– of subsidiary companies and entities	*107,949*	*107,949*	*–*
– of other companies and entities	*2,196*	*6,310*	*-4,114*
– 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	**5,419,769**	**8,229,484**	**-2,809,715**
a) Government securities	138,120	24,572	113,548
b) Other bonds	28,393	44,881	-16,488
c) Shares and participating interests	4,408,437	7,557,101	-3,148,664
– of subsidiary companies and entities	*19,650*	*24,385*	*-4,735*
– of other companies and entities	*4,388,787*	*7,532,716*	*-3,143,929*
d) EFTs and units of collective undertakings	844,819	602,930	241,889
of which: denominated in foreign currency	*149,258*	*222,457*	*-73,199*
Total A	**28,813,593**	**33,498,545**	**-4,684,952**
B. OTHER SECURITIES DENOMINATED IN EUROS (Items 7 and 8)			
1. Securities held to maturity	**54,785,528**	**56,932,887**	**-2,147,359**
a) Government securities (Item 7)	36,824,502	38,819,289	-1,994,787
b) Other bonds (Item 7)	49,086	48,886	200
c) Government securities deriving from the bond conversion and the management of stockpiling (Item 8)	17,911,940	18,064,712	-152,772
2. Securities other than those held to maturity	**4,354,036**	**1,276,398**	**3,077,638**
a) Government securities (Item 7)	4,354,036	1,276,398	3,077,638
Total B	**59,139,564**	**58,209,285**	**930,279**
Total A+B	**87,953,157**	**91,707,830**	**-3,754,673**

(1) For comparison, data for 2007 include the corresponding balances of UIC (Table 22.5). Its portfolio, amounting to €2,440,796 thousand, consisted of securities held to maturity (€1,153,000 thousand of government securities and €11,390 thousand of other bonds), equity investments held as permanent investments (€1 thousand) and equity investments other than those held as permanent investments (€7 thousand) entered under Subitem 11.3, and securities other than those held to maturity (€1,276,398 thousand of government securities) entered under Item 7.

In more detail, the Bank's portfolio comprises:

A) securities related to investments of reserves and provisions (Subitem 11.3 – *Financial assets related to investments of reserves and provisions*) are denominated in euros and to a very small extent in foreign currency. At year-end 81 per cent of the portfolio consisted of bonds and the remainder of shares, participating interests, ETFs and units of collective investment undertakings. Most of the investments in shares consisted of listed securities.

The Bank invests in ETFs and units of collective investment undertakings denominated in foreign currency. The resulting position is hedged against exchange rate risk by forward purchases of the corresponding currencies.

The controlling interests refer to Società italiana di iniziative edilizie e fondiarie S.p.A. (SIDIEF) and Bonifiche Ferraresi S.p.A. The participating interests held as 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 in the BIS is equal to 9.61 per cent of its capital.

B) other bond securities denominated in euros.

In particular:

- Item 7 (*securities issued by euro-area residents)* consists of bonds, of which 56 per cent were issued by the Italian government and most of the remainder by other euro-area countries; the net purchases during the year were mainly of the latter category;
- Item 8 (*General government debt*) 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 €103 million corresponded to the annual accrued amount of the related discounts.

  The securities deriving from the termination of the mandatory management of stockpiling consist of non-interest-bearing BTPs; the reduction of €50 million was due to the annual amount redeemed.

Another €34 million of claims deriving from the termination of the management of mandatory stockpiling, also included in Item 8, have not been converted into securities since the relevant legislation made the issue of such securities subject to approval by the State Audit Office of the accounts of the transactions that gave rise to the claims. Following legislation on this matter in 2006, the Bank is waiting for the Ministry for the Economy and Finance to decide how the amount is to be paid.

Bonds held to maturity include securities whose book value (€19,725 million) was higher than the year-end valuation at market prices (€19,515 million). The securities in question – issued by the Italian government and the governments of other euro-area countries – are recorded at cost in accordance with the accounting rules of the Eurosystem.

Intra-Eurosystem claims and liabilities (Item 9 on the assets side and Item 9 on the liabilities sides)

On the assets side:

- the *participating interest in the ECB* and the *claims deriving from the transfer of foreign reserves to the ECB* were unchanged at 31 December 2008;

Table 22.10

Positions with the ECB and the other euro-area NCBs
(thousands of euros)

	31.12.2008	31.12.2007 (1)	Changes
Assets			
9.1 Participating interest in the ECB	721,792	721,792	–
9.2 Claims deriving from the transfer of foreign reserves to the ECB	7,217,925	7,217,925	–
9.4 Other claims within the Eurosystem (net)	23,452,284	35,804,637	-12,352,353
Total	**31,392,001**	**43,744,354**	**-12,352,353**
Liabilities			
9.2 Net liabilities related to the allocation of euro banknotes within the Eurosystem	13,313,089	16,244,517	-2,931,428
Total	**13,313,089**	**16,244,517**	**-2,931,428**

(1) For comparison, data for 2007 include the balances of UIC (Table 22.5).

Pursuant to Article 28 of the Statute of the ESCB, the ESCB national central banks are the sole subscribers and holders of the capital of the ECB. Subscriptions depend on the shares, which are determined on the basis of the key for the subscription of the ECB's capital established in Article 29 of the Statute and adjusted every five years or when a new country joins the EU. These adjustments took place on 1 January 2004 and 1 January 2009. The first adjustment resulting from the entry of new central banks in the ESCB in response to the accession of their countries to the European Union was made on 1 May 2004 and the last on 1 January 2007 following the accession of Romania and Bulgaria. At the end of 2008 the Bank of Italy's share of the ECB's subscribed capital was equal to 12.5297 per cent; following the adjustment on 1 January 2009 the figure was amended again, to 12.4966 per cent.

Considering only the Eurosystem NCBs, the Bank of Italy's share of the ECB's capital, which was last adjusted on 1 January 2008 following the entry of Malta and Cyprus, amounted to 17.9776 per cent at the end of 2008; this figure was amended again, to 17.9056, on 1 January 2009 following the five-year adjustment and Slovakia's entry into the Eurosystem.

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 income statement: Net interest income).

– there was a decrease in *Other claims within the Eurosystem (net)*, which derive mainly from the operation of the TARGET/TARGET2 system. The latter gave rise to a credit position that fell by €12,837 million (from €35,756 million to €22,919 million); by contrast the average position over the year increased from €23,800 million to €40,629 million.

As in 2007, 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 assets side)

This item consists mainly (66 per cent) of securities (see *Securities portfolio*) included in Subitem 11.3. It also contains: *tangible* and *intangible fixed assets* (8 per cent) and *deferred tax assets* (15 per cent), 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 €4,066 million for those used for its operations and €1,274 million for those related to investments of severance pay and pension provisions.

Deferred tax assets (Subitem 11.8, which includes, with a negative sign, deferred tax liabilities for corporate income tax) increased by €100 million as a consequence of:

– the recording of €333 million of the deferred tax assets on the year's allocation to a buffer against counterparty risk associated with Eurosystem monetary policy operations (see *Provisions and provisions for general risks*);
– the offsetting of €270 million of the deferred taxes deriving from the carryforward of the tax losses for 2002-04;
– the decrease of €28 million in deferred liabilities for corporate tax due to accelerated depreciation following the alignment of book/accounting and fiscal values;
– the increase of €9 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 carryforward of the tax losses incurred in the years 2002-04. In particular, the loss for 2002 derived from the bond conversion under Law 289/2002, while those for 2003 and 2004 derived from unrealized losses. The rules governing the carryforward of these losses are laid down in Article 65 of Law 289/2002 as amended by Law 248/2005. The rules state that the losses may be offset with no time restriction up to 50 per cent of the corporate income tax liability each year. The inclusion of deferred tax assets in the balance sheet is based on the reasonable expectation – considering the outlook for the Bank's income and the applicable tax law – of offsetting the full amount of the above-mentioned tax losses.

Sundry (Subitem 11.9 on the assets side) includes the balance sheet total (€106 million) of the defined-contribution supplementary pension fund for staff hired since 28 April 1993, which is matched on the liabilities side by an equal amount entered in Subitem 11.3 of *Other liabilities*. The other components of the subitem 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 liabilities 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 €13,946 million (from €112,213 million to €126,159 million). The banknotes actually in circulation, without taking account of the adjustments for their distribution within the Eurosystem, increased by €11,014 million (from €128,458 million to €139,472 million). The average stock of banknotes rose from €118,530 million to €126,816 million, an increase of 7 per cent, compared with 9 per cent for the euro area.

Liabilities to general government and other counterparties in euros (Item 4 on the liabilities side)

The item refers mainly to the deposits held by the Treasury with the Bank of Italy. The other liabilities include debtor positions with general government in respect of advances received for the management of the external collection and payment services in euros.

Compared with 2007, the year-end balance on the Treasury accounts with the Bank of Italy increased significantly, while the average balance rose from €21,483 million to €23,588 million. The year-end balance of the sinking fund for the redemption of government securities increased slightly, while the average balance decreased significantly, from €326 million to €20 million.

Liabilities to non-euro-area residents denominated in euros (Item 5 on the liabilities side)

These comprise:

– *liabilities to non-euro-area EU central banks*, which did not represent a significant amount at the end of the year (€64 million at end-2007);

– *other liabilities*, which increased from €25 million in 2007 to €201 million and mainly referred to liabilities to non-EU central banks and accounts held by customers that use the Eurosystem Reserve Management Services (ERMS).

Other liabilities (Item 11 on the liabilities side)

The subitem *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 (€709 million).

Provisions and provision for general risks (Items 12 and 14 on the liabilities side)

Balances and movements in *Provisions* (Item 12) are shown in the following table.

Table 22.11

Provisions (Item 12) – balances and movements
(thousands of euros)

	Insurance cover	Tax provision (1)	Provision for Euro-system monetary policy operations	Sundry staff-related provisions				Total
				for staff severance pay and pensions	for staff costs	for severance pay (2)	for grants to BI pensioners and their survivors	
Opening balances (3)	**309,874**	**256,283**	**–**	**6,032,996**	**104,783**	**1,827**	**2,046**	**6,707,809**
Increases	**–**	**433,277**	**1,031,193**	**257,607**	**148,332**	**852**	**83**	**1,871,344**
Allocations	–	432,699	1,031,193	257,607	148,332	265	83	1,870,179
Other increase	–	578	–	–	–	587	–	1,165
Decreases	**–**	**-255,216**	**–**	**-543**	**-77,412**	**-23**	**-34**	**-333,228**
Withdrawals	–	-250,150	–	-543 (4)	-77,412	-23	-34	-328,162
Other decrease	–	-5,066	–	–	–	–	–	-5,066
Closing balances	**309,874**	**434,344**	**1,031,193**	**6,290,060**	**175,703**	**2,656**	**2,095**	**8,245,925**

(1) Other changes in the Provision for taxes include the change in deferred tax liabilities for IRAP and the allocation of €153 thousand of interest accrued on the instalments of flat-rate withholding tax per Article 1.48 of Law 244/2007. – (2) Includes severance pay of contract staff and of ordinary staff prior to joining the supplementary pension fund. – (3) The opening balances include the balances of UIC (Table 22.5). The provisions transferred from UIC amounted to €467,810 thousand, of which €22,902 thousand relating to the provision for taxes, €438,046 thousand to allocations to severance pay and pension provisions, and €6,862 thousand to other staff costs. – (4) Includes the transfer of severance pay of staff participating in the supplementary pension fund.

The increase in *Provisions for specific risks* (Subitem 12.1) was due mainly to the transfer to the provision against counterparty risk associated with Eurosystem monetary policy operations. In accordance with the general accounting principle of prudence, the Governing Council of the ECB has deemed it appropriate to establish a buffer, totalling €5,736 million. In accordance with Article 32.4 of the ESCB Statute, this buffer was funded among all the national central banks of participating member states (NCBs) in proportion to their subscribed capital key shares in the ECB prevailing in 2008. The amount pertaining to the Bank of Italy represents 17.9776 per cent of the total and is equal to €1,031 million.

The increase in *Sundry staff-related provisions* (Subitem 12.2) was the result of:

a) the transfer of €257 million to the severance pay and pension provisions, which rose from €6,033 million at the end of 2007 (including the allocations transferred from UIC) to €6,290 million at the end of 2008. Of this amount €5,135 million was for supplementary pensions and €1,155 million for severance pay. Allocations for the year reflect in particular the updating of the mortality tables used to compute the actuarial reserves as well as the salary increases envisaged in labour contracts;

b) the increase of €71 million in the provision for staff costs. Of this figure, €59 million relate to early retirement measures in connection with the reorganization of the Bank's branch network.

The *Provision for general risks* (Item 14) rose from €6,647 million in 2007 to €7,096 million after the increase of €273 million following the merging of UIC and the transfer of €176 million approved by the General Council. The allocation for 2008 resumes the replenishment following the withdrawals of previous years.

Revaluation accounts (Item 13 on the liabilities side)

These include the valuation at market prices of gold, foreign currency, securities and reverse operations (see *Gold, assets and liabilities denominated in foreign currency* and *Securities portfolio*).

Table 22.12

Revaluation accounts (Item 13)
(thousands of euros)

	Balance at 31.12.2007 (1)	Withdrawals	Net revaluations	Balance at 31.12.2008
Exchange rate revaluations	**25,372,518**		**6,215,324**	**31,587,842**
of which: gold	*25,372,466*		*4,202,048*	*29,574,514*
net foreign currency assets	*37*		*2,013,122*	*2,013,159* (2)
financial assets related to investments of reserves and provisions	*15*		*154*	*169* (2)
Price revaluations	**4,604,801**		**-2,313,062**	**2,291,739**
of which: foreign currency securities	*230,156*		*550,089*	*780,245*
securities denominated in euros	*1,481*		*74,358*	*75,839*
financial assets related to investments of reserves and provisions	*4,373,164*		*-2,937,509*	*1,435,655*
Revaluations at 1 January 1999	**20**	**-9**	**–**	**11**
Total	**29,977,339**	**-9**	**3,902,262**	**33,879,592**

(1) The opening balances include the balances of UIC (Table 22.5). The revaluation accounts of UIC amounted to €1,504 thousand, of which €23 thousand related to the exchange rate revaluation of net foreign currency assets and €1,481 thousand to the price revaluation of securities denominated in euros. – (2) Includes net revaluations relating to forward operations.

Capital and reserves (Item 15 on the liabilities side)

As detailed below:

Table 22.13

Capital and reserves (Item 15) *(thousands of euros)*	31.12.2008	31.12.2007 (1)	Changes
15.1 Capital	**156**	**156**	**–**
15.2 Reserves under Article 39 of the Statute	**11,882,707**	**11,757,789**	**124,918**
Ordinary	5,859,575	5,827,829	31,746
Extraordinary	6,023,132	5,929,960	93,172
15.3 Other reserves	**7,739,511**	**7,737,846**	**1,665**
Revaluation reserves under Law 72/1983	694,502	694,502	–
Revaluation reserves under Law 408/1990	683,274	683,274	–
Revaluation reserves under Law 413/1991	16,943	16,943	–
Revaluation reserves under Law 342/2000	896,577	896,577	–
Revaluation reserves under Law 266/2005	1,521,240	1,519,575	1,665
Fund for the renewal of tangible fixed assets	1,805,044	1,805,044	–
Surplus from the merging of UIC (Law 231/2007)	2,121,931	2,121,931	–
Total	**19,622,374**	**19,495,791**	**126,583**

(1) For comparison, the data for 2007 include the balances of UIC (Table 22.5)

The attribution of the balances of UIC on 1 January 2008 at historical cost led to an increase of €2,196 million in the item *Other reserves*. Of this amount, €74 million related to reserves on which tax is kept in abeyance already entered in the 2007 balance sheet of UIC as an asset revaluation and €2,122 million to the attribution of the surplus from the merger.

The movements of the ordinary and extraordinary reserves are detailed below:

Table 22.14

Movements in ordinary and extraordinary reserves (Subitem 15.2) *(thousands of euros)*	Balance at 31.12.2007	Allocation of 2007 profit under Art.39 of the Statute	Distribution to shareholders under Art.40 of the Statute (1)	2008 income earned under Art.40 of the Statute	Balance at 31.12.2008
Ordinary	5,827,829	19,031	-27,870	40,585	5,859,575
Extraordinary	5,929,960	19,031	-28,277	102,418	6,023,132
Total	**11,757,789**	**38,062**	**-56,147**	**143,003**	**11,882,707**

(1) From the income earned in 2007.

Table 22.15

Shareholders in the Bank of Italy	At end-2008				At end-2007			
	Number	Share (1)	%	Votes	Number	Share (1)	%	Votes
With voting rights	58	299,934	100	539	60	299,934	100	582
S.p.A.s engaged in banking, including companies under Article 1, Legislative Decree 356/1990	*51*	*253,434*	*84*	*418*	*53*	*253,434*	*84*	*461*
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**	**66**	**300,000**	**100**	**582**

(1) The nominal value of each share is €0.52.

Memorandum accounts

The memorandum accounts totalled €419,329 million in 2008.

Table 22.16

Memorandum accounts
(thousands of euros)

	31.12.2008	31.12.2007	Changes
Orders in progress	**794,893**	**30,450**	**764,443**
purchase	790,105	–	790,105
sale	4,788	30,450	-25,662
Forward operations	**66,615,773**	**28,718,758**	**37,897,015**
forward sales of securities	57,070,852	28,342,451	28,728,401
forward sales of foreign currencies	8,494,108	314,083	8,180,025
forward purchases of foreign currencies	882,834	–	882,834
purchase futures	167,979	62,224	105,755
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	**824,450**	**379,183**	**445,267**
to the IMF for loans granted	824,450	379,183	445,267
Collateral received	**109,562,383**	**42,214,366**	**67,348,017**
for refinancing operations (1)	108,972,092	41,747,730	67,224,362
other	590,291	466,636	123,655
Collateral granted	**30,351**	**25,666**	**4,685**
Third-party securities and valuables on deposit with the Bank	**151,514,455**	**174,404,408**	**-22,889,953**
Own securities and valuables held with the Bank and third parties	**86,877,432**	**78,384,700**	**8,492,732**
Memorandum accounts of the supplementary pension fund	**56,198**	**42,715**	**13,483**
Total	**419,329,235**	**324,200,246**	**95,128,989**

(1) Includes securities and bank loans used as collateral.

In particular, forward sales of securities include commitments associated with the restitution of securities used as collateral for reverse operations.

Forward sales of foreign currency include the following commitments:

– to the ECB in connection with the Term Auction Facility granted to Eurosystem counterparties through reverse operations (see *Gold and assets and liabilities denominated in foreign currency*) and dollar/euro swaps;

– 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; at the same time the ECB undertakes analogous operations with the Eurosystem NCBs, which use the francs to provide liquidity to euro-area counterparties;

– 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 Eurosystem counterparties for dollar and Swiss franc swaps entered into as part of the aforementioned foreign currency financing programmes.

Securities loans relate to extraordinary liquidity-support operations undertaken at the end of 2008. The securities loaned by the Bank and those received as collateral from counterparties are shown at their market value.

Futures are shown at the notional value of contracts; the collateral provided includes securities deposited with the clearer. Commitments to the IMF for loans granted relate to existing IMF initiatives with Italy for financing to be disbursed.

Comments on the items of the income statement

The net profit for the year was €175 million, compared with €95 million in 2007. The comparative data in the tables illustrating the items of the income statement do not include the income and expenses of the UIC.

Net interest income (Item 1)

Net interest income increased by €312 million, from €3,072 million to €3,384 million.

Interest income increased as a result of the higher rate of return on assets denominated in euros, mainly due to the larger average stock of interest-bearing assets. The interest earned on foreign currency assets decreased owing to their lower average rate of return. *Interest expense* also increased, but to a lesser extent and primarily owing to the rise in the average stock of 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 22.17

Interest income (Subitem 1.1) *(thousands of euros)*			
	2008	2007	Changes
On assets denominated in euros	5,268,001	4,372,940	895,061
securities	*2,373,514*	*2,363,880*	*9,634*
lending operations	*802,635*	*771,526*	*31,109*
intra-ESCB balances	*2,040,163*	*1,206,070*	*834,093*
other	*51,689*	*31,464*	*20,225*
On assets denominated in foreign currency	814,270	1,182,183	-367,913
securities	*550,535*	*770,196*	*-219,661*
other assets denominated in foreign currency	*233,900*	*369,519*	*-135,619*
receivables from the IMF	*29,835*	*42,468*	*-12,633*
Total	**6,082,271**	**5,555,123**	**527,148**

At year-end 2008 the interest income on foreign currency assets included €58 million from short-term financing in dollars to Eurosystem counterparties under the Term Auction Facility. A corresponding amount of interest is due to the ECB in respect of the provision of foreign currency funds (Table 22.18: *Sundry* interest on liabilities denominated in foreign currency).

Table 22.18

Interest expense (Subitem 1.2) *(thousands of euros)*			
	2008	2007	Changes
On liabilities denominated in euros	2,613,003	2,423,089	189,914
Treasury payments account	*1,043,942*	*1,015,107*	*28,835*
sinking fund for the redemption of government securities	*791*	*11,423*	*-10,632*
current accounts (covering the minimum reserve system)	*934,903*	*844,036*	*90,867*
intra-ESCB balances	*545,830*	*512,573*	*33,257*
sundry	*87,537*	*39,950*	*47,587*
On liabilities denominated in foreign currency	84,868	59,564	25,304
counterpart of SDRs allocated by the IMF	*19,374*	*31,855*	*-12,481*
sundry	*65,494*	*27,709*	*37,785*
Total	**2,697,871**	**2,482,653**	**215,218**

Net result of financial operations, writedowns and transfers to/from risk provisions (Item 2)

The result for 2008 comprises:

– net profit on trading in securities denominated in foreign currency (€334 million), deriving primarily from sales of securities denominated in dollars;

– net profit on foreign exchange trading (€18 million), deriving from sales of assets denominated in dollars and Swiss francs;

– net profit (€3 million) on foreign currency derivatives, including gold;

– net profit on other financial operations, which include the fees periodically paid to the Bank of Italy on foreign currency securities loans under the Automated securities lending programme (€5.3 million), and income from securities loans to support market liquidity (€2.3 million);

– write-downs of financial assets and positions in foreign currency as a result of the depreciation of the pound sterling (€1,222 million) and reductions in securities prices (€23 million);

– the transfer of €176 million to the provision for general risks.

Table 22.19

Net result of financial operations, writedowns and transfers to/from risk provisions (Item 2)
(thousands of euros)

	2008	2007	Changes (1)
Profits (+) and losses (-) on financial operations	362,029	-33,770	395,799
trading in securities denominated in euros	*420*	*797*	*-377*
trading in securities denominated in foreign currency	*333,569*	*21,463*	*312,106*
foreign exchange trading	*17,851*	*-57,716*	*75,567*
derivative contracts denominated in foreign currency	*2,554*	*-1,347*	*3,901*
other transactions	*7,635*	*3,033*	*4,602*
Write-downs (-) of financial assets and positions	-1,245,176	-1,910,094	664,918
exchange rate losses	*-1,222,163*	*-1,909,579*	*687,416*
price losses			
– securities denominated in foreign currency	*-578*	*-515*	*-63*
– securities denominated in euros	*-22,435*	*–*	*-22,435*
Transfers to (-) and from (+) the provision for general risks for exchange rate and price changes	-176,000	1,284,000	-1,460,000
Total	**-1,059,147**	**-659,864**	**-399,283**

(1) Negative changes indicate smaller profits or larger losses/writedowns; positive changes larger profits or smaller losses/writedowns.

Net income from fees and commissions (Item 3)

The result for the year shows an increase of €17 million, from €4 million to €21 million, mainly owing to the disappearance, following the merger of UIC, of the fees it received for the management of part of the Bank's foreign exchange reserves. *Fee and commission income* (up from €24 million to €27 million) includes: fees for financial services on behalf of public-sector entities (€3 million); charges payable by the participants in the BI-Rel and TARGET2 systems (€7 million); charges for Correspondent Central Banking Model services (€4 million), those for the use of Central Credit Register information (€4 million) and substitute protest declarations (€4 million). *Fee and commission expense* (down from €20 million to €6 million) consists mainly of €4 million of income from the centralized securities management service.

Income from participating interests (Item 4)

The item *Income from participating interests* increased by €204 million, from €13 million to €217 million, and refers only to the Bank of Italy's share of the ECB's seigniorage income on banknotes.

In 2008 part of the ECB's seigniorage income (€2,230 million) was withheld for transfer to a provision for foreign exchange rate, interest rate and gold price risks; the remainder (€1,206 million, of which the Bank of Italy's share was €217 million) was distributed to the Eurosystem NCBs as a dividend prepayment.

Taking into account the prepayment already made, in March 2009 the Bank of Italy received a further €21 million.

Net result of the pooling of monetary income (Item 5)

The result for 2008 was -€715 million, which includes:

– the receipt of the Bank of Italy's share of the pooling of monetary income (€316 million, compared with €48 million in 2007);

– the transfer of the Bank of Italy's share to the provision in respect of monetary policy operations (€1,031 million).

The result in 2008 was the difference between the monetary income pooled, €4,632 million, and that redistributed, €4,948 million. The monetary income pooled of each NCB is determined by measuring the actual annual income that derives from the earmarkable assets held against its liability base. The liability base of each NCB consists of: banknotes in circulation; liabilities to credit institutions related to monetary policy operations denominated in euros; net intra-Eurosystem liabilities resulting from TARGET transactions; and net intra-Eurosystem liabilities related to the allocation of euro banknotes within the Eurosystem. Any interest paid on liabilities included within the liability base is deducted from the monetary income to be pooled. The earmarkable assets of each NCB consist of: lending to euro-area credit institutions related to monetary policy operations; intra-Eurosystem claims equivalent to the transfer of foreign reserve assets to the ECB; net intra-Eurosystem claims resulting from TARGET transactions; net intra-Eurosystem claims related to the allocation of euro banknotes within the Eurosystem; and a limited amount of each NCB's gold holdings in proportion to each NCB's capital key share. Gold is considered to generate no income. Where the value of an NCB's earmarkable assets exceeds or falls short of the value of its liability base, the difference is offset by applying the last marginal rate applied to Eurosystem main refinancing operations. The monetary income pooled by the Eurosystem is allocated to each NCB according to its subscribed capital key.

Net income from financial assets representing investments of reserves and provisions (Item 6)

The decrease in this item was due to the write-downs deriving from the adjustment to the end-year prices of shares and investments in EFTs and units of collective undertakings, which was only partly offset by the increase in the profits earned on the disposal of equity securities as part of a gradual change in the geographical and sectoral composition of the portfolio of listed shares.

Table 22.20

Net income from financial assets representing investments of reserves and provisions (Item 6)
(thousands of euros)

	2008	2007	Changes
Interest (1)	956,886	991,121	-34,235
reserves pursuant to the Statute	*311,224*	*320,385*	*-9,161*
other reserves and provisions	*645,662*	*670,736*	*-25,074*
Dividends	302,115	305,436	-3,321
reserves pursuant to the Statute	*162,583*	*169,032*	*-6,449*
other reserves and provisions	*139,532*	*136,404*	*3,128*
Profits/losses from trading and disposals	266,242	85,709	180,533
reserves pursuant to the Statute	*151,429*	*63,069*	*88,360*
other reserves and provisions	*114,813*	*22,640*	*92,173*
Write-downs	-700,248	-43,315	-656,933
reserves pursuant to the Statute	*-486,837*	*-26,495*	*-460,342*
other reserves and provisions	*-213,411*	*-16,820*	*-196,591*
Other components	4,625	2,271	2,354
reserves pursuant to the Statute	*4,604*	*2,271*	*2,333*
other reserves and provisions	*21*	–	*21*
Total	**829,620**	**1,341,222**	**-511,602**

(1) The item *Interest income* has been changed to *Interest* owing to the presence of negative components of income deriving from transactions to hedge foreign currency investments.

Appropriation of investment income to reserves provided for in the Statute (Item 9)

As provided for in Article 40 of the Statute, income earned on investments of the ordinary and extraordinary reserves is used to increase these reserves. The amount appropriated in 2008 fell from €528 million to €143 million, owing to price decreases mainly of equities, which were offset only in part by the larger profit on trading (for more details, see *Net income from financial assets representing investments of reserves and provisions*).

Sundry expenses and charges (Item 10)

This item comprises:

Table 22.21

Sundry expenses and charges (Item 10)
(thousands of euros)

	2008	2007	Changes
Staff wages and salaries and related costs	697,282	629,873	67,409
Other staff costs	54,351	40,496	13,855
Transfers to provisions for accrued expenses and staff severance pay and pensions	347,139	97,496	249,643
staff severance pay and pensions	*257,607*	*23,636*	*233,971*
accrued expenses not yet paid	*89,184*	*73,704*	*15,480*
other	*348*	*156*	*192*
Pensions and severance payments	281,072	292,441	-11,369
Emoluments paid to head and branch office collegial bodies (1)	3,861	2,889	972
Administrative costs	431,739	400,569	31,170
Depreciation of tangible and intangible fixed assets	203,453	195,756	7,697
Costs of banknote production services	7,075	–	7,075
Other expenses	22,633	27,424	-4,791
Total	**2,048,605**	**1,686,944**	**361,661**

(1) The item includes the accumulated remuneration due to the General Council and the Board of Auditors, amounting respectively to €1,109,014 (€898,694 in 2007) and €130,000 (€90,656 in 2007), net of value added tax and social security contributions.

The increase in *Staff wages and salaries and related costs* was primarily due to that in the number of staff following the merging of UIC.

Table 22.22

The Bank's staff

	Average number		Percentage composition of persons in service	
	2008	2007	2008	2007
Managerial	2,093	1,902	26.9	25.5
Non-executive	4,599	4,465	59.1	59.9
General services and security	604	603	7.8	8.1
Blue-collar	482	486	6.2	6.5
Total payroll workers	**7,778**	**7,456**	**100.0**	**100.0**
Contract workers	31	32		

Administrative costs increased by €31 million. In more detail, systems assistance increased by €5 million (from €24 million to €29 million); participation in TARGET2 by €6 million (from €1 million to €7 million); utilities by €5 million (from €24 million to €29 million); and electronic transmission by €2 million (from €15 million to €17 million). By contrast, security services and banknote escort decreased by €2 million (from €91 million to €89 million). Equipment rentals remained basically unchanged (€25 million), as did building maintenance (€55 million), external software leasing and maintenance (€31 million) and raw and subsidiary materials for banknote production (€28 million).

Costs of banknote production services, which include costs for banknote production outside the Bank, totalled €7 million in 2008.

Extraordinary income and expense (Item 12)

Extraordinary income and expense showed a negative balance of €61 million, primarily owing to the €59 million of early retirement incentives paid to staff employed in the Bank's branches that were closed as part of the overall reorganization of the branch network.

Taxes on income for the year and productive activities (Item 13)

Taxes for the year amount to €328 million and comprise both the current taxes due to the tax authorities and the change in deferred tax assets and liabilities as well as the liability (€16 million) for withholding tax due to the alignment of accounting/book and fiscal values of assets.

More specifically, corporate income tax for the year included €270.5 million of taxes for the current year and recorded in the tax provision and €270.5 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. Overall, corporate income tax for the year, including deferred taxes, amounted to €218 million, compared with €1,530 million in 2007, of which €1,255 million in relation to the reduction in deferred tax assets caused by the lowering of the tax rate from 33 to 27.5 per cent.

The regional tax on productive activities (Irap) rose from €80 million to €94 million, the result of €146 million of tax for the year, recorded in the tax provision, and a change of €52 million in the deferred component.

Table 22.23

Taxes on income for the year (Item 13)
(thousands of euros)

	2008	2007
Taxes for the year (-)	-432.699 (1)	-225.400
Change in deferred tax assets (+/-)	100.330	-1.385.539
Change in deferred tax liabilities (+/-)	4.641	449
Taxes on income for the year (-)	**-327.728**	**-1.610.490**

(1) Includes €15,999 of withholding tax in relation to the alignment of book/accounting and fiscal values of assets subject, until 31 December 2007, to fiscal accelerated depreciation.

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 2008 of €175,211,691:

	euros
– 20 per cent to the ordinary reserve	35,042,338
– an amount equal to 6 per cent of the share capital to shareholders ...	9,360
– 20 per cent to the extraordinary reserve	35,042,338
– an additional amount equal to 4 per cent of the share capital to shareholders	6,240
– the remaining amount to the State	105,111,415
Total	175,211,691

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 €58,788,000, equal to 0.50 per cent (as in 2007) of the total reserves at 31 December 2007.

If these proposals are approved, the total dividend will be equal to €58,803,600 corresponding to €196,012 per share.

THE GOVERNOR

Mario Draghi

23. DOCUMENTATION ATTACHED TO THE ANNUAL ACCOUNTS

REPORT OF THE BOARD OF AUDITORS

ON THE 115th FINANCIAL YEAR OF THE BANK OF ITALY
AND THE ACCOUNTS FOR THE YEAR ENDED 31 DECEMBER 2008

To the shareholders,

We have examined the annual accounts of the Bank of Italy for the year ended 31 December 2008, 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 accounting checks were also based on the same principles.

In our opinion the annual accounts of the Bank of Italy for the year ended 31 December 2008 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 tax losses for the years 2002-04, is based on the reasonable expectation – considering the outlook for the Bank's income – of offsetting the full amount of the above-mentioned tax losses. In relation to the result for the year, deferred tax assets increased by €102 million (from €6,311 million to €6,413 million).

The General Council approved the transfer of €176 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	€	267,430,630,026
Liabilities	€	247,633,044,007
Capital and reserves	€	19,622,374,328
Net profit for the year (as shown in the income statement)	€	175,211,691

The memorandum accounts, equal to €419,329,234,853, 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	€	35,042,338
– an amount equal to 6 per cent of the share capital to shareholders	€	9,360
– 20 per cent to the extraordinary reserve	€	35,042,338
– an additional amount equal to 4 per cent of the share capital to shareholders	€	6,240
– the remaining amount to the State	€	105,111,415
Total	€	175,211,691

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 €58,788,000, equal to 0.50 per cent of such reserves at 31 December 2007 and within the limits laid down in the above-mentioned article.

During the year ended 31 December 2008 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 2008 that have been submitted to you (the balance sheet, the income statement and the notes to the accounts) and the proposed allocation of the net profit for the year and the additional allocation to capital pursuant to Article 40 of the Statute.

THE BOARD OF AUDITORS

Angelo Provasoli (Chairman)
Giovanni Fiori
Elisabetta Gualandri
Gian Domenico Mosco
Dario Velo

LIST OF ABBREVIATIONS

ABI – *Associazione bancaria italiana*
Italian Banking Association

BI–COMP – *Banca d'Italia Compensazione*
Bank of Italy Clearing System

BI–REL – *Banca d'Italia Regolamento Lordo*
Bank of Italy real-time gross settlement system

BOTs – *Buoni ordinari del Tesoro*
Treasury bills

BTPs – *Buoni del Tesoro poliennali*
Treasury bonds

CCTs – *Certificati di credito del Tesoro*
Treasury credit certificates

CIPA – *Convenzione interbancaria per i problemi dell'automazione*
Interbank Convention on Automation

Confindustria – *Confederazione generale dell'industria italiana*
Confederation of Italian Industry

Consob – *Commissione nazionale per le società e la borsa*
Companies and Stock Exchange Commission

Covip – *Commissione di vigilanza sui fondi pensione*
Pension fund supervisory authority

CTOs – *Certificati del Tesoro con opzione*
Treasury option certificates

CTZs – *Certificati del Tesoro zero-coupon*
Zero-coupon Treasury certificates

EFPD – Economic and Financial Planning Document

FPR – Forecasting and Planning Report

HICP – Harmonized index of consumer prices

ICI – *Imposta comunale sugli immobili*
Municipal real estate tax

Iciap – *Imposta comunale per l'esercizio di imprese e di arti e professioni*
Municipal tax on businesses and the self-employed

Ilor – *Imposta locale sui redditi*
Local income tax

INAIL – *Istituto nazionale per l'assicurazione contro gli infortuni sul lavoro*
National Industrial Accidents Insurance Institute

INPS – *Istituto nazionale per la previdenza sociale*
National Social Security Institute

Irap	–	*Imposta regionale sulle attività produttive* Regional tax on productive activities
Irpef	–	*Imposta sul reddito delle persone fisiche* Personal income tax
Ires	–	*Imposta sul reddito delle società* Corporate income tax
ISAE	–	*Istituto di studi e analisi economica* Institute for Economic Research and Analysis
Istat	–	*Istituto nazionale di statistica* National Institute of Statistics
Isvap	–	*Istituto per la vigilanza sulle assicurazioni private e di interesse collettivo* Supervisory authority for the insurance industry
MTS	–	*Mercato telematico dei titoli di Stato* Screen-based secondary market in government securities
QRBR	–	Quarterly Report on the Borrowing Requirement
SACE	–	*Istituto per i servizi assicurativi per il commercio estero* Foreign Trade Insurance Services Agency
SIM	–	*Società di intermediazione mobiliare* Italian investment firm
TARGET	–	Trans-European Automated Real-Time Gross Settlement Express Transfer System
UIC	–	*Ufficio italiano dei cambi* Italian Foreign Exchange Office

ADMINISTRATION OF THE BANK OF ITALY

AT 31 DECEMBER 2008

GOVERNING BOARD - DIRECTORATE

Mario DRAGHI	Governor - Member of the Governing Board
Fabrizio SACCOMANNI	Director general - Member of the Governing Board
Antonio FINOCCHIARO *	Deputy director general - Member of the Governing Board
Ignazio VISCO	Deputy director general - Member of the Governing Board
Giovanni CAROSIO	Deputy director general - Member of the Governing Board
Anna Maria TARANTOLA **	Deputy director general - Member of the Governing Board

* Until 12.1.2009
** Since 13.1.2009

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
Anna Maria TARANTOLA *	responsible for banking and financial supervision
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 organization and logistics
Carlo PISANTI	responsible for currency circulation
Olivia BRIZZI	advisor to the directorate on matters concerning the reorganization of the bank
Claudio CLEMENTE	accountant general
Giovanni CASTALDI	responsible for the financial intelligence unit
Carlo CHIESA	responsible for reorganizing it functions
Stefano MIELI **	responsible for banking and financial supervision

* Deputy Director General since 13.1.2009
** Managing Director since 28.1.2009