BANCA D'ITALIA
EUROSISTEMA

Annual Report

Abridged Version

Ordinary Meeting of Shareholders
Rome, 31 May 2011

117th FINANCIAL YEAR

2010

Financial Year 117th

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Address
Via Nazionale, 91
00184 Rome - Italy

Telephone
+39 0647921

Website
www.bancaditalia.it

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–	the phenomenon in question does not occur
....	the phenomenon occurs but the value is not known
..	the value is known but is nil or less than half the final digit shown

THE INTERNATIONAL ECONOMY

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

World output expanded by 5.0 per cent in 2010, a strong recovery after the small contraction of 0.5 per cent in 2009. The growth in the advanced economies was relatively modest (3.0 per cent); in the emerging and developing countries it was much more vigorous (7.3 per cent).

Economic activity in the leading advanced economies continued to be held back by the repercussions of the deep recession of 2008-09, triggered by the serious financial crisis. At the end of last year, GDP had returned to its pre-crisis level only in the United States, while in the United Kingdom, Japan and the euro area economic activity was still at a lower level.

In the emerging and developing countries, which as a whole were only marginally affected by the financial crisis, the recovery was very sharp, especially in China and India, which, with an average increase in GDP of 9.7 per cent, continued to make the main contribution to the growth of the world economy.

The stance of the monetary policies of the leading advanced economies was kept expansionary for the whole of 2010, with reference rates remaining virtually unchanged at extraordinarily low levels; in addition to these low rates, the Federal Reserve and the Bank of Japan adopted non-standard measures. In the early months of 2011, inflation began to pick up, driven by the increase in energy and food prices. Against this background the Eurosystem raised its reference rate in April.

In the United Kingdom and some euro-area countries a start has been made on plans to consolidate the public finances, thereby putting an end to the stimuli aimed at combating the effects of the financial crisis. Measures to support growth are still prevalent in the United States and Japan, but the rapid rise in their public debts makes the drafting of deficit-reduction measures urgent.

The governments and central banks of many emerging countries progressively normalized their fiscal and monetary policies in 2010, partly in view of the return to almost full utilization of the factors of production. Against this background, the increases in raw material prices were passed on to consumer prices from the summer onwards, leading central banks to intervene repeatedly to make monetary conditions less accommodating. Fearing that the widening of interest rate differentials might attract further inflows of short-term capital, thus boosting the expansion of credit and the upward pressure on the prices of financial assets and the exchange rate, many emerging countries, including China and Brazil, restricted bank credit by other means as well.

The United States

The United States economy grew by 2.9 per cent in 2010 (Table 1.1), with inventory accumulation contributing about half the increase. The critical state of the real-estate market and the persistence of restrictions, albeit less severe than in the preceding years, on the supply of bank credit countered the support for growth provided by monetary and fiscal policy.

Table 1.1

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

	2008	2009	2010	2010				2011
				Q1	Q2	Q3	Q4	Q1
United States								
GDP (1)	..	-2.6	2.9	3.7	1.7	2.6	3.1	1.8
Domestic demand (1)	-1.1	-3.6	3.3	3.9	5.1	4.2	-0.2	1.8
Inflation (2)	3.8	-0.4	1.6	2.4	1.8	1.2	1.3	2.1
Japan								
GDP (1)	-1.2	-6.3	4.0	9.1	0.2	3.8	-3.0	-3.7
Domestic demand (1)	-1.4	-4.8	2.2	7.0	-0.6	4.6	-2.7	-3.0
Inflation (2)	1.4	-1.4	-0.7	-1.2	-0.9	-0.8	0.1	..
European Union								
GDP (1)	0.5	-4.2	1.8	1.8	4.1	2.0	0.9	3.1
Domestic demand (1)	0.4	-4.2	1.3	2.8	3.5	1.3	0.2	….
Inflation (2)	3.7	1.0	2.1	1.7	2.0	2.1	2.5	2.9
United Kingdom								
GDP (1)	-0.1	-4.9	1.3	0.8	4.3	2.9	-1.9	2.0
Domestic demand (1)	-0.7	-5.5	2.4	4.1	3.7	3.4	0.1	….
Inflation (2)	3.6	2.2	3.3	3.3	3.5	3.1	3.4	4.1
Canada								
GDP (1)	0.5	-2.5	3.1	5.5	2.2	1.8	3.3	….
Domestic demand (1) (3)	2.8	-1.8	4.4	5.4	3.7	3.7	4.7	….
Inflation (2)	2.4	0.3	1.8	1.6	1.4	1.8	2.3	2.6
Advanced economies								
GDP (4)	0.2	-3.4	3.0	….	….	….	….	….
Memorandum item:								
World output (4)	2.9	-0.5	5.0	….	….	….	….	….

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

Household consumption expanded by 1.7 per cent, in line with the increase of 1.4 per cent in real disposable personal income. The personal saving rate for the year amounted to 5.8 per cent, with virtually no change on 2009. Households continued to reduce their debt and by the end of the year the ratio of mortgage and consumer debt to disposable personal income was 108.6 per cent, a decrease of 6.5 percentage points on the end of 2009.

Non-residential fixed investment grew by 5.7 per cent, recovering only part of the contraction that had occurred during the recession. Non-financial corporations' gross profits increased considerably, benefiting from substantial productivity gains and a modest increase in labour costs. Residential fixed investment diminished by 3 per cent, which was less than in the preceding years.

Non-farm payroll employment rose by about 900,000 units, making good only a little more than one-tenth of the large job losses recorded in the two previous years (8.7 million units). The unemployment rate declined by 0.5 percentage points to stand at 9.4 per cent in December, owing in part to a fall of 0.4 points in the labour force participation rate. The long-term unemployed – those out of work for at least 27 weeks – were more than 40 per cent of the total on average for the year, thus aggravating the problem of finding them work in view of the deterioration in human capital generally associated with long periods of inactivity.

According to an advance estimate of national accounts data, in the first quarter of 2011 GDP slowed to a very modest rate of growth (1.8 per cent on an annual basis) as a consequence of the slowdown in non-residential fixed investment and the contraction in government expenditure. In the first four months of 2011, the recovery in non-farm payroll employment continued, with an increase of 768,000 units, and the unemployment rate continued to fall, reaching 9.0 per cent in April.

Consumer price inflation slowed to 1.1 per cent in November 2010. In the second half of last year, measures of inflation that exclude the most volatile components had pointed to a risk of deflation. In particular, core inflation, net of energy and food products, had fallen to a low of 0.6 per cent in October. From December onwards, inflation picked up again, as a result of the large increase in energy and food prices, to stand at 3.2 per cent in April.

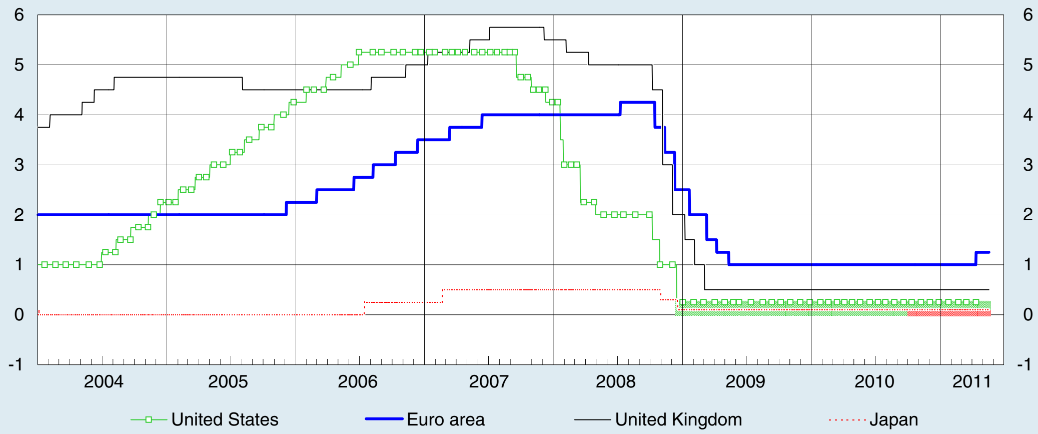
In 2010 and in the early months of 2011, the Federal Reserve adopted a variety of vigorous monetary policy measures to support the recovery and counter the risk of deflation. It kept its reference rate in a range between 0.00 and 0.25 per cent, reiterating its intention to leave the rate unchanged for an extended period at each meeting of the Federal Open Market Committee (Figure 1.1). In August, the Federal Reserve began a series of purchases of longer-term securities issued by the US Treasury, thereby offsetting the reduction in its holdings of agency debt and agency mortgage-backed securities. In November, it launched a new programme to purchase longer-term Treasury securities, which should be completed by the end of June for a total of $600 billion.

The Federal Reserve continued to signal its determination to counter potential inflationary pressure in the future by preparing instruments that would facilitate a flexible and possibly rapid reduction in excess bank reserves. In particular, it included mortgage-backed securities among the financial instruments that can be used as collateral in reverse repos and experimented with auctions of term deposits. Long-term inflation expectations, as measured by the Federal Reserve Bank of Philadelphia's *Survey of Professional Forecasters*, remained stable at around 2.3 per cent in 2010 and in the early months of 2011.

The stance of budgetary policy was kept expansionary. In December, the Administration launched a package of temporary stimulus measures based principally on a reduction of the employee's portion of the payroll tax for Social Security and incentives for investment in machinery. The package also included the extension to 2011 of unemployment benefits for the long-term unemployed and the extension until 2012 of the tax cuts enacted by the Bush Administration in 2001 and 2003.

Figure 1.1

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



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

According to Congressional Budget Office estimates, the federal budget deficit on the assumption of unchanged legislation, which is plausible considering the deadlock between the Administration and Congress, will rise from 8.9 per cent of GDP in 2010 to 9.3 per cent in 2011 and then fall to 6.9 per cent in 2012.

According to the International Monetary Fund, general government net borrowing will fall from 10.6 per cent of GDP in 2010 to 7.5 per cent in 2012, while gross debt will rise from 91.6 per cent of GDP at the end of 2010 to 102.9 per cent at the end of 2012. Looking further ahead, there is the risk of a large increase in federal debt (and hence in general government gross debt) as a consequence of the expected increase in the cost of the main healthcare programmes (Medicare and Medicaid) and social security.

The real-estate market crisis. – The Case-Shiller home price index covering the ten largest metropolitan areas fluctuated in 2010: a moderate recovery in the first half of the year, due to temporary tax incentives for buyers, was followed by a sharp fall in the second half and in the early months of 2011. In February, the index was down 3.5 per cent on December 2009 and 32.5 per cent on the peak recorded in June 2006.

The persistence of the crisis in the residential housing market, of which further evidence is to be found in the small number of sales of new homes, is due to several factors, including the tightening of the supply of mortgage loans from the banking system and the high proportion of mortgage foreclosures started.

As regards the measures to support the housing market, the Home Affordable Modification Program, introduced in March 2009 to promote loan modifications for borrowers faced with default, failed to achieve the, albeit high, objective of modifying between 3 and 4 million contracts. By March 2011, only about 587,000 mortgage loans had been permanently modified. Further evidence of the Program's limited effectiveness is to be found in the Congressional Budget Office estimate of its cost, no more than $1 billion, compared with an initial allocation of $50 billion in the context of the Troubled Asset Relief Program.

After recording a very large fall of about 29 per cent in 2009, the prices of commercial real estate fluctuated. In February 2011, Moody's price index, which covers four property types (office, retail, industrial and multi-family with more than four units) was 6.5 per cent down on December 2009.

Japan

In 2010, Japanese GDP grew by 4.0 per cent (Table 1.1). The most important contributions to this result came from net exports (1.8 percentage points) and consumption (just over one point). Exports increased by 23.9 per cent, driven by those to East Asia, which accounted for more than half the total. The recovery in consumption came primarily from purchases of durables, which were stimulated by economic policy incentives. Labour market conditions improved only a little. In December 2010, the unemployment rate was 4.9 per cent, down by 0.3 percentage points on twelve months earlier; over the same period total employment grew by just 0.1 per cent (40,000 units).

In March 2011, economic activity was seriously disrupted by the earthquake that hit the Tohoku region in the North-East of Japan (see the box "The economic consequences of the earthquake in Japan" in *Economic Bulletin*, April 2011). The disaster affected GDP in several ways: by reducing the potential supply of electricity, damaging industrial facilities and interrupting the supply of intermediate goods. Industrial production fell by 15 per cent in March compared with the previous month. According to preliminary estimates, GDP fell in the first quarter by an annualized 3.7 per cent.

The deflationary tendencies diminished in intensity. Excluding energy and food products, the decline in consumer prices slowed from 1.6 per cent in May 2010 to 0.7 per cent in March. On the basis of the overall index of consumer prices, deflation came to a halt in the early months of 2011.

The Bank of Japan accentuated the expansionary stance of monetary policy in 2010. In October it reduced the range of its reference rate to 0.0 to 0.1 per cent. At the same time it launched the Asset Purchase Programme with the aim of disbursing three- and six-month loans at an interest rate of 0.1 per cent for a total of ¥30,000 billion (about 6.2 per cent of GDP) and making extraordinary temporary purchases of government securities and various private sector financial instruments for a total of ¥5,000 billion. In June, the central bank launched a ¥3,000 billion loan package at particularly favourable conditions with a maturity of one year, extendable up to four years, to encourage the disbursement of funds by the financial system to firms with plans to innovate and improve productivity. To attenuate the adverse effects of the earthquake on economic activity and the confidence of consumers and companies, in March the Bank of Japan increased the Asset Purchase Programme to ¥10,000 billion and in April it set up a ¥1,000 billion fund for the support of bank loans to firms located in the region hit by the earthquake.

According to the latest IMF estimates, Japanese general government net borrowing, equal to 9.5 per cent of GDP in 2010, will remain high in coming years, owing in part to the reconstruction costs associated with the earthquake. Accordingly, general government gross debt is expected to rise from 220.3 per cent of GDP at the end of 2010 to 233.4 per cent at the end of 2012.

The European Union

In 2010, the GDP of the 27 countries belonging to the European Union grew by 1.8 per cent, as did the GDP of the euro-area countries.

The United Kingdom. – Economic activity expanded by 1.3 per cent last year, thanks to the substantial contribution provided by inventories. Household consumption, held back by restrictive credit conditions and highly uncertain prospects for earnings, grew by no more than 0.6 per cent. Consumer price inflation fluctuated between 3 and 4 per cent for the whole of 2010; in the early months of this year it exceeded 4 per cent. The sharp upturn in inflation, including measures that exclude the most volatile components, is generally attributed to the depreciation of the pound and temporary factors such as the increase in VAT rates and the rise in raw material prices.

The Bank of England maintained the expansionary stance of monetary policy. Its reference rate remained unchanged at 0.5 per cent; the stock of securities acquired in connection with the creation of reserves was unchanged at £200 billion (about 14 per cent of GDP). The decision not to alter the monetary policy stance, even though the rate of inflation had exceeded the 2 per cent target by more than 2 percentage points, reflected the belief that the recent price movements were due to factors of a mainly temporary nature.

In the 2010-11 financial year to the end of March, the public sector borrowing requirement, excluding the temporary effects of measures in support of the financial system, fell to 9.6 per cent of GDP (from 11.1 per cent in 2009-10). The improvement in the public finances is in line with the consolidation plan set out in the emergency budget adopted in June. This established the following objectives: the complete elimination over five years of the cyclically adjusted current budget deficit, and the start, in the 2015-16 financial year, of a reduction in the ratio to GDP of public sector net debt, excluding the temporary effects of measures in support of the financial system. The overall design of the corrective action was confirmed in the budget submitted to Parliament in March of this year and, according to the Office for Budget Responsibility (a body set up last year to provide independent analysis of fiscal policy) is consistent with achievement of the objectives set: the cyclically adjusted current budget deficit is expected to fall from 4.6 per cent of GDP in 2010-11 to 3.2 per cent in 2011-12 and be essentially eliminated in 2014-15; public sector net debt, which was just below 60 per cent of GDP in March, is expected to rise to 70.9 per cent in March 2014 and then to fall gradually.

The new European Union members. – After contracting sharply in 2009, economic activity expanded in nearly all the eight new EU member countries not part of the euro area, albeit at rates that were significantly different and, except for Poland, below their pre-crisis levels (Table 1.2). Overall, GDP grew by 2.1 per cent (compared with a contraction of 3.5 per cent in 2009), driven mainly by exports and inventories. Domestic demand remained weak, although there were signs of improvement over the year.

Inflationary pressure, which had been relatively restrained in the first part of the year, began to build up again at the end of 2010 and in the early months of this year, spurred by the increase in energy and food prices. In 2010, inflation averaged 3.2 per cent, half a percentage point up on 2009.

Table 1.2

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

	GDP		Consumer prices (2)		Balance on current account (3)		External debt (3) (4)	Govt. budget balance (3)		Public debt (3)
	2009	2010	2009	2010	2009	2010	2010	2009	2010	2010
Bulgaria	-5.5	0.2	2.5	3.0	-8.9	-1.0	104.7	-4.7	-3.2	16.2
Czech Republic	-4.1	2.3	0.6	1.2	-3.2	-3.8	49.5	-5.9	-4.7	38.5
Estonia	-13.9	3.1	0.2	2.7	4.5	3.6	115.0	-1.7	0.1	6.6
Hungary	-6.7	1.2	4.0	4.7	0.4	2.1	158.5	-4.5	-4.2	80.2
Latvia	-18.0	-0.3	3.3	-1.2	8.6	3.6	163.6	-9.7	-7.7	44.7
Lithuania	-14.7	1.3	4.2	1.2	4.3	1.8	85.9	-9.5	-7.1	38.2
Poland	1.7	3.8	4.0	2.7	-2.2	-3.4	66.4	-7.3	-7.9	55.0
Romania	-7.1	-1.3	5.6	6.1	-4.2	-4.1	76.1	-8.5	-6.4	30.8
Total	**-3.5**	**2.1**	**3.7**	**3.2**	**....**	**....**	**81.3**	**-6.8**	**-6.3**	**48.1**

Sources: Based on Eurostat and World Bank data.
(1) Includes Estonia, which adopted the euro on 1 January 2011. – (2) Harmonized Index of Consumer Prices. – (3) As a percentage of GDP. – (4) Gross.

In the first half of the year, the central banks of the countries with inflation targets (the Czech Republic, Hungary, Poland and Romania) continued to lower their reference rates, except Poland, by a minimum of 25 basis points in the Czech Republic and a maximum of 175 in Romania. With the increase in inflationary pressure the expansionary phase of the cycle came to an end and between November 2010 and May 2011 the Hungarian and Polish central banks ratcheted up their reference rates by a total of 75 basis points. In the other countries, which have fixed exchange rate regimes, the gradual reduction in short-term interest rates over the year contributed to the easing of monetary conditions.

Following the pronounced deterioration that occurred in these countries' public finances in 2009 as a consequence of the crisis and the discretionary measures adopted to counter it, in 2010 they improved everywhere, except in Poland, where general government net borrowing rose to 7.9 per cent of GDP, from 7.2 per cent in 2009, owing to an increase in public expenditure.

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

China. – The rate of growth in economic activity rose to 10.3 per cent, from 9.2 per cent in 2009, returning close to the pre-crisis values (Table 1.3). Domestic investment continued to provide the main support for growth, while the contribution of net exports turned positive (swinging from -3.7 percentage points of GDP to 0.8 points) but remained below the levels in 2005-07.

Table 1.3

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

	GDP			Consumer prices		Balance on current account (1)		Budget balance (1) (2)	
	2004-08	2009	2010	2009	2010	2009	2010	2009	2010
China	11.6	9.2	10.3	-0.7	3.3	6.0	5.2	-2.8	-1.6
India (3)	8.6	7.0	8.6	10.9	12.0	-2.8	-3.2	-10.0	-9.4
Brazil	4.8	-0.6	7.5	4.9	5.0	-1.5	-2.3	-3.1	-2.9
Russia	7.1	-7.8	4.0	11.7	6.9	4.1	4.9	-6.3	-3.6

Sources: IMF and national statistics.
(1) As a percentage of GDP. – (2) Consolidated public sector. For India the figure refers to the fiscal year, which ends on 31 March of the year following that indicated. – (3) GDP at factor cost.

The growth in fixed capital formation slowed sharply to 11.8 per cent in real terms, from 24.5 per cent in 2009, following the progressive completion of the infrastructure plan introduced by the government in the autumn of 2008. The slowdown in public expenditure was partly offset by the acceleration in private investment.

Total consumption (including that of the public sector) increased by 8.1 per cent, more or less as in 2009. Purchases of durable goods continued to grow rapidly, especially in rural areas, boosted by the rise in household incomes and the renewal of temporary incentives for such purchases.

The sharp rise in consumer price inflation in 2010, to an average of 3.3 per cent, reflected both the increase in the prices of energy and food commodities and more widespread pressure deriving from domestic demand, above all for healthcare and housing services. The increase of 7.2 per cent in the prices of food products, which still account for about 30 per cent of households' total spending, contributed nearly two-thirds of the increase in the overall inflation rate. In the early months of 2011, this continued to accelerate and in April reached 5.3 per cent, well above the authority's target of 4 per cent. Even when the most volatile components are excluded, core inflation rose to 2.3 per cent, the highest value since measurements began in 2006.

The spike in inflation led last summer to a wave of strikes in factories located in the industrialized eastern regions of the country. The demands for higher wages induced local authorities in nearly all the provinces to increase the legal minimum wage. In the country as a whole the increase amounted to 24 per cent, with 30 per cent recorded in some of the poorer provinces in the interior (at the end of 2010 the monthly minimum wage averaged 870 renminbi, or about $128, whereas in the main industrial cities, such as Shenzhen, Guangzhou and Shanghai, it was nearly $190). These increases tend to have significant effects on the effective earnings of immigrant workers from rural areas, who do unskilled jobs, especially in manufacturing and construction, and receive wages close to the legal minimum.

In response to the growing inflationary pressure the People's Bank of China intensified its monetary tightening: the compulsory reserve ratio for bank deposits was raised repeatedly from the beginning of 2010 onwards, by a total of 5.5 percentage points, and reached 21 per cent for large banks. From October onwards, the central bank ratcheted up the interest rates on one-year bank loans and deposits by a total of 100 basis points, to 6.3 and 3.25 per cent, respectively. In real terms, however, these interest rates are still below their pre-crisis levels. In an attempt to curb imported inflation, in June 2010, the authorities restored a certain degree of flexibility to the exchange rate with the dollar, although to date they have exploited it only to a limited extent.

In 2010, the expansion in bank credit, although slowing compared with the exceptionally rapid pace in 2009, continued to overshoot the objective, especially in the property sector. The loans granted by banks grew in value by 20 per cent, as against 32 per cent the year before. The restrictive administrative measures mainly concerned the conditions for granting mortgage loans and credit to property companies, partly with the aim of slowing the rate of increase in housing prices, which had been rising sharply since the summer of 2009. The latest data indicate that the increase in property prices in the main urban areas has halved compared with the peaks recorded in the spring of 2010, falling in April to a twelve-month rate of 6 per cent.

At the end of January, the People's Bank of China announced its decision to abolish the quantitative objective for the granting of new bank loans in favour of a broader reference aggregate known as total social financing, better able to reflect the real liquidity conditions in the economy.

In 2010, the deficit of the consolidated public sector dropped to 1.6 per cent of GDP, from 2.8 per cent in 2009, as a consequence of the large increase in tax revenue. The budget for 2011 envisages a shift in the composition of public expenditure in support of households' incomes and consumption and a reform of direct taxation to achieve greater equality. The reform provides for an increase in the threshold for exemption from income tax from 2,000 to 3,000 renminbi per month (about $460). The change will affect about 50 million taxpayers (12.5 per cent of the total number) and result in a decrease in revenue of 1.4 per cent. In line with the aims set forth by the government in the new five-year plan published in March, in addition to bringing greater equality, the change could strengthen consumption as poorer households have a higher propensity to spend.

In the first quarter of 2011, GDP slowed slightly, growing by 9.7 per cent compared with the first quarter of 2010. By contrast with the previous quarters, consumption provided the largest contribution to the increase (5.9 percentage points), while the contributions of investment and exports decreased.

India. – In 2010, GDP, measured at factor cost, increased by 8.6 per cent, compared with 7.0 per cent in 2009, thus returning to a growth rate close to that of the five years 2004-08. The particularly strong recovery in industry and private services, coupled with the good performance of agriculture, more than offset the drying up of the impulse provided by fiscal policy in 2009. On the demand side, output was driven by the rapid growth in the construction of infrastructure and the consumption of durable goods and by the swing to positive net exports.

Inflation, as measured by the wholesale price index, the main reference indicator for monetary policy, rose to an average of 9.5 per cent in 2010, from 2.2 per cent in 2009, driven by the rise in food prices and increasingly by the widespread acceleration in the prices of manufactures. The increase in the consumer price index, in which the food component is preponderant, rose to 12 per cent, reflecting the rise in the prices of fruit and vegetables and products with a higher protein content.

Faced with systematically higher-than-expected inflation, from the beginning of 2010 onwards the Indian central bank followed a restrictive policy and repeatedly raised the official repo and reverse repo rates, by a total of 250 and 300 basis points respectively, to stand at 7.25 and 6.25 per cent at the beginning of May, although these interest rates remained negative in real terms. At the same time the central bank raised the compulsory reserve ratio by 100 basis points. In the 2010-11 financial year (ended in March) the consolidated public sector deficit declined to 9.4 per cent of GDP, from the peak of 10.0 per cent in the previous year, thanks to the large increase in revenue, which benefited from the good performance of the economy and one-off receipts from privatizations and sales of telecommunications licences. India's public finances are more fragile than those of other emerging countries, with large budget deficits and a relatively high public debt (about 70 per cent of GDP).

Brazil. – In 2010, GDP grew at a fast pace, expanding by 7.5 per cent after contracting by 0.6 per cent in 2009. The rapid increase in domestic consumption and investment demand benefited from the substantial inflows of capital from abroad and the larger receipts from exports of raw materials. The rate of increase in economic activity eased in the second half of the year, returning to a more sustainable level in relation to the economy's growth potential, estimated to be about 4.4 per cent.

Private consumption grew by 7.0 per cent, the highest rate for fifteen years, thanks to the favourable conditions in the labour market, where the unemployment rate fell to 5.3 per cent in December, and the plentiful supply of credit. After contracting sharply in 2009, corporate investment rebounded, growing by 21.9 per cent. By contrast, net exports' contribution to growth turned negative, amounting to -2.8 percentage points, owing to the very rapid growth in imports. Despite the improvement in the terms of trade deriving from the rise in raw material prices, the trade surplus contracted considerably compared with the previous years.

Inflationary pressure began to build up again from October 2010 onwards, rising from an average of 5 per cent for that year to 6.5 per cent in April, equal to the upper limit of the central bank's target range (4.5 ± 2 per cent). To counter this trend, the monetary authorities raised the reference rate in steps by a total of 325 basis points between April 2010 and April 2011, when it stood at 12 per cent.

Faced with substantial and persistent inflows of foreign capital, the authorities first raised the tax on purchases of bonds by foreign investors, already in force since the end of 2009, to 6 per cent. Subsequently, with effect from the beginning of 2011, the scope of the measure was extended to include all foreign borrowing transactions with a maturity of less than two years.

In 2010, the deficit of the enlarged public sector declined to 2.9 per cent of GDP, from 3.1 per cent in 2009, thanks to the extraordinary revenue deriving from the sale of drilling rights for the new offshore oil fields, amounting to about 1 per cent of GDP. For this year the government has introduced restrictive measures intended to produce a primary surplus of about 3 per cent of GDP, as against 2.4 per cent in 2010.

Russia. – The Russian economy grew by 4.0 per cent in 2010, a relatively low rate that made good only part of the large contraction of 7.8 per cent recorded in 2009. The recovery in investment amounted to 6.1 per cent but was held back by the persistence of tight credit conditions in the first half of the year; by contrast the growth of 4.0 per cent in consumption was affected by the impact on purchasing power of the sharp rise in the prices of food products from August onwards, owing to the major damage inflicted by the fires that swept across large parts of the country. Starting in the last part of 2010, the increased receipts from oil exports sustained the growth in domestic demand, bringing an acceleration in economic activity.

The inflationary impulse of the rise in commodity prices was powerful, in terms of both the impact effects and the subsequent deterioration in expectations. Consumer price inflation rose from 5.5 per cent in July (the lowest level for twenty years) to 9.6 per cent in April, well above the monetary authorities' target range of 6 to 7 per cent.

The persistent inflationary pressure led the central bank to adopt a more restrictive monetary policy stance at the beginning of 2011. Starting in January, the reference rate was raised by 50 basis points, reaching 8.25 per cent in April, and the compulsory reserve ratio by 150 basis points for domestic liabilities and up to 300 basis points for foreign currency liabilities. In 2010, the public sector deficit fell to 3.6 per cent of GDP, from 6.3 per cent in 2009, benefiting from the upturn in tax revenue. According to the recently approved budget for this year, the authorities expect a further large increase in revenue from oil exports, which is to be used in part to increase social spending and in part to reduce the fiscal deficit.

2. THE FINANCIAL AND FOREIGN EXCHANGE MARKETS

Conditions in the international financial markets improved in 2010. Against a background of lower volatility share prices rose in several advanced countries, including the United States, and in the main emerging economies. Risk premiums on corporate bonds issued in industrialized countries decreased, as did the yield spreads on emerging economies' sovereign debt.

The severe strains that had developed at the end of April last year on the government bond markets of some European countries with serious problems with their public finances, in particular Greece, resurfaced at various times in the months that followed, and spread to Ireland and Portugal, where the accumulation of large macroeconomic and banking imbalances weighed on budgets. The financial support agreed by the EU and the IMF for these three countries helped contain the turbulence. Although the risk premiums on Greek, Irish and Portuguese sovereign debt remain extremely volatile and at record levels, reflecting the depth of uncertainty over the outlook for the public finances in these countries, conditions in the financial markets continued to improve overall in the early months of 2011.

Capital inflows to the emerging economies continued in 2010, above all in the relatively more volatile form of portfolio investment. The main recipient economies struggled to curb the expansion of credit to the private sector, recording an increase in inflationary pressure and in the prices of financial assets. Some reacted by raising the monetary policy reference rate and by introducing direct controls on credit and restrictions on capital movements.

In the new EU member states not belonging to the euro area the improvement in the conditions on financial markets was less marked, in part reflecting the more hesitant recovery of these economies and in part lower capital inflows, to banks in particular.

Industrial countries

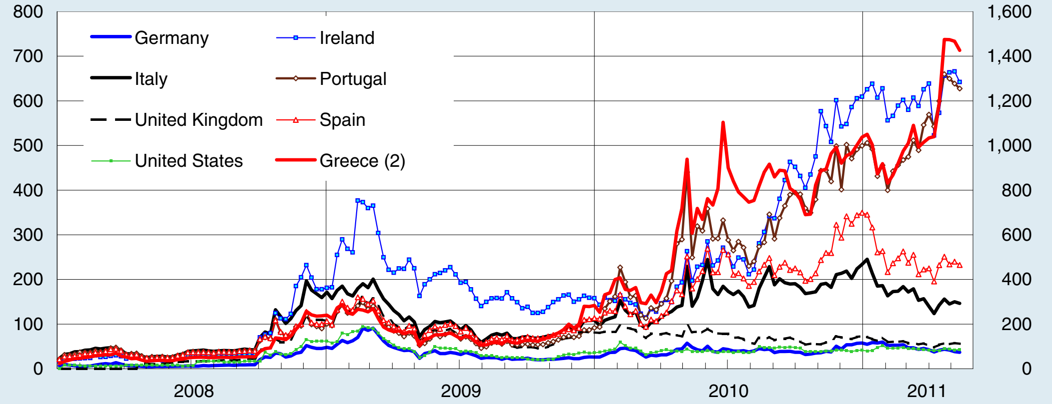
In the first four months of 2010, financial conditions gradually improved. At the end of April, the Greek sovereign debt crisis triggered a massive restructuring of portfolios towards assets considered less risky, in particular German and US government securities, whose yields fell rapidly. The financial support for Greece, agreed in May by the EU and the IMF, gradually eased tensions. From the summer onwards, the risk premiums on the interbank and bond markets fell and share prices started to climb again, only partly held down by the renewed pressure on Irish and Portuguese sovereign debt from the end of 2010.

At the end of April 2010, the premiums on five-year CDSs on Greek government bonds rose to over 800 basis points (Figure 2.1). Significant increases were also observed in connection with the debt of other European countries and, to a lesser extent, Japan. After the measures adopted by the EU in May, premiums fell throughout the area, but rose again sharply at the end of October over fears of contagion triggered by the serious difficulties of the Irish banking system. At the end of November, the EU and the IMF agreed a financial support plan for Ireland for a total of €85 billion. Tensions subsided in January, but already in February, Greek, Irish and Portuguese premiums turned upwards again, following a decision by the three main rating agencies to cut these countries' credit ratings and those of a number of banks headquartered there. In May, the EU and the IMF approved a financial assistance plan for Portugal, for a total of €78 billion.

Figure 2.1

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

(end-of-week data; basis points)



Source: Thomson Reuters Datastream.
(1) Up to the week ended on 13 May 2011. – (2) Right-hand scale.

Long-term interest rates on the leading economies' government securities, which remained stable in the early months of 2010, fell rapidly from mid-April until the end of August, owing to the restructuring of portfolios towards assets considered less risky. In this phase, yields on ten-year government bonds fell by 1.5 percentage points in the United States (to 2.5 per cent) by around one point in Germany and the UK (to 2.1 and 2.9 per cent, respectively) and by 0.5 points in Japan (to 0.9 per cent). From early September to mid-February 2011, yields rose again, to between 3.0 and 3.5 per cent in the United States, Germany and the UK, and to 1.1 per cent in Japan.

Conditions on the interbank markets suffered only temporarily as a result of the tensions in government bond markets, first in April 2010 and subsequently, for euro deposits only, at the end of the year. From January 2010 to 20 May 2011, the interest rate spreads between unsecured three-month interbank deposits and three-month overnight index swaps – a measure of counterparty and liquidity risks – fell for the euro and the yen, remained virtually unchanged for the dollar and rose slightly for sterling. Current spreads are below 30 basis points for the euro and around 15 basis points for the dollar and yen; these levels are below those recorded in the first half of 2008, on the eve of the collapse of Lehman Brothers, but still high by historical standards. The interbank markets have benefited from the prolongation of accommodating monetary conditions, the strengthening of world economic growth and the decline in uncertainty about the future of the international banking system. In 2010 and the first quarter of 2011, the losses announced or recorded on banks' books fell to $130 billion, from almost $370 billion in 2009 ($750 billion in 2008).

The downward trend in risk premiums on private sector bonds continued last year, with only a temporary interruption between the end of April and mid-July. Since the beginning of 2010, the yield spreads between the bonds of non-financial companies with a high credit rating (BBB) and ten-year government securities fell from 2.0 to 1.7 percentage points for the dollar and from 1.6 to 1.4 points for the euro; those for high-yield bonds declined, respectively, from 6.4 to 4.8 points and from 7.6 to 4.9 points. The low yields on private sector bonds, equal to or just above historically low levels, encouraged widespread recourse to the bond market by firms, notwithstanding their high self-financing capacity. Last year, net issues in the United States, the euro area and the United Kingdom amounted to around $200 billion, lower than the record of more than $300 billion recorded in 2009, but still high by historical standards.

Between the beginning of January and mid-April 2010, share prices recorded limited gains of around 5 per cent. Subsequently, as the Greek crisis intensified, prices suffered massive generalized losses, of over 20 per cent, until early July. The measures adopted by the European authorities and international financial institutions enabled prices to stabilize over the summer. At the end of August, expectations of further monetary expansion by the Federal Reserve prompted stock market indices to turn up again, with sharp increases recorded in the United States and the United Kingdom; in the euro area the expansion was more subdued, owing to renewed tensions in government bond markets and their extension to Ireland and Portugal. In Japan, the gains in share prices recorded between August 2010 and the early months of 2011 were completely eroded following the earthquake of 11 March.

On foreign exchange markets in the first half of 2010, when economic developments in the United States appeared more favourable and the prospect of monetary tightening by the Federal Reserve closer to hand, the dollar rose significantly against the euro and sterling (by around 20 and 12 per cent, respectively), while remaining virtually unchanged against the yen. From the summer onwards, expectations of further monetary expansion in the United States weakened the dollar, which fell by around 15 per cent against the euro and sterling. Since November the US currency has held steady against the yen, after the Bank of Japan adopted a more expansionary monetary policy stance. On 17 March, on the days immediately following the earthquake, Japan's currency soared to the highest level since the Second World War, to 79 yen per dollar, reflecting the abrupt cessation of carry trades; the coordinated intervention by the central banks of the Group of Seven on 18 March helped market operations return to normal.

Emerging economies

Last summer the share markets of the emerging economies rallied following the fluctuations of the first six months of 2010 linked to the uncertain prospects for global economic recovery and sovereign debt tensions in the peripheral euro-area countries. At the end of the year, the phase of improvement ended owing to the intensification of inflationary risks and the reallocation of international investors' portfolios towards the securities of the advanced economies. After the marked gains recorded between late March and early April 2011, share prices turned down again.

Sovereign debt premiums, measured by the yield spread between emerging economies' government debt securities denominated in dollars and those of the United States, rose slightly in May 2010 owing to growing tensions over Greek debt, before falling again. They are now at levels close to those observed on the eve of the collapse of Lehman Brothers.

In 2010, net inflows of private capital to Asia exceeded the amounts recorded in the years immediately preceding the global crisis; in Latin America, they returned to the levels of 2007-08. In addition to the greatly improved prospects for growth in the emerging economies, the prolongation of very expansionary monetary conditions in the advanced countries and their progressive tightening in emerging economies contributed to the rapid increase in flows. Unlike the two previous periods of growth in flows to the emerging economies, in 1990-95 and the early 2000s, the lower incidence of direct investment contrasted with the rapid growth in portfolio investment. The predominance of these, generally more variable, flows, against a background of strong risk aversion, reflects the restructuring of international portfolios away from the advanced economies, whose recovery appears weaker and more uncertain. On the other hand, the deleveraging of financial institutions in the advanced economies partly limited the recovery of bank flows.

In the Asian economies and some Latin American countries, capital inflows were associated with abundant domestic liquidity and full production capacity utilization, leading to an unwelcome acceleration in the prices of goods and services and financial and fixed assets. In countries where exchange rate regimes are less flexible or anchored to the dollar there is little room for monetary policy action, while a tightening of monetary conditions in economies with flexible exchange rate regimes risks generating further capital inflows and additional upward pressure on their currencies.

New EU member states not belonging to the euro area

After deteriorating sharply between April and June 2010 in connection with the turbulence on the euro-area sovereign debt markets, financial market conditions in these countries improved rapidly in the second half of the year and in the early months of 2011. Better prospects for growth and greater confidence in the sustainability of the public finances were contributory factors.

In almost all the countries domestic credit contracted in real terms, owing to weak demand for loans, the precarious financial situation of households and firms, and supply conditions that remained generally stringent. Credit supply was also influenced by the absence of a recovery in international interbank lending.

3. WORLD TRADE AND PAYMENTS BALANCES

In 2010, world trade in goods and services expanded by 12.4 per cent in volume. The recovery was extremely rapid in the emerging economies, particularly those in Asia.

Commodities rose sharply, gaining pace from the summer onwards, in response to expectations of a strengthening in economic activity as well as supply-side pressures. This trend, together with the economic recovery, led to a further widening of current account imbalances.

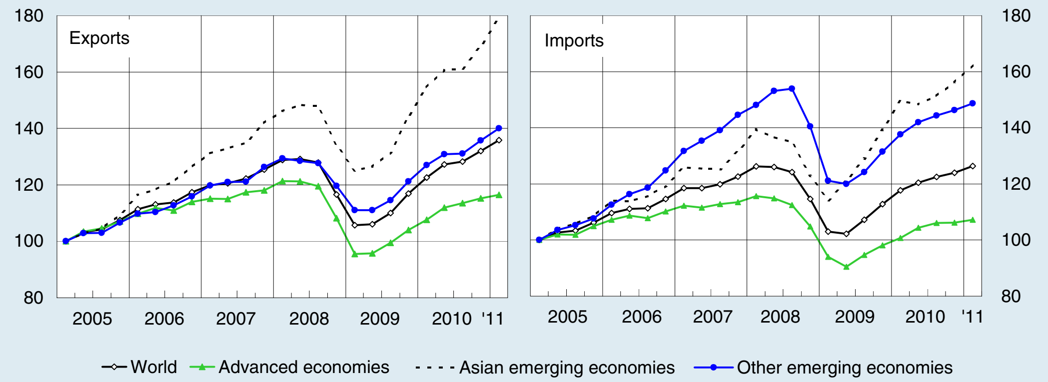
World trade

The pick up in world trade concerned mainly goods, which are more exposed to cyclical fluctuations than services. World exports of durables, in particular, which had been hit hardest by the 2009 crisis, grew by close to 70 per cent at current dollar prices.

Although the recovery in trade was generalized it varied widely in intensity in the different geographical areas, reflecting the different pace of economic growth. In the emerging economies, especially those of Asia, it more than made good the sharp contraction recorded at the height of the crisis, and the volume of imports and exports resumed growing at a pace close to that of the first half of 2008. By contrast, in the advanced economies trade revived slowly, hampered by weak domestic demand (Figure 3.1). At the end of 2010, the imports of the United States and the euro area were still below the levels recorded in the second quarter of 2008, but exports, increasingly directed towards the expanding emerging economies, had almost entirely recouped the previous losses.

Figure 3.1

World trade in goods: main geographical areas (1)
(index, Q1 2005=100; volumes)



Source: Netherlands Bureau for Economic Policy Analysis.
(1) For 2011, estimates based on the first two months of the year.

World trade in goods, which had grown at an annualized rate of 18.5 per cent in the first half of 2010, slowed during the summer as the world economy lost impetus. However, the partial data now available point to an acceleration towards the end of the year and in early 2011.

The importers among the leading advanced and emerging countries made limited recourse in 2010 to defensive protectionist measures such as anti-dumping duties, safeguard clauses or new tariffs or non-tariff measures. The Doha Round multilateral negotiations on trade liberalization begun in 2001 continued to drag on, making a successful conclusion appear increasingly unlikely.

Commodity prices

The year saw sharp increases in international commodity prices. Oil and metal prices led the way and outstripped food commodities, rising by 28 and 48 per cent respectively on average for the year. The increases occurred mainly in the second half of the year, reflecting the recovery of world economic activity and, in the case of food commodities, an unexpected contraction in supply. Unlike oil prices, which are still below the unprecedented peak reached in July 2008, the prices of the main non-fuel commodities as a whole overshot the highs registered in the early part of that year.

World crude oil demand grew by 3.4 per cent in 2010, the largest increase since 2004. Two-thirds of this was due to expanding consumption in the emerging economies, half of which attributable to China. Demand in the advanced countries also exceeded expectations, but was still 6.5 per cent lower than in 2007.

The supply of oil did not entirely keep up with the increased demand. Production by the non-OPEC countries grew by 2.1 per cent, the highest rate since 2002, accommodating 40 per cent of the extra demand. The OPEC cartel, on the other hand, cautiously opted to expand the supply slowly, fearing a weaker recovery of consumption. In the OECD countries, the relatively abundant stocks of crude oil held by the private sector in the first half of 2010 had fallen below the average for 2005-09 by the end of the year.

In the first four months of 2011, the price of oil (the average for the three main grades) rose from $90 to $120 a barrel owing to the halt of production in Libya and the risk of the political upheaval spreading to the Middle East and the Persian Gulf. Although other OPEC countries announced they were willing to contribute part of their spare capacity (equal to about 5 per cent of world demand) to make good the lack of Libyan supplies (1.8 per cent of world demand), the cartel's overall production in fact fell by 4.9 per cent because refineries in some southern European countries found it difficult to substitute it for Libyan crude. In the first three weeks in May, with increased volatility, the price of crude oil fell back to $109 a barrel.

Balance-of-payments disequilibria

In 2010, the US current account deficit began to widen once more, from 2.7 per cent of GDP in 2009 to 3.2 per cent (Table 3.1), although remaining below pre-crisis

Table 3.1

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

	Current account balance (1)						Reserves		
	2008		2009		2010		2008	2009	2010
	billion dollars	% of GDP	billion dollars	% of GDP	billion dollars	% of GDP	billion dollars	billion dollars	billion dollars
United States	**-668.9**	**-4.7**	**-378.4**	**-2.7**	**-470.2**	**-3.2**	**7.1**	**53.1**	**1.7**
Euro area	**-201.4**	**-1.5**	**-65.8**	**-0.6**	**-76.9**	**-0.6**	**3.4**	**64.1**	**17.5**
Japan	**157.1**	**3.2**	**141.7**	**2.8**	**194.7**	**3.6**	**56.6**	**12.9**	**39.3**
United Kingdom	**-43.4**	**-1.6**	**-37.1**	**-1.7**	**-56.1**	**-2.5**	**-4.6**	**11.4**	**12.6**
Canada	**8.0**	**0.4**	**-38.4**	**-2.8**	**-48.5**	**-3.1**	**2.8**	**10.5**	**2.8**
Latin America	**-31.2**	**-0.7**	**-25.0**	**-0.6**	**-56.9**	**-1.2**	**52.6**	**50.5**	**84.3**
Asia	**513.5**	**5.9**	**437.7**	**4.9**	**435.5**	**4.0**	**412.0**	**747.4**	**653.7**
Newly-industrialized Asian economies	87.7	5.0	128.9	8.0	133.0	7.1	1.5	212.2	106.1
Hong Kong	*29.5*	*13.7*	*18.0*	*8.6*	*14.8*	*6.6*	*29.8*	*73.3*	*12.9*
Singapore	*27.5*	*14.5*	*35.2*	*19.2*	*49.4*	*22.2*	*11.2*	*13.6*	*37.9*
South Korea	*3.2*	*0.3*	*32.8*	*3.9*	*28.2*	*2.8*	*-61.0*	*68.8*	*21.6*
Taiwan	*27.5*	*6.9*	*42.9*	*11.4*	*40.6*	*9.4*	*21.4*	*56.5*	*33.8*
ASEAN-4	44.5	3.8	73.7	6.4	48.7	3.4	11.2	50.7	87.4
Indonesia	*0.1*	*0.0*	*10.6*	*2.0*	*5.7*	*0.8*	*-5.4*	*14.0*	*29.3*
Malaysia	*38.6*	*17.4*	*31.9*	*16.5*	*28.2*	*11.9*	*-9.9*	*4.3*	*9.4*
Philippines	*3.6*	*2.2*	*9.4*	*5.8*	*8.5*	*4.5*	*3.0*	*5.6*	*16.6*
Thailand	*2.2*	*0.8*	*21.9*	*8.3*	*14.8*	*4.6*	*23.4*	*26.8*	*32.0*
India	-31.1	-2.5	-26.0	-2.0	-51.6	-3.4	-19.6	17.8	10.1
China	412.4	9.1	261.1	5.2	305.4	5.2	419.0	466.8	450.0
Central and Eastern Europe	**-151.3**	**-7.9**	**-44.3**	**-2.8**	**-76.0**	**-4.3**	**-3.4**	**38.8**	**21.5**
Main oil-exporting countries	**588.5**	**10.7**	**207.4**	**4.6**	**319.5**	**8.6**	**99.1**	**-21.5**	**107.2**
OPEC (2)	421.5	18.3	115.5	5.8	200.8	10.2	155.9	-28.8	55.6
Algeria	*34.5*	*20.2*	*0.4*	*0.3*	*15.1*	*9.4*	*32.9*	*5.8*	*13.6*
Angola	*7.2*	*8.6*	*-7.5*	*-10.0*	*-1.5*	*-1.8*	*6.7*	*-4.2*	*6.0*
Ecuador	*1.2*	*2.2*	*-0.4*	*-0.7*	*-2.6*	*-4.4*	*0.9*	*-0.9*	*-1.4*
Iran	*24.0*	*7.3*	*13.5*	*4.2*	*21.6*	*6.0*	*....*	*....*	*....*
Kuwait	*60.2*	*40.5*	*28.6*	*26.1*	*41.7*	*31.8*	*0.5*	*3.2*	*1.0*
Libya	*37.1*	*41.7*	*9.4*	*15.6*	*11.9*	*16.0*	*12.9*	*6.4*	*0.9*
Nigeria	*31.8*	*15.4*	*21.9*	*13.0*	*13.9*	*6.4*	*1.7*	*-8.2*	*-9.8*
Qatar	*32.3*	*29.2*	*10.0*	*10.2*	*24.3*	*18.7*	*0.2*	*8.7*	*12.3*
Saudi Arabia	*132.5*	*27.8*	*22.8*	*6.1*	*38.8*	*8.7*	*136.8*	*-32.6*	*35.0*
United Arab Emirates	*23.3*	*7.4*	*8.2*	*3.0*	*23.3*	*7.7*	*-45.5*	*4.4*	*6.7*
Venezuela	*37.4*	*12.0*	*8.6*	*2.6*	*14.4*	*4.9*	*8.9*	*-11.4*	*-8.6*
Mexico	-16.3	-1.5	-6.3	-0.7	-5.7	-0.5	8.0	4.5	20.7
Norway	79.9	17.9	49.6	13.1	53.3	12.9	-9.9	-2.1	4.0
Russia	103.5	6.2	48.6	4.0	71.1	4.9	-55.0	4.9	26.9

Sources: IMF and national statistics.
(1) Due to errors, omissions and differences in international statistics, the world current account balance, instead of being nil, has turned positive (according to IMF estimates by $232.4 billion in 2008, $225.5 billion in 2009 and $282.6 billion in 2010). – (2) The OPEC aggregate does not include Iraq; the flow of foreign exchange reserves does not include Iran.

levels. The increase was attributable to the widening of the trade deficit, which rose from $507 billion to $647 billion, above all following the deterioration in the terms of trade caused by the rise in the cost of imported energy. By contrast, the surpluses on services and net investment income improved.

The ratio of the US net debtor position to GDP is expected to remain virtually unchanged from the figure registered at the end of 2009 (20.8 per cent of GDP). The effects of changes in the dollar values of foreign financial assets and liabilities should remain positive, thanks to the depreciation of the dollar and the recovery of international stock markets, offsetting at least part of the deterioration caused by the deficit on current account.

After plummeting in 2009, the current account surplus of the main oil-exporting countries doubled to $319.5 billion, driven by the sharp rise in crude oil prices. It nonetheless remained below the peak of $588.5 billion recorded in 2008.

Among the group of Asian economies with a structural surplus on current account, the overall result rose to $683 billion or 4.7 per cent of GDP, reflecting the 3.6 per cent jump in Japan's surplus, while that of the newly-industrialized countries and China remained stable. China's current account surplus narrowed from 6 per cent of GDP in 2009 to 5.2 per cent owing to the reduction in the trade surplus, which was influenced by the increase in prices of imported raw materials.

The build-up of foreign exchange reserves by emerging and developing economies continued at a strong pace in 2010. Overall, stocks rose by $880 billion, compared with $500 billion in 2009. The process accelerated in the second part of the year and is estimated to have continued in the early months of 2011.

4. THE G20 AND INTERNATIONAL ECONOMIC COOPERATION

The Group of Twenty (G20) is the main intergovernmental forum and informal instrument for international economic cooperation. The Group's agenda is very broad and covers areas in which the official sector was previously operating in a dispersed and uncoordinated manner. The G20 is not an international financial institution and thus lacks the legitimacy that derives from specific mechanisms of representation and governance. Nevertheless, the G20 has become the primary locus where the work agenda of key organizations, especially the Financial Stability Board (FSB) and the International Monetary Fund (IMF), is determined.

Main decisions taken in 2010

IMF quotas and governance. – The G20 made a decisive contribution to the IMF quota and governance reform. In particular, it was decided to double the quotas, with a shift of over 6 per cent in quota shares to dynamic emerging markets and developing countries. The weight of the major emerging economies is expected to increase further at the next General Review of Quotas, which the G20 decided to bring forward by two years and conclude by January 2014. As regards the governance of the IMF, it was decided to change the structure of the Executive Board, moving to an all-elected Board and revoking the power of the five largest countries to appoint their own representatives directly. Moreover, advanced European countries decided to put two of their seats at the disposal of emerging countries.

Revision of the IMF's lending facilities. – Some important reforms of the IMF's lending toolkit were approved. In particular, it was decided to strengthen the Flexible Credit Line (FCL), a facility reserved to member countries with very strong fundamentals, policies, and track records of policy implementation, by extending its duration and removing the theoretical access cap to such resources, which was ten times the member's quota; furthermore, a new Precautionary Credit Line (PCL) was created, reserved to countries that do not satisfy the requirements of the FCL but that have relatively sound fundamentals and policies.

IMF surveillance over member countries. – In 2010, some innovations were introduced to enhance the multilateral aspects of surveillance. In particular, it was decided: (a) to introduce new reports with recommendations to groups of countries facing similar issues (thematic and multi-country reports); and (b) to prepare, on an experimental basis, Spillover Reports for countries and areas of systemic importance.

These reports aim to highlight the international implications of national economic policies and will be used not only in the bilateral consultations with the authorities of those countries and areas, but also in the discussions at the International Monetary and Financial Committee and in the G20's Mutual Assessment Process, described below. In 2011 Spillover Reports will be produced on the United States, Japan, China, the euro area and the United Kingdom.

Another important innovation is the decision to make it mandatory, for all systemically important IMF member countries, to participate in the Financial Stability Assessment Programs (FSAP) every five years (or every three years on a voluntary basis).

IMF resources and loans to member countries. – In 2010, IMF member countries' demand for financial assistance increased further. Excluding the previously mentioned FCL and PCL subscriptions, 11 new programmes were approved for a total of SDR 60.2 billion (about $100 billion), 37 billion more than in 2009 and equal to 12.5 per cent of the IMF's capital. In the first five months of 2011 three more programmes were approved for a total of SDR 96 billion ($154 billion). The stock of IMF credit held by member countries rose to SDR 56 billion in 2010 and to 66 billion in mid-May this year, from SDR 37 billion at the end of 2009.

The New Arrangements to Borrow (NAB) became formally effective on 11 March 2011, with an increased number of participant countries and new procedures for the use of its resources. The total size of the credit lines under the expanded NAB now amounts to about SDR 370 billion ($590 billion). In April, the first activation of the NAB was approved for the period April-September 2011, giving potential access to a large part of these resources (SDR 211 billion). The IMF's current forward commitment capacity, i.e. a measure of the resources available for new financial commitments (taking into account purchases and repurchases already scheduled for the next few months and net of prudential provisions), thus rose to SDR 270 billion ($430 billion).

Resources of the multilateral development banks and bilateral aid. – In 2010, the main development banks approved significant capital increases: $86 billion for the World Bank (an increase of 45 per cent); and $70 billion (70 per cent) for the Inter-American Development Bank. In addition, the African Development Bank and the European Bank for Reconstruction and Development approved increases of $62 billion and $10 billion respectively. During the year, the World Bank funded projects for a total of $165 billion, the Asian Development Bank for $17.6 billion, and the Inter-American Development Bank for $12.5 billion.

In December 2010, the negotiations for the sixteenth replenishment of the capital of the International Development Association (IDA-16) were concluded. The replenishment objective was set at about $49 billion for the period July 2011-June 2014.

In 2010, official development assistance increased by 6.5 per cent at constant prices and exchange rates compared with 2009. Aid from the members of the Development Assistance Committee (DAC) reached an all-time high of $128.7 billion (0.32 per cent of those countries' gross national income). The countries granting the largest volume of aid were, in order: the United States ($30 billion, +3.5 per cent compared with 2009), the United Kingdom ($13 billion, +19.4 per cent), France ($13 billion, +7.3 per cent), Germany ($13 billion, +9.9 per cent) and Japan ($10 billion, +11.8 per cent). Italy contributed about $3 billion, equal to 0.15 per cent of gross national income, 1.5 per cent less than in 2009. In 2011, bilateral aid could be jeopardized by the main donor countries' efforts to adjust their public finances.

Revision of supervision and oversight of the financial system. – In December 2010, the G20 contributed to the approval of Basel III and also reached an agreement on systemically important financial institutions (SIFIs), on the basis of a proposal from the FSB. It was further decided to undertake a series of financial initiatives.

The G20 agenda for the current year

The Framework for Strong, Sustainable and Balanced Growth and the MAP. – In September 2009, the G20 leaders approved an ambitious programme of international coordination for a lasting and balanced recovery of the world economy over the medium term. To this end, they launched the Framework for Strong, Sustainable, and Balanced Growth. The backbone of this framework is the Mutual Assessment Process (MAP) through which G20 countries identify multilateral implications of national economic policies and agree on possible corrective actions.

After an initial stalemate, at the Seoul summit the G20 gave fresh impetus to the process, agreeing to identify a set of indicators and guidelines for assessing the countries' external and internal imbalances. The process is entirely managed by the G20 while the IMF, together with other international institutions, provides only technical support. The indicators, finalized in February 2011, are to be used in a two-step process. In the first, concluded in April, indicative guidelines and methodological approaches were chosen to identify countries with large and persistent imbalances. In the second step, more in-depth assessment will be made of the root causes of these countries' imbalances; of the impediments to adjustment, whilst taking due consideration of exchange rate, fiscal, monetary and other policies; and, lastly, of the corrective actions.

The indicators selected to evaluate countries' internal imbalance are: public debt and fiscal deficits, the private savings rate and private debt. For the external imbalance, the trade balance, and net investment income flows and transfers are considered. Based on the guidelines approved in April, each indicator has four reference values (one obtained with a structural approach, the other three with statistical methods), which are more stringent for countries that account for more than 5 per cent of the aggregate GDP of the G20. The countries selected for the second step are those having persistently large imbalances in at least one indicator according to at least two approaches. The official list of such countries will be released at the G20 summit in Cannes in November this year.

Reform of the international monetary system. – The reform of the international monetary system is at the centre of the G20 agenda for 2011 and covers the following areas: the analysis and management of international capital flows; the definition and measurement of global liquidity; problems connected with the accumulation and management of official reserves; the role of SDRs and their currency basket composition; the strengthening of global financial safety nets; and IMF cooperation with regional financial arrangements. Looking ahead, the discussion on the reform of the international financial system will overlap that on strengthening IMF surveillance (the IMF could assess members' capital flows management and their levels of foreign exchange reserves).

Other initiatives. – The G20 is also working on other areas, amongst which the causes and effects of rising commodity prices, energy (including fossil fuels subsidies), the use of clean technologies and better energy efficiency.

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

5. MACROECONOMIC DEVELOPMENTS

The recovery in the euro area proceeded at a modest pace in 2010, with sharp disparities from country to country. Since the cyclical trough in the summer of 2009, area-wide GDP has regained more than half the five-point loss registered in the course of the recession.

Fuelled by the rapid expansion of world trade, exports provided the main support for economic activity, benefiting above all the industrial sector, which had been the most severely affected by the global recession. Domestic demand, instead, made only a limited contribution: household consumption was held back by the slack labour market and declining real disposable income, while construction investment contracted further.

The pace of economic activity picked up in the first quarter of 2011, but various risks still weigh on the outlook for growth. The current account imbalances within the area remain substantial; their correction, which began after 2008 as an effect of the recession and the adjustment measures of the deficit countries, is still slow and modest. The pressures on some member countries' sovereign debt, which have been alternately mounting and easing for over a year now, have become more severe again in recent months. The adjustment of the budget deficits is still incomplete.

Consumer inflation in the euro area was low at 1.6 per cent year on year in 2010. Core inflation was lower still at 1.0 per cent. The rise in world commodity prices has pushed the inflation rate up to over 2 per cent since the turn of the year. Domestic cost rises, however, have remained moderate. Forecasters expect the inflation rate to fall back below 2 per cent on average in 2012. Medium- and long-term expectations remain consistent with the Eurosystem's definition of price stability.

The euro area

The area's GDP increased by 1.8 per cent in 2010 after falling 4.1 per cent in 2009. Growth was fastest in Germany (3.6 per cent), more moderate in France and Italy (1.5 and 1.3 per cent respectively), and almost nil in Spain (Table 5.1). In Greece and Ireland, output continued to contract.

German economic growth was led by the expansion of world demand, thanks to its relatively greater openness to foreign trade, strong gains in price competitiveness (Figure 5.1) and success in increasing trade with the fast-growing emerging economies. Germany's exports of goods and services expanded by 14.1 per cent in volume terms in 2010 and by the end of the year had regained their pre-recession levels. Expansion was less marked in Italy and France (9.1 and 9.7 per cent respectively). For the euro area as a whole, taking import growth also into account, foreign trade made a net positive contribution of 0.8 percentage points to GDP growth.

Table 5.1

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

	2008	2009	2010	2010			
	Year	Year	Year	Q1	Q2	Q3	Q4
				GDP			
France	-0.1	-2.7	1.5	0.2	0.5	0.4	0.3
Germany (2)	1.0	-4.7	3.6	0.5	2.1	0.8	0.4
Italy (2)	-1.3	-5.2	1.3	0.6	0.5	0.3	0.1
Spain	0.9	-3.7	-0.1	0.1	0.3	..	0.2
Euro area (2) (3)	0.4	-4.1	1.8	0.4	1.0	0.4	0.3
				Imports			
France	0.9	-10.8	8.8	1.8	3.4	4.1	-0.7
Germany	3.3	- 9.4	12.6	5.5	7.9	1.4	0.9
Italy	-4.4	-13.7	10.5	4.0	0.4	4.9	3.4
Spain	-5.3	-17.8	5.4	4.0	4.2	-4.3	1.6
Euro area (3)	0.8	-11.9	9.3	3.6	4.2	1.5	1.0
				Exports			
France	-0.3	-12.4	9.7	4.7	3.1	2.0	0.3
Germany	2.5	-14.3	14.1	2.2	7.6	2.7	2.5
Italy	-4.3	-18.4	9.1	4.2	2.5	2.6	0.5
Spain	-1.1	-11.6	10.3	4.4	1.4	0.5	3.9
Euro area (3)	0.9	-13.1	11.2	3.1	4.5	2.1	1.6
				Household consumption (4)			
France	0.2	0.2	1.4	0.1	0.1	0.6	0.4
Germany	0.7	-0.2	0.4	0.2	0.4	0.5	0.2
Italy	-0.8	-1.8	1.0	0.2	0.1	0.4	0.2
Spain	-0.6	-4.2	1.2	0.9	1.4	-1.0	0.3
Euro area (3)	0.4	-1.1	0.8	0.3	0.2	0.2	0.4
				Government consumption			
France	1.3	2.3	1.2	..	0.2	0.2	0.1
Germany	2.3	2.9	2.3	1.9	-1.0	1.5	0.6
Italy	0.5	1.0	-0.6	-0.7	0.5	-0.4	-0.6
Spain	5.8	3.2	-0.7	-0.5	1.1	-0.7	-0.7
Euro area (3)	2.3	2.5	0.7	-0.1	0.2	0.4	0.1
				Gross fixed investment			
France	0.3	-9.0	-1.2	-1.2	1.1	0.9	0.5
Germany	2.5	-10.1	6.0	1.5	5.5	1.5	-1.1
Italy	-3.8	-11.9	2.5	1.2	1.4	0.8	-0.7
Spain	-4.8	-16.0	-7.6	-1.8	-0.3	-2.8	-1.5
Euro area (3)	-0.8	-11.4	-0.8	-0.2	2.1	-0.2	-0.5
				National demand (5)			
France	0.3	-2.4	1.4	-0.5	0.6	1.0	0.1
Germany	1.2	-2.0	2.6	1.9	2.2	..	-0.5
Italy	-1.4	-3.9	1.7	0.5	..	0.9	0.9
Spain	-0.6	-6.0	-1.1	..	1.1	-1.3	-0.4
Euro area (3)	0.4	-3.5	1.0	0.6	0.9	0.1	..

Sources: Based on national statistics and Eurostat data.
(1) The quarterly data are adjusted for seasonal and calendar effects. – (2) The quarterly data include information made available after the publication of the full set of national accounts. – (3) The aggregate for the euro area relates to 17 countries. – (4) Consumption of resident households and non-profit institutions serving households. – (5) Includes changes in stocks and valuables.

Domestic demand, net of changes in inventories, contributed half a percentage point to growth. Government consumption slowed in connection with the budget adjustment measures undertaken in a number of countries. Household spending, which had fallen by 1.1 per cent in 2009, returned to expansion last year but only at the modest rate of 0.8 per cent, owing to the persistent uncertainty over the state of the labour market and the 0.7 per cent reduction in real disposable income, the first such decrease since the advent of monetary union.

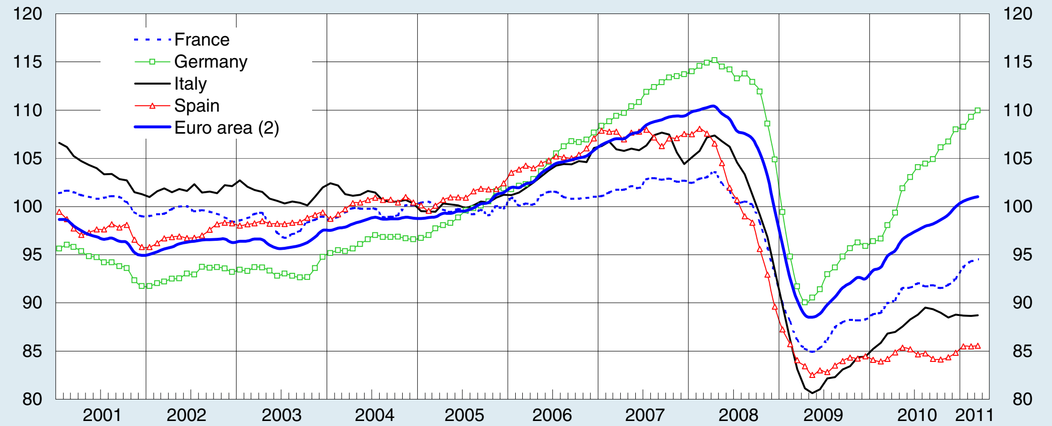
The propensity of consumer and producer households to save, which had risen during the recession in part for precautionary motives, fell back last year to pre-recession levels, decreasing from 15.3 to 13.9 per cent, gross of changes in pension fund reserves.

Investment in machinery and equipment recovered by 2.8 per cent after the 14.8 per cent contraction of 2009. The upturn was fuelled by improving demand expectations and a reduction in idle capacity. The surveys conducted by the European Commission found that the capacity utilization rate rose from its low point of about 70 per cent in 2009 to around 80 per cent last year. The contraction in construction activity continued into its third year. Residential investment (which accounts for about half of all building activity) contracted by 3.4 per cent and non-residential construction by nearly 5 per cent.

In the first three months of 2011, area-wide GDP grew by 0.8 per cent quarter on quarter. This sharp acceleration was due to strong gains in France (1.0 per cent) and especially Germany (1.5 per cent), while growth remained weak in Italy. In the area as a whole, growth continued to be sustained primarily by industrial production, which has now recouped more than half the drop of nearly 20 points registered during the recession (Figure 5.1).

Figure 5.1

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

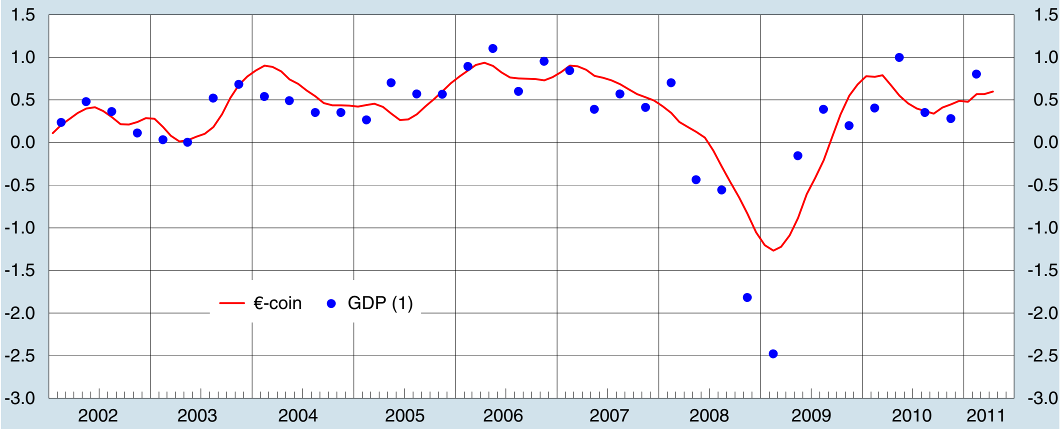


Sources: Based on Istat and Eurostat data.
(1) Indices, 2005=100; seasonally adjusted data. – (2) The aggregate for the euro area relates to 17 countries.

Since the start of 2011, the €-COIN coincident indicator has been at a level consistent with quarterly growth of 0.6 per cent (Figure 5.2).

Figure 5.2

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



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

Prices and costs

Consumer prices. – Consumer price inflation, which had been practically nil (0.3 per cent) in 2009, rose to 1.6 per cent on average in 2010 (Table 5.2). The increase was almost entirely due to energy prices, which rose by 7.4 per cent after falling by 8.1 per cent in 2009. The prices of food products also contributed, albeit modestly, rising by 1.1 per cent compared with 0.7 per cent in 2009. The core inflation rate, net of these two components, was lower, falling by about half a point to 1.0 per cent thanks to the moderation of domestic costs.

Table 5.2

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

	France			Germany			Italy			Spain			Euro area (3)		
	2008	2009	2010	2008	2009	2010	2008	2009	2010	2008	2009	2010	2008	2009	2010
Consumer prices (1)															
General index	3.2	0.1	1.7	2.8	0.2	1.2	3.5	0.8	1.6	4.1	-0.2	2.1	3.3	0.3	1.6
Index excluding food and energy products	1.8	1.4	1.0	1.3	1.3	0.6	2.2	1.6	1.7	2.4	0.9	0.8	1.8	1.4	1.0
of which: goods	*0.9*	*0.5*	*0.2*	*0.6*	*1.2*	*0.5*	*1.7*	*1.3*	*1.2*	*0.4*	*-0.9*	*0.3*	*0.8*	*0.6*	*0.5*
services	*2.4*	*2.2*	*1.5*	*1.7*	*1.5*	*0.7*	*2.7*	*1.8*	*1.9*	*3.9*	*2.2*	*1.1*	*2.6*	*2.0*	*1.4*
Food products	4.8	0.5	1.3	4.3	-0.3	1.5	5.2	1.9	0.5	5.7	0.2	1.1	5.1	0.7	1.1
of which: processed	*5.6*	*0.8*	*0.7*	*5.0*	*-0.1*	*0.8*	*6.1*	*1.9*	*0.9*	*7.4*	*1.0*	*1.4*	*6.1*	*1.1*	*0.9*
unprocessed	*3.7*	*-0.1*	*2.1*	*2.6*	*-0.7*	*3.0*	*3.8*	*1.9*	*..*	*3.9*	*-0.7*	*0.7*	*3.5*	*0.2*	*1.3*
Energy products	10.8	-11.2	9.7	9.4	-5.4	3.9	10.1	-8.9	4.2	11.9	-9.0	12.5	10.3	-8.1	7.4
Producer prices (2)	**5.6**	**-6.4**	**3.4**	**5.4**	**-4.0**	**1.5**	**5.8**	**-5.4**	**3.1**	**6.5**	**-3.4**	**-3.2**	**6.1**	**-5.1**	**2.9**
GDP price deflator	**2.5**	**0.5**	**0.8**	**1.0**	**1.4**	**0.6**	**2.8**	**2.3**	**0.6**	**2.4**	**0.6**	**1.0**	**2.0**	**1.0**	**0.8**

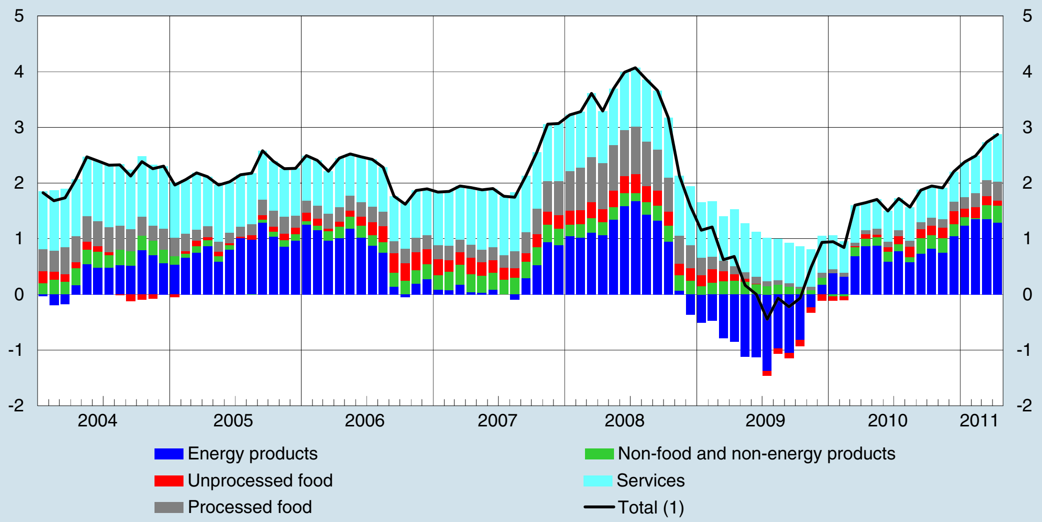
Source: Based on Eurostat data.
(1) Harmonized index of consumer prices. – (2) Producer price index for industrial products sold in the domestic market. – (3) For producer prices and the GDP deflator, the aggregate for the euro area relates to 17 countries; for consumer prices, it relates to the member countries in the year indicated.

Consumer prices accelerated progressively throughout the year, owing to the sharp rise in commodity prices and the waning of favourable base effects. Indirect tax increases in some countries played a role from the third quarter on.

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.

At the start of 2011, consumer inflation rose further to 2.8 per cent in the twelve months to April (Figure 5.3). It was driven largely by the volatile components (energy and food) as well as by some services indirectly affected by higher energy costs. Core inflation also picked up to a twelve-month rate of 1.6 per cent in April. In the coming months cost pressures from imported inputs will presumably be offset by moderating domestic costs and weak household spending.

Producer prices, costs and profit margins. – The producer prices of products sold in the domestic market rose by 2.9 per cent last year after falling by 5.1 per cent in 2009. The increase was due to intermediate goods, energy products and food products, which were most strongly affected by the rise in raw materials. These pressures continued in the early months of 2011. In March, the rate of producer price inflation rose to 6.7 per cent. In the context of the strengthening cyclical upturn, the producer prices of non-food final consumption goods also began to rise again (to a twelve-month rate of 0.8 per cent in March). Qualitative indicators drawn from business surveys show a picture of intensifying pressures on the costs of intermediate inputs.

The producer prices of non-energy goods sold in non-euro-area markets rose faster than domestic market prices (2.7 and 1.6 per cent respectively on average in 2010). Contributing factors were strengthening demand in the export markets and the 6 per cent decline in the nominal effective exchange rate of the euro.

For 2010 as a whole, unit labour costs for the entire euro-area economy fell by 0.5 per cent (Table 5.3), reflecting a deceleration in hourly earnings growth to 0.9 per cent and a 1.4 per cent rise in productivity in connection with the cyclical upturn. The fall in unit labour costs was reflected in widening profit margins. In industry excluding construction the mark-up – defined as the value added deflator at factor cost over unit labour costs – increased by about 6 per cent in 2010 after narrowing by 8.2 per cent in 2009.

Table 5.3

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

	Hourly labour costs (1)		Hourly productivity						Unit labour costs	
					Value added (2)		Hours worked			
	2009	2010	2009	2010	2009	2010	2009	2010	2009	2010
					Industry excluding construction (3)					
France	1.6	3.2	-3.9	7.2	-8.5	3.9	-4.8	-3.1	5.7	-3.7
Germany	5.2	-1.7	-8.1	6.0	-16.7	10.1	-9.4	3.9	14.4	-7.2
Italy	3.7	2.1	-5.9	7.2	-15.6	4.8	-10.3	-2.2	10.3	-4.8
Spain	2.7	0.3	0.0	4.8	-12.4	1.3	-12.4	-3.4	2.7	-4.3
Euro area (4)	4.4	0.6	-4.7	6.4	-13.3	6.1	-9.0	-0.3	9.6	-5.4
					Services (5)					
France	2.1	1.9	-0.4	0.6	-1.3	1.5	-0.9	0.9	2.6	1.3
Germany	3.6	0.5	-0.7	-0.1	-1.5	2.3	-0.8	2.4	4.3	0.6
Italy	0.9	1.6	-1.5	1.0	-2.6	1.0	-1.1	0.1	2.4	0.6
Spain	3.0	0.1	0.8	0.5	-1.0	0.5	-1.9	..	2.2	-0.4
Euro area (4)	2.7	0.9	-0.5	0.3	-1.8	1.3	-1.3	1.0	3.3	0.6
					Total economy					
France	1.9	2.1	-0.9	1.3	-2.4	1.3	-1.6	..	2.8	0.8
Germany	3.4	-0.1	-2.8	1.4	-5.3	4.0	-2.6	2.6	6.4	-1.5
Italy	1.8	1.7	-2.4	1.9	-5.6	1.5	-3.3	-0.4	4.3	-0.2
Spain	3.8	0.2	3.0	1.5	-3.5	-0.2	-6.3	-1.7	0.8	-1.3
Euro area (4)	3.2	0.9	-1.0	1.4	-4.3	1.8	-3.3	0.4	4.2	-0.5

Source: Based on Eurostat data.
(1) For France, Spain and the euro area, calculated on the basis of quarterly data. – (2) Chain-linked volumes. – (3) Manufacturing, mining and quarrying, and electricity generation and distribution. – (4) The aggregate for the euro area relates to 17 countries. – (5) Comprises “wholesale and retail trade, transport and communications”, financial and real-estate services” and “other services”.

Inflation expectations. – In 2010 the medium-term inflation expectations of the professional forecasters surveyed by Consensus Economics remained consistent with the Eurosystem’s definition of price stability. In recent months the short-term price forecasts have been revised progressively upwards, but those for the medium term have remained stable below 2 per cent (Table 5.4). These forecasts, in line with those of the leading international organizations, discount a modest decline in oil prices and continuing wage moderation this year and next. Longer-term expectations and those that can be inferred from the financial markets also point to basically stationary levels of inflation consistent with the price-stability objective.

Table 5.4

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

	2011	2012
France	2.0	1.7
Germany	2.3	2.0
Italy	2.5	2.1
Spain	3.0	1.8
Euro area (2)	2.5	1.9

Source: Consensus Economics.
(1) May 2011. – (2) The aggregate for the euro area relates to 17 countries.

Employment

In spite of the cyclical upturn, employment in the euro area was slightly lower (by 0.5 per cent) in 2010 as a whole than in 2009, though with a modest upward tendency in the course of the year. There were considerable differences among the main countries. Spain recorded a sharp further decline of 2.3 per cent, above all in construction, while in Italy and France the number of persons in work fell by 0.7 per cent. In Germany the number employed rose by 0.5 per cent, and the total number of hours worked increased more substantially, by 2.6 per cent, reflecting the phasing out, as economic activity quickened, of the short-time working that had been introduced to maintain jobs during the recession.

The euro-area employment rate slipped from 64.7 to 64.2 per cent for the year. It held stable in Germany and France at 71.1 and 64.0 per cent respectively while declining to 56.9 per cent in Italy and 58.6 per cent in Spain. The overall unemployment rate rose from 9.5 to 10.0 per cent last year. The rise was sharpest in Spain, where the rate reached 20.1 per cent, more limited in Italy (8.4 per cent) and France (9.8 per cent). In Germany the jobless rate came down by about one percentage point to 6.8 per cent.

The balance of payments

In 2010 the euro area's current account recorded a deficit of €36.7 billion (0.4 per cent of GDP), €10.9 billion more than in 2009 (Table 5.5). The deterioration was due to a reduction of €16.8 billion in the surplus on trade in goods and an increase of €9.6 billion in the deficit on current transfers. These items were partially offset by the balance on the income account and the surplus on trade in services, which improved by €8.2 billion and €7.3 billion respectively. Net inflows on the financial account rose from €10.0 billion to €34.4 billion. Errors and omissions were negative at €5.4 billion.

Table 5.5

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

	2006	2007	2008	2009	2010
Current account	**-12.6**	**7.4**	**-142.4**	**-25.7**	**-36.7**
Goods	8.1	42.2	-22.5	37.5	20.7
Services	42.5	47.9	41.1	33.8	41.0
Income	16.5	5.3	-63.3	-6.4	1.8
Transfers	-79.7	-88.1	-97.7	-90.6	-100.2
Capital account	**9.4**	**4.8**	**9.2**	**6.6**	**7.7**
Financial account	**-6.2**	**3.0**	**141.5**	**10.0**	**34.4**
Direct investment	-159.7	-90.4	-236.0	-109.4	-78.6
Portfolio investment	186.2	126.8	283.3	270.7	143.2
Financial derivatives	-0.6	-66.9	-82.9	37.2	8.0
Other investment	-30.8	38.6	180.5	-193.1	-28.1
of which: monetary financial institutions (2)	*-34.7*	*85.9*	*-132.1*	*68.5*	*-11.4*
Change in official reserves (3)	-1.3	-5.1	-3.4	4.6	-10.2
Errors and omissions	**9.4**	**-15.1**	**-8.3**	**9.2**	**-5.4**

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

The current account. – The growth in goods exports reflected the pattern in world trade growth, peaking in mid-year and slackening gradually in the following months. By comparison with 2009 the overall growth came to 20.0 per cent. The area's exports continued to benefit from expanding trade with Asia and the OPEC countries, while exports to the United States and the United Kingdom held stationary after expanding in the first quarter. The depreciation of the euro, year on year, helped to sustain price competitiveness.

Imports of goods rose by 21.9 per cent in value terms, owing both to imported inputs for use in the production of exports and to the price increases caused by the rising prices of oil and other commodities. Nevertheless, the total value of imports was still 4.3 per cent lower than in 2008.

The surplus on trade in services widened. Service trade was most intense with the United Kingdom (in surplus) and the United States (in deficit). The balance on the income account, which was negative by €6.4 billion in 2009, recorded a €1.8 billion surplus.

Table 5.6

Current account balances and net foreign position of the euro area and selected member states

(percentage of GDP; for the net foreign position, end-of-year stocks)

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
	Balance of payments - current account											
Belgium	5.1	4.0	3.4	4.5	3.4	3.2	2.0	1.9	1.6	-1.8	0.4	1.4
France	3.1	1.5	1.8	1.2	0.7	0.5	-0.5	-0.6	-1.0	-1.7	-1.5	-1.7
Germany	-1.3	-1.7	..	2.0	1.9	4.7	5.0	6.2	7.4	6.2	5.6	5.7
Greece	-5.3	-7.7	-7.2	-6.6	-6.5	-5.8	-7.6	-11.2	-14.4	-14.7	-11.2	-10.4
Ireland	0.2	-0.4	-0.6	-1.0	..	-0.6	-3.5	-3.6	-5.3	-5.6	-3.0	-0.7
Italy (1)	0.7	-0.5	-0.1	-0.8	-1.3	-0.9	-1.7	-2.6	-2.4	-2.9	-2.0	-3.5
Netherlands	3.8	1.9	2.4	2.5	5.6	7.6	7.4	9.3	6.7	4.4	4.9	7.7
Portugal	-8.7	-10.4	-10.3	-8.3	-6.5	-8.4	-10.4	-10.7	-10.1	-12.6	-10.9	-9.9
Spain	-2.9	-4.0	-3.9	-3.3	-3.5	-5.3	-7.4	-9.0	-10.0	-9.6	-5.2	-4.5
Euro area (2)	-0.5	-1.5	-0.4	0.6	0.3	0.8	0.1	-0.1	0.1	-1.5	-0.3	-0.4
	International investment position (3)											
Belgium (4)	….	62.7	53.5	36.5	36.3	27.9	33.7	29.2	28.9	31.0	44.5	….
France	-8.0	-7.6	-2.0	3.0	-4.1	-4.7	-3.9	-8.1	-8.4	-10.2	-12.5	….
Germany	4.5	3.2	8.7	5.1	6.6	10.6	20.9	27.8	27.0	26.6	37.3	42.0
Greece	-32.8	-38.5	-46.5	-52.9	-58.9	-67.0	-76.6	-84.3	-80.5	-75.6	-84.9	-98.2
Ireland	50.5	-8.0	-15.2	-18.0	-20.1	-18.0	-24.6	-5.3	-19.5	-71.4	-98.4	-97.0
Italy (1)	-13.4	-13.2	-9.9	-13.8	-15.1	-16.3	-15.7	-20.6	-24.6	-24.2	-25.3	-24.3
Netherlands	-8.2	-15.2	-13.4	-24.3	-1.7	3.7	-2.6	3.2	-6.0	2.0	18.1	19.9
Portugal	-32.0	-39.6	-46.4	-55.5	-58.4	-63.3	-67.6	-79.1	-88.9	-96.1	-110.5	-107.9
Spain	-32.1	-32.0	-35.6	-41.6	-45.3	-51.9	-55.6	-65.9	-78.1	-79.3	-91.1	-87.1
Euro area (2)	-6.1	-7.3	-5.4	-9.5	-10.1	-10.9	-8.9	-11.9	-14.1	-17.8	-16.4	-12.9

Sources: Based on Bank of Italy, ECB, BIS, Eurostat and Istat data and national statistics.
(1) From 1999 through 2007 (2006 for investment position), calculated by the old methodology. The reconstruction of the full time series based on the new methodology is under way. – (2) The aggregate for the euro area relates to 17 countries. – (3) Difference between the stock of financial assets and liabilities (all the institutional sectors are considered). – (4) For 2000 and 2001, the data refer to Belgium and Luxembourg.

The small deficit on current account for the euro area as a whole again concealed large disparities between member states. Some countries continued to display very considerable imbalances, although they had been brought gradually down since the peaks of 2008 (Table 5.6). The way in which current deficits were financed changed significantly. Previously, they had been covered mainly by inward portfolio investment, but the sovereign debt tensions caused substantial disinvestment in the securities issued by the deficit countries, offset in Spain by the repatriation of capital invested abroad, and in Greece and Portugal by capital inflows in the form of loans, including as part of monetary policy operations and, for Greece, lending by international and European institutions.

Direct and portfolio investment. – Within the financial account, the euro area registered net direct and portfolio investment inflows of €64.6 billion in 2010, €96.7 billion less than in 2009. This was mostly due to the sharp decrease of €106.7 billion in net purchases of debt securities, only partially offset by the reduction of €30.8 billion in net outward direct investment.

The pattern of portfolio investment during the year reflected the volatile market climate. There were signs of a recovery in equity investment in the first quarter, but risk aversion heightened again in May with the resurgence of financial market tensions. In the third quarter, non-residents disposed of money market instruments while continuing to buy euro-area equities, and residents increased their foreign portfolio investments. As the financial strains eased, in the fourth quarter non-residents resumed their purchases of euro-area bonds.

Direct investment activity was modest. The decline in net outflows mainly involved equity capital investment, especially in non-bank corporations.

Deposits and loans. – After the exceptionally massive disinvestment of 2009, net investment increased last year on both the asset and the liability side, producing a net outflow of €28.1 billion, compared with €193.1 billion in 2009.

The international investment position. – At the end of 2010 the euro area's international investment position showed net liabilities of €1,190.6 billion, or 12.9 per cent of GDP, compared with 16.4 per cent a year earlier. Against the increase in net liabilities on the financial account, the improvement resulted from the positive contribution of value adjustments.

6. BUDGETARY POLICIES

After increasing sharply in 2008-09, the budget deficits of the euro-area countries improved slightly overall last year. The European Commission estimates that they will be reduced further in 2011 and 2012 as more stringent budget policies are adopted to restore conditions for sustainable public finances.

The recession and the financial pressures have brought to light some problems regarding European economic governance. National governments and European Union institutions are drafting a set of measures to tighten budgetary discipline, manage macroeconomic imbalances and financial crises, and promote structural reform.

Budgetary policies and performance in 2010. – After jumping from 0.7 per cent of GDP in 2007 to 6.3 per cent in 2009, area-wide general government net borrowing decreased by 0.3 percentage points last year, to 6.0 per cent (Table 6.1). The financial support measures widened the deficit by 0.5 percentage points of GDP, against 0.1 points in 2009.

Table 6.1

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

	Net borrowing				Debt			
	2009	2010	2011 (1)	2012 (1)	2009	2010	2011 (1)	2012 (1)
Austria	4.1	4.6	3.7	3.3	69.6	72.3	73.8	75.4
Belgium	5.9	4.1	3.7	4.2	96.2	96.8	97.0	97.5
Cyprus	6.0	5.3	5.1	4.9	58.0	60.8	62.3	64.3
Estonia	1.7	-0.1	0.6	2.4	7.2	6.6	6.1	6.9
Finland	2.6	2.5	1.0	0.7	43.8	48.4	50.6	52.2
France	7.5	7.0	5.8	5.3	78.3	81.7	84.7	86.8
Germany	3.0	3.3	2.0	1.2	73.5	83.2	82.4	81.1
Greece	15.4	10.5	9.5	9.3	127.1	142.8	157.7	166.1
Ireland	14.3	32.4	10.5	8.8	65.6	96.2	112.0	117.9
Italy	5.4	4.6	4.0	3.2	116.1	119.0	120.3	119.8
Luxembourg	0.9	1.7	1.0	1.1	14.6	18.4	17.2	19.0
Malta	3.7	3.6	3.0	3.0	67.6	68.0	68.0	67.9
Netherlands	5.5	5.4	3.7	2.3	60.8	62.7	63.9	64.0
Portugal	10.1	9.1	5.9	4.5	83.0	93.0	101.7	107.4
Slovakia	8.0	7.9	5.1	4.6	35.4	41.0	44.8	46.8
Slovenia	6.0	5.6	5.8	5.0	35.2	38.0	42.8	46.0
Spain	11.1	9.2	6.3	5.3	53.3	60.1	68.1	71.0
Euro area	6.3	6.0	4.3	3.5	79.3	85.4	87.7	88.5

Source: European Commission, *Spring Forecasts*, May 2011.
(1) Forecasts.

The overall outturn was better than the targets set in the stability programme updates submitted between the end of 2009 and April 2010, which had projected a further increase of 0.4 points in area-wide net borrowing, to 6.7 per cent of GDP. The difference is mainly ascribable to better-than-forecast economic growth (1.8 against 1.0 per cent).

While revenue remained virtually stationary at 44.5 per cent of GDP, the area-wide primary deficit declined by 0.3 points, to 3.2 per cent. This can be ascribed to the contraction in primary expenditure as the economic support measures approved at the end of 2008 and in 2009 were phased out and to the introduction of measures to strengthen the public finances. Over one-third of the reduction in the ratio of primary expenditure to GDP related to capital spending. Measures affecting public sector employment had a considerable impact, since staffing levels declined while wages remained generally stable. Interest expense was virtually unchanged at 2.8 per cent of GDP.

Although the public finances improved in most countries in 2010, the deficit overshot the threshold of 3 per cent of GDP in all the euro-area countries except Estonia, Finland and Luxembourg. Fifteen countries have been placed under the excessive deficit procedure and must bring their deficits back below the threshold by deadlines ranging from 2011 for Malta and Finland (in the latter case the procedure was invoked on the basis of erroneous expectations that the deficit would exceed 3 per cent in 2010) to 2015 for Ireland.

The average debt-to-GDP ratio in the euro area increased by 6.1 percentage points in 2010, to 85.4 per cent. It was over 60 per cent in twelve countries and topped 100 per cent in Greece and Italy, reaching 142.8 and 119.0 per cent respectively.

Financial support for countries in difficulty. – In March 2010, a financial support mechanism was devised for the euro-area member states based on bilateral loans, with each country contributing in proportion to its share in the paid-in capital key of the ECB. In May, Greece obtained financial assistance totalling €110 billion, €80 billion of which provided by the euro-area countries (Italy contributed €15 billion) and the rest by the IMF; the loan was conditional on the adoption of a stringent programme of public financial adjustment and structural reforms.

In view of the persistent market pressures and to prevent Greece's financial problems spreading to other member states, on 10 May, the Council of the European Union devised two further instruments, the European Financial Stabilisation Mechanism (EFSM) and the European Financial Stability Facility (EFSF), with the capacity to mobilize substantial funds for temporary financial assistance to euro-area members.

On 28 November 2010, a programme of financial support measures was agreed for Ireland. The package totalled €85 billion, of which €22.5 billion to be provided through the EFSM and €17.7 through the EFSF. The loans, at non-preferential interest rates, were conditional on the Irish authorities' commitment to adopt measures to strengthen the public finances, to enact structural reforms and to proceed to restructure the banking system.

On 7 April this year, Portugal applied for financial assistance from the EU and the IMF. An agreement was reached on 16 May for loans worth €78 billion provided in equal measure by the EFSM, the EFSF and the IMF over a period of three years.

The bilateral loans to Greece will increase the lender countries' debt as they entail heavier recourse to the market, other conditions being equal. According to Eurostat's decision of 27 January, the funding provided by the EFSF will increase the gross public debt of the countries participating in the bail-out according to the share guaranteed (and increase their financial assets by the same amount). The EFSM and EFSF have a limited period of operation; their support packages must be approved by the end of June 2013, after which operations can only relate to existing positions.

The medium- and long-term outlook. – According to the European Commission's May forecasts, area-wide net borrowing will decrease by 1.7 percentage points in 2011, to 4.3 per cent of GDP. The deficit is projected to narrow in all the countries except Estonia and Slovenia, where it will widen by 0.7 and 0.2 points respectively.

Assuming unchanged budgetary policies, the Commission estimates that the deficit will be reduced by a further 0.8 percentage points in 2012, to 3.5 per cent of GDP. The primary deficit is projected to decline by 2.8 points in the period 2011-12, to 0.4 per cent of GDP: revenue will increase by 0.4 points while primary current expenditure and capital expenditure will decrease by 1.5 and 0.9 points respectively. The debt-to-GDP ratio is expected to rise from 85.4 per cent in 2010 to 88.5 per cent in 2012.

The reform of European governance

The economic and financial crisis has highlighted some problems regarding European economic governance. Europe's budgetary rules have not guaranteed the adoption of prudent budget policies, capable of properly exploiting the favourable phases of the economic cycle to strengthen the public finances. The system of multilateral surveillance did not possess forceful tools to prevent and correct macroeconomic imbalances. Moreover, there were no mechanisms for intervention in the case of grave financial crisis in a member state. Lastly, weaknesses in the banking system emerged that helped to spread the crisis, making it necessary to tighten regulation and supervision at the European level.

In the spring of 2010, a process of reform began involving both member states and EU institutions. In March, the Council of the European Union had set up a task force, chaired by the European Council President Herman Van Rompuy, to draft a set of proposals for reinforcing European economic governance. The final report was approved on 28 October by the European Council, which also decided to create a permanent crisis resolution mechanism. The Commission contributed to the debate and released a detailed reform plan on 29 September.

Some of the reform proposals have already been implemented. The European semester, for instance, a mechanism designed to improve ex ante economic policy coordination, was launched this year. Within this framework, the European Council of 24 and 25 March 2011 laid down economic policy guidelines that were later reflected in the member states' programmes, which call for priority to be given to strengthening the public finances. The Council also endorsed the reform proposals designed to tighten European budgetary rules and extend multilateral surveillance to macroeconomic performance. Talks are currently under way with the European Parliament in the hope of passing the reforms by the end of June this year.

Regarding fiscal rules, the reforms will include a reinforcement of the Stability and Growth Pact. It is proposed to strengthen the procedures to prevent budget imbalances by introducing a benchmark for expenditure, which should not increase faster than the potential GDP growth rate. Countries that have not yet reached their medium-term budget objectives should ensure, taking into account discretionary measures on the revenue side, that their growth in expenditure is consistent with an annual reduction of at least 0.5 percentage points of GDP in their structural budget balance (i.e. adjusted for the economic cycle and temporary measures). This requirement would reinforce the Pact's existing guidelines for meeting the medium-term objective by preventing a situation where countries use the extraordinary revenues obtained during a cyclical upswing to comply with the requirement of structural budget balance.

Regarding corrective procedures in the event of budget imbalances, the proposals include introducing a numerical rule that would implement a course of action envisaged in the Treaty of Maastricht by opening the excessive deficit procedure when a country's effort to reduce its deficit towards 60 per cent of GDP is deemed unsatisfactory. The standard is the reduction of the average debt/GDP ratio over the previous three years by one-twentieth of the difference with respect to the 60 per cent threshold. A smaller reduction would not automatically launch the excessive deficit procedure as other relevant factors would also be taken into account, including the medium-term outlook for the debt, the level of private sector debt, the implementation of pension reforms and the maturity structure of liabilities.

In order to make the Stability and Growth pact more enforceable the Commission will extend sanctions to the preventive phase as well as reinforce those already in force on the corrective side. Countries that deviate significantly and persistently from the path of convergence towards the medium-term objectives and do not take corrective action must make an interest-bearing deposit of 0.2 per cent of GDP. When the excessive deficit procedure is opened, a non-interest-bearing deposit must be made. A greater degree of automatism will be introduced so that the sanctions proposed by the Commission are adopted automatically unless a qualified majority of the Council rejects them following the "reverse voting" rule, whereas at present a qualified majority is required to impose them.

Regarding macroeconomic imbalances, the European Council's reform proposal includes an annual review designed to provide early warning by means of a scoreboard embracing a few indicators for which crisis thresholds must be established.

The European Council of 24 and 25 March also adopted the Euro Plus Pact, which has been joined by six countries outside the euro area (Bulgaria, Denmark, Latvia, Lithuania, Poland and Romania). Its objective is to strengthen economic policy coordination further in the euro area, notably by improving the competitiveness and convergence of the national economies. It calls for stronger political commitment to four objectives relating, respectively, to competitiveness, employment, sustainable public finances and financial stability (see the box "The decision of the European Council of 24 and 25 March 2011" in *Economic Bulletin*, April 2011). Lastly, the Council also established the characteristics of the European Stability Mechanism, the permanent crisis management system, which had been broadly agreed by the euro-area finance ministers on 28 November 2010.

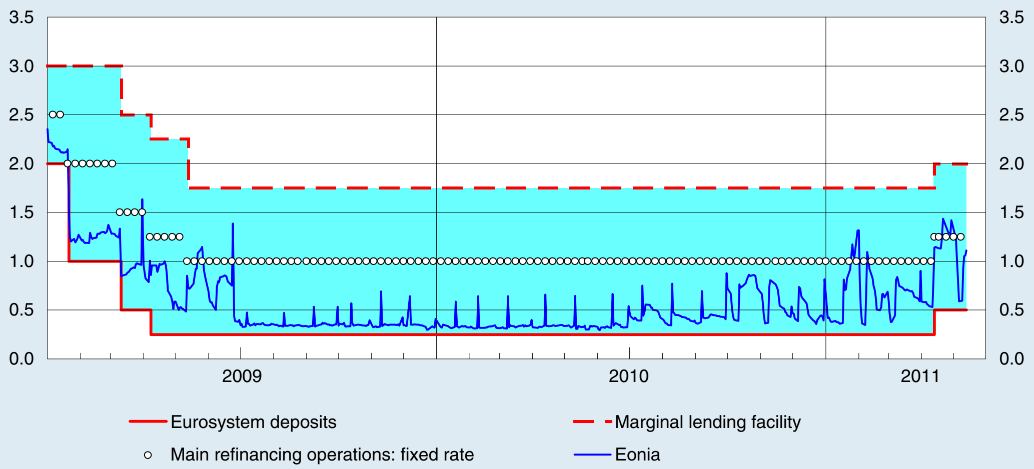
7. THE COMMON MONETARY POLICY

Against a background of economic activity on the mend but still well below the potential level, low current and expected inflation and sovereign debt markets under heavy pressure, the Governing Council of the European Central Bank maintained highly accommodative monetary conditions in 2010.

The interest rate on main refinancing operations remained unchanged at 1 per cent (Figure 7.1). Very-short-term money market rates were well below that level for much of the year, owing to the abundant liquidity generated by the procedures used to carry out refinancing operations. Real short-term interest rates were negative. The strong credibility that the Eurosystem has earned made it possible to keep medium-term inflation expectations firmly anchored to the objective of price stability.

Figure 7.1

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



Sources: ECB and Thomson Reuters Datastream.

In the early months of 2010, the progressive improvement in the conditions of the money, financial and credit markets had made it possible for some of the unconventional monetary policy measures introduced in the preceding years to be phased out. In May, the sovereign debt markets of some euro-area countries came under strong pressure. At the same time that the member countries instituted a fund to safeguard financial stability – the European Financial Stability Fund (EFSF) – the Governing Council of the ECB reintroduced some extraordinary refinancing measures and launched the Securities Markets Programme of purchases of bonds issued in the area. The programme is temporary and its amount limited; its effects on the monetary base will be neutralized through liquidity-absorbing operations. Its aim is to restore orderly conditions on the market segments hit by the crisis, thereby preserving the functioning of the monetary policy transmission mechanism.

The strains on sovereign debt intensified in the first few months of 2011. In March the European Council increased the EFSF's effective lending capacity and established the features of the European Stability Mechanism (ESM), the permanent crisis-management mechanism that will enter into force in 2013.

The sharp increases in commodity prices began to show up in higher inflation from the end of 2010 onwards. The ECB Governing Council confirmed its determination to keep developments in international prices from producing a deterioration in inflation expectations beyond the inevitable short-term effects. At its meeting at the beginning of April, the Governing Council decided to raise official rates by 25 basis points, bringing the rate on main refinancing operations to 1.25 per cent.

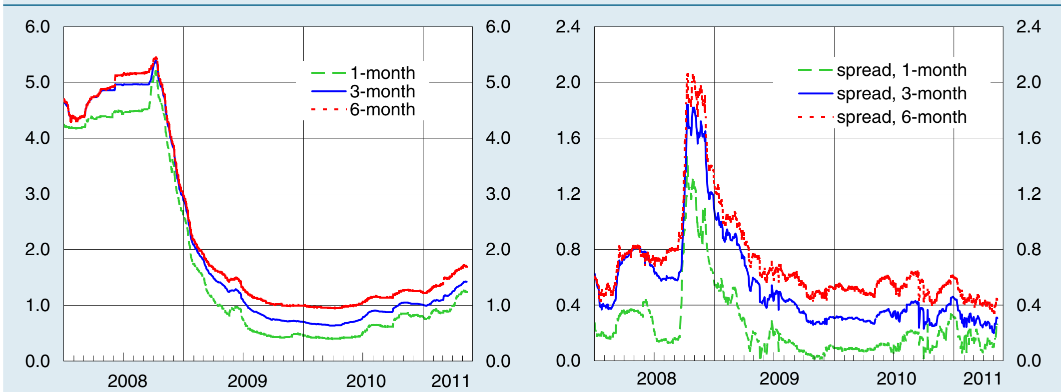
Interest rates and the exchange rate of the euro

Short-term interest rates. – In the first half of 2010, money market rates remained at the exceptionally low levels they had reached at the end of 2009, below the rate on main refinancing operations (which remained at the historical low of 1 per cent). The abundant liquidity supplied by the Eurosystem contributed to this.

Beginning in the summer, the gradual mopping up of excess liquidity caused money market rates to move steadily upwards. This movement intensified after the Governing Council's decision to raise official rates by 25 basis points at the start of April 2011. Three-month Euribor, which had stood at 0.7 per cent in the first half of 2010, reached 1.0 per cent at the end of the year and 1.4 per cent in mid-May 2011. The spreads between the rates on unsecured interbank loans (Euribor) and the rates on secured ones (Eurepo), which can be taken as a gauge of the risk premiums in the interbank markets, held at roughly the levels of end-2009, albeit with considerable fluctuations (Figure 7.2). In mid-May, the spread at three months was 30 basis points.

Figure 7.2

Euribor rates and spreads with corresponding Eurepo rates
(daily data; per cent)



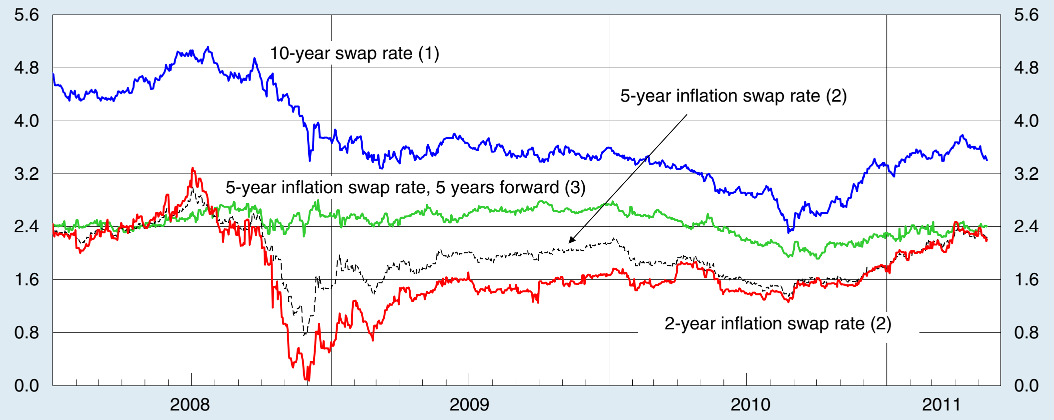
Source: Thomson Reuters Datastream.

Real short-term interest rates remained negative, reaching a low of minus 1.3 per cent at the end of 2010 owing to the rise in short-term inflation expectations. At the end of April they were negative by 1.0 per cent, two percentage points below the average for the period from the introduction of the euro up to the onset of the financial crisis.

Long-term rates. – Measured on the basis of ten-year swap contracts in euros, long-term interest rates declined in the first half of the year and at the end of the summer reached their lowest level since the adoption of the common currency (2.3 per cent; Figure 7.3). Subsequently they rose, reflecting the improvement in the euro area's economic prospects and the increase in inflation expectations.

Figure 7.3

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



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

Medium-term inflation expectations, derived from swap contracts on the euro-area inflation rate, remained moderate. They diminished in the first half of 2010 and then rose in response to the sharp increases in commodity prices and the steady improvement in the area's economic outlook (Figure 7.3). In mid-May 2011, inflation expectations stood at 2.2 per cent on both the two-year and five-year horizon. This level, which includes risk premiums, is well below the peak recorded in the summer of 2008 when oil prices spiked. Inflation expectations on a horizon between five and ten years ahead, which are influenced to a lesser extent by the current behaviour of consumer prices, remained stable. Taking risk premiums into account, the level of inflation expectations is consistent with the objective of price stability.

Similar findings come from the surveys carried out by Consensus Economics and from the ECB's Survey of Professional Forecasters. The latter, conducted in mid-April 2011, found that the possibility of inflation exceeding 2 per cent on a five-year horizon was assigned an average probability of about 50 per cent, some 7 percentage points less than in July 2008.

The yield spreads of some euro-area countries' government securities over Germany's widened sharply from the spring of 2010 onwards, reflecting the repeated bouts of tension that hit the sovereign debt markets of Greece, Ireland, Portugal and, to a lesser extent, the markets for Spanish, Italian and Belgian securities as well. The measures taken by the euro-area countries, with the European Commission and the IMF, and by the ECB eased the strains. In the first half of May 2011, the spreads on Greek, Irish and Portuguese government bonds reached new highs since the launch of the third phase of European monetary union – 1260, 760 and 660 basis points, respectively. During this period the spreads on Spanish, Italian and Belgian securities held stable at 220, 150 and 110 basis points.

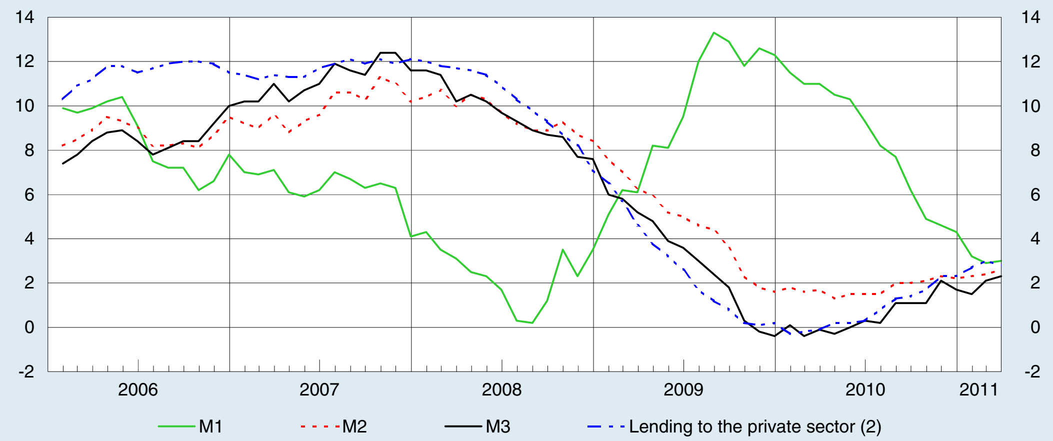
The exchange rate of the euro. – In the first half of 2010, the euro depreciated both in nominal effective terms and against the dollar, mainly reflecting mounting concern over Greek sovereign debt. The trend reversed in the summer, despite the intensifying financial strains; the euro appreciated, albeit with wide fluctuations, following the release of better-than-expected news on the macroeconomic outlook and the gradual widening of the differential between short-term interest rates in euros and dollars. In the spring of 2011, the euro strengthened further against the dollar in connection with expectations of differing monetary policy stances of the ECB and the Federal Reserve. In mid-May, the euro's exchange rate against the dollar was about the same as it had been at the start of 2010; its nominal effective exchange rate was about 5 per cent weaker.

Money and credit

Money. – The twelve-month rate of growth in the M3 money supply turned positive midway through 2010 and gradually increased in the second half of the year and the first few months of 2011, though remaining extremely low (Figure 7.4). The persistently slow expansion of the money supply reflects the continuing weakness of economic activity and, in some countries, the large outflow of funds from the banking system. The gradual recovery was due in part to the flattening of the yield curve, which favoured portfolio reallocation from assets not included in M3 to the more liquid assets included in the aggregate; the widening of the negative yield spread between overnight deposit rates and rates on the other deposits included in M3 encouraged reallocation towards the latter.

Figure 7.4

Money and credit aggregates in the euro area
(end-of-month data; twelve-month percentage changes) (1)



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

Credit. – The twelve-month rate of growth in bank lending to the private sector, which was negative at the start of 2010, gradually gained pace during the year and reached 2.8 per cent in March 2011 (Figure 7.4).

The trend in credit to the private sector differs considerably from country to country within the area. In the countries directly affected by the strains in sovereign debt markets, lending to the private sector was basically unchanged in March 2011 from a year earlier, with a sharp contraction in the case of Ireland. The highest growth rates were recorded in France, Italy and the Netherlands. In Germany, the expansion in lending was moderate.

Within the private sector, lending to non-financial corporations returned to growth (1.9 per cent in the twelve months to March 2011); during the recession it had contracted, showing a twelve-month decline of 2.5 per cent at the start of 2010. During the cyclical upswing, lending to firms was fuelled by growing demand for the financing of fixed investment, inventories and working capital. The rate of growth in lending to households picked up slightly (2.9 per cent in the twelve months to March 2011), thanks mainly to the expansion in loans for house purchases.

The responses of the banks participating in the quarterly Bank Lending Survey for the euro area signalled the absence of significant supply-side strains for the area as a whole during 2010 and the first quarter of 2011. However, lending standards differed markedly across countries; in particular, there were indications of a pronounced tightening in some countries directly involved in the sovereign debt crisis, whose banks are finding it increasingly difficult to raise funds on the wholesale markets.

The cost of bank credit remained stable for most of 2010. In the last part of the year and the first few months of 2011, the interest rates on bank loans to firms rose slightly: in March 2011, the rate on short-term loans stood at 3.7 per cent, up from 3.5 per cent in December 2009. By contrast, the rates on new loans to households for house purchase remained more or less stable at 3.7 per cent.

Monetary policy operations

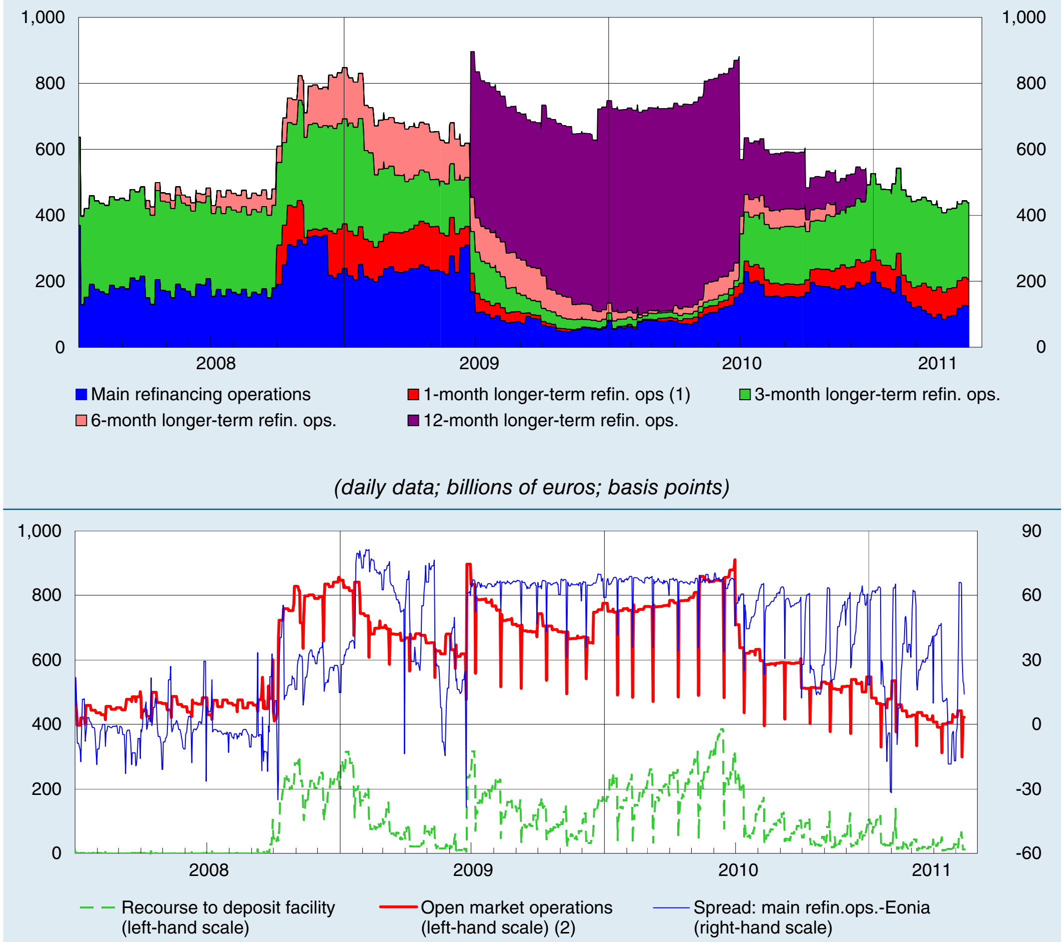
In recent years new refinancing operations have been introduced at various maturities and a system of fixed-rate tenders with full allotment has been adopted. In the early months of 2010, with conditions in the money and financial markets improving, some unconventional measures no longer deemed necessary were removed. During that phase, no refinancing operations were carried out with a maturity of six or twelve months or in foreign currency. In March, the ECB Governing Council reintroduced variable-rate tenders in three-month operations. The Covered Bond Purchase Programme, begun in July 2009, was completed in July 2010 with the purchase of a total of €60 billion worth of securities.

In May 2010, however, the emergence of strains on the sovereign debt markets of some countries of the area and the risk that they might spread to other countries and other market segments and affect the liquidity conditions of the banking system induced the Governing Council to return to fixed-rate tenders with full allotment in the three-month refinancing operations, to carry out a new six-month operation and to provide liquidity in dollars. To safeguard the functioning of the monetary policy transmission mechanism, the Governing Council undertook a programme of purchases of public and private securities issued in the euro area, deciding to sterilize their effects on liquidity. At the end of April 2011, the stocks of securities purchased under this Securities Markets Programme amounted to €76 billion.

Carrying out financing operations with full allotment led to expansive liquidity conditions. The outstanding amount of refinancing operations reached €900 billion on 1 July, on the eve of the maturity of the first twelve-month operation (with which €440 billion had been injected; Figure 7.5). On the same date the Eurosystem's balance sheet reached its maximum size since the launch of the third phase of European monetary union (€2,150 billion).

Figure 7.5

Open market operations, deposit facility and spread between rate on main refinancing operations and Eonia
(daily data; billions of euros)



Source: ECB.
(1) Operations with a special maturity equal to the duration of the maintenance period. – (2) Excludes purchases under the Securities Markets Programme.

The excess of liquidity, measured on the basis of the funds deposited by the banking system with the deposit facility, was very high, averaging about €202 billion in the maintenance periods falling between January and June 2010 (Table 7.1). Consequently, the Eonia rate, which normally is approximately in line with the rate on main refinancing operations, remained close to the lower limit of the official-rate corridor (Figures 7.1 and 7.5).

Table 7.1

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

	2009 1 Jan.-24 June	2009 25 June-31 Dec.	2010 1 Jan.-30 June	2010 1 July-31 Dec.	2011 1 Jan.-10 May
Main refinancing operations (MROs)					
Volume (1)					
Euro area	236.3	75.1	85.8	177.7	135.9
Italy	8.4	4.2	2.0	7.3	9.7
Italy's share (2)	3.6	5.6	2.4	4.1	7.1
Number of participants per tender					
Euro area	558	257	85	145	209
Italy	14	9	6	19	28
Longer-term refinancing operations					
Volume (3)					
Euro area	458.8	643.2	671.0	381.3	321.2
Italy	24.2	23.9	25.3	25.2	30.5
Italy's share (2)	5.3	3.7	3.8	6.6	9.5
Number of participants per tender					
Euro area	82	98	24	100	118
Italy	4	4	3	15	23
Standing facilities (4)					
Marginal lending facility					
Euro area	1.6	0.5	0.5	0.7	1.8
Italy	0.0	0.0	0.0	0.0	0.0
Deposit facility					
Euro area	110.5	119.8	201.7	93.3	37.7
Italy	3.1	2.1	3.0	0.6	0.5
Excess reserves (5)					
Euro area	0.49	0.48	0.56	0.58	0.66
Italy	0.19	0.21	0.22	0.19	0.17
Money market rates					
Eonia	1.10	0.36	0.35	0.52	0.77
Spread MROs-Eonia (6)	48.1	64.1	65.3	47.7	28.4
Volatility of the spread (7)	26.0	5.3	7.0	15.4	25.2

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

Liquidity conditions began to return to normal in the second half of the year following the maturity of the twelve-month operations and the lessening of demand for liquidity. Recourse to the deposit facility progressively diminished, falling to €23 billion in the maintenance period ending in April 2011; the Eonia rate gradually approached the fixed rate on main refinancing operations while displaying pronounced volatility (Table 7.1).

In March 2011, the ECB decided to maintain, at least until 12 July, fixed-rate tender procedures with full allotment for main refinancing operations, for special-term refinancing operations (with a maturity of one maintenance period) and for three-month tenders.

THE ITALIAN ECONOMY

8. DEMAND, SUPPLY AND PRICES

In 2010, the Italian economy returned to modest growth of 1.3 per cent, close to the average for the ten years before the recession, prolonging the country's lag with respect to the euro area as a whole. From the start of the cyclical recovery in the summer of 2009, GDP has recouped just 2 of the 7 percentage points lost during the global crisis.

The expansion in output was driven mainly by exports, fuelled by the strong recovery in world trade, albeit less so than in the other main European countries, especially Germany. Italy's export performance reflected the fact that today's most dynamic economies, particularly the emerging Asian countries, represent only a small share of Italy's outlet markets. Moreover, the relatively slower growth of the exporting sectors meant less stimulus for upstream manufacturing industries.

The recovery in national demand was modest. Household consumption was again dampened by the decline in real disposable income and the poor outlook for the labour market. The propensity to save diminished, following a trend under way for two decades. The saving rate of Italian households is now one of the lowest among the main euro-area countries.

Spending on machinery and equipment rose sharply in the first half of the year in response to tax incentives, but slowed considerably when these came to an end, given the ample margins of spare capacity and uncertainty about the outlook for demand. The recession continued in the construction sector, although easing somewhat.

The slow growth of the Italian economy in 2010 was ascribable to both industry and services, particularly services provided by general government, which were subject to tight budget constraints. In the first quarter of 2011, GDP growth was barely positive and well below the euro-area average. The data now indicate that the recovery will continue at a slow pace in the coming months.

Inflation remained low on average for the year, increasing slightly in the second half following the acceleration in commodity prices. Core inflation stayed at the moderate levels recorded in 2009. Pressure on consumer prices intensified at the beginning of this year, partly owing to the increase in some service prices caused by the rise in energy prices. Analysts expect the increases to be temporary, with consumer price inflation averaging around 2 per cent in 2012.

Household consumption

In 2010, Italian household consumption increased by just 1.0 per cent in volume, ending two years of contraction (Table 8.1). Purchases of semi-durable goods rose by 4.1 per cent, driven by spending on clothing. Those of non-durables, up by 1.0 per cent, were again dampened by the stagnation of food expenditure. Durable goods purchases continued to fall (1.9 per cent) and have dropped by almost 12 per cent in total in the past three years. The contraction in 2010 was attributable to the decline of 13.1 per cent in expenditure on transport equipment after the tax incentives for new motor vehicles expired, which was partly offset by a recovery of 22.0 per cent in purchases of mobiles and telephone equipment. Spending on services grew by 0.9 per cent, boosted by expenditure on recreation and culture.

Table 8.1

Sources and uses of income

	As a percentage of GDP in 2010 (volumes at previous-year prices)	2009			2010		
		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	–	-5.2	2.3	–	1.3	0.6	–
Imports of goods *fob* and services (1)	26.5	-13.7	-7.4	4.0	10.5	8.6	-2.5
of which: goods	*21.5*	*-13.6*	*-9.2*	*3.2*	*13.3*	*9.1*	*-2.5*
Uses							
National demand	100.8	-3.9	0.6	-4.0	1.7	1.6	1.7
Consumption of resident households	59.4	-1.8	..	-1.1	1.0	1.5	0.6
Consumption of general government and non-profit institutions serving households	21.5	1.0	2.0	0.2	-0.6	1.3	-0.1
Gross fixed investment	19.3	-11.9	1.0	-2.5	2.5	1.5	0.5
machinery, equipment and transport equipment	*8.7*	*-16.4*	*0.9*	*-1.5*	*10.6*	*0.8*	*0.8*
intangible assets	*0.9*	*-4.4*	*1.0*	*..*	*1.4*	*1.8*	*..*
construction	*9.7*	*-8.7*	*1.1*	*-0.9*	*-3.7*	*2.0*	*-0.4*
Change in stocks and valuables (2)	–	–	–	-0.6	–	–	0.7
Exports of goods *fob* and services (3)	25.7	-18.4	-1.4	-5.3	9.1	4.9	2.2
of which: goods	*20.9*	*-19.3*	*-1.9*	*-4.6*	*9.8*	*5.9*	*1.9*
Net exports	–	–	–	-1.3	–	–	-0.4

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

Consumer households' prudence in spending reflected the weakness of real disposable income, down by 0.5 per cent in 2010 and by 4.6 per cent over the last three years (Table 8.2). The slight recovery in nominal income, up by 1.0 per cent compared with a contraction of 3.1 per cent in 2009, was more than offset by inflation. Taking into account the erosion of the real value of net financial assets owing to the increase in expected inflation, the decline in real disposable income comes to 1.6 per cent.

Table 8.2

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

	As a percentage of households' gross disposable income in 2010	2008	2009	2010
		Percentage changes		
Earnings net of social contributions charged to workers	43.2	3.3	-1.0	1.2
Income from salaried employment per standard labour unit	–	*3.7*	*1.6*	*2.2*
Total social contributions (1)	–	*-0.5*	*0.3*	*0.2*
Standard employee labour units	–	*0.1*	*-2.8*	*-1.1*
Income from self-employment net of social contributions (2)	20.5	-3.0	-2.6	..
Income from self-employment per standard labour unit	–	*-0.6*	*1.1*	*-0.3*
Total social contributions (1)	–	*-0.9*	*-0.7*	*-0.1*
Standard self-employed labour units	–	*-1.6*	*-3.0*	*0.4*
Net property income (3)	23.5	3.0	-15.0	0.3
Social benefits and other net transfers	31.2	4.9	4.8	2.7
of which: net social benefits	–	*4.9*	*4.7*	*2.3*
Current taxes on income and wealth (–)	18.4	5.1	-3.1	2.2
Households' gross disposable income	**100**	**2.0**	**-3.1**	**1.0**
in real terms (4)	–	-1.1	-3.1	-0.5
in real terms, adjusted for expected inflation (4) (5)	–	-1.4	-1.1	-1.6
in real terms, adjusted for past inflation (4) (6)	–	-0.6	-0.6	-2.6
Private sector gross disposable income	–	**1.4**	**-1.1**	**1.8**
in real terms (4)	–	-1.7	-1.2	0.3
in real terms, adjusted for expected inflation (4) (5)	–	-1.5	1.1	-1.1
in real terms, adjusted for past inflation (4) (6)	–	-0.6	1.7	-2.2
		Percentages		
Consumer households' average propensity to save (7)	–	**11.3**	**10.2**	**8.9**
calculated on income adjusted for expected inflation	–	8.6	9.2	6.9
calculated on income adjusted for past inflation	–	9.0	10.1	6.8
Private sector average propensity to save (7)	–	**22.5**	**23.1**	**22.6**
calculated on income adjusted for expected inflation	–	23.3	23.3	23.1
calculated on income adjusted for past inflation	–	23.2	23.1	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) Deflated using the resident households' consumption deflator. – (5) Gross disposable income net of expected losses on net financial assets due to inflation (estimated on the basis of the Consensus Economics survey). – (6) Gross disposable income net of actual losses on net financial assets owing to inflation, calculated ex post. – (7) Ratio of saving (before depreciation and amortization and not adjusted for changes in net equity of households in pension fund reserves) to the gross disposable income of the sector.

Although well below the average for the previous three years, the increase in net social benefits contributed 0.8 percentage points to the growth in nominal disposable income. Taking into account the rise in current taxes on income and wealth and unchanged social security contributions, government measures provided a positive contribution of 0.3 points to nominal disposable income. A positive factor was the 1.2 per cent increase in total wages and salaries, due entirely to the growth of just over 2 per cent in per capita wages against a further drop in the number of full-time equivalent employees.

Self-employment income has not yet returned to growth. Property income stagnated after contracting sharply in 2009. The small upturn in the aggregate dividends and other distributed profits and the acceleration in gross operating profits were offset by a another decline in households' net interest income.

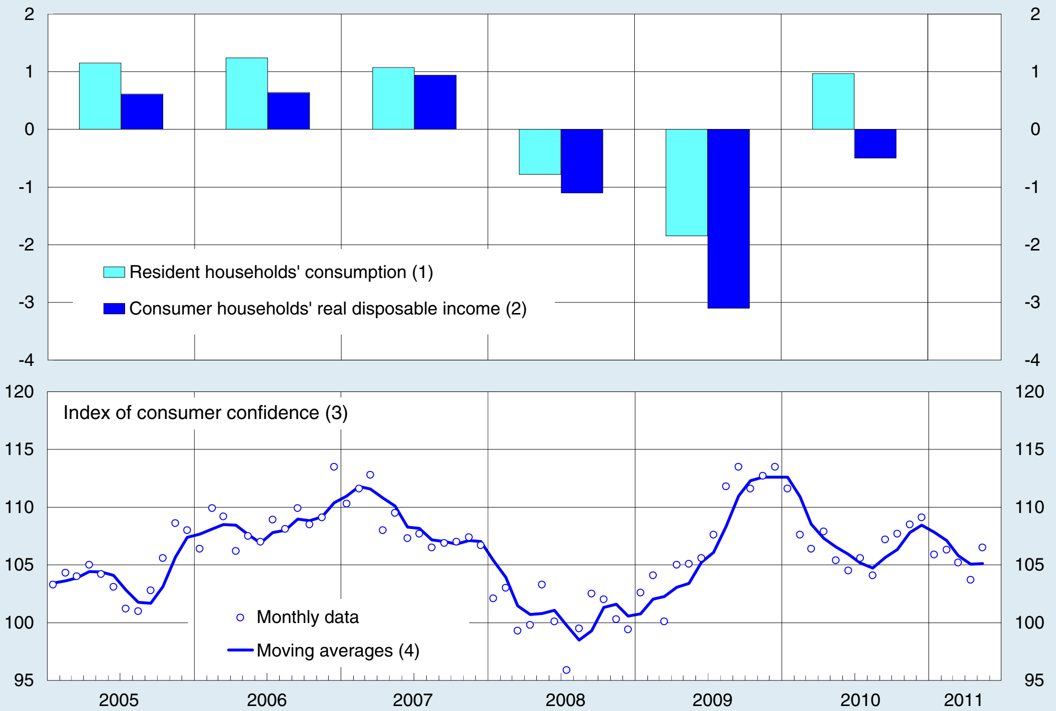
With expenditure rising, albeit modestly, the decline in disposable income in real terms led to a reduction in consumer households' propensity to save. In 2010, the saving rate fell to 8.9 per cent, or 6.9 per cent measured with reference to income adjusted for expected monetary erosion of financial assets. This continued a long-term trend: at the beginning of the decade the saving rate was 12.6 per cent and in the 1990s it averaged around 18 per cent. Italy's saving rate is now one of the lowest among the main euro-area countries.

Given the persistent weakness of disposable income and the uncertain outlook, with its repercussions on consumer confidence (Figure 8.1), consumption was sustained

Figure 8.1

Consumption, real income and consumer confidence

(growth rates and indices)



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

to some degree by the high level of wealth. According to preliminary estimates, at the end of the year wealth was more than 7.5 times the disposable income of consumer households, compared with about 7 times in 2005.

In the private sector (households and firms), the saving rate fell by 0.5 percentage points, to 18.0 per cent of national gross disposable income. For the economy as a whole, the rate stayed close to the previous year's low of 16.4 per cent. The contribution of general government was again negative, though less so than in 2009. The deficit on current transactions with the rest of the world widened to 4.3 per cent, the highest level since the middle of the 1970s.

Investment

Gross fixed investment increased by 2.5 per cent in 2010, compared with an overall contraction of 15.2 per cent in the previous two years (Table 8.3). The gain reflected the 9.6 per cent rise in purchases of capital goods (machinery and equipment, transport equipment and intangible goods), which was partly offset by a contraction of a further 3.7 per cent in investment in construction. The propensity to invest remained unchanged at 19.3 per cent of GDP (calculated at the previous year's prices), still more than 1 percentage point below the average for the last decade. Although investment net of depreciation increased by 14.7 per cent in 2010, it remains historically low and is over 60 per cent below the pre-recession level (in France and Germany the shortfall is about 45 per cent).

Table 8.3

Fixed investment

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

	Percentage share in 2010 (1) (volumes at previous-year prices)	Percentage change			As a percentage of GDP (1) (volumes at previous-year prices)	
		2008	2009	2010	2000	2010
Construction	50.4	-3.0	-8.7	-3.7	9.3	9.7
residential	*21.3*	*-0.6*	*-8.8*	*-2.9*	*3.8*	*4.1*
other	*24.4*	*-4.4*	*-7.9*	*-5.4*	*4.7*	*4.7*
property transfer costs	*4.7*	*-5.9*	*-12.2*	*2.8*	*0.8*	*0.9*
Machinery and equipment	35.4	-5.7	-16.1	11.1	7.6	6.8
Transport equipment	9.9	-2.9	-17.1	8.5	2.3	1.9
Intangible assets	4.4	-1.0	-4.4	1.4	0.9	0.9
Total gross fixed investment	**100**	**-3.8**	**-11.9**	**2.5**	**20.1**	**19.3**
Total excluding residential buildings	–	-4.7	-12.7	4.1	16.4	15.2
Total excluding construction	–	-4.7	-15.3	9.6	10.8	9.6
Total net fixed investment (2)	**–**	**-18.5**	**-56.8**	**14.7**	**5.6**	**2.3**

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

The increase in purchases of capital goods was fostered by the recovery in world demand and by less restrictive credit supply conditions. It was concentrated in the first half of the year, spurred by the tax incentives introduced in the middle of 2009 (Decree Law 78/2009, ratified by Law 102/2009, known as the Tremonti-*ter*) which expired at the end of June 2010. The resulting decision to bring forward investment led to the slowdown in the second half of the year, given the large margins of spare capacity.

Investment in construction, characterized, as in the past, by more persistent cyclical fluctuations, continued to contract. It picked up slightly in second half of the year, particularly in the residential sector, which grew for the first time in two years. Housing transactions, which had declined by over 25 per cent during the recession, stopped falling and instead rose by 0.4 per cent in 2010; house prices remained virtually stationary in nominal terms. Investment in non-residential construction, which had decreased by 20.5 per cent since 2004, fell by a further 5.4 per cent, partly owing to the poor performance of public works as a result of tight budget constraints. As there are no official statistics, indications about this come from the survey conducted from February to April of this year by the branches of the Bank of Italy on a sample of 504 construction firms with 20 or more workers, according to which the volume of new public works diminished by over 4 per cent. Firms expect a further contraction this year.

According to the Bank of Italy's spring survey on a sample of 3,937 firms with 20 or more workers in industry excluding construction and in private non-financial services, gross fixed investment in manufacturing exceeded the amount originally planned and was particularly buoyant among exporting firms, as well as service firms with 50 or more workers (Table 8.4). Expectations for 2011 are for a slowdown in total investment, reflecting the contraction in industry and moderate growth in the service sector.

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 2010 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 2010	*0.4*	*11.6*	*2.1*	*0.4*	*-7.5*	*0.8*	*-5.9*	*3.2*	*-3.1*
realization rate (4)	*102.6*	*105.9*	*108.4*	*107.7*	*93.6*	*107.4*	*95.3*	*105.3*	*99.0*
plans for 2011	*-5.1*	*-18.1*	*-12.1*	*0.2*	*8.5*	*-3.4*	*2.8*	*-2.2*	*-8.9*
Realized investment in 2010	0.7	11.8	1.2	1.5	-4.7	0.7	-4.7	4.7	-3.2
Realization rate (4)	100.8	103.6	105.7	103.1	95.5	105.0	93.8	104.4	97.1
Plans for 2011	-2.5	-16.4	-10.5	2.3	7.5	-0.3	3.3	-0.6	-4.5
Services (5)									
Realized investment in 2010	6.8	3.0	8.7	6.3	7.5	....	....	12.0	-1.1
Plans for 2011	0.7	-12.0	-6.7	0.4	8.0	....	....	0.0	2.0
Total									
Realized investment in 2010	3.5	7.6	4.5	3.5	1.4	0.7	-4.7	8.5	-2.3
Plans for 2011	-0.9	-14.4	-8.5	1.5	7.8	-0.3	3.3	-0.2	-1.7

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 2010. – (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 2009 for 2010, both at current prices. – (5) Private sector non-financial services.

Exports and imports

Exports. – After plummeting by 18.4 per cent in 2009, exports of goods and services grew by 9.1 per cent in volume last year, sustained by the rise in exports of chemicals and transport equipment. The performance of Italy's sectors of specialization, particularly mechanical equipment, was less buoyant.

Overall, exports grew less than the volume of world trade, which returned to pre-crisis levels within a year. According to the quarterly national accounts, Italian exports rose by 13.0 per cent compared with the low recorded in mid-2009, recouping less than half the loss suffered during the recession, compared with around 22 per cent in Germany and 13 per cent in France. The slower recovery of Italian exports reflects their geographical composition, as they are concentrated in outlet markets that have shown less growth than today's most dynamic areas, notably the Asian emerging countries (Table 8.5).

Table 8.5

Exports and imports *cif-fob* by main countries and areas: indices of average unit values (AUVs) and volumes

(percentage composition in the year and percentage changes on previous years; indices, 2005=100)

	Exports						Imports					
	2009			2010			2009			2010		
	% comp. of values	% change in AUVs	% change in volumes	% comp. of values	% change in AUVs	% change in volumes	% comp. of values	% change in AUVs	% change in volumes	% comp. of values	% change in AUVs	% change in volumes
EU-27 countries	**57.6**	**-3.5**	**-19.9**	**57.3**	**7.5**	**7.2**	**57.4**	**-4.4**	**-14.4**	**54.9**	**5.7**	**11.5**
of which: euro area of 16	*44.1*	*-3.8*	*-18.4*	*43.5*	*7.3*	*6.0*	*46.3*	*-4.6*	*-15.0*	*44.1*	*5.6*	*10.6*
of which: France	*11.6*	*-1.4*	*-17.0*	*11.6*	*6.6*	*7.9*	*8.9*	*-3.8*	*-16.6*	*8.3*	*7.1*	*8.1*
Germany	*12.7*	*-1.9*	*-20.1*	*13.0*	*7.1*	*10.9*	*16.7*	*-3.3*	*-16.0*	*15.9*	*4.6*	*12.5*
Spain	*5.7*	*-9.7*	*-23.3*	*5.8*	*10.9*	*6.0*	*4.4*	*-5.2*	*-16.9*	*4.5*	*5.8*	*19.8*
United Kingdom	*5.1*	*-1.4*	*-21.6*	*5.3*	*5.7*	*14.4*	*3.3*	*-1.9*	*-15.8*	*3.3*	*5.9*	*16.5*
Non-EU countries	**42.4**	**0.1**	**-18.6**	**42.7**	**4.5**	**11.3**	**42.6**	**-15.7**	**-13.4**	**45.1**	**16.3**	**12.3**
of which: China	*2.3*	*4.8*	*-1.7*	*2.5*	*3.3*	*25.0*	*6.5*	*0.4*	*-18.5*	*7.8*	*3.5*	*43.6*
DAEs (1)	*3.0*	*2.8*	*-16.3*	*3.0*	*7.7*	*9.6*	*1.9*	*-6.6*	*-22.2*	*2.1*	*7.9*	*25.1*
Japan	*1.3*	*5.0*	*-16.6*	*1.2*	*4.2*	*3.9*	*1.3*	*8.1*	*-28.1*	*1.2*	*5.4*	*4.1*
Russia	*2.2*	*2.5*	*-40.0*	*2.3*	*1.2*	*21.2*	*4.1*	*-22.8*	*-2.6*	*3.6*	*20.9*	*-10.7*
United States	*5.9*	*2.9*	*-27.9*	*6.0*	*3.8*	*14.4*	*3.2*	*0.1*	*-19.4*	*3.0*	*14.1*	*3.2*
Total	**100**	**-1.9**	**-19.4**	**100**	**6.1**	**9.0**	**100**	**-10.1**	**-13.5**	**100**	**10.7**	**11.4**

Source: Based on Istat data.
(1) Dynamic Asian economies: Hong Kong , Malaysia, Singapore, South Korea, Taiwan and Thailand.

The inability of Italian exports to take full advantage of the expansion in world trade is due to structural factors that weigh on productivity, limiting the competitiveness of domestic firms. Between the beginning of 2009 and the end of 2010, the competitiveness of Italian goods, measured on the basis of manufacturing producer prices, improved by just over 3 percentage points, compared with more than 5 points for Germany, prolonging their relatively poorer performance in the previous ten years.

Imports. – In 2010, imports of goods and services increased by 10.5 per cent in volume; the 13.3 per cent rise in imports of goods alone was partly offset by a small decline in services. A relatively strong boost came from purchases of photovoltaic products, partly to take advantage of government incentives for the production of renewable energy before they were modified at the beginning of 2011.

Supply

The recovery in GDP in 2010 was sustained by the growth in value added in industry excluding construction (4.8 per cent) and, more moderately, in services (1.0 per cent). Output contracted by a further 3.4 per cent in the construction sector.

In manufacturing, the largest increase in value added was recorded in base metals and fabricated metal products, mechanical engineering products and electrical and electronic machinery. In the traditional sectors (textiles and clothing, hides and leather, furniture) value added recovered only a very small part of the decline recorded during the recession.

The growth in value added in the service sector was modest, partly owing to the stagnation in general government activity, including healthcare and education. These sectors, which were affected by budget restrictions, accounted for more than half the gap with respect to the growth of Germany's service sector (1.8 and 3.5 per cent, respectively, since the start of the recovery).

Italy's GDP grew by 0.1 per cent in the first quarter of this year compared with the last quarter of 2010. The gap with respect to the faster growth rates of the other main euro-area countries continues to reflect the slowdown in industry under way since the last months of 2010. The latest indicators suggest that the cyclical upswing will continue in the spring, gaining pace with respect to the first quarter. Economic activity will again depend chiefly on exports; there are no indications of a significant strengthening of household expenditure.

Prices and costs

Consumer prices. – Consumer price inflation in Italy, as measured by the index for the entire resident population (CPI), rose by a moderate 1.5 per cent in 2010, compared with 0.8 per cent in 2009 (Table 8.6). The acceleration reflected pressures of external origin: the import deflator increased by 8.6 per cent, against a decline of 7.4 per cent in 2009. Domestic inflation — measured by the GDP deflator — slowed from 2.3 to 0.6 per cent, owing to the sharp deceleration in unit labour costs.

During the year consumer price inflation gained pace, averaging 1.3 and 1.7 per cent respectively in the first and second half of the year compared with the same periods in 2009. The increase reflected the sharp rises in the most volatile components of the index, notably energy products. Core inflation, excluding food and energy products, held steady at 1.5 per cent.

Table 8.6

Consumer prices

	Percentage changes on previous year		Percentage weights
	2009	2010	2010
Index of consumer prices for the entire resident population	**0.8**	**1.5**	**100**
Unregulated goods and services	**0.9**	**1.7**	**89.4**
Unprocessed food	1.5	-0.3	6.7
of which: fruit	*2.4*	*-3.6*	*1.1*
meat	*1.8*	*0.5*	*3.9*
Processed food	2.1	0.6	10.6
of which: bread and cereals	*2.4*	*0.4*	*3.4*
Energy products	-13.2	11.2	4.1
Non-food and non-energy products	1.2	1.1	27.8
Services	1.8	1.8	38.1
of which: restaurants, bars etc.	*2.4*	*2.1*	*7.9*
accommodation	*-2.3*	*0.2*	*2.6*
all-inclusive holiday packages	*-0.5*	*0.7*	*0.3*
air transport	*-13.0*	*-1.4*	*0.6*
Tobacco	4.1	3.3	2.2
Regulated goods and services	**0.3**	**-0.3**	**10.6**
of which: gas (1)	*-1.5*	*-2.5*	*2.0*
electricity	*-1.9*	*-6.8*	*1.3*
water	*5.9*	*8.2*	*0.7*
rail transport	*4.8*	*10.7*	*0.4*
Overall index net of food and energy (2)	**1.5**	**1.5**	**73.5**
Harmonized index of consumer prices	**0.8**	**1.6**	**100**

Source: Based on Istat data.
(1) Includes liquefied hydrocarbons, whose prices are unregulated, which account for 0.2 per cent of the total basket. – (2) Also net of tobacco.

The twelve-month increase in the harmonized index of consumer prices (HICP) was 1.6 per cent in 2010 as a whole. The inflation differential with respect to the euro area, which was about 0.5 percentage points in 2009, was wiped out, mainly by the more moderate acceleration in energy prices in Italy (4.2 per cent against 7.4 per cent in the euro area). This trend reflects not only the delay with which regulated prices in Italy (particularly for electricity) react to changes in oil prices, but also the raising of excise duties on fuel in some euro-area countries. Excluding the most volatile components, however, the inflation gap widened from 0.2 to 0.7 percentage points owing to larger rises in Italy in the prices of some services, notably air transport, hotels and catering and holiday packages.

Inflationary pressures gained strength at the beginning of 2011. In April, the twelve-month increase in the national consumer price index reached 2.6 per cent, driven by price hikes for food and energy, transport (indirectly linked to higher energy costs) and some public tariffs. In the first four months of this year, the HICP increased in line with the CPI (2.4 per cent on the year-earlier period). However, the monthly profile of the HICP was very volatile owing to methodological changes introduced by Istat in 2011 in the way the prices of seasonal products are recorded.

Producer prices and costs. – In 2010, the producer price index for the domestic market rose by 3.1 per cent on average, compared with a decrease of 5.4 per cent in the previous year. The increase was driven mainly by the components that are most sensitive to changes in commodity prices, i.e. food, intermediate products and energy. At the beginning of 2011, these pressures built up further, especially on food products. Since January, the producer prices of non-food final consumer goods have also accelerated.

Both the quarterly survey conducted in March 2011 by the Bank of Italy together with *Il Sole 24 Ore* and the Purchasing Managers Index for manufacturing point to the risk of further increases in selling prices. Last year Italian firms adopted more cautious pricing policies on foreign markets than on domestic ones: in 2010, the producer prices of non-energy products for export went up by 1.1 per cent and for the domestic market by 1.8 per cent.

The strong upward pressure coming from imported inputs was countered by the moderation of domestic costs. Unit labour costs in the economy as a whole fell slightly, against an increase of over 4 per cent in 2009. Given the less than 2 per cent rise in hourly earnings, the drop in unit labour costs can be ascribed to the increase in hourly productivity, which rose by 1.9 per cent, mainly owing to the cyclical upswing, compared with a decrease of 2.4 per cent in 2009. In industry, where productivity gains were larger, unit labour costs declined by around 5 per cent. This benefited profit margins, which improved in 2010 after contracting in the previous year.

Inflation expectations. – Inflation expectations remained stable below 2 per cent throughout 2010. Short-term expectations increased in the early months of this year in response to the rise in commodity prices, but those for the medium and long term remained well anchored. The analysts surveyed in May by Consensus Economics expected consumer prices to rise by 2.5 per cent in 2011, in line with the euro-area average, and to decline to around 2 per cent growth in 2012 assuming continued wage moderation and a gradual easing of strains in international commodity markets.

9. THE LABOUR MARKET

Employment diminished again in 2010, although not as much as in 2009. So far the halting recovery in economic activity has been reflected only in an increase in the number of fixed-term and part-time jobs. In March 2011, the number of residents employed was still nearly 600,000 below the April 2008 peak. The recent recession saw a sharper fall in output than that of the early 1990s but a milder decline in employment, owing to a contraction in working hours thanks in part to extensive recourse to the Wage Supplementation Fund. The Bank of Italy's survey of industrial and service firms found expectations of further staff downsizing in 2011, though not as sharp as in 2010, to be achieved mainly by not replacing workers who leave.

While the labour supply stagnated, the unemployment rate rose further in 2010, and in March 2011 was still 8.3 per cent. The rise was sharper for men and especially for young people, among whom it reached 28.6 per cent. A broader gauge of unutilized labour including discouraged workers and those on Wage Supplementation is about three percentage points higher than the pre-recession level.

Actual earnings per full-time equivalent worker increased in 2010 in both nominal and real terms, at lower rates than the yearly average recorded since the mid-1990s. The rise in industry excluding construction was largely due to a change in the composition of the work force towards higher-wage segments. The situation of substantial wage moderation should continue in 2011 and 2012 as well. After a decade of stagnation, in 2010, labour productivity recouped scarcely half the decline recorded since the onset of the recession; only in industry excluding construction has virtually all of the loss been made good. Unit labour costs declined, on average for the year, but there was still a further loss of competitiveness against the other main euro-area economies save France.

Employment and labour input during the crisis

According to the national accounts, the average number of persons employed declined by 0.7 per cent last year, on top of the 1.7 per cent fall in 2009 (Table 9.1 and Figure 9.1). The number of hours worked decreased by 0.4 per cent. At the end of the year the number of persons in work was 562,000 lower (2.2 per cent) than the peak registered in the second quarter of 2008, on a seasonally adjusted basis, while the total number of hours worked had fallen by 3.8 per cent, more closely in line with the 4.8 per cent loss in real value added. According to preliminary data from Istat's labour force survey, employment expanded slightly in the first quarter of 2011. The reduction in the number of hours worked per employee, which attenuated the job loss in 2009, came to a halt in 2010 (up 0.1 per cent, following the 1.9 per cent decline of the previous year).

Table 9.1

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

	Persons in employment				Standard labour units				Total hours worked			
	Per cent		Percentage change		Per cent		Percentage change		Per cent		Percentage change	
	2000	2010	2010/ 2000	2010/ 2009	2000	2010	2010/ 2000	2010/ 2009	2000	2010	2010/ 2000	2010/ 2009
Agriculture, forestry, fisheries	**4.8**	**4.0**	**-10.9**	**1.7**	**6.4**	**5.3**	**-14.1**	**1.6**	**6.3**	**5.4**	**-11.5**	**0.5**
Industry excl. construction	**22.6**	**19.4**	**-7.8**	**-3.7**	**21.7**	**18.2**	**-13.9**	**-3.5**	**21.6**	**18.0**	**-14.3**	**-2.2**
of which: manufacturing	*21.8*	*18.7*	*-7.7*	*-3.8*	*20.9*	*17.5*	*-14.0*	*-3.7*	....	....	....	....
Construction	**6.8**	**7.7**	**22.7**	**-1.4**	**6.9**	**8.0**	**20.1**	**-1.1**	**6.6**	**7.8**	**20.4**	**-1.1**
Services	**65.8**	**68.9**	**12.6**	**0.1**	**65.0**	**68.4**	**8.1**	**-0.1**	**65.5**	**68.8**	**7.9**	**0.1**
Wholesale/retail trade, hotels, transport, communications	24.6	24.4	7.0	-0.5	26.6	27.0	4.1	-0.5	29.1	28.9	1.9	-0.6
Wholesale/retail trade and repairs	*15.0*	*14.5*	*4.2*	*-0.2*	*14.6*	*14.3*	*0.7*	*-0.5*	....	....	....	....
Hotels and restaurants	*4.2*	*5.0*	*28.9*	*0.4*	*5.5*	*6.0*	*11.3*	*0.3*	....	....	....	....
Transport, storage and communications	*5.3*	*4.8*	*-2.5*	*-2.4*	*6.5*	*6.7*	*5.5*	*-1.2*	....	....	....	....
Monetary and financial intermediation and business services	12.9	15.1	26.0	0.6	12.4	14.7	21.4	0.7	12.1	14.7	24.3	1.5
Monetary and financial intermediation	*2.6*	*2.6*	*6.9*	*-0.3*	*2.5*	*2.6*	*6.5*	*-0.4*	....	....	....	....
Business services (1)	*10.3*	*12.5*	*30.7*	*0.8*	*9.9*	*12.1*	*25.2*	*0.9*	....	....	....	....
Other service activities	28.4	29.4	11.4	0.3	26.0	26.8	5.8	-0.1	24.2	25.2	6.9	..
General government (2)	*6.4*	*5.4*	*-8.9*	*-0.7*	*6.2*	*5.5*	*-9.5*	*-0.7*	....	....	....	....
Education	*6.8*	*6.3*	*-0.2*	*-1.5*	*6.6*	*6.4*	*-1.2*	*-1.3*	....	....	....	....
Healthcare	*6.3*	*6.8*	*15.0*	*1.0*	*6.1*	*6.6*	*10.5*	*1.1*	....	....	....	....
Other public, social and personal services	*4.1*	*4.6*	*20.5*	*0.5*	*4.0*	*4.5*	*16.5*	*0.1*	....	....	....	....
Domestic services for households and live-in help	*4.8*	*6.3*	*42.3*	*2.3*	*3.1*	*3.9*	*28.7*	*0.4*	....	....	....	....
Total	**100.0**	**100.0**	**7.5**	**-0.7**	**100.0**	**100.0**	**2.7**	**-0.7**	**100.0**	**100.0**	**2.7**	**-0.4**

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

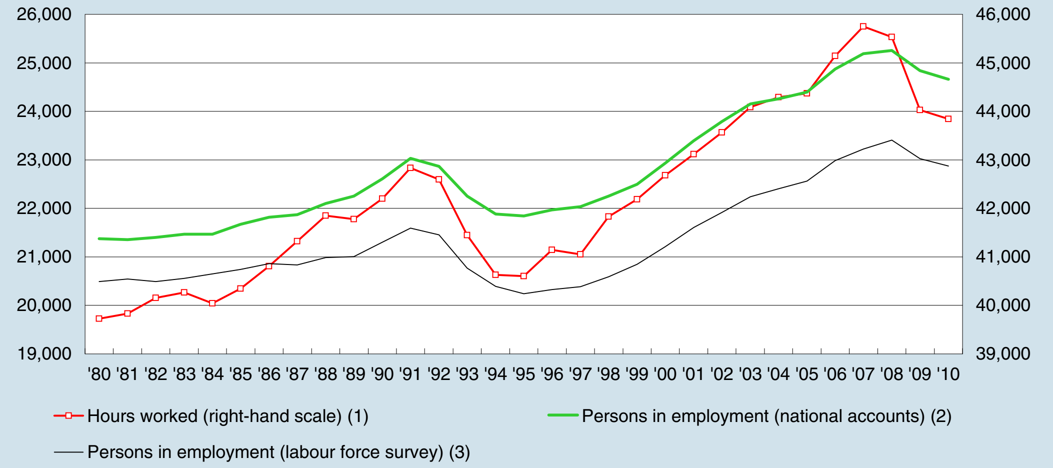
In industry excluding construction, per capita hours rose last year by 1.3 per cent to recoup part of the 7.0 per cent decline registered in 2009. One factor was a drastic decline in vacation days, which had been utilized much more intensively during the most acute phase of the recession, in part at employers' request.

INPS authorized 1,204 million Wage Supplementation benefit hours in 2010, an increase of 31.7 per cent. The ordinary component declined by 40.7 per cent, but this was more than offset by the surge in extraordinary and under-waiver components, as a consequence of the protracted recession and the extension of benefits to ordinarily ineligible sectors. The number of hours authorized began to diminish in November

2010 but remained at historically high levels (Figure 9.2). According to INPS the number of hours effectively used by firms was practically unchanged between 2009 and 2010, while according to Istat's labour force surveys it decreased significantly.

Figure 9.1

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

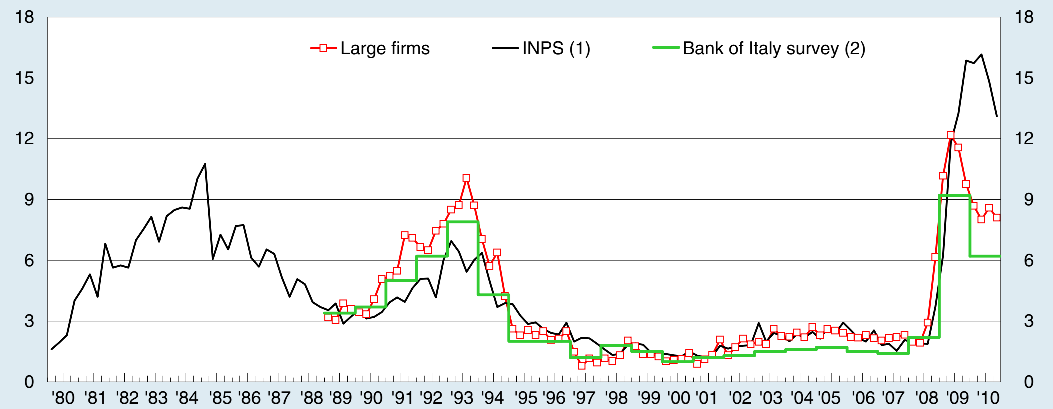


Sources: Istat, national accounts and labour force survey.
(1) Hours worked by residents and non-residents, official and unreported, employed in resident firms. – (2) Number of residents and non-residents, official and unreported, employed in resident firms. – (3) Number of officially registered residents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

By comparison with the 1992-93 downturn, employment held up better during the recent recession despite a sharper slump in economic activity, especially in industry excluding construction (Figure 9.3). Contributing factors were labour demand in the service sector and the reduction in working hours in industry, thanks to the massive resort to Wage Supplementation. Moreover, it is likely that this time staffing was closer to firms' desired levels, alleviating the need for further drastic cuts in labour input.

Figure 9.2

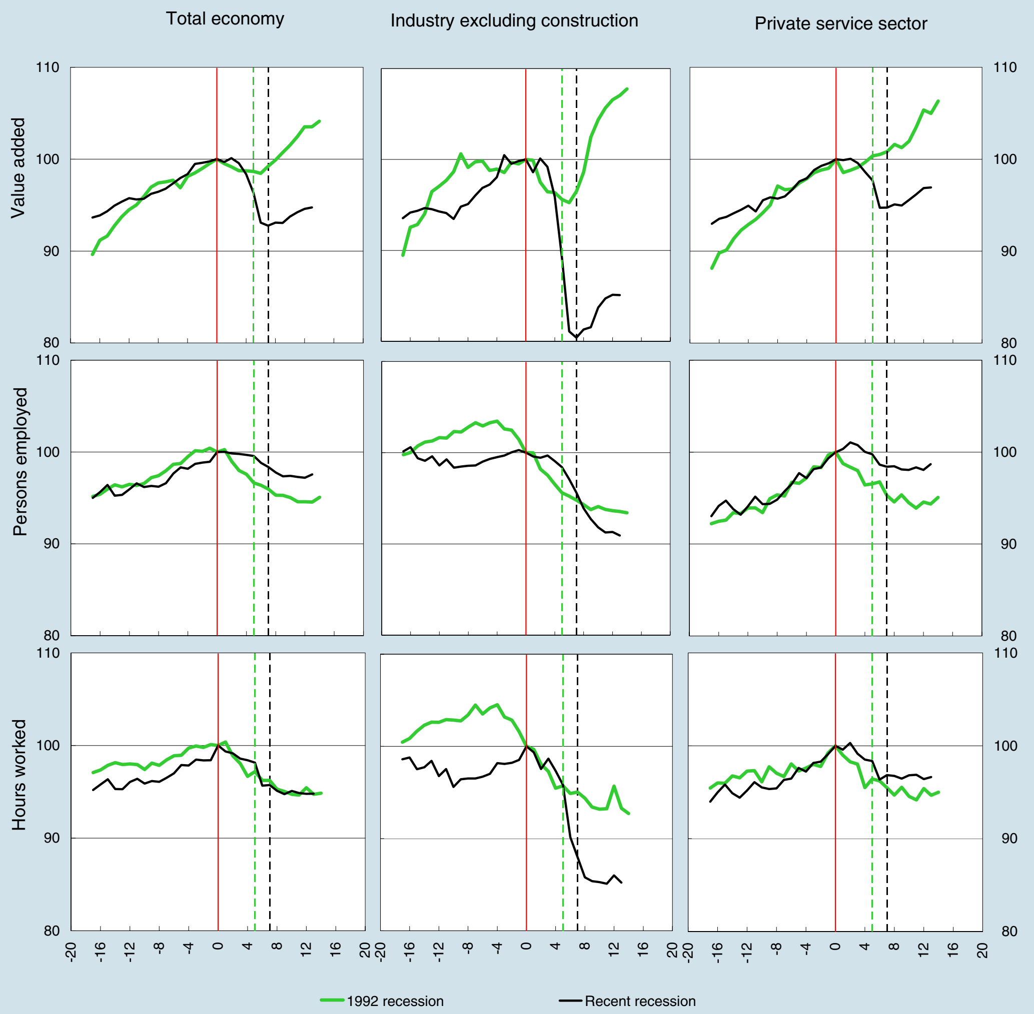
Ratio of Wage Supplementation benefit hours to total hours worked in industry excluding construction
(per cent)



Sources: Based on data from INPS; Istat, national accounts and *Large firms labour indicators*; and Banca d'Italia, *Survey of Industrial and Service Firms*.
(1) Hours authorized (INPS) as a percentage of total hours worked by employees (national accounts). – (2) Firms with at least 50 workers.

Figure 9.3

The 1992-93 recession and the recent recession compared (1)
(index numbers)



Source: Based on data from Istat, national accounts and ISAE-Istat for official dating of Italian economic cycles.
(1) Indices: 100 corresponds to the quarter of the cyclical peak (Q1 1992 and Q3 2007, respectively). The horizontal axis plots the number of quarters after the peak (solid vertical line); the dotted green vertical line indicates the end of the 1992-93 recession; the black dotted line, the end of the recent recession.

The employment decline between 2009 and 2010 was pronounced in industry excluding construction (a fall of 3.7 per cent in the number of persons employed; Table 9.1), in transport, storage and communications (2.4 per cent) and in education (1.5 per cent). The most significant increases were in domestic services (2.3 per cent), agriculture (1.7 per cent) and healthcare (1.0 per cent). Payroll employment in general government, as gauged by the number of full-time equivalent workers, fell for the fourth consecutive year, coming down to the levels of ten years earlier.

The job vacancy rate (which Istat defines as the ratio of positions for which employers are actively seeking candidates outside their firms to the sum of filled plus vacant positions) rose from 0.5 per cent in 2009 to 0.7 per cent in firms with at least ten employees in industry and the private service sector (excluding social and personal services) but remained below the pre-recession level (1.0 per cent in the second quarter of 2008).

Firms' tendency to hire on fixed-term contracts, which emerged towards the end of 2009, strengthened last year in view of the uncertainty over the strength and timing of the recovery.

According to the Bank of Italy's survey of industrial and service firms with at least 20 workers, employment will contract further in 2011 by an average of 0.5 per cent. Staffing levels will decline further in industry excluding construction while holding steady in non-financial service firms.

The composition of employment

Istat's labour force survey, which only covers the officially resident population, signals that employment declined by 0.7 per cent or 153,000 persons on average in 2010, after falling by 1.6 per cent in 2009 (Table 9.2). The entire decrease was accounted for by men's employment (down 1.1 per cent), while the number of women in work was stationary. More than half the contraction for the year occurred in the South of Italy, with a fall of 1.4 per cent compared with 0.4 per cent in the Centre and North.

Table 9.2

Structure of employment in Italy, 2010 (1)
(thousands of persons and per cent)

	Centre and North		South		Italy	
	Thousands of persons	Percentage change 2010-09	Thousands of persons	Percentage change 2010-09	Thousands of persons	Percentage change 2010-09
Employees	**12,570**	**-0.6**	**4,540**	**-1.9**	**17,110**	**-1.0**
Permanent	11,154	-1.0	3,773	-2.0	14,927	-1.3
full-time	*9,439*	*-2.0*	*3,329*	*-2.6*	*12,768*	*-2.2*
part-time	*1,715*	*4.7*	*444*	*2.7*	*2,159*	*4.3*
Fixed-term and temporary	1,416	2.8	767	-1.1	2,182	1.4
full-time	*1,050*	*0.9*	*578*	*-3.4*	*1,627*	*-0.7*
part-time	*366*	*8.7*	*189*	*6.4*	*555*	*7.9*
Self-employed	**4,101**	**0.3**	**1,661**	**0.1**	**5,762**	**0.2**
Entrepreneurs, professionals and own-account workers	3,494	-0.1	1,459	..	4,953	-0.1
with employees	*1,107*	*-3.4*	*417*	*3.4*	*1,524*	*-1.6*
without employees	*2,387*	*1.5*	*1,042*	*-1.3*	*3,429*	*0.7*
Family workers	277	2.3	93	0.5	369	1.8
Cooperative members	30	30.4	10	-11.9	40	16.4
Collaborators	232	-0.7	73	0.7	305	-0.4
Occasional workers	69	6.9	26	4.8	95	6.3
Full-time	3,562	-0.1	1,478	-0.5	5,040	-0.2
Part-time	539	3.5	183	4.4	722	3.8
Total employment	**16,671**	**-0.4**	**6,201**	**-1.4**	**22,872**	**-0.7**

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

The employment rate for the population of working age (15-64) fell by 0.6 percentage points to 56.9 per cent, about the same as eight years earlier, owing in part to the increase in the relevant population (Table 9.3). As in 2009, the decline was sharpest among men, especially in the South, and among foreigners in the Centre and North. All age groups were affected save the 55-64 group, whose employment rate rose by 0.8 percentage points owing to a decline in the number of terminations as a consequence of the raising of the retirement age. The fall was particularly sharp (2.0 points) among people aged 25-34, men and women alike. In the central age group (35-54) the female employment rate rose to 60.0 per cent while the male rate fell to 86.9 per cent. This is the age group in which the gender gap is greatest, accounting for a good part of the disparity in employment rates between Italy and the European Union target.

Table 9.3

Labour supply in Italy, 2010
(thousands of persons and per cent)

	Centre and North		South		Italy	
	Thousands of persons (1)	Percentage change 2010-09 (2)	Thousands of persons (1)	Percentage change 2010-09 (2)	Thousands of persons (1)	Percentage change 2010-09 (2)
Labour force	**17,815**	**0.2**	**7,159**	**-0.4**	**24,975**	**..**
Women	7,655	0.4	2,572	0.5	10,227	0.5
Men	10,160	..	4,587	-0.9	14,748	-0.3
Italians	15,751	-0.8	6,868	-1.1	22,619	-0.9
Foreigners	2,064	8.8	292	21.3	2,355	10.2
Total employment	**16,671**	**-0.4**	**6,201**	**-1.4**	**22,872**	**-0.7**
Women	7,073	..	2,165	..	9,238	..
Men	9,598	-0.7	4,036	-2.1	13,634	-1.1
Italians	14,854	-1.4	5,937	-2.2	20,791	-1.6
Foreigners	1,817	8.2	264	21.1	2,081	9.7
Job seekers	**1,144**	**9.4**	**958**	**6.6**	**2,102**	**8.1**
Women	581	5.3	407	3.7	989	4.7
Men	563	13.9	551	8.8	1,114	11.3
Italians	898	8.3	931	6.2	1,828	7.2
Foreigners	246	13.7	28	23.5	274	14.7
Participation rate (ages 15-64)	**68.4**	**-0.2**	**50.8**	**-0.3**	**62.2**	**-0.2**
Women	59.3	-0.1	36.3	0.1	51.1	..
Men	77.5	-0.2	65.6	-0.8	73.3	-0.4
Italians	67.9	-0.1	50.3	-0.4	61.4	-0.2
Foreigners	72.5	-1.4	64.4	0.1	71.4	-1.3
Employment rate (ages 15-64)	**64.0**	**-0.5**	**43.9**	**-0.7**	**56.9**	**-0.6**
Women	54.8	-0.3	30.5	-0.1	46.1	-0.2
Men	73.1	-0.7	57.6	-1.4	67.7	-0.9
Italians	64.0	-0.4	43.4	-0.8	56.3	-0.6
Foreigners	63.8	-1.6	58.2	..	63.1	-1.5
Unemployment rate	**6.4**	**0.5**	**13.4**	**0.9**	**8.4**	**0.6**
Women	7.6	0.4	15.8	0.5	9.7	0.4
Men	5.5	0.7	12.0	1.1	7.6	0.8
Italians	5.7	0.5	13.6	0.9	8.1	0.6
Foreigners	11.9	0.5	9.5	0.2	11.6	0.5
Youth unemployment rate	**22.1**	**2.0**	**38.8**	**2.8**	**27.8**	**2.4**
Women	24.0	0.9	40.6	-0.3	29.4	0.7
Men	20.7	2.8	37.7	4.6	26.8	3.5
Italians	21.4	1.9	39.5	2.7	28.2	2.4
Foreigners	25.7	2.2	22.3	10.4	25.3	2.9

Source: Based on Istat, labour force survey.
(1) Participation, employment and unemployment rates are percentages. The unemployment rate is the number of job-seekers aged 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. – (2) For participation, employment and unemployment rates, changes in percentage points.

The Europe 2020 strategy revised the European target to an overall employment rate of 75 per cent for the 20-64 age group. In its national reform plan, the Italian government set a target of 67-69 per cent, starting with 61.1 per cent in 2010. This target cannot be attained without raising the female employment rate, by at least twice as much as the male rate according to the Government. The measures envisaged to help women to reconcile work with family commitments and promote equal opportunity in access to work include the opening of home daycare facilities, teleworking, registers of caregivers and babysitters, vouchers for care services, and training for women who want to go back to work.

Women's labour force participation is also influenced by tax provisions. The potential conflict between income support for large families, especially low-income households, and the expansion of female employment is less acute in some tax systems than others, holding revenue constant. Even an apparently neutral individual income tax system like Italy's can be an employment disincentive to married women, because their earnings may make their husbands ineligible for the tax credit for dependents and for family allowances, which diminish as household income rises. To attenuate this potential conflict, some tax systems offer a tax credit for family care for working women or for households in which both spouses work, even part-time; where the worker owes no tax, there may be a direct monetary transfer (e.g. the earned income tax credit in the United States and the working tax credit in the United Kingdom). Such tax provisions make working more advantageous especially for unskilled, low-income married women, whose labour market participation rate is lowest.

The employment contraction in 2010 involved only payroll jobs (1.0 per cent), while the number of self-employed rose marginally (0.2 per cent) after three years of decline. In contrast with the pattern earlier in the recession, now the fall in payroll employment was concentrated among permanent and full-time workers. The number of employees working part time had risen steadily from the early 1990s until an interruption in 2009. Last year the growth resumed: the number of part-time employees rose by 5.0 per cent and their share of total payroll employment by 0.9 percentage points to 15.9 per cent. The number of fixed-term employees rose by 1.4 per cent to account for 12.8 per cent of all payroll jobs.

The difficulty of job market access for young people that emerged in the early 1970s had been attenuated starting in the mid-1990s with the introduction of more flexible employment contracts, in a context of substantial wage moderation. Until the recent recession the employment rate of persons under 35 not engaged in training or education had made notable gains, rising from 65.5 per cent in 2001 to 71.1 per cent in 2007, nearly twice the increase recorded over the previous three decades. But the protraction of education and training, combined with the longer and longer time needed to obtain stable, well-paid employment, has significantly increased the family dependency of young people. The share of 30-year-olds still living with their parents rose from 16 per cent in 1981 to 38 per cent in 2009.

Unemployment, the supply of labour and income support

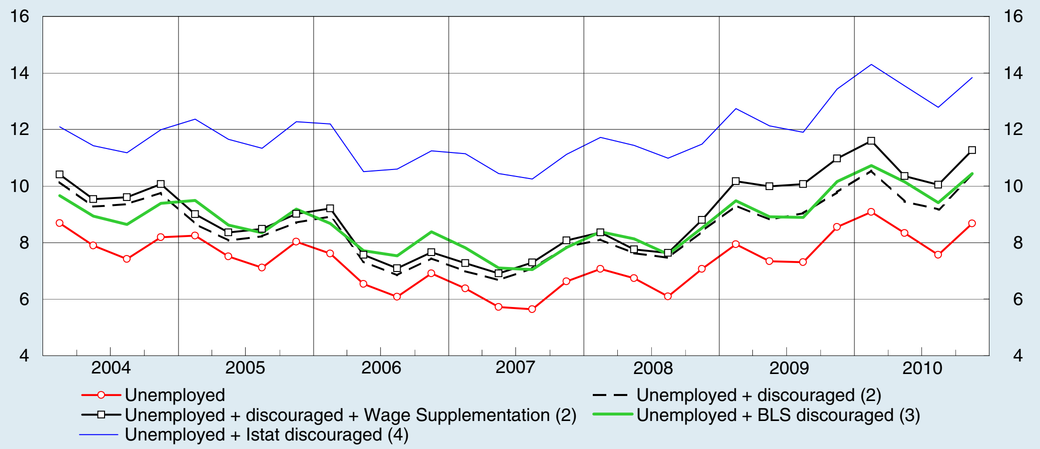
After contracting by 0.5 per cent in 2009, the total supply of labour remained unchanged in 2010, while the population grew by 0.5 per cent. The labour force participation rate of the working-age population, after falling sharply in 2009, slipped further to 62.2 per cent (Table 9.3), the same level as eight years earlier. The activity rate among young people aged 15-34, even excluding those engaged in education or training, fell back to its level of 15 years previous (77.1 per cent).

In 2010 as a whole, of the 2.1 million unemployed, half had lost their jobs, a quarter had been economically inactive, and another quarter were seeking their first job. The unemployment rate rose from 7.8 to 8.4 per cent for the year. According to preliminary data it came down slightly in the first quarter of 2011 to 8.3 per cent on a seasonally-adjusted basis. The increase in the unemployment rate was larger among men than among women (0.8 as against 0.4 percentage points) and greatest of all among young people. The rate among 15-24-year-olds jumped by 2.4 percentage points to 27.8 per cent. The rate also rose among foreigners, from 11.2 to 11.6 per cent. That the recession is continuing is shown by the trend in long-term joblessness (at least twelve months), which increased by one percentage point over two years to 4.1 per cent.

The unemployment rate does not measure the full extent of underutilization of the labour force, especially in recession, because it does not count the hours of work lost by employees on Wage Supplementation and because it fails to reflect the exacerbation of the discouragement syndrome whereby people who are available to work immediately are less active in hunting for jobs. Taking these two factors into account, we estimate that the average rate of unutilized potential labour supply rose from 10.3 per cent in 2009 to 10.8 per cent in 2010, about three percentage points more than before the recession. Counting only discouraged workers, the rise is from 9.2 to 9.9 per cent (Figure 9.4; see the box "Estimates of unutilized available labour", *Economic Bulletin*, January 2010).The Government's anti-crisis measures extending income support to ordinarily ineligible persons were applied in 2010.

Figure 9.4

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



Source: Based on Istat labour force surveys.
(1) The unemployment rate is the ratio of job seekers to the labour force; the measures of unutilized available labour are calculated by adding to both numerator and denominator the number of discouraged workers by the various definitions and, where relevant, the number of full-time equivalent workers on Wage Supplementation. – (2) For the criteria for calculation, see *Economic Bulletin,* January 2010. – (3) The US Bureau of Labor Statistics defines discouraged workers as persons available to work immediately who have taken at least one job search action within the last twelve months but who are not now actively looking for a job because they do not think they can find one. – (4) Istat defines discouraged workers as those who are available to work immediately but who are not looking for a job because they do not think they can find one.

Earnings and labour costs

Actual earnings per full-time equivalent employee rose by 2.1 per cent in nominal terms for the entire economy in 2010, up from 1.8 per cent in 2009 (Table 9.4). The

Table 9.4

Labour costs and productivity in Italy
(annual percentage changes)

	Value added (1)	Total standard labour units	Value added per standard labour unit (1)	Compensation per standard employee labour unit	Labour costs per standard employee labour unit (2)	Unit labour costs (2) (3)	Labour's share of value added (2) (4)	Real labour costs per standard employee labour unit (2) (5)	Real earnings per standard employee labour unit (6)
				Industry excluding construction					
1996-2000	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
2006-2010	-2.1	-2.6	0.4	3.4	3.2	2.7	65.5	1.0	1.5
2007	1.9	0.8	1.1	3.3	3.3	2.1	63.1	-0.7	1.4
2008	-3.4	-1.4	-2.1	4.0	4.1	6.3	65.3	1.3	0.6
2009	-15.6	-9.3	-7.0	2.8	2.6	10.4	68.7	-2.2	2.0
2010	4.8	-3.5	8.7	3.6	3.2	-5.0	66.3	4.9	2.0
				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
2006-2010	-2.4	0.4	-2.8	3.3	3.3	6.2	69.7	-0.6	1.4
2007	0.5	3.0	-2.4	2.8	3.4	6.0	67.5	-0.9	1.0
2008	-2.8	..	-2.8	4.2	4.5	7.5	68.8	-0.9	0.8
2009	-7.7	-1.2	-6.6	4.2	3.1	10.4	71.4	-3.1	3.4
2010	-3.4	-1.1	-2.4	2.5	2.8	5.3	74.4	1.7	0.9
				Private services (7) (8)					
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
2006-2010	0.1	0.3	-0.1	2.5	2.4	2.5	72.4	1.2	0.6
2007	3.1	1.4	1.7	3.1	3.1	1.4	71.0	0.8	1.3
2008	-1.2	..	-1.2	3.2	3.4	4.6	72.2	0.5	-0.1
2009	-5.6	-2.0	-3.6	1.0	0.9	4.7	73.2	-2.3	0.2
2010	2.3	-0.1	2.3	2.1	1.9	-0.5	73.9	3.3	0.6
				Private sector (8)					
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
2006-2010	-0.8	-0.6	-0.2	2.9	2.7	2.9	72.0	1.0	1.0
2007	2.4	1.1	1.3	3.2	3.2	1.9	69.9	0.2	1.4
2008	-2.0	-0.5	-1.5	3.5	3.7	5.2	71.5	0.7	0.2
2009	-8.8	-3.9	-5.1	1.9	1.6	7.1	73.8	-2.0	1.1
2010	2.4	-0.9	3.4	2.6	2.3	-1.1	73.9	3.5	1.0
				Total economy (8)					
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
2006-2010	-0.5	-0.3	-0.2	2.6	2.5	2.7	74.6	0.7	0.7
2007	2.0	1.0	1.1	2.4	2.4	1.3	72.9	-0.2	0.5
2008	-1.5	-0.4	-1.1	3.7	3.8	4.9	74.2	0.6	0.3
2009	-6.6	-2.9	-3.8	1.8	1.7	5.7	76.0	-1.5	1.0
2010	1.8	-0.7	2.5	2.1	2.0	-0.5	75.9	2.5	0.6

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

acceleration was accounted for by the private sector (where gains quickened from 1.9 to 2.6 per cent), with wage growth speeding up both in industry excluding construction (from 2.8 to 3.6 per cent) and in private services (from 1.0 to 2.1 per cent), against a slowdown in public services (from 1.6 to 1.3 per cent) and in agriculture (from 3.2 to 1.5 per cent). Hourly wage growth eased slightly from 2.0 to 1.9 per cent owing to a slowdown in industry that was only partly offset by an acceleration in the service sector.

Wage growth mandated by industry-wide collective bargaining agreements averaged 2.1 per cent, one point less than in 2009. The slowdown affected all sectors but was most pronounced in the private service sector. As in 2009, the numerous private service sector contracts signed (including hotels and restaurants, construction, clothing and textiles in 2010, the distributive trades in early 2011) adhered to the principles laid down in the agreement on the reform of collective bargaining signed on 22 January 2009 by business and labour organizations, with the exception of the CGIL trade union confederation, and the subsequent agreements.

Actual earnings were boosted by wage drift, defined as the difference between the growth in earnings and the specific contractual contribution of national wage agreements to that growth. Wage drift was significant, especially in industry excluding construction, given the still unfavourable economic picture. A significant factor in raising average earnings was the shift in the composition of employment towards the higher-paid segments of the work force (see the box "The changing composition of the workforce and average wages in the private sector" in *Economic Bulletin,* April 2011).

Given the pick-up in consumer prices due chiefly to the volatile food and energy components, average actual earnings per full-time equivalent employee rose by 0.6 per cent in real terms in 2010, 0.4 points less than in 2009 (Table 9.4).

After rising by 5 per cent per year in 2008-09, unit labour costs in the entire economy declined by 0.5 per cent last year, reflecting the recovery in productivity, which gained 2.5 per cent after losing 2.5 per cent per year in 2008-09. Unit labour costs fell by 5.0 per cent in industry excluding construction, the only sector in which virtually all of the loss of 2008-09 has been recouped. In the private service sector, excluding rentals, unit labour costs fell by about the same rate as in the economy as a whole.

Unit labour costs declined in 2010 both in Germany (1.5 per cent) and Spain (1.3 per cent), and slowed their growth in France (from 2.8 to 1.1 per cent). German and Spanish hourly earnings stagnated, while in France the gain in productivity was accompanied by an acceleration in hourly earnings.

10. THE PRODUCTIVE STRUCTURE AND STRUCTURAL POLICIES

In 2010, value added increased in almost all the sectors of the Italian economy and labour productivity also returned to growth, but the recovery was less vigorous than in the other large European economies. In a period in which the main source of support for productive activity is the expansion of world demand, Italian firms are finding it difficult to innovate and enter foreign markets, particularly those of the emerging countries.

The slowness of the recovery in economic activity is due to shortcomings in the Italian productive economy that make it fragile in the new competitive environment. These deficiencies depend both on factors internal to firms, such as small size and the limitations of exclusive family control, and on external factors, such as insufficient infrastructure, high tax rates combined with widespread tax evasion, an uncertain and complex regulatory framework, excessively long administrative procedures, too much official paperwork, and inadequate contract enforcement. The lack of competition in the service sector adversely affects productivity, including sectors downstream.

Sectoral dynamics

In 2010, on average, real value added in Italy increased by 1.5 per cent, with growth in almost all the main sectors of activity. Industry excluding construction, driven by the pick-up in world trade, increased its value added by 4.8 per cent, recovering a little more than a fifth of the 18.5 per cent reduction registered in 2008-09. The growth of value added in wholesale and retail trade (4.2 per cent) sustained the modest increase in the service sector as a whole (1.0 per cent). The construction sector continued to contract, its value added declining by 3.4 per cent in 2010 following a fall of 10.3 per cent in 2008-09 (Table 10.1).

The expansion of value added in manufacturing (4.5 per cent), less than the German average (11.3 per cent), was concentrated in the capital goods sector, which has benefited from the emerging economies' strong demand for investment goods and the robust recovery of industry in Germany, Italy's main outlet market (in 2010 it took 13 per cent of Italian exports). There was a 7.9 per cent increase in value added in the metal and engineering sector net of transport equipment, driven in particular by basic metals and metal products, machines and mechanical equipment. In transport equipment manufacturing, however, growth was barely 1.3 per cent. The value added of the consumer goods sectors remained basically unchanged; while there was a 4.3 per cent expansion in the textile and clothing sector, there were significant contractions in wood and furniture (1.8 per cent) and, above all, in leather and footwear (3.5 per cent).

Table 10.1

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

	Share of total value added in 2010 (1)	Value added (2)					Productivity (3)				
		2001-2005	2006-2007	2008	2009	2010	2001-2005	2006-2007	2008	2009	2010
INDUSTRY	**25.8**	**0.1**	**2.2**	**-3.3**	**-13.8**	**2.8**	**-0.4**	**1.0**	**-2.3**	**-7.4**	**5.8**
Industry excluding construction	19.7	-0.5	2.5	-3.4	-15.6	4.8	-0.1	1.6	-2.1	-7.0	8.7
Mining and quarrying	0.3	-2.9	1.0	-5.5	-10.7	-3.8	-3.1	3.4	-3.3	-7.1	-1.4
Manufacturing	17.1	-0.7	2.7	-4.7	-16.0	4.5	-0.4	1.8	-3.4	-7.2	8.5
Food products	1.8	-1.0	1.9	-3.8	-0.2	1.6	-0.8	0.3	-4.3	4.5	5.2
Textiles and clothing	1.4	-3.5	-1.1	-3.3	-7.8	4.3	-1.2	2.5	-1.4	5.1	12.1
Leather products	0.5	-3.6	2.6	-7.3	-18.2	-3.5	0.6	2.6	-7.0	-6.5	1.7
Wood and furniture	0.4	-2.3	1.3	-11.6	-21.3	-1.8	-0.3	2.6	-9.0	-15.6	-1.9
Paper, printing and publishing	1.0	-0.8	1.3	-3.5	-11.6	0.6	-0.5	1.5	-1.8	-6.0	4.9
Coke and refined petroleum products	0.2	-8.2	-2.6	-20.5	-5.8	47.7	-7.3	-4.0	-19.3	0.4	49.6
Chemicals	1.2	-0.4	1.4	-1.9	-6.7	2.5	0.1	1.3	-0.1	-1.8	4.4
Rubber and plastics	0.6	-0.5	-0.9	-7.1	-15.9	4.1	1.2	0.9	-4.4	-6.0	5.6
Non-metallic minerals	0.8	0.6	0.6	-4.8	-24.3	2.4	0.4	0.2	-1.6	-15.7	5.5
Basic metals and metal products	3.0	1.2	4.8	-4.6	-23.0	9.7	0.2	0.9	-3.6	-12.1	14.2
Machinery and equipment	2.5	0.7	4.7	-3.2	-21.9	7.1	-0.7	3.0	-3.1	-14.8	10.7
Electrical equipment	1.9	0.2	3.9	-4.7	-18.6	6.0	-0.4	1.6	-4.0	-11.2	7.2
Transport equipment	1.0	-3.5	8.4	-4.8	-21.7	1.3	-1.8	4.6	-3.0	-7.4	5.3
Other manufacturing	0.9	-1.8	1.4	-5.0	-14.1	0.3	-1.6	2.7	-0.5	-6.9	7.4
Energy, gas and water	2.3	2.4	0.7	8.8	-12.9	8.3	4.4	0.7	10.4	-11.9	7.7
Construction	6.1	2.8	1.1	-2.8	-7.7	-3.4	-0.6	-1.0	-2.8	-6.6	-2.4
SERVICES	**74.2**	**1.3**	**1.7**	**-0.4**	**-2.6**	**1.0**	**..**	**0.3**	**-0.5**	**-1.5**	**1.1**
of which:											
Wholesale and retail trade	*11.3*	*..*	*1.4*	*-1.9*	*-10.4*	*4.2*	*-0.4*	*0.4*	*-1.3*	*-8.1*	*4.7*
Hotels and restaurants	*3.9*	*-1.0*	*2.9*	*0.2*	*-2.6*	*0.9*	*-3.3*	*2.5*	*0.8*	*-1.4*	*0.6*
Transport and communications	*7.4*	*3.5*	*1.4*	*-1.3*	*-3.7*	*1.4*	*2.5*	*-0.5*	*-2.0*	*-1.0*	*2.6*
Credit and insurance	*5.0*	*1.3*	*8.0*	*0.6*	*-0.4*	*1.2*	*0.9*	*5.1*	*-0.1*	*0.9*	*1.6*
Services to firms and households	*23.9*	*1.7*	*1.1*	*-0.3*	*-2.0*	*0.5*	*-1.7*	*-1.6*	*-0.8*	*-0.5*	*-0.5*
TOTAL	**100.0**	**0.9**	**1.9**	**-1.2**	**-5.7**	**1.5**	**-0.1**	**0.5**	**-1.0**	**-2.9**	**2.4**

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

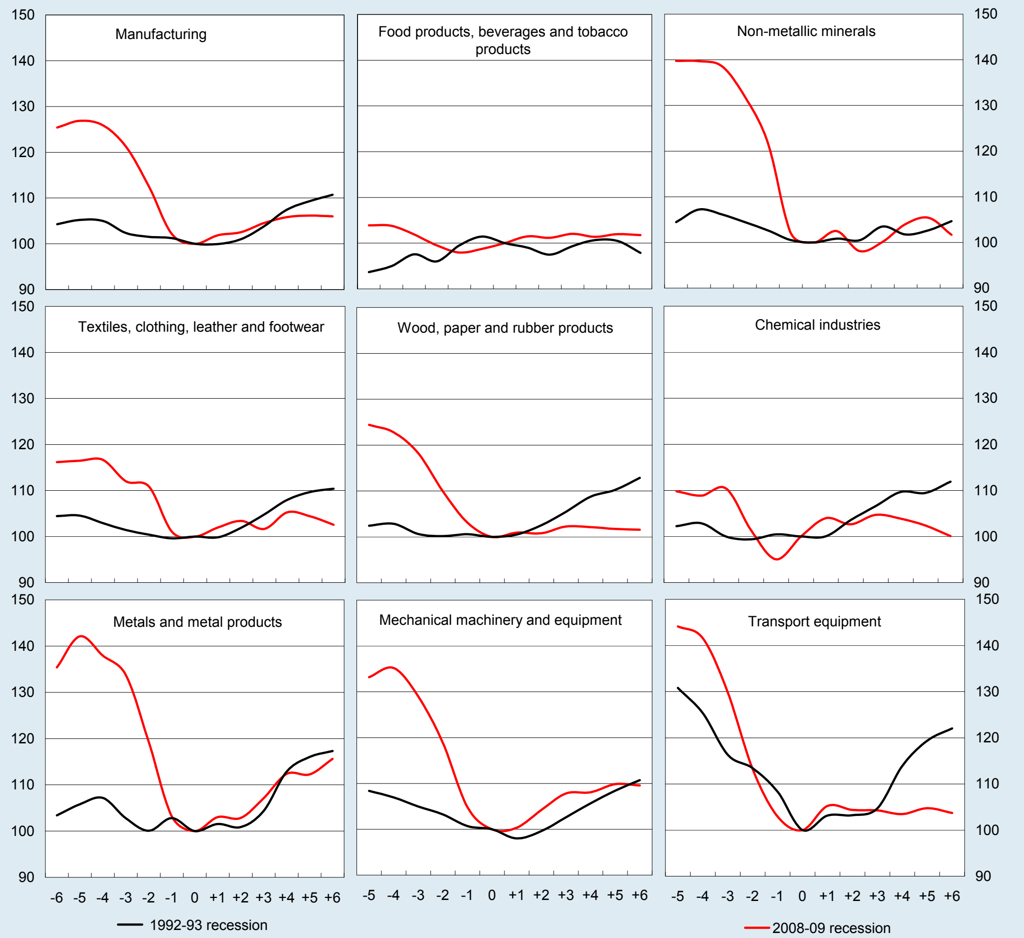
By comparison with the 1992-93 recession, the latest one was marked by a much sharper reduction in activity in all manufacturing sectors except food processing, and by a generally halting recovery. Only in the metal and engineering industry (excluding transport equipment) has the recovery been of comparable strength; it has been much weaker for intermediate and consumer goods (Figure 10.1).

Labour productivity increased in all sectors in 2010, with the exception of wood products and construction, recording overall growth of 2.4 per cent, due largely to the further reduction in labour input. Productivity growth was particularly sharp in manufacturing (8.5 per cent), especially in metal and engineering products and in textiles and clothing. Unlike the other sectors, textiles and clothing, together with food processing, had already scored productivity gains in 2009.

Figure 10.1

Two recoveries compared: growth of value added after the 1992-93 and the 2008-09 recessions (1)

(1992-93 recession, indices: Q2 1993=100; 2008-09 recession, indices: Q2 2009=100)



Source: Based on Istat data.
(1) Value added at basic prices (chain-linked volumes). Quarterly data, seasonally adjusted.

Firms

According to Chamber of Commerce data, in 2010 the number of businesses rose by 72,530 or by 1.2 per cent, similar to the pre-recession rate, compared with 0.6 per cent in 2008 and 0.3 per cent in 2009. Growth was more buoyant for incorporated enterprises, a sign that the productive economy is in the process of moving towards more complex forms of organization.

Calculations based on the Bank of Italy's survey of industrial and non-financial service firms with 20 or more employees confirm the recovery in the manufacturing sector, whose turnover rose last year by 3.6 per cent at constant prices (for the total sample, growth was 1.1 per cent). In line with indications that the recovery might slacken, in 2011 it is estimated that the turnover of manufacturing firms will record real growth of around 2.6 per cent, with better prospects for larger businesses and those most present in foreign markets.

In manufacturing, turnover in 2011 is forecast to be 4.6 per cent for firms that export more than two-thirds of their output and 4.1 per cent for those with at least 500 workers. Further studies of the panel of firms that were also surveyed in 2006 show that the future prospects in terms of increased turnover are better for companies that were already exporting to China before the crisis (5.0 per cent) and for those that in 2000-06 had begun restructuring by overhauling company strategy (3.1 per cent).

Barriers to recovery and problems for growth

Italy's economic recovery, slower than that in the other major European countries, reflects the growth gap already observed in the decade preceding the recent economic and financial crisis. Between 1998 and 2007 labour productivity grew by 0.1 per cent annually, far below the rate in France (1.0 per cent), Germany (1.3 per cent) and the United Kingdom (1.8 per cent).

Strengthening the recovery and returning to a more satisfactory growth path will require innovative strategies to raise productivity and profitability. As we have noted in the past (see "Report on trends in the Italian productive system", Banca d'Italia, *Occasional Papers,* 45, 2009), the strategic choices of the last ten years that have been successful in terms of company performance have involved expanding the range of products and markets, brand enhancement and, most important, innovation and entry into emerging countries' markets.

Firms' capacity to innovate is a basic springboard to improved productive efficiency and successful competition in international markets. Italy's spending on research and development (R&D), which accounted for 1.2 per cent of GDP in 2008, puts it at the bottom of the rankings among the EU-15 countries, far below France, Germany and the Scandinavian countries. The gap is due mainly to the low contribution from the private sector (0.5 per cent of GDP, as opposed to 1.1. per cent in the EU-15, 1.5 per cent in France and 2.0 per cent in Germany).

The Italian lag reflects firms' low propensity for R&D and their preference for incremental innovations, which require less financial and organizational resources. Data published by Eurostat in its Community Innovation Survey for 2006-08 indicate that 31 per cent of all companies with at least ten employees engage in R&D in Germany, 22 per cent in France, 17 per cent in Italy and 11 per cent in Spain.

The spread and pace of internationalization are important indicators of the competitiveness of a productive economy and its capacity to diversify in the presence of the risk of unfavourable demand trends in specific sectors or markets. According to the data gathered from a sample of European manufacturing firms with at least 10 employees (European Firms in a Global Economy, EFIGE), in 2008 about 70 per cent of Italian firms had exported part of their output, a higher proportion than either French or German firms. The propensity for internationalization is much lower, above all in comparison with the other major European countries, when the gauge used is exports to non-EU markets or foreign direct investment.

According to EFIGE, in 2008 the share of manufacturing exporters present in the Chinese and Indian markets was 17.7 per cent for Italy, 22.2 per cent for France and 27.9 per cent for Germany. The proportion of companies either with foreign direct investment or with production or commercial collaboration with foreign enterprises was 6.2 per cent in Italy, against 8.2 per cent in France and 9.2 per cent in Germany.

The backwardness of Italian manufacturing firms in innovating and internationalizing depends to a significant extent on their smallness: with an average of 8 workers (against 11 in Spain, 14 in France and 35 in Germany), it is hard to sustain the costs and high risks of research and innovation or expansion into foreign markets. In Italy, the problem is not only the low proportion of firms with as many as 10 workers but also their average size in relation to their European partners. According to Eurostat, the average number of workers in these firms in 2007 was 37 in Italy, 46 in Spain, 76 in France and 84 in Germany.

EFIGE data show that taking sectoral differences into account Italian firms' propensity for foreign direct investment increases with company size: below 4 per cent for firms with fewer than 100 workers and reaching as much as 27 per cent only among those with at least 250. According to the Bank of Italy's survey of industrial and service firms, adjusted for sector, geographical location and productivity, manufacturing firms with more than 100 workers (less than 14 per cent of the total) are 20 per cent more likely to invest in research and 16 per cent more likely to export.

The limitations inherent in small size per se are exacerbated by strict family ownership and, above all, management. If a firm's assets coincide with those of the family, this reduces the willingness to undertake risky projects, while the low propensity to recruit managerial resources on the market, even when the family owners are lacking them, can harm the management of the enterprise.

Family-run companies have a relatively large weight in the Italian economy. These companies are marked by a lower propensity for R&D and lower-than-average penetration of emerging markets. According to EFIGE data, manufacturing firms that are entirely family-owned and run account for 59 per cent of all enterprises in Italy, against 18 per cent in France and 22 per cent in Germany.

The regulatory framework for business enterprises

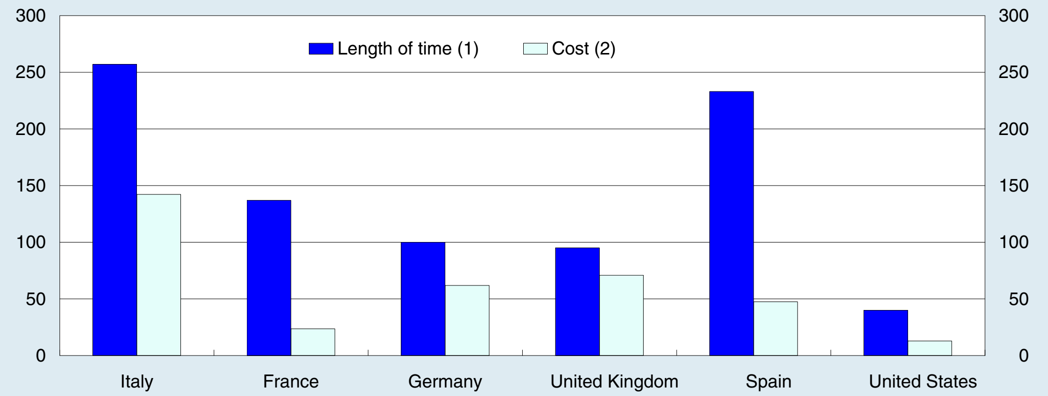
Despite the reforms enacted in recent years, the conditions for doing business in Italy still appear quite unfavourable by international standards. They are still characterized a great number of rules and regulations, changeable, unclear and inconsistent. The administrative procedures governing market entry and business enterprise are long and costly. The regulations impose significant bureaucratic and administrative costs. The excessive length of civil trials does not provide adequate enforcement of contracts. Better suited to the needs of the productive economy are company law and bankruptcy law.

According to the World Bank's last "Doing Business" survey, the time taken and cost sustained to obtain building permits in Italy are greater than in the other major European countries or the United States (Figure 10.2).

Legislative and administrative simplification. – Implementation of reform programmes for the simplification of the legislative and administrative framework for business continued in 2010. The programme to reduce the number of laws in force,

Figure 10.2

Duration and cost for building permit issue



Source: World Bank, *Doing Business in 2011,* 2010.
(1) Days. – (2) Percentage of per capita gross national income.

which had begun with Law 246/2005, was completed last year with the repeal of the pre-1970 laws deemed unnecessary. Today, the number of laws in force (about 10,000) is about the same as in France but twice as great as in Germany. Despite the reduction in the number of laws, the legislative framework remains extremely complex. There remain significant problems for the re-ordering of sectoral laws and for the production of new legislation.

As regards administrative simplification, some important measures to facilitate business start-ups were taken, such as the introduction of the Certified Declaration of Business Start-up and the approval of the regulation implementing reform of the One-stop Office for Productive Activities. The effective application of these measures could be held up by fragmented administrative jurisdictions, poorly coordinated sectoral regulations, and the complexity of the reorganization required. The Certified Declaration allows a business to be started up immediately on presentation of the certificates stating that all the legal requirements have been met. The One-stop Office is the administrative point of reference, at the municipal level, for all business start-up procedures.

Progress was made in reducing the administrative costs deriving from national legislation (Law 133/2008), which permitted significant savings for businesses.

Civil justice. – The civil justice system appears to be overburdened by a high propensity to litigate, especially for certain legal matters and in certain geographical areas. To encourage out-of-court settlement, it has been made compulsory to attempt conciliation in civil and commercial cases. The potentially very substantial effects of this measure could be undermined by a lack of sufficient incentives for the persons who assist the parties to avoid going to court. Specific measures have been introduced to discourage nuisance suits, resulting in a significant reduction of the caseload.

Greater attention to organizational aspects and to productivity in the use of resources would help to improve the functioning of court offices. The precondition for introducing a system of performance assessment and for deploying best practices more widely is the availability of more and better data. Collaboration among all the institutions involved to foster wider use of IT will be an important factor in reaching this objective.

Bankruptcy law. – In 2010, the modernization of bankruptcy law continued. To encourage the restructuring of businesses in crisis, Decree Law 78/2010 (the public finance package for 2011-13) removed some of the regulatory barriers to the provision of funding to facilitate access to debt restructuring procedures or out-of-court restructuring agreements (bridging loans).

The reforms of some years back for more efficient resolution of difficulties (Law 80/2005 and Legislative Decree 5/2006) have had positive effects on credit conditions for businesses. Our econometric analyses of Italian manufacturing firms show that following these reforms the cost of bank loans for the firms most exposed to the risk of bankruptcy fell by 12 basis points for new loans and 10 basis points for current account overdrafts.

Company law. – In April 2011, Consob issued new secondary legislation on takeover bids that takes account of some legislative changes and innovations in financial instruments. Overall, the new regulatory framework produces a better balance between protecting minority shareholders and fostering a dynamic market for corporate control.

The rules introduced last year for shareholder participation at meetings are being applied for the first time in the meeting season now under way. The removal of the main barriers to institutional shareholders' exercising their voting rights has led to a significant increase in their participation. In the long run, this could produce more effective monitoring of directors and greater protection for minority shareholders.

Regulation and competition in the service sector

Despite the very substantial liberalization and privatization realized since the 1990s, by international standards Italy is still marked by heavy regulation in some service sectors and by significant public ownership. Greater openness to competition in these sectors would enhance efficiency, to the benefit both of consumers and of the firms that operate downstream.

Table 10.2

Indicators of regulation of non-manufacturing sectors in the major European countries
(rank among the 30 OECD countries in 2007)

	Wholesale and retail trade (1)	Electricity	Gas	Postal services	Professional services (1)	Telecommu-nications	Air transport	Rail transport	Road transport
Italy	**18**	**4**	**10**	**27**	**28**	**6**	**20**	**11**	**23**
France	24	18	10	16	16	20	9	14	27
Germany	15	2	7	2	25	12	1	4	12
Spain	20	2	4	12	15	10	19	19	3
United Kingdom	9	1	2	16	2	2	13	1	3

Source: OECD, *Indicators of Product Market Regulation*.
(1) Data for 2008.

According to the OECD indicators of product market regulation, the sectors in which Italian regulation is most restrictive are professional services, postal services, air and road transportation and retail trade. In rail transport Italy ranks high, but there are large differences compared with the countries that have liberalized more (Table 10.2).

In recent years the liberalization of regulated sectors has not made much progress; in some cases, such as legal services, the legislative proposals now in course of parliamentary passage actually envisage more restrictions than at present. The annual competition bill – an important instrument for regulatory improvements in favour of competition – has not yet been presented to Parliament, more than a year after the legal deadline laid down by Law 99/2009. There has been a restrictive approach to the transposition of recent EU directives. In the field of local public services, despite the progress made, there remain substantial impediments to fostering competition and increasing efficiency.

11. THE INFRASTRUCTURAL ENDOWMENT [1]

The endowment of public capital is one of the factors that determine an economy's growth potential. The impact of investment spending on the well-being of the population and economic activity depends on how efficiently financial resources are employed and on the subsequent utilization of the public works. Italian public infrastructural expenditure has been higher than the average for France, Germany and the United Kingdom for the last three decades, but Italy still suffers a gap in physical infrastructural endowment with respect to those countries. Within Italy, the endowment is lower in the South than in the Centre and North. Comparing the amount of spending with the infrastructural endowment shows that there is room for improvement in the use of financial resources, especially in the South. This opportunity has to be seized in order to provide all parts of the country with adequate infrastructural facilities.

In the last decade, since the enactment of the Objective Law in 2001, some progress has been made in public works planning, but time to completion is still long and costs remain high by international standards, as do budget overruns. Apart from widespread illegality, this reflects the uncertainty of the funding framework, weakness in project selection and assessment, overlapping powers and responsibilities among different levels of government, and the shortcomings of the rules governing contract awards and the monitoring of works.

Italy's relatively low project realization capacity for a given amount of financial resources is likely to have especially adverse consequences at a time of adjustment of the public finances. The ratio of general government investment to GDP averaged 2.3 per cent from 2000 to 2009, fell to 2.1 per cent in 2010 and is expected to fall further to 1.6 per cent in 2012. Systematic cost-benefit analysis, which is envisaged in the enabling act for the reform of public works legislation, could foster the selection of the projects that, for a given appropriation, have the greatest impact on the functioning of the infrastructural network by eliminating bottlenecks and permitting the full utilization of existing structures. So far, Italy's public-private partnerships – recourse to which is still fairly limited – have stressed the financial side, i.e. the possibility of limiting the debt of the contracting entity. Rules facilitating clear and efficient allocation of risks among the parties would provide the incentives needed to capitalize on the private sector's technical and management expertise.

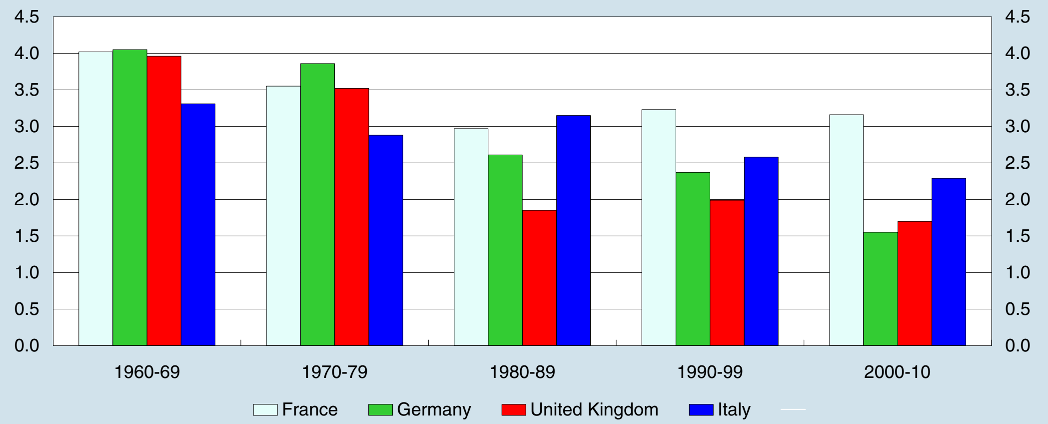
[1] This chapter is based on the papers making up the volume "Le infrastrutture in Italia: dotazione, programmazione, realizzazione", Banca d'Italia, *Seminari e convegni*, 7, April 2011.

Public investment expenditure and infrastructural endowment

From 1990 through 2010, general government investment expenditure averaged 2.4 per cent of GDP in Italy, just below the euro-area average of 2.5 per cent. Italy's outlay was less than that of France (3.2 per cent) but more than that of Germany (1.9 per cent) and the United Kingdom (1.8 per cent). By comparison with the 1960s and 1970s, as all countries reduced their expenditure, Italy's relative position has improved (Figure 11.1).

Figure 11.1

General government gross fixed investment in the main European countries
(as a percentage of GDP)



Sources: Based on OECD and Eurostat data.

General government gross fixed investment is an imprecise and incomplete measure of public infrastructure spending: imprecise because it includes not only construction but also purchases of machinery and equipment; and incomplete because many infrastructures are actually realized by government-controlled enterprises and public service concession-holders that are not within the general government perimeter. No comparable international statistics are available either on the share of public investment expenditure going to construction or on the infrastructural spending of entities outside general government. The portion of total infrastructural spending accounted for by these entities' works varies from country to country and over time.

Between 1990 and 2010, total general government expenditure on capital account, which comprises transfers (including grants to government-owned enterprises that realize infrastructures) came to 4.0 per cent of GDP in Italy, in line with the euro-area average. It was just below the ratio for France (4.2 per cent) and higher than for Germany (3.5 per cent) and the United Kingdom (2.9 per cent).

Within Italy, regional public accounts are available from 1996 to 2008. Over that period the investment expenditure of the enlarged public sector, which in addition to general government comprises public enterprises (such as Enel and the State Railways), averaged 4.7 per cent of GDP in the South and 3.6 per cent in the Centre and North. The gap was greater before 2000 and narrowed thereafter, owing mainly to increased investment by government-owned corporations in the northern part of the country. Over the entire period, real per capita expenditure in the South, which had been higher than in the rest of the country in the previous decades, was on average only three-quarters of the amount spent in the Centre and North; since 2000 the gap has widened.

To quantify a territory's infrastructural endowment, three different types of indicator may be used: monetary, i.e. estimating the amount of infrastructure by applying permanent inventory accounting to expenditure flows; physical, based on the volumes of construction (e.g. number of kilometres of road and railway); and measures of the quality of the service provided by the infrastructures (e.g. travel time).

The measures of public capital endowment based on financial flows put Italy on a par with the other main European countries. At the turn of the century, the ratio of public capital to GDP was estimated at 48 per cent in Italy and 47 per cent, on average, in France, Germany and the United Kingdom. The physical measures of infrastructural endowment paint a different picture: setting the European average at 100, the index for Italy was 102, the same as France but significantly lower than Germany (123) and the United Kingdom (117).

As for the distribution of infrastructure within the country, the permanent inventory method shows the ratio of the stock of public capital to GDP to have been nearly twice as high in the South as in the Centre and North in the second half of the last decade. In per capita terms the disparity narrows very considerably, to just over 10 per cent. And if indicators of physical endowment are applied, the South lags behind. The *Istituto Guglielmo Tagliacarne* index puts the South's endowment at just over 80 in 2009 compared with an average of more than 110 for the Centre and North.

Such summary indices of infrastructural capital, whether monetary or physical, do not take account of the utilization of the structures or the quality of the service they provide. To that end, more detailed measures are needed. For instance, for transport one can refer to indicators of the time required to access the primary transport network (indices of accessibility) or to travel from one locality to another (indices of interconnection). That is, one may be interested in ease of access to the transportation network or in speed of connection within it. Both are important factors in determining the quality of the transport infrastructure from the standpoint, say, of freight shipments; the two indicators provide complementary information.

For Italy, both the accessibility index developed by *Istituto superiore di formazione e ricerca sui trasporti* and the interconnection index (for road transport only) show great variability even within macroregions. Relatively low index numbers are concentrated in the South and the Islands and are fairly common in the inland areas of the Centre; but they are also to be found in the North-East. A limitation of both types of indicator is their inability to distinguish between the diverse factors that affect service quality. Travel time, in fact, depends not only on the state of the infrastructure but also on the intensity of demand, as in the case of road congestion, and on organizational efficiency, which depends in turn on the degree of market competition and the quality of regulation.

An examination of the volumes of expenditure together with the physical endowment of infrastructure suggests that there is scope for improving the utilization of financial resources, especially in the South. Achieving efficiency in resource use will require integrated analyses to determine requirements based on effective and potential demand, plus cost-benefit analysis of the various alternative solutions. Quality indicators are necessarily analytical, which makes it evident that no single measure, by itself, is sufficient to determine the necessity of a given project in a given territory or to determine how it is to be realized.

The realization of public works

The data available do not allow systematic, detailed international comparison but only indicate that the average cost of public works is relatively high in Italy, both for motorway and for high-speed rail projects. Factors in the disparity with respect to other European countries include not only topography and patterns of settlement but also certain technical choices. There is also evidence that the average time required to complete projects is longer in Italy. And time and cost overruns are greater in Italy than in the other countries.

A survey conducted in 2008 by the Italian Authority for the Supervision of Public Contracts found that the per-kilometre cost of high-speed rail in Italy was three times higher than in France or Spain, and that there was a similar disparity in time to completion. For motorways, the average cost is more than twice as high as in Spain. A 2009 survey by the European Commission found that Italian time and cost overruns on public works projects were significantly worse than the European average: for medium-sized and large transport infrastructure projects co-financed by the European Regional Development Fund between 2000 and 2006, Italian time overshoots averaged 88 per cent of the initial schedule, compared with 26 per cent in the other countries; cost overruns averaged 37 against 21 per cent.

Overall time and cost overruns are only marginally less for smaller projects, which are less complex technically but more often managed by small contracting entities. Time to completion, for a given contract amount, is slightly longer in the South. During the planning phase in particular, the overall duration is significantly affected by the time needed to move from one administrative step to the next.

The Supervision Authority's data on public works contracts worth more than €150,000 indicate that in 2005-09 there were cost overruns greater than 20 per cent in 15 per cent of all projects, compared with 10 per cent in 2000-04. Between 2000 and 2007 the total time from planning to contract award lengthened considerably in the South and was 30 per cent longer, on average, than in the rest of the country. A recent study by the Ministry for Economic Development's public investment control unit analysing total realization time for a homogeneous set of infrastructures included in the Planning Framework Agreements between central and regional governments in the past 15 years found that nearly a third of the time was taken up by the dead interval between the completion of one bureaucratic phase and the start of the next.

The time and cost of realization are affected not only by widespread illegality but also by a series of additional factors: *(i)* the absence of multi-year spending targets and the incomplete set of instruments for coordination among different levels of government; *(ii)* the limited use of standardized valuations of projects' economic and social costs and benefits; and *(iii)* the shortcomings of the most common public procurement procedures, which often fail to select the best bid.

Italian public works planning has been reformed several times in the last ten years, along the lines indicated in the Objective Law of 2001. Comprehensive multi-year financial planning consistent with the broader objective of balance in the public finances is necessary on the one hand to provide certainty regarding the availability of resources and on the other to impose effective budget constraints. Certainty of resources serves to avoid initiating works that cannot be completed on time for lack of funds. The budget constraint is an essential safeguard for the efficiency of expenditure.

If investment projects are not subjected to systematic comparative evaluation, it is impossible to guarantee the most productive use of public resources. Such evaluation is essential even when a project corresponds to definite and generally agreed priorities, in order to ensure that the most efficient of the technically practicable alternatives is chosen. The Accounting and Public Finances Law (Law 196/2009) provides for an enabling act empowering the Government to rationalize public works spending. The guidelines for this delegation of power call for alignment with international best practices in the use of cost-benefit analysis.

Furthermore, when choices are based on transparent analysis of costs and benefits this may defuse the opposition of local communities to the realization of works in their territory. Often such opposition is natural, since the benefits are distributed through the entire territory while the negative externalities, especially environmental, of many public works are highly localized. The request for additional works to compensate the local community for the adverse impact of a project raises its cost substantially. The problems have been aggravated by the powerful drive to administrative decentralization in recent years.

The need to combat widespread illegality and the fragmented structure of the market in public works has decreased the efficiency of the public procurement rules and thereby increased the cost of projects. The rules tend to limit the discretionary powers of the administrations conducting public procurement. The small size of the contracting entities, especially in the South, limits their capacity for technical evaluation of bids on their merits.

Between 2000 and 2007, more than 65 per cent of the competitive tenders examined by the Authority for the Supervision of Public Contracts had an auction base of less than €500,000. Consolidation and sharing of technical structures would permit economies of scale and more frequent application of selection criteria that include assessment of the quality of the tenders. The additional discretionary power thus accorded to the contracting administrations needs to be counterbalanced by stepped-up anti-corruption measures (certifying bodies, controls on sub-contracting, monitoring).

Private capital

Over the past decade, public procurement in Europe has increasingly resorted to forms of public-private partnership (PPP), i.e. cooperation between governmental authorities and private parties for the financing, construction, renovation, operation or maintenance of an infrastructure or the provision of a service.

The potential advantage of public-private partnership lies in optimizing the management of the various operational activities necessary to the project, in particular by integrating construction with subsequent utilization. PPP should also hold down total costs by suitable risk-sharing. The private party should assume the enterprise risk in both the construction and the operation phase. The public entity should bear the regulatory and administrative risks. However, the inherent complexity of this type of agreement entails high fixed costs for instituting the partnership.

One – improper – incentive for PPP is the possibility of reducing public borrowing to fund the project. That is, the private party advances the construction cost in exchange for future public spending commitments.

In 2004, Eurostat laid down the rules for the treatment of PPP in defining member states' budget deficits and general government debt. The rules envisage three types of risk in public-private partnership: construction risk (lateness, cost overruns, technical problems and non-compliance with agreed standards); service availability risk (quality or quantity of service not up to agreed levels); and demand risk (actual utilization below the amount assumed in negotiating the contract). If the non-government party bears construction risk and at least one of the other two types of risk, the project is entered as a private-sector asset and its financing does not constitute public debt.

Although the traditional contracting methods are still the most common in Europe, PPP is winning an increasing portion of this market. Between 1990 and 2009, 67 per cent of all public works projects in the United Kingdom (53 per cent by value) were awarded on this basis. The incidence of PPP is also significant in Spain, less so in France and Germany. It is especially low in Italy, perhaps owing to the lack of guidelines and contractual standards allowing for clear and efficient allocation of the project risk.

Contracting via public-private partnership has increased significantly in Italy. The number of such tenders rose from 1 per cent of the total in 2002 to 4.1 per cent in 2010, and their value from 5 to 20 per cent. But there is very high project mortality: over that period, in almost half the tenders (46.3 per cent) the contract was never actually awarded. And PPP-financed projects in Italy have been relatively small, with an average size of around €17 million in 2002-10, compared with €123 million in the United Kingdom. Often these are "cold" works (those whose operation does not directly generate market revenue) and with charges, moreover, that bear little relation to service quality; or else they are relatively uncomplicated projects with readily predictable cash flow and presumably low management risk. Aside from a few major projects involving motorways, metros and hospitals, most of Italy's public works have consisted in local investment in parking facilities, sports facilities, or cemeteries. For such projects, the advantages of public-private partnership over traditional contract award procedures are not immediately clear. In other countries, recourse to this technique depends on prior assessment of its economic advantage over other formulas.

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

The deficit on the current account of Italy's balance of payments widened from 2.0 to 3.5 per cent of GDP following the improvement registered in 2009 (Table 12.1).

Table 12.1

Balance of payments
(billions of euros)

	2008	2009	2010
Current account	**-45.5**	**-30.3**	**-53.5**
Goods	-2.1	0.8	-20.4
Non-energy products (1)	55.3	41.5	30.9
Energy products (1)	-57.5	-40.7	-51.3
Services	-8.6	-8.4	-8.8
Income	-19.4	-10.4	-8.2
Transfers	-15.4	-12.3	-16.1
of which: EU institutions	*-9.9*	*-7.0*	*-10.1*
Capital account	**-0.2**	**-0.1**	**-0.5**
Intangible assets	-1.0	-0.6	-0.7
Transfers	0.9	0.5	0.2
of which: EU institutions	*2.2*	*1.6*	*1.5*
Financial account	**31.4**	**37.3**	**88.7**
Direct investment	-53.1	-0.9	-8.7
Outward	-45.7	-15.3	-15.9
Inward	-7.4	14.5	7.2
Portfolio investment	75.2	28.1	38.5
Equities	61.9	2.6	-37.9
Debt securities	13.3	25.5	76.4
Financial derivatives	1.9	4.3	2.4
Other investment	13.0	5.7	57.6
of which: monetary financial institutions (2)	*-18.5*	*-2.4*	*8.3*
Change in reserve assets (3)	-5.6	0.1	-1.0
Errors and omissions	**14.3**	**-7.0**	**-34.7**

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

The deterioration reflects the position on merchandise trade, which turned negative last year after being broadly in balance in 2009. It was largely due to only two sectors: energy raw materials, whose deficit grew mainly because of the rise in oil prices, and electronic apparatus, where the major factor was the jump in imports of photovoltaic cells.

Net direct investment inflows were half those of the previous year while net outflows were about the same, against the background of the global resurgence in direct investment concentrated in the emerging countries. Net portfolio investment inflows grew as the result of the increase in purchases of Italian medium- and long-term bonds by non-residents, reflecting stronger investor confidence in Italian government securities. The item *other investment*, consisting chiefly of deposits and loans, showed a recovery in cross-border flows, which began to return to normal after exceptionally large net disinvestment in the two years 2008-09 on both the funding and the lending side.

Balancing an overall deficit of €54.1 billion on the current and capital accounts and net inflows of €88.7 billion in the financial account, the entry under errors and omissions was negative by €34.7 billion.

On the basis of the new data on the international investment position, Italy's net external debtor position amounted to 24.3 per cent of GDP at the end of the year, compared with 25.3 per cent at the end of 2009.

The system used to gather and compile the statistics of Italy's balance of payments and international investment position has been overhauled in the last two years, with the discontinuance of the use of reports of banks' settlements. Generally, more use is now made of sample surveys and banks have been all but relieved of the burden of making statistical reports on behalf of their customers. The new system uses multiple sources: (a) statistical reports, such as those of the entities supervised by the Bank of Italy; (b) administrative data collected by other institutions in compliance with legal obligations; (c) sample surveys, particularly with non-financial and insurance firms for which direct reports are gathered from a sample of some 7,000 firms selected on the basis of their size and overall foreign transactions. For financial transactions, stock and flow data are reported. To date, the time series have been revised from January 2008 onwards for flows and from December 2007 for stocks. The revision of the preceding periods will be published shortly.

The current and capital accounts

Trade in goods. – The *fob-fob* merchandise trade balance, after the previous year's slight surplus, swung back into deficit by €20.4 billion (1.3 per cent of GDP). Exports grew by 15.8 per cent, in connection with the strengthening of world demand. Imports expanded at a faster pace (23.1 per cent), driven by appreciably larger purchases of both energy products and intermediate goods, particularly electronic apparatus. The provision of substantial public subsidies to the sector stimulated imports of photovoltaic cells, causing a further contraction in the surplus on goods excluding oil products. The energy deficit grew for the second consecutive year, pushed up by higher oil prices compared with 2009 (reflected in a 32 per cent increase in the average unit value of imported crude oil) and, to a lesser extent, the growth in the volume of imports of energy products due to the recovery in economic activity.

The worsening of the trade balance reflected the increase in the deficit with the EU countries (€5.9 billion, up from €1.1 billion in 2009) and, above all, the swing in the trade balance with non-EU countries from a €1.9 billion surplus in 2009 to a €14.5 billion deficit last year.

The deficit with the euro-area countries rose from €7.6 billion to €13.4 billion as a result of more pronounced growth in imports than in exports (17.7 and 14.3 per cent respectively). The deficit with Germany grew by €1.8 billion, reflecting in particular the above-mentioned developments in trade in electronic products. The surplus with France widened, thanks chiefly to the larger surplus on traditional Italian goods (textiles and clothing, hides and leather products, furniture). The surplus with Spain diminished for the third year running. The surplus with Greece also shrank, while the deficit with the Netherlands grew.

The worsening of the balance with non-EU countries was largely due to trade with the OPEC countries and China. The higher price of oil, accentuated by the euro's depreciation year on year, caused the deficit to widen with Italy's main energy suppliers. The faster growth of imports compared with exports led to a significant increase in the shortfall with China (€19.0 billion), Italy's largest bilateral deficit. Italian demand for intermediate and capital goods, particularly electronic products and auto components, explains a good part of the large increase in purchases from China, while the growth in Italian exports to China was led by machinery and equipment, which account for nearly half the total. The surplus with the United States started to grow again (from €7.9 billion to €9.6 billion): exports recovered across the board, most notably for transport equipment and chemicals and pharmaceuticals.

Turning to developments by product sector, all of the reduction in the surplus in non-energy manufactures was due to the sharp worsening of about €8 billion in the deficit on electronic products; imports of photovoltaic cells were some €6 billion more than in 2009. The trade balance on basic metals and fabricated metal products, in surplus only since 2008, also worsened: the increase in imports, mostly intra-industrial inputs, was far more pronounced than that in exports owing to the combination of volume growth and higher prices. After a small deterioration in 2009, the deficit on transport equipment began narrowing again in connection with the sluggish growth in imports following the lapsing of tax incentives.

Services. – The services deficit worsened slightly, increasing from €8.4 billion to €8.8 billion. The improvement in the balance on *other business services* (merchanting and other trade-related services, professional services and services between related enterprises) was more than offset by the deterioration recorded for other types of services (except travel and communications).

The structural surplus on travel, which accounts for about a third of trade in services, was unchanged in 2010 after three years of contraction. Despite the economic recovery, the growth in both inflows and outflows was modest (1.4 and 2.0 per cent respectively). The number of visitors to Italy increased, but there was a further decline in overnight stays, particularly for business purposes.

The slight upturn in Italians' expenditure abroad similarly came almost entirely from personal travel, plausibly as a substitution effect to the detriment of short vacations within Italy. One likely factor was the systematic reduction in air fares, especially on routes within Europe, as a consequence of the larger supply of low-cost flights.

According to Istat, there was a 13.4 per cent drop in spending by Italians for domestic travel, due to the decline in both short vacations and business travel. According to the Bank of Italy's survey on international tourism, between 2007 and 2010 the average outlay by Italians for the purchase of a return flight within the EU came down by 18 per cent (from €262 to €214; in 2002 it was €378).

The deficit on transport services, which had diminished in 2009, increased by €1.4 billion to a ten-year high; the low market shares of Italian carriers in all modes of transport determines an inverse correlation between the trend of the balance and the economic cycle. The increase in gross flows from goods transport services was due in part to the upturn in freight rates, which rose by about 13 per cent with respect to 2009 for trade overall according to the Bank of Italy's annual survey on international goods transport. For sea imports the increase amounted to 32 per cent, a consequence of the marked sensitivity of maritime freight rates to the trend of world trade, although rates still remained below their 2008 levels. By contrast, the deficit on passenger transport by air narrowed slightly; inflows rose by 12.5 per cent while outflows were about the same as in the previous year, partly as a result of the slight gain in Italian carriers' market share (equal to about 15 per cent in 2010).

Direct reporting by firms permitted more precise allocation of transactions for services other than travel and transport, reducing the share attributed to residual items by comparison with the old statistical reporting system. The shift to the new system did not significantly alter the overall balance. The relative importance of the flows under *other business services* diminished, especially on the debit side, reducing the related deficit. The share of transactions entered under construction services also declined, most of these flows being reallocated to direct investment in real estate. By contrast, the share of flows increased for nearly all the remaining types of services: financial services, insurance services, computer and information services, royalties and licence fees, communication and postal services. Except for the latter, the adoption of the new system caused a greater increase on the debit side, thereby worsening the overall deficit.

The deficit on *other business services* shrank significantly, from €4.5 billion in 2009 to €1.8 billion, as a consequence of the combination of robust growth in exports (18.7 per cent), particularly to Germany, and a modest rise in imports (1.8 per cent).

Income. – The introduction of the new reporting system resulted in major changes under the income account, with an increase in credits and a decrease in debits under investment income. For 2009 the changeover more than halved the deficit.

The deficit on investment income totalled €10.3 billion, an improvement from €11.3 billion in 2009. For income under *other investment* both inflows and outflows were about half those recorded in 2009, owing to the low level of interest rates. For direct investment income, there was a reduction in outflows, particularly in interest payments to foreign affiliates. By contrast, portfolio investment income registered a modest decrease in inflows and increase in outflows: the low level of interest rates resulted in a reduction in bond coupon payments, particularly on the credit side.

Transfers. – The deficit recorded under current transfers grew from €12.3 billion to €16.1 billion owing to a reduction in inflows, particularly for production subsidies and other intergovernmental transfers. After a decade of uninterrupted growth, the deficit on workers' remittances shrank slightly (€6.1 billion, against €6.3 billion in 2009).

Investment

The new system also allows more accurate definition of the flows regarding non-bank sectors for the financial account. In addition, direct reporting by firms makes for better identification of any corporate links between the two parties to a transaction. These changes entailed reallocations of flows between direct investment and other investment (mainly loans). For portfolio investment, the change with respect to the figures published in last year's Annual Report was largely insignificant, since at the time the new system was already in use for this component. Its adoption had mainly implied some reclassifications, between the public and private sectors and between the short-term and long-term components.

Direct investment. – Global flows of direct investment are estimated to have returned to growth after two years of significant contraction, particularly in 2009. The recovery in flows was uneven: stronger in the emerging economies, more modest in the advanced economies. For the major European countries there was a further fall in both outward and inward direct investment. An exception was Germany, which had already registered an upturn in both inflows and outflows in 2009. In Italy, the decline in net inward investment since the financial crisis of 2008 continued last year with a decrease of about one half, from €14.5 billion in 2009 to €7.2 billion. By contrast, net Italian investment abroad was basically stable (€15.9 billion, against €15.3 billion in 2009, but still significantly down from €45.7 billion in 2008).

Portfolio investment. – The preference for relatively low-risk securities that had characterized capital movements in 2008 and the first half of 2009 gave way to a renewed appetite for risk on the part of Italian investors. Purchases of foreign equities grew, continuing a trend that began in the second half of 2009 after large disposals in the previous period. There was €41.5 billion of net investment in foreign funds (compared with €17.5 billion in 2009), mostly based in Luxembourg (€27.3 billion) or Ireland (€8.6 billion). By contrast, there were net disposals of foreign debt securities (notably those issued in the United States). As a result, the allocation of the portfolio of Italian external assets is now closer to what it was in the period preceding the financial crisis.

An opposite development was recorded on the liabilities side. Compared with the previous year, in 2010 foreign investors sharply reduced their net purchases both of equities (from €14.8 billion to €2.7 billion) and of Italian money market instruments (chiefly BOTs, from €38.8 billion to €2.5 billion). At the same time they made massive net purchases of medium- and long-term debt securities (almost all of them consisting of other types of public securities) totalling €64.6 billion, €51.5 billion more than the previous year, a sign of the firming up of confidence in Italian government securities after the lows of 2008. Non-residents also resumed making net purchases of Italian financial institutions' bonds, albeit by a slim margin. Overall, the net inflow of portfolio investment by non-residents came to €69.8 billion, €3.2 billion more than in 2009 and ten times more than in 2008.

Other investment. – *Other investment* (mainly deposits and loans) relating to the banking sector registered signs of a return to normality in cross-border transactions. There was a net increase in both loans (€3.4 billion) and deposits (€11.7 billion) after the sharp declines recorded in 2008 and 2009.

The net international investment position

The new data on Italy's international investment position are obtained by combining a variety of sources, the chief one being direct surveys of the stocks with securities custodians and with a sample of firms. In the past, the data were calculated by adding up the flows and applying valuation adjustments to the initial stock. The new position shows an increase in Italy's net external debt (from 19.4 to 25.3 per cent of GDP in 2009); the increase is due mainly to a reduction in stocks, more pronounced on the asset side, affecting loans and bank deposits and, to a lesser extent, the non-equity components of direct investment (intra-group loans). Presumably, the new system does not pick up all of the stocks of assets held abroad by households through non-resident intermediaries, a sphere in which the objective obstacles to collecting statistical data are considerable everywhere. The amounts that emerged as a consequence of the foreign assets disclosure schemes in 2001-03 and 2009-10 suggest that the volume of assets held abroad in violation of the reporting requirements is very considerable.

Table 12.2

Net international investment position
(billions of euros)

	Stocks at end-2009 (1)	January-December 2010					Stocks at end-2010 (1)
		Flows (2)	Value adjustments			Change in stocks	
			Total	Exchange rate	Other		
	(a)	(b)	(c)=(d)+(e)	(d)	(e)	(f)=(b)+(c)	(a)+(f)
				Resident non-banks			
Assets	1,145.5	26.0	26.4	9.8	16.6	52.4	1,197.8
Direct investment	271.4	11.5	4.5	2.4	2.1	16.1	287.5
Portfolio investment	685.0	12.4	19.3	7.0	12.3	31.7	716.7
of which: equities	*264.3*	*39.0*	*21.5*	*4.4*	*17.1*	*60.5*	*324.8*
Other investment	171.3	3.0	0.4	0.4	..	3.4	174.7
Derivatives	17.8	-0.9	2.1	..	2.1	1.2	18.9
Liabilities	1,399.9	71.8	-37.4	5.0	-42.3	34.4	1,434.3
Direct investment	234.5	5.3	-6.4	0.3	-6.7	-1.1	233.4
Portfolio investment	1,040.9	67.1	-37.6	3.8	-41.5	29.5	1,070.3
of which: equities	*119.0*	*1.2*	*-3.6*	*..*	*-3.6*	*-2.4*	*116.6*
Other investment	104.1	-1.5	0.8	0.8	..	-0.7	103.4
Derivatives	20.5	0.9	5.8	..	5.8	6.7	27.2
Net position	**-254.4**	**-45.8**	**63.7**	**4.8**	**58.9**	**17.9**	**-236.5**
				Resident banks			
Assets	429.7	-6.6	16.6	3.1	13.5	10.0	439.7
Liabilities	751.4	10.5	8.6	6.6	2.0	19.1	770.6
Net position	**-321.7**	**-17.1**	**8.0**	**-3.5**	**11.5**	**-9.1**	**-330.9**
				Central bank			
Assets	191.3	-23.2	25.5	3.1	22.4	2.3	193.6
Liabilities	0.3	2.6	..	..	..	2.6	3.0
Net position	**191.0**	**-25.8**	**25.5**	**3.1**	**22.4**	**-0.3**	**190.6**
Total net position	**-385.2**	**-88.7**	**97.2**	**4.4**	**92.7**	**8.5**	**-376.7**

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

In 2010, Italy's net external debtor position declined from €385.2 billion to €376.7 billion, or 24.3 per cent of GDP (Table 12.2). The effect of value adjustments more than offset the growth in net borrowing to €88.7 billion under the financial account.

Non-bank sectors' portfolio assets rose from €685.0 billion in 2009 to €716.7 billion. The equity component grew thanks to the resurgence of portfolio investment abroad, particularly in investment fund units, and to valuation gains reflecting the rise in most of the world's stock markets. The increase outweighed the contraction in holdings of foreign debt securities. The stock of equity portfolio investment liabilities decreased slightly; a small reduction due to value adjustments was partly offset by equally modest net purchases from abroad. The decline in the prices of Italian public securities, in connection with the widening of yield spreads owing to the tensions affecting the euro area, only partly offset the increase in liabilities due to foreign investors' significant volume of net purchases of medium- and long-term government securities. Direct investment assets grew as a result of net outflows and, to a lesser extent, the increase in the value of equity in foreign affiliates due to exchange rate and price adjustments. Direct investment liabilities were stable.

The banks' net position worsened slightly; this was the net outcome of growth in both assets and liabilities. The Bank of Italy's net external creditor position was essentially unchanged; the reduction in net assets within the Eurosystem was offset by the increase in both foreign portfolio securities and reserve assets, especially gold reserves as a consequence of the rise in the price of gold.

13. THE PUBLIC FINANCES

Following large increases in the two previous years, in 2010 general government net borrowing contracted by 0.8 percentage points to 4.6 per cent of GDP; the improvement reflected the reduction in the ratio of expenditure to GDP, which was offset only in part by the fall in the revenue ratio.

The large decline in capital expenditure was accompanied by an increase in primary current expenditure that fell short of the rate of inflation. These developments derived from the measures adopted in the three-year budget introduced in the summer of 2008, whose impact was offset only in part by the measures in support of the economy adopted in the two following years.

Interest payments declined further, benefiting from the residual effects of the fall in interest rates in 2008-09. These more than offset the impact of the growth in the debt, which rose to 119.0 per cent of GDP at the end of 2010.

The performance of the public finances in the early months of 2011 appears consistent with the objective of reducing net borrowing for the year to 3.9 per cent of GDP. This result would reflect a further fall in capital expenditure and a rate of increase in current expenditure still below the rate of inflation.

For 2012, the Economy and Finance Document confirms the estimates on a current legislation basis published in September 2010: net borrowing is expected to fall below 3 per cent of GDP, in line with the commitment entered into at European level to eliminate the excessive deficit, and public debt to start contracting in relation to GDP.

For the two following years, the Economy and Finance Document provides for a significant adjustment, intended to achieve a broadly balanced budget in 2014. The measures needed to achieve this objective, indicated as amounting to 2.3 percentage points of GDP, are to be mostly on the expenditure side. The Government plans to formulate the measures in the coming weeks, so that Parliament can approve them by the end of July.

The plans are consistent with the European budgetary rules in force and comply with the debt-reduction constraint proposed in the context of the reform of European governance currently under discussion. Smaller improvements in the primary budget balance would risk being annulled by the growth in interest payments, as happened at the end of the 1980s.

The objectives of the Economy and Finance Document imply a substantial and prolonged decrease in expenditure. For the effort to be sustainable, it will be necessary to increase the efficiency of the various public bodies and assess the adequacy of each item of expenditure.

Fiscal drag has increased the tax burden by €6 billion over the last three years. The Government has indicated a reduction in tax rates, to be financed in part by reducing tax evasion, as a priority for the future reform of taxation.

THE PUBLIC FINANCES IN 2010

Budgetary policy for 2010

The objective set for net borrowing in 2010 in the Economic and Financial Planning Document of June 2008 was 1.0 per cent of GDP. In the following months, in the light of the rapid deterioration in economic conditions, the objective was progressively raised to 5.0 per cent in July 2009. The subsequent planning documents confirmed this objective (Table 13.1). No further adjustment measures have been passed since the budget measures approved in July 2008 (see the box "The budget for the years 2009-2011" in *Economic Bulletin*, October 2008).

Table 13.1

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

	General government				*Memorandum items*		
	Net borrowing	Primary surplus	Interest payments	Debt	Real GDP growth rate (%)	Nominal GDP	Estimate of 2009 net borrowing
Objectives							
Economic and Financial Planning Document (July 2009)	76.9	2.6	79.5	....	0.5	1,549.6	81.3
as a percentage of GDP	*5.0*	*0.2*	*5.1*	*118.2*			*5.3*
Forecasting and Planning Report and Economic and Financial Planning Document update (September 2009)	77.6	-0.7	77.0	....	0.7	1,564.8	80.9
as a percentage of GDP	*5.0*	*0.0*	*4.9*	*117.3*			*5.3*
Stability Programme and Updating Note 2010-2012 (January 2010)	77.9	-1.6	76.3	....	1.1	1,572.4	80.5
as a percentage of GDP	*5.0*	*-0.1*	*4.9*	*116.9*			*5.3*
Estimates released in 2010							
Combined Report on the Economy and the Public Finances (May 2010)	78.1	-6.8	71.4	....	1.0	1,554.3	80.8
as a percentage of GDP	*5.0*	*-0.4*	*4.6*	*118.4*			*5.3*
Public Finance Decision (September 2010)	77.1	-5.1	72.1	1,842.3	1.2	1,554.7	80.8
as a percentage of GDP	*5.0*	*-0.3*	*4.6*	*118.5*			*5.3*
Outturn (1)	**71.2**	**-1.1**	**70.2**	**1,843.0**	**1.3**	**1,548.8**	**81.7**
as a percentage of GDP	*4.6*	*-0.1*	*4.5*	*119.0*			*5.4*

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

Objectives and forecasts. – The July 2009 Economic and Financial Planning Document set a target for the reduction in net borrowing from 5.3 per cent of GDP to 5.0 per cent in 2010, which coincided with the estimate on a current legislation basis.

In September, the Forecasting and Planning Report confirmed the forecast for net borrowing published in the Economic and Financial Planning Document, but accentuated the decrease expected in capital expenditure, while slightly increasing the rate of growth in primary current expenditure. Together with the Forecasting and Planning Report, the Government presented the Finance Bill for 2010, which did not introduce any adjustments to the budget balance.

In December 2009, on the basis of the results expected for the year, the Council of the European Union launched an excessive deficit procedure against Italy and asked for the country's deficit to be brought below the threshold of 3 per cent of GDP by 2012, an objective that was in line with the adjustment path already established in the Forecasting and Planning Report.

The January 2010 Stability Programme, the May 2010 Combined Report on the Economy and the Public Finances and the September 2010 Public Finance Decision confirmed the forecast for the deficit, although they significantly altered the expenditure and revenue estimates and raised the GDP growth estimate by about half a percentage point compared with the Forecasting and Planning Report.

Net borrowing

In 2010, general government net borrowing fell from 5.4 to 4.6 per cent of GDP (Table 13.2). Net of interest payments, the budget was close to balance, compared with a deficit of 0.7 per cent of GDP in 2009. The results were more favourable than the average for the other euro-area countries and than the forecasts of the Public Finance Decision.

Table 13.2

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

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Revenue	45.0	44.5	45.1	44.5	44.2	45.8	46.9	46.7	47.1	46.6
Expenditure (2)	48.1	47.5	48.6	48.0	48.5	49.2	48.4	49.4	52.5	51.2
of which: interest payments	*6.3*	*5.6*	*5.1*	*4.8*	*4.7*	*4.7*	*5.0*	*5.2*	*4.6*	*4.5*
Primary surplus	3.2	2.7	1.6	1.2	0.3	1.3	3.5	2.5	-0.7	-0.1
Net borrowing	3.1	2.9	3.5	3.5	4.3	3.4	1.5	2.7	5.4	4.6
Borrowing requirement net of privatization receipts	5.0	3.1	4.3	4.2	5.3	4.0	2.0	3.1	5.7	4.3
Debt	108.8	105.7	104.4	103.9	105.9	106.6	103.6	106.3	116.1	119.0

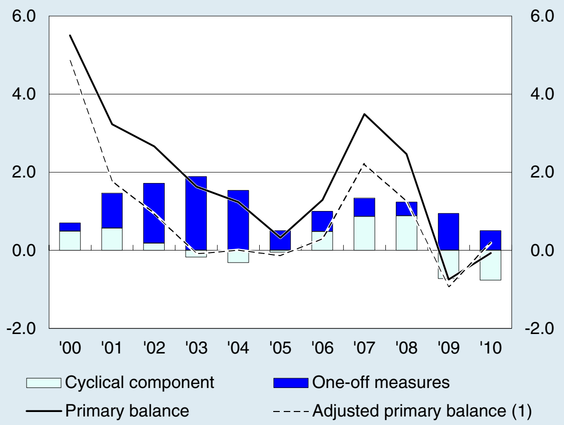
Source: Based on Istat data for the general government consolidated accounts items.
(1) Rounding may cause discrepancies. – (2) The proceeds of sales of public assets are recorded as a deduction from this item.

The improvement in the public finances compared with 2009 derived from the decrease of 1.3 percentage points in the ratio of primary expenditure to GDP, which more than offset the decrease of 0.5 percentage points in the revenue ratio.

The limited growth in expenditure reflected the cuts made by the 2008 three-year budget adjustment. The effects of these measures were only slightly attenuated by the anti-crisis decrees adopted in 2008 and 2009, the Finance Law for 2010 and the budget adjustment for 2011-13, which were officially estimated to have produced net increases in revenue and expenditure of about €7 billion in 2010. When these measures are taken into account, the actual increase in expenditure in 2009-10 was slightly smaller than that expected in September 2008. The fact that the amount of resources available to spending bodies was announced well in advance may have allowed them to plan more effectively, thus fostering achievement of the objectives for expenditure.

Figure 13.1

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



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

Structural primary net borrowing, i.e. adjusted for cyclical factors and one-off measures decreased by about one percentage point of GDP (Figure 13.1). The improvement was due in equal measure to the contraction in expenditure and the growth in revenue.

Revenue and expenditure

Revenue. – General government revenue, which in 2009 had decreased by 2.2 per cent (€16.0 billion), showed a small increase of 0.9 per cent (€6.6 billion) in 2010. Tax and social security receipts declined from 43.1 to 42.6 per cent of GDP (Table 13.3).

Table 13.3

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

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Direct taxes	14.7	13.9	13.4	13.3	13.3	14.4	15.1	15.3	14.7	14.6
Indirect taxes	14.2	14.3	14.0	14.0	14.2	14.8	14.7	13.8	13.6	14.0
Capital taxes	0.1	0.2	1.3	0.6	0.1	0.0	0.0	0.0	0.8	0.2
Tax revenue	**29.0**	**28.4**	**28.7**	**28.0**	**27.6**	**29.2**	**29.8**	**29.1**	**29.0**	**28.8**
Social security contributions	12.3	12.5	12.6	12.6	12.8	12.8	13.3	13.8	14.1	13.8
Tax revenue and social security contributions	**41.3**	**40.8**	**41.4**	**40.6**	**40.4**	**42.0**	**43.1**	**42.9**	**43.1**	**42.6**
Other current revenue	3.5	3.5	3.4	3.6	3.5	3.6	3.5	3.6	3.8	3.8
Other capital revenue	0.2	0.2	0.3	0.3	0.3	0.3	0.3	0.2	0.2	0.2
Total revenue	**45.0**	**44.5**	**45.1**	**44.5**	**44.2**	**45.8**	**46.9**	**46.7**	**47.1**	**46.6**

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

The modest growth in revenue reflected the sharp fall of €8.9 billion in capital tax revenue as a result of the fall in receipts from the foreign assets disclosure scheme and in revenue from the withholding taxes introduced by the 2008 anti-crisis decree. On the other hand, current revenue grew in line with GDP, rising by 2.1 per cent (€15.0 billion), driven mainly by indirect taxes, especially VAT, which grew by 5.1 per cent (€10.5 billion). Receipts of the latter were affected by the large reduction in the volume of offsets (nearly €6 billion according to the Ministry for the Economy and Finance) following the introduction in January 2010 of more restrictive rules. Direct tax revenue grew by 1.2 per cent (€2.6 billion), thanks to the rise in personal income tax receipts. Actual social security contributions increased by 0.5 per cent (€1.1 billion), while earnings rose faster, by 1.0 per cent.

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

Personal income tax receipts increased by 4.2 per cent (€6.4. billion), driven by the rise of 2.8 per cent (€3.3 billion) in employee withholding taxes and the reduction in the size of the payment on account established at the end of 2009, which resulted in some revenue, officially estimated at nearly €4 billion, being postponed from 2009 to 2010. The increase in receipts due to fiscal drag is estimated to have been a little less than €2 billion.

The latest revision of the structure of personal income tax came into force on 1 January 2007. In the three years 2008-10 it is estimated that fiscal drag increased receipts by nearly €6 billion, a little less than half a percentage point of GDP, assuming the same amount of income in real terms and excluding personal income surtaxes. In 2011, it is estimated that there will be a further additional tax burden of nearly €3 billion.

Corporate income tax receipts remained basically unchanged after contracting for two successive years. The increase of 3.6 per cent (€0.9 billion) in the payment on account for 2010 and that in assessments notified by the authorities offset the fall of 10.3 per cent (€1.0 billion) in the self-assessed balance for 2009, which was affected by the unfavourable economic conditions.

Revenue from the withholding taxes on investment income fell by 42.5 per cent (€5.6 billion), primarily in connection with the fall of €5.2 billion in receipts from the tax on bank deposit interest payments due to the lagged effect of the decline in interest rates and the excess payments on account paid in 2009. The other direct taxes entered in the state budget accounts fell by €7.4 billion. Contributory factors included the reduction of €4.7 billion in the revenue from the withholding taxes introduced by the 2008 anti-crisis decree and the drying up of almost all the revenue from the foreign assets disclosure scheme, with a contraction of €3.2 billion.

Indirect tax revenue was sustained by the increase of 3.8 per cent (€4.2 billion) in VAT. The receipts from VAT on imports from non-EU countries grew by 27.7 per cent (€3.1 billion), primarily owing to the increase in the price of oil. Receipts of domestic VAT grew by 1.1 per cent (€1.1 billion), in line with the growth in the tax base, estimated by summing households' taxable final expenditure and non-deductible intermediate consumption and investment.

The evasion of VAT continues to be higher than in the other main European countries. An analysis by the Finance Department of the Ministry for the Economy and Finance published in the State Audit Office's Report of 24 May 2011 on the Coordination of the Public Finances shows that the VAT base not declared in Italy in 2009 was more than one-third of the theoretical base. This is less only than the estimate for Spain and far greater than those for France, Germany, the Netherlands and the United Kingdom.

Receipts from the excise taxes on mineral oils decreased by 5.1 per cent (€1.1 billion); excluding accounting differences, they fell by just under 2 per cent. Receipts from the excise tax on methane decreased by 4.4 per cent (€0.2 billion) owing to the smaller balance paid in April.

Expenditure. – In 2010, general government primary expenditure fell by 0.5 per cent in absolute terms, the first such contraction since the end of the Second World War. The result reflected the large decrease in capital expenditure. In relative terms the aggregate declined to 46.7 per cent of GDP (Table 13.4).

Table 13.4

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

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Compensation of employees	10.5	10.6	10.8	10.8	11.0	11.0	10.6	10.8	11.3	11.1
Intermediate consumption	5.1	5.2	5.3	5.4	5.5	5.2	5.2	5.5	6.0	5.9
Market purchases of social benefits in kind	2.5	2.6	2.6	2.7	2.8	2.8	2.7	2.7	3.0	2.9
Social benefits in cash	16.2	16.5	16.8	16.9	17.0	17.0	17.1	17.7	19.2	19.3
Interest payments	6.3	5.5	5.1	4.7	4.6	4.6	5.0	5.2	4.6	4.5
Other current expenditure	3.2	3.3	3.6	3.6	3.6	3.6	3.7	3.8	4.1	4.0
Total current expenditure	**43.9**	**43.8**	**44.2**	**44.0**	**44.4**	**44.2**	**44.3**	**45.6**	**48.1**	**47.8**
of which: current expenditure net of interest payments	*37.6*	*38.3*	*39.1*	*39.3*	*39.8*	*39.5*	*39.3*	*40.4*	*43.5*	*43.2*
Gross fixed investment (2)	2.4	1.7	2.5	2.4	2.4	2.3	2.3	2.2	2.5	2.1
Other capital expenditure	1.8	1.9	1.9	1.5	1.7	2.7	1.7	1.5	1.8	1.4
Total capital expenditure (2)	**4.2**	**3.6**	**4.3**	**4.0**	**4.1**	**5.0**	**4.0**	**3.8**	**4.4**	**3.5**
Total expenditure (2)	**48.1**	**47.4**	**48.6**	**48.0**	**48.5**	**49.2**	**48.4**	**49.4**	**52.5**	**51.2**
of which: expenditure net of interest payments (2)	*41.8*	*41.9*	*43.4*	*43.3*	*43.9*	*44.6*	*43.4*	*44.2*	*47.8*	*46.7*

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

Primary current expenditure grew by 1.3 per cent. This was below the rate of inflation and reflected the modest growth in compensation of employees, intermediate consumption and market purchases of social benefits in kind.

The growth in compensation of employees (0.5 per cent) was affected by the salary increases awarded to managers for 2006-07 and 2008-09. The latter increase virtually completed the 2008-09 contract renewals for public employees.

An econometric analysis based on the EU-SILC sample survey covering ten euro-area countries and the period 2004-07 estimates – with account taken of respondents' age, sex, educational qualifications, professional status and geographical location – a wage differential in favour of the public sector in all the countries considered. The differential was especially large (between 19 and 25 per cent) in Greece, Italy, Ireland, Portugal and Spain; it was about 10 per cent in Austria, Germany and Slovenia and about 5 per cent in Belgium and France. The differential, which is wider for female workers, generally narrows when it is estimated on monthly instead of hourly wages; even so, it remains around 16-17 per cent in Greece, Ireland and Spain and above 10 per cent in Italy, Germany, Portugal and Slovenia. For the countries for which geographically disaggregated data are available, large differentials were found in Italy and Spain, smaller ones in Greece and France, and virtually no differences in Austria, Belgium and Germany, suggesting that a system of local-level wage bargaining in the public sector, as in Belgium and Germany, may lead to wage dynamics that are more consistent with local labour market conditions.

Intermediate consumption increased slightly, by 0.4 per cent, after rising rapidly by 6.5 per cent in 2009, owing in part to the bunching of deliveries to the Ministry of Defence and the increase in indirectly measured financial intermediation services. Central government outlays contracted by 6.2 per cent as a result of the lapsing of the above factors, while local government spending increased by 2.7 per cent.

Expenditure on social benefits in kind slowed significantly, rising by 1.0 per cent, as against an average of 3.5 per cent in the five preceding years. The result reflected the slowdown in health expenditure, which accounts for about 90 per cent of this item.

Expenditure on social benefits in cash increased by 2.3 per cent. The pension component, which accounts for more than 85 per cent of this item, grew by 2.1 per cent, as against 4.1 per cent in 2009. The increase in the non-pension component was much smaller than in the preceding years: 3.5 per cent, against 13.0 per cent in 2009, 12.3 per cent in 2008 and 12.4 per cent in 2007.

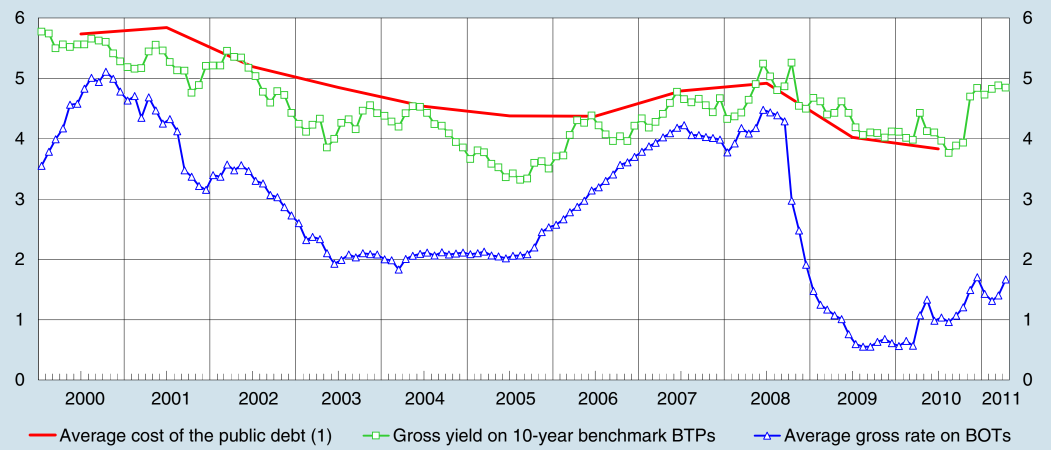
The drop of 18.5 per cent in capital expenditure brought the ratio of this item to GDP to a ten-year low. Net of the proceeds of real-estate disposals and the cost of repurchasing buildings unsold in the SCIP2 securitization programme (€0.9 billion), investment fell by 14.1 per cent, to 2.1 per cent of GDP. At 15.6 per cent the decrease was more pronounced for local government, which accounts for over 70 per cent of this item, than for central government, which recorded a contraction of 8.7 per cent.

Interest payments decreased slightly, by 0.4 per cent. In 2010, the average issue rate on short-term securities was up slightly on 2009, by 0.2 percentage points (Figure 13.2). The decrease in long-term rates was of the same order. The impact on expenditure of the increase in the debt was offset both by the reduction in 2009 in the interest rates on the short-term and variable-rate components and by the replacement of high-coupon long-term securities issued in the past.

The yield differential between Italian ten-year bonds and German Bunds reached a maximum of about 200 basis points at the end of November 2010. At the end of April 2011 it had narrowed to just over 160 basis points.

Figure 13.2

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



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

Local government

In 2010, for the first time in thirty years, local government revenue and expenditure both contracted. The fall in revenue was more pronounced, however, so that the deficit rose from 0.3 to 0.5 per cent of GDP.

Total revenue decreased by 2.9 per cent, to 15.3 per cent of GDP, owing to the contraction of 8.3 per cent in transfers from other public bodies and from abroad. In particular, public transfers on current account decreased by 6.6 per cent, to €99.2 billion, and investment grants fell by 20.3 per cent to €10.1 billion. Resources from abroad, notably funds disbursed by the European Union, decreased by 25.5 per cent to €1.6 billion.

After falling in 2008 and 2009, tax revenue began to grow again, rising by 2.8 per cent to 6.1 per cent of GDP. Indirect tax revenue increased by 1.8 per cent to €64.1 billion and direct tax revenue by 5.0 per cent to €31.1 billion.

Local government expenditure contracted by 1.9 per cent in 2010, to 15.8 per cent of GDP. The primary current component grew by 1.5 per cent, to €210.4 billion, slowing sharply with respect to 2008 and 2009. In particular, compensation of employees increased by 1.6 per cent, to €72.9 billion, and intermediate consumption by 2.7 per cent, to €64.7 billion.

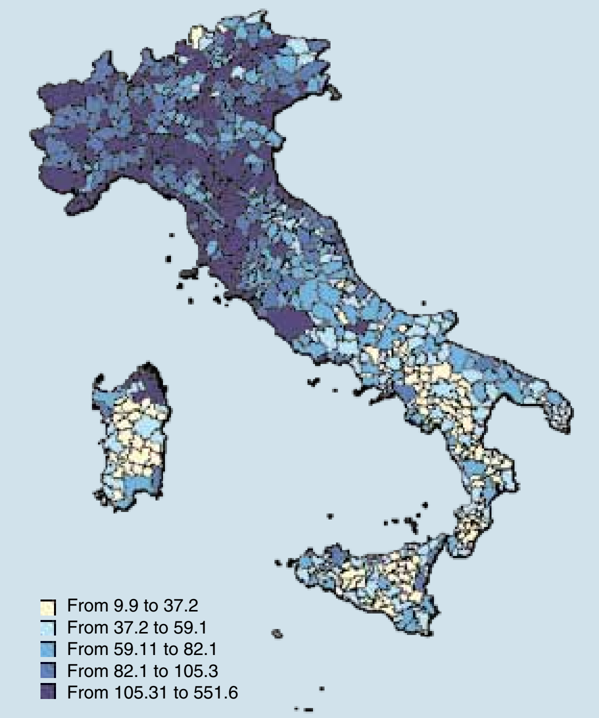
As a ratio to GDP, capital expenditure declined to the level recorded in the mid-1990s. Excluding the proceeds of real-estate disposals, it fell by 18.2 per cent, to €31.7 billion, reflecting the pronounced contraction of 15.6 per cent in investment, to €24.3 billion, and of 27.9 per cent in investment grants.

Local authorities' use of derivatives. – Local authorities' use of derivatives continued to diminish, partly as a consequence of the early closing of transactions. Since June 2008 local authorities have been banned from entering into new contracts until the Ministry for the Economy and Finance revises the regulatory framework.

Figure 13.3

Per capita receipts of property taxes (1)

(indices, Italy = 100)



Source: Based on Ministry for the Economy and Finance data for 2008.
(1) Local labour system averages. Quintile distribution of the 686 local systems (not weighted by population). The receipts are the sum of personal income tax on income from real estate (excluding agricultural income), registration and stamp taxes on property rental contracts, and 30 per cent of registration and stamp taxes on transfers of real estate, mortgage and cadastral taxes and mortgage fees. In the absence of official estimates of its geographical distribution, receipts from the flat-rate tax on rents and special cadastral taxes are not considered.

The implementation of fiscal federalism. – The new arrangements introduced by Law 42/2009 will result in a revision of the financial relationships between central government and local authorities. So far five legislative decrees have been approved. On some important matters these decrees refer to other measures to be adopted in future (more than 60 according to a recent analysis by the Research Department of the Chamber of Deputies).

Some of the measures approved provide for central government transfers to be replaced by sharing in central government tax revenue. This will require a revision of the personal income surtax for ordinary-statute regions and of personal income tax revenue-sharing for provinces. For municipalities the withdrawal of central government transfers will be offset by the devolution of part of the revenue deriving from the taxation of property.

In 2013, some of the existing taxes of the ordinary-statute regions based on central government legislation will be turned into regional taxes and therefore governed by measures that the regions themselves adopt. In 2014, it will become possible for municipalities to levy "own" and "secondary" taxes in place of other forms of taxation. Local authorities' fiscal autonomy will increase, especially from 2014 onwards.

The decentralized tax revenues will be redistributed in part by means of equalization funds that will be required to ensure the complete coverage of standard costs and financing needs, the financing of fundamental functions, and the partial offsetting of differences in the ability to raise tax revenue for non-fundamental functions. The ways in which equalization will be achieved are still largely unspecified. For municipalities, redistribution will be crucial since receipts of property taxes differ widely across the country, especially between small and large municipalities and between rural and urban areas (Figure 13.3).

The borrowing requirement and the debt

The borrowing requirement. – After rising for two successive years, in 2010 the general government borrowing requirement fell from €85.9 billion to €67.0 billion and from 5.7 to 4.3 per cent of GDP (Table 13.5).

Table 13.5

General government balances and debt
(millions of euros)

	2006	2007	2008	2009	2010
Net borrowing	49,921	23,541	42,705	81,741	71,211
Total borrowing requirement	59,282	26,812	49,144	85,912	67,036
Borrowing requirement net of privatization receipts (1)	59,320	30,312	49,163	86,711	67,045
Debt	1,584,096	1,602,116	1,666,603	1,763,864	1,843,051
Memorandum items:					
Treasury deposits at the Bank of Italy	22,864	9,721	20,333	31,731	43,249
Loans to EMU member states	–	–	–	–	3,890
Average residual maturity of the debt (in years)	7.2	7.2	7.5	7.6	7.8

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

Net issues of medium- and long-term securities amounting to €88.0 billion, €1.0 billion of loans from monetary and financial institutions and the increase of €0.2 billion in coins in circulation financed not only the borrowing requirement but also the increase of €11.5 billion in the Treasury's deposits at the Bank of Italy, the €10.1 billion of net redemptions of short-term securities, the fall of €0.3 billion in the liabilities associated with securitizations and the reduction in the deposits held by non-general-government entities with the Treasury, down by €0.2 billion overall, despite the increase of €9.2 billion in the deposits of Cassa Depositi e Prestiti S.p.A..

The disparity between the borrowing requirement and net borrowing. – In 2010, the general government borrowing requirement was 0.3 percentage points of GDP smaller than general government net borrowing, after being uninterruptedly larger for more than a decade (Table 13.6). The factors contributing to the gap included the differences deriving from the use of cash-basis accounts for the borrowing requirement and accrual-basis accounts for net borrowing (-0.7 percentage points of GDP, against an average of 0.1 points for the period 2001-09). These differences more than offset the accumulation of financial assets (0.5 points of GDP, more than half due to the loan granted to Greece), which increases the borrowing requirement but not net borrowing.

The debt. – In 2010, the ratio of general government debt to GDP rose for the third successive year, increasing from 116.1 to 119.0 per cent. The increase was caused by the primary deficit (0.1 percentage points of GDP), the difference between the average cost of the debt and the GDP growth rate (2.3 points) and the residual component (0.5 points) involving factors that have a different impact on the debt and the borrowing requirement.

The management of the debt in 2010 continued to be aimed at reducing the refinancing risk in a context marked by uncertainty and volatile sovereign securities markets. The Treasury's deposits at the Bank of Italy continued to increase, rising from €31.7 billion to €43.2 billion and, despite the favourable conditions at the short end of the yield curve, the proportion of medium- and long-term securities was increased further, from 75.4 per cent in 2009 to 77.0 per cent in 2010. The average residual maturity of the total debt lengthened from seven years and seven months at the end of 2009 to seven years and nine months at the end of 2010.

Table 13.6

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

		2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
(a)	**Net borrowing (Istat)**	**3.1**	**2.9**	**3.5**	**3.5**	**4.3**	**3.4**	**1.5**	**2.7**	**5.4**	**4.6**
(b)	Balance of financial items (1)	0.5	0.3	0.3	1.0	1.3	0.6	0.5	0.2	0.6	0.5
(c)	Cash basis minus accrual basis	0.6	-0.3	0.7	-0.4	-0.4	0.1	0.0	0.3	-0.2	-0.7
	primary balance	*0.9*	*0.2*	*0.9*	*-0.2*	*-0.3*	*-0.1*	*0.3*	*0.1*	*-0.4*	*-0.8*
	interest payments	*-0.2*	*-0.4*	*-0.2*	*-0.2*	*-0.1*	*0.3*	*-0.2*	*0.2*	*0.2*	*0.1*
(d)=(a)+(b)+(c)	**Public sector borrowing requirement (MEF)**	**4.2**	**3.0**	**4.4**	**4.1**	**5.2**	**4.0**	**2.1**	**3.3**	**5.9**	**4.4**
(e)=(g)-(d)	Difference between the general government and public sector borrowing requirements	0.7	0.1	-0.2	0.1	0.1	0.0	-0.1	-0.1	-0.2	0.0
(g)	**General government borrowing requirement net of privatization receipts (BI)**	**5.0**	**3.1**	**4.3**	**4.2**	**5.3**	**4.0**	**2.0**	**3.1**	**5.7**	**4.3**
(h)	Privatization receipts (-)	-0.4	-0.2	-1.3	-0.6	-0.3	0.0	-0.2	0.0	-0.1	0.0
(i)=(g)+(h)	**Total borrowing requirement (BI)**	**4.6**	**3.0**	**3.0**	**3.6**	**5.0**	**4.0**	**1.7**	**3.1**	**5.7**	**4.3**
(l)	Change in Treasury's deposits at the Bank of Italy	0.2	0.0	-0.6	0.2	-0.1	0.6	-0.8	0.7	0.8	0.7
(m)	Issue discounts	-0.2	-1.9	-0.3	0.0	-0.2	0.2	0.3	0.3	0.0	0.0
(n)	Change in the euro value of foreign exchange liabilities	0.0	-0.3	-0.2	-0.1	0.1	-0.1	0.0	0.0	0.0	0.0
(o)=(i)+(l)+(m)+(n)	**Change in the debt (BI)**	**4.7**	**0.8**	**1.9**	**3.7**	**4.8**	**4.7**	**1.2**	**4.1**	**6.4**	**5.1**
(p)=(a)-(o)	Difference between net borrowing and the change in the debt	-1.6	2.1	1.6	-0.2	-0.5	-1.3	0.4	-1.4	-1.0	-0.5
(f)=(a)-(g)	*Difference between general government net borrowing and the general government borrowing requirement*	*-1.9*	*-0.2*	*-0.8*	*-0.7*	*-1.0*	*-0.6*	*-0.4*	*-0.4*	*-0.3*	*0.3*
(q)=(g)-(o)	*Difference between the general government borrowing requirement and the change in the debt*	*0.3*	*2.3*	*2.4*	*0.5*	*0.5*	*-0.7*	*0.8*	*-1.0*	*-0.7*	*-0.8*

Sources: For net borrowing and interest payments on an accrual basis, Istat; for the public sector borrowing requirement (net of privatization receipts) and interest payments on a cash basis, the Ministry for the Economy and Finance – MEF; for the issue discounts and the change in the euro value of foreign exchange liabilities, the Bank of Italy (BI); for the balance on financial asset items, based on *Conti Finanziari* data, BI.
(1) Includes the changes in holdings of the following instruments: cash and deposits (net of the Treasury's deposits at the Bank of Italy), debt securities, shares and other equity (net of privatization receipts) and loans. In 2006, the cancellation of claims on TAV S.p.A. (€12,950 million) affected net borrowing but not the borrowing requirement; the discrepancy was assigned to the balance of financial items.

The increase in the debt reflected that in central government debt, which rose from 108.7 to 111.8 per cent of GDP. Local government debt declined by 0.1 percentage points of GDP to 7.2 per cent (Table 13.7).

Table 13.7

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

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
General government	**108.8**	**105.7**	**104.4**	**103.9**	**105.9**	**106.6**	**103.6**	**106.3**	**116.1**	**119.0**
Central government	*104.9*	*101.9*	*99.1*	*98.4*	*99.8*	*99.5*	*96.4*	*99.5*	*108.7*	*111.8*
Local government	*3.2*	*3.4*	*5.1*	*5.4*	*6.1*	*7.1*	*7.1*	*6.8*	*7.3*	*7.2*
Social security institutions	*0.6*	*0.4*	*0.2*	*0.1*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*

General government trade payables. – On the basis of the responses to the Bank of Italy Survey of Industrial and Service Firms with at least twenty employees, it can be estimated that the total trade payables of general government remained basically unchanged with respect to the high level of 2009 (more than 4 per cent of GDP).

The lengthening of the average time to payment, from 236 to 240 days, was offset by the reduction in business with general government. The time to payment in the South is more than 20 per cent longer than the national average.

By international standards the average general government time to payment is very long. According to the European Payment Index 2010 survey, based on a sample of about 6,000 firms in 25 countries, the average general government time to payment reached 186 days in Italy in 2010, as against 36 in Germany and 65 in France.

In February, Directive 2011/7/EU was adopted in order to reduce delays in the settlement of trade payables more effectively. The stringency of the new rules, which member states are required to transpose by 16 March 2013, should be ensured by the impossibility of negotiating contractual waivers.

BUDGETARY POLICY FOR 2011 AND THE MEDIUM TERM

Budgetary policy for 2011

The objective of 3.9 per cent of GDP set for net borrowing in September 2009 was confirmed in January 2010 by the Stability Programme (Table 13.8) and in May by the Combined Report on the Economy and the Public Finances. Owing to less favourable growth forecasts, the latter raised the forecast for the deficit in 2011 on a current legislation basis by 0.4 percentage points of GDP compared with the Stability Programme and the size of the adjustment needed to achieve the objective to 0.8 points of GDP.

With financial markets turbulent following the Greek crisis, at the end of May 2010 the Government brought forward the budget adjustment for the years 2011-13. The measures consisted primarily of spending cuts and more effective action to counter tax evasion.

In September, the Public Finance Decision confirmed the target of a deficit equal to 3.9 per cent of GDP, despite a downward revision of the GDP growth rate from 1.5 to 1.3 per cent. The adverse effect on revenue dynamics in 2011 was offset by the upward revision of revenue expected in 2010.

Table 13.8

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

	General government				*Memorandum items*			
	Net borrowing	Primary surplus	Interest payments	Debt	Real GDP growth rate (%)	Nominal GDP	Net borrowing 2010	Debt 2010
Objectives								
Stability Programme and Updating Note 2010-2012 (January 2010)	....	....	....	....	2.0	1,631.6	77.9	....
as a percentage of GDP	*3.9*	*1.3*	*5.2*	*116.5*			*5.0*	*116.9*
Combined Report on the Economy and the Public Finances (May 2010)	....	....	....	....	1.5	1,606.0	....	....
as a percentage of GDP	*3.9*	*1.0*	*4.9*	*118.7*			*5.0*	*118.4*
Public Finance Decision (September 2010)	63.1	12.5	75.7	1,910.0	1.3	1,602.8	77.1	1,842.3
as a percentage of GDP	*3.9*	*0.8*	*4.7*	*119.2*			*5.0*	*118.5*
Estimates								
Economy and Finance Document (April 2011)	61.9	14.2	76.1	....	1.1	1,593.3	71.2	....
as a percentage of GDP	*3.9*	*0.9*	*4.8*	*120.0*			*4.6*	*119.0*

In December, Parliament approved the Stability Law and the Budget Law, which, in accordance with the Public Sector Accounting and Public Finances Law (Law 196/2009), form the budget for the three following years. The measures they contain provide for a different allocation of resources compared with the current legislation, but without this having any effect on net borrowing (Table 13.9).

In February, Parliament also ratified Decree Law 225/2010, which is officially estimated not to have any effect on the budget balance and, among other things, contains a reform of the tax treatment of Italian securities investment funds.

The latest estimates for the public finances. – The Economy and Finance Document presented in April confirms the estimate of net borrowing in 2011 given in the Public Finance Decision, despite the outturn for the deficit in 2010 having been more favourable than expected. In fact, the Document contains an upward revision of the rate of growth in primary current expenditure from 0.4 to 1.1 per cent, and of that in interest payments from 5.0 to 8.5 per cent).

The primary balance is forecast to swing from a deficit of 0.1 per cent of GDP in 2010 to a surplus of 0.9 per cent in 2011. The reduction in the structural deficit is estimated at half a percentage point of GDP. The debt will rise further in relation to GDP, reaching 120.0 per cent at the end of 2011.

The improvement in the budget balance reflects the fall of about one percentage point in the ratio of primary expenditure to GDP, to 45.6 per cent. The overall change in primary expenditure in the three years 2009-11, equal to 4.7 per cent and €32.7

billion, is in line with the forecast of September 2008, which took account of the impact of the three-year budget of the summer of 2008. The additional cuts introduced in the three-year budget of the summer of 2010 allow the divergence of some expenditure items from the path laid down in 2008 to be offset.

Table 13.9

Effects of the stability law and the budget law on the general government consolidated accounts
(millions of euros)

	2011	2012	2013
PROCUREMENT OF RESOURCES	**7,038**	**2,598**	**2,199**
Measures that increase revenue	**1,651**	**1,063**	**768**
Fight against tax evasion and illegal gambling	632	240	240
Tax rules applicable to leasing contracts	348	168	161
Indirect effects on public employment	365	217	217
Other	305	438	149
Measures that reduce expenditure	**-5,388**	**-1,534**	**-1,431**
Current expenditure	**-2,145**	**-1,427**	**-1,393**
Structural intervention fund	-1,051	-135	-29
Reserve and special funds	-524	-440	-455
Other	-571	-852	-909
Capital expenditure	**-3,243**	**-108**	**-38**
Sale of digital frequencies	-2,400	-0	-0
Structural intervention fund	-701	-90	-20
Other	-142	-18	-18
USE OF RESOURCES	**7,038**	**2,596**	**2,198**
Measures that reduce revenue	**-1,669**	**-1,372**	**-1,103**
Extension of tax relief for productivity contracts	-835	-263	-0
Repeal of increases in social security contributions	-509	-509	-509
Tax relief for agriculture	-250	-250	-250
Other	-74	-349	-343
Measures that increase expenditure	**5,369**	**1,225**	**1,096**
Current expenditure	**4,188**	**1,177**	**1,059**
University fund	800	500	500
Employment fund	600	0	0
Urgent interventions fund	800	0	0
Peace missions	750	0	0
Healthcare	348	0	0
Other	891	677	559
Capital expenditure	**1,181**	**48**	**37**
Haulage and intermodal facilities	400	0	0
Domestic Stability Pact	480	0	0
Other	301	48	37
EFFECT ON THE PRIMARY BALANCE	**1**	**2**	**0**

Source: Based on data published in the Economy and Finance Document.

The recent assessments published by the European Commission, which envisage GDP growth of 1.0 per cent (slightly less than the figure given in the Economy and Finance Document), show the deficit falling to 4.0 per cent of GDP, basically in line with the Government's forecasts.

On the basis of preliminary estimates, in the first four months of this year the general government borrowing requirement amounted to more than €41 billion, about €2 billion less than in the first four months of 2010.

In the first four months of this year, state budget tax revenue grew significantly, rising by 6.0 per cent (€6.3 billion) with respect to the first four months of 2010. Major contributory factors included the increase of 7.0 per cent (€2.0 billion) in VAT, partly owing to the rise in the price of oil, and that of 3.1 per cent (€1.4 billion) in employee withholding taxes. The revenue from the one-off tax replacing the cadastral and mortgage taxes on real-estate leasing contracts introduced by the Stability Law of 2010 exceeded the official assessment of €0.3 billion and amounted to €1.3 billion.

The developments in the public finances so far appear consistent with the estimate for net borrowing contained in the Economy and Finance Document.

Programmes and prospects for 2012-14

The Economy and Finance Document confirms the objective of 2.7 per cent of GDP for net borrowing in 2012, as already specified in September 2009, and indicates a significant adjustment in the two following years with the aim of achieving a deficit equal to 1.5 per cent of GDP in 2013 and to 0.2 per cent in 2014. At the end of the period the primary surplus should be equal to 5.2 per cent of GDP.

Despite the budgetary stringency, the macroeconomic developments for the next three years included in the Economy and Finance Document envisage a gradual increase in the growth rate of GDP, from 1.3 per cent in 2012 to 1.5 per cent in 2013 (2.0 per cent in both years according to the Public Finance Decision) and 1.6 per cent in 2014.

For the deficit objectives to be achieved, the Economy and Finance Document considers that adjustment measures are needed in 2013-14 amounting to 2.3 percentage points of GDP (about €40 billion), with 1.2 points in 2013 and 1.1 points in 2014 compared with the results on an unchanged legislation basis. The Document indicates that the adjustment will mainly concern expenditure. The reform of public sector accounting provides for the measures to be defined in September; the Government is planning to bring the adjustment forward to permit parliamentary approval by the end of July.

The Economy and Finance Document also estimates that the additional expenditure in 2014 consistent with unchanged policies compared with those on a current legislation basis amounts to 0.3 percentage points of GDP. If budget decisions turn some of this potential spending – which concerns compensation of employees, intermediate consumption and other current expenditure items – into real costs, it will be necessary to increase future budget adjustments accordingly.

According to the Economy and Finance Document's estimates, the ratio of the public debt to GDP will begin to come down in 2012. In 2014 it will be 112.8 per cent, that is 7.2 percentage points lower than the figure expected at the end of this year.

Account is taken of the actual and expected disbursements of loans to Greece and of the actual disbursements of loans to Ireland by the European Financial Stability Facility up to the first quarter of 2011. By contrast, the assessments – as specified in the Economy and Finance Document – do not include future disbursements by the Facility (such as those agreed as part of the package of support for Ireland and Portugal) or the payments serving to create the capital of the permanent crisis management mechanism (the European Stability Mechanism), which are scheduled from July 2013 onwards. The estimates consider Greece's repayments as starting in 2013; however, the extraordinary Council of the European Union of 11 March extended the duration of the loans granted so far from three to seven and a half years.

The adjustment path. – The consolidation of the public finances shown in the Economy and Finance Document is based on a reduction in the ratio of primary expenditure to GDP of more than four percentage points over the three years 2012-14.

In 2012, according to the estimates published in the Document, for the third successive year the increase in primary expenditure (1.0 per cent) will be below the rate of consumer price inflation (2 per cent). Capital expenditure is expected to contract in nominal terms again for the third successive year. This aggregate is expected to fall to 2.8 per cent of GDP, the lowest value of recent decades.

According to the information provided in the Economy and Finance Document and assuming that capital expenditure remains unchanged in relation to GDP at the 2012 level, in 2013-14 achievement of the objective for net borrowing will require a reduction in primary current expenditure of about 0.5 percentage points per year in nominal terms and of more than 2.0 points in real terms. This would produce a reduction of nearly 7 per cent in real terms between 2010 and 2014.

For the reduction in expenditure to be sustainable it must be accompanied by an increase in the efficiency of the public bodies concerned. It will be necessary to assess the adequacy of each item of expenditure and the results of each programme and to review the priority to be assigned to public action. To this end it will be helpful to carry out systematic and far-reaching spending reviews, adopt performance indicators for central and local government units, and go beyond the principle of historical spending.

The return to high growth is a very important condition for the success of the consolidation plan. It is desirable that expenditure measures impinge as little as possible on the items that can contribute the most to sustaining growth, such as investment in human capital and the strengthening of infrastructure. Measures are also needed that, without entailing costs for the budget, foster competition and efficiency in the market for products and in that for factors of production.

The Economy and Finance Document states that measures on the revenue side of the budget will be limited, thus making it possible to stabilize revenue in relation to GDP at its 2010 level. The Government has also undertaken to carry out a reform of taxation whose general principles are set out in the Economy and Finance Document. They include a reduction in the number of preferential tax regimes and exemptions with the aim of simplifying the system and making it more neutral. It is also stated that the intention is to shift the tax burden from direct to indirect taxation. The Government has also indicated a reduction in tax rates as a priority, to be financed in part by reducing tax evasion.

Compliance with the European budgetary rules. – The programmes described in the Economy and Finance Document comply with the undertaking entered into by Italy under the excessive deficit procedure to bring the budget deficit below the 3 per cent threshold in 2012. In addition, the adjustment of the structural balance, equal to 0.5 percentage points of GDP in 2011 and to 0.8 points in each of the three years

2012-14, is consistent with that required by the Stability and Growth Pact (at least 0.5 percentage points of GDP per year).

The Economy and Finance Document's objectives can also be assessed against the proposals for the reform of European governance concerning the introduction of a rule on the growth of expenditure (as part of the preventive phase of the Stability and Growth Pact) and of a numerical rule to give operational effect to the provision of the Maastricht Treaty calling for an adequate reduction in the debt of countries in which it exceeds 60 per cent of GDP.

The rule proposed for expenditure requires, for countries that – like Italy – have not yet achieved their medium-term objective, an expenditure growth rate about one percentage point below the potential nominal GDP growth rate. The Government's undertaking to reduce the ratio of primary expenditure to GDP by more than four percentage points over the three years 2012-14 would permit compliance with this rule.

The debt rule establishes an objective, in relation to GDP, implying a reduction over three years of the order of 5 per cent per year of the difference between the debt ratio and the reference value of 60 per cent.

The programmes included in the Economy and Finance Document appear consistent with the above-mentioned rule, assuming that it is first applied with reference to 2013-15. In fact compliance would require a reduction in the debt in 2015 of nearly two percentage points with respect to the level planned for 2014 in the Economy and Finance Document (to about 111 per cent of GDP). If the budget balance planned for 2014 is maintained in the following year, the fall required in 2015 appears achievable under a broad range of scenarios for GDP and interest rates in that year.

14. THE FINANCIAL CONDITION OF HOUSEHOLDS AND FIRMS

The overall financial balance of the non-financial private sector, which had improved to show a surplus of 1.0 per cent of GDP in 2009, turned negative again last year with a deficit of 1.5 per cent of GDP. The developments for both households and firms reflected the sluggishness of income growth.

Continuing a trend that is now a decade long, the saving rate of consumer and producer households declined. The household sector's financial surplus amounted to €31 billion (2.0 per cent of GDP), less than in 2009. Households continued to invest both in relatively low-risk postal savings and insurance products and in shares and other equity; overall, the proportion of risky assets in their portfolios diminished owing to the poor performance of share prices. The large purchases of bank bonds that had marked the years 2007-09 came to a halt. Households' borrowings from intermediaries grew more rapidly than in 2009, particularly for mortgage loans. Their financial debt was lower in relation to disposable income than the euro-area average. Most new loans for house purchases were again at variable rates. In a period of weak income growth, the historically low level of interest rates and the measures taken in favour of mortgage borrowers averted an increase in the proportion of household income going to service debt.

A weak, hesitant economic recovery allowed firms to recoup only part of the previous year's sharp drop in profitability. Financing needs stemming from increased investment and production volumes caused the corporate sector's financial deficit to rise to 3.5 per cent of GDP, giving impetus to credit demand. Despite the persistence of supply-side frictions, bank lending returned to growth. Some measures taken during the crisis to support access to credit proved effective in easing firms' liquidity strains. Overall, the recovery in productive activity was not enough to permit a substantial improvement in firms' financial condition, which remained fragile. Signs of strain can be seen in the frequency of business-to-business payment delays, firms' persistent difficulties in repaying bank loans and the still rapid increase in bankruptcies. Firms' higher leverage compared with the past and the large share of their short-term or variable-rate borrowing make them vulnerable to a rise in interest rates, especially in the absence of an improvement in cash flow.

HOUSEHOLDS

Households' financial saving and wealth

The saving rate of consumer and producer households declined in 2010 to 12.1 per cent of disposable income, 1.4 points less than in 2009. The reduction in the saving rate is a long-term trend: during the last decade the rate came down by about 4 percentage points.

Table 14.1

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

	End-of period stocks			Flows	
	Dec. 2010	Percentage composition		2009	2010
		Dec. 2009	Dec. 2010		
ASSETS (2)					
Cash	111,939	2.9	3.1	7,062	5,305
Instruments issued by banks	1,016,240	28.2	27.7	50,910	-23,559
of which: sight deposits	515,823	*13.9*	*14.1*	*21,309*	*-9,729*
other deposits	*132,541*	*4.1*	*3.6*	*3,656*	*-4,081*
medium- and long-term securities	367,876	*10.2*	*10.0*	*25,945*	*-9,749*
Postal deposits and other savings (3)	325,788	8.5	8.9	17,948	11,904
Government securities	188,254	5.8	5.1	-55,221	-4,369
of which: short-term	*19,038*	*0.7*	*0.5*	*-64,275*	*-5,858*
medium- and long-term	*169,216*	*5.1*	*4.6*	*9,054*	*1,489*
Corporate medium- and long-term securities	329	0.1	0.0	-2,081	4,865
Investment fund units	243,204	6.1	6.6	8,712	-867
of which: Italian	*153,416*	*4.3*	*4.2*	*-616*	*-18,199*
foreign	*89,788*	*1.8*	*2.5*	*9,328*	*17,332*
Shares and other equity	755,555	21.7	20.6	43,042	48,065
of which: Italian	*725,407*	*21.0*	*19.8*	44,031	*46,670*
foreign	*30,148*	*0.7*	*0.8*	*-989*	*1,395*
Other external assets	230,793	6.3	6.3	-35,178	-1,698
of which: deposits	*63,780*	*1.8*	*1.7*	*-33,514*	*-3,426*
short-term securities	*624*	*0.0*	*0.0*	*444*	*11*
medium- and long-term securities	*166,389*	*4.5*	*4.5*	*-2,109*	1,717
Insurance, pension fund reserves and severance pay entitlements	668,287	17.1	18.2	28,029	26,396
of which: life insurance	*417,782*	*10.4*	*11.4*	*24,343*	*23,837*
Other financial assets (4)	122,625	3.2	3.3	-6,460	3,925
Total assets	**3,663,013**	**100.0**	**100.0**	**56,763**	**69,966**
LIABILITIES					
Short-term debt (5)	58,338	6.3	6.3	-72	2,574
of which: bank	*54,666*	*6.0*	*5.9*	*57*	*2,077*
Medium- and long-term debt (6)	643,404	69.2	69.7	20,368	31,468
of which: bank	*537,998*	*50.1*	*58.3*	*27,608*	*37,333*
Other financial liabilities (7)	221,523	24.5	24.0	-5,285	5,283
Total liabilities	**923,265**	**100.0**	**100.0**	**15,011**	**39,325**
BALANCE	**2,739,748**			41,752	**30,641**

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

Gross financial assets diminished by nearly 1 per cent, less than in 2009, when they fell by 1.7 per cent. The contraction was due to a decline in their value, which was nonetheless smaller than in the previous year. Net financial wealth remained broadly unchanged at 2.6 times disposable income, close to the ratio in the United States and the United Kingdom (2.9) and higher than the euro-area average (2.0).

In 2009, households' net wealth was equal to 8.2 times disposable income. During the decade the financial component of wealth shrank: real assets grew from 58 per cent of the total in 2000 to 68 per cent. The change in the balance between the two components was largely due to the different performance of financial asset prices compared with house prices.

Investment in financial assets. – Investment in financial assets grew with respect to 2009: total net purchases amounted to €70 billion, up from €57 billion (Table 14.1).

There were further substantial net purchases of both postal savings instruments (€12 billion) and life insurance policies (€24 billion), especially traditional policies with minimum return guarantees. Insurance reserves, pension funds and severance pay funds rose to 18.2 per cent of total assets, continuing a 15-year upward trend. Nevertheless, this ratio is still lower than the euro-area average (30.2 per cent), chiefly because of the limited development of supplementary pension schemes.

Net investment in bank liabilities came to a halt last year. Overall, bank funding instruments fell from 28.2 to 27.7 per cent of households' financial assets. In 2010, households made further net disposals of Italian government securities, though far less than in 2009 (€4 billion, against €55 billion); the disposals were of short-term securities. By international standards Italian households' financial portfolios continue to be characterized by the relatively large proportion of bonds (19.8 per cent, compared with the euro-area average of 7.5 per cent), half of which issued by banks.

Net purchases of shares and other equity rose slightly to €48 billion, but these assets fell to 21 per cent of the total portfolio as a result of the decline in share prices during the year. Shares and other equity and investment funds made up 27 per cent of Italian households' financial portfolios at the end of the year, higher than the euro-area average (24 per cent) owing to the high incidence of unlisted shares and other equity. There was an overall net outflow of savings from investment funds, with a reallocation in favour of foreign funds.

Household debt

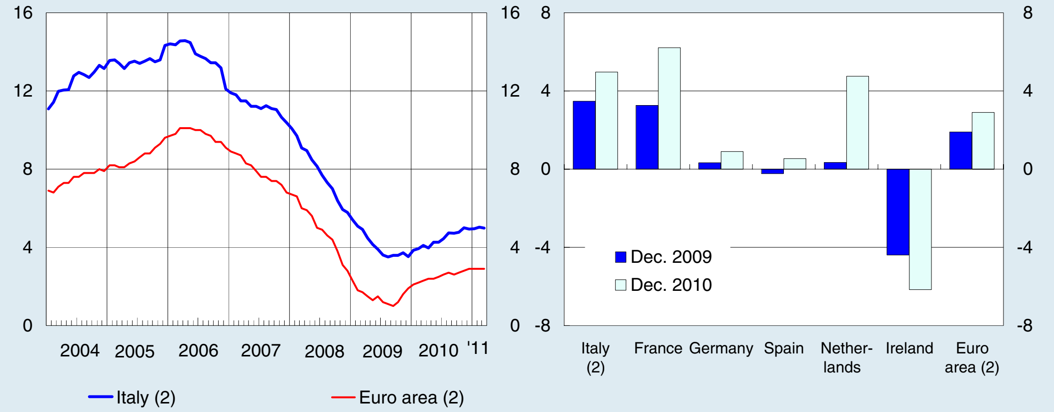
Bank lending to consumer and producer households grew in Italy by 4.9 per cent in 2010, compared with 3.5 per cent in 2009 (Figure 14.1); the expansion in the euro area was more moderate and differed considerably among the main countries. Lending by all financial intermediaries to consumer households alone, net of repos and bad debts, grew by somewhat less (3.4 per cent) and its pace slowed in the first few months of 2011 to 3.2 per cent in the twelve months to March (Table 14.2).

Household financial debt rose to 66 per cent of disposable income (Figure 14.2), less than the euro-area average (99 per cent) and lower than in the United States and the United Kingdom (where the figure exceeds 100 per cent).

Loans for house purchases. – The historically low level of interest rates stimulated consumer households' demand for loans for house purchases, which grew by 3.4 per cent on an annual basis and accelerated in the first few months of 2011 to twelve-month growth of 4.0 per cent in March. In 2010, other loans also recorded strong growth (8.5 per cent), led by general-purpose mortgage loans; the twelve-month rate of growth fell to 6.0 per cent in March.

Figure 14.1

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



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

After two years of decline new lending for house purchases grew by 12 per cent, to €57 billion; excluding subrogations and replacements, which entail the conclusion of a new mortgage loan contract in place of the existing one, the growth rate was higher (19 per cent).

Table 14.2

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

	Percentage changes on previous year					Stock Dec. 2010 (2)
	December 2007	December 2008	December 2009	December 2010	March 2011	
			Loans for house purchases			
Banks	11.8	5.4	1.8	3.4	4.0	326,770
			Consumer credit			
Banks	6.9	7.6	5.2	0.3	-0.3	58,220
Financial companies	21.9	3.1	-0.3	-1.0	-2.5	52,883
Total banks and financial companies	13.9	5.4	2.6	-0.3	-1.3	111,103
			Other loans (3)			
Banks	12.4	8.1	7.3	8.5	6.0	85,869
			Total loans			
Total banks and financial companies	12.3	5.8	2.8	3.4	3.2	523,742

Source: Supervisory reports.
(1) Loans exclude repos and bad debts; households do not include non-profit institutions serving households. The percentage changes are adjusted for the effects of securitizations and reclassifications. The data for March 2011 are provisional. – (2) Including securitized loans. – (3) Other loans consist mainly of overdrafts and mortgages other than those for the purchase, construction or restructuring of residential property.

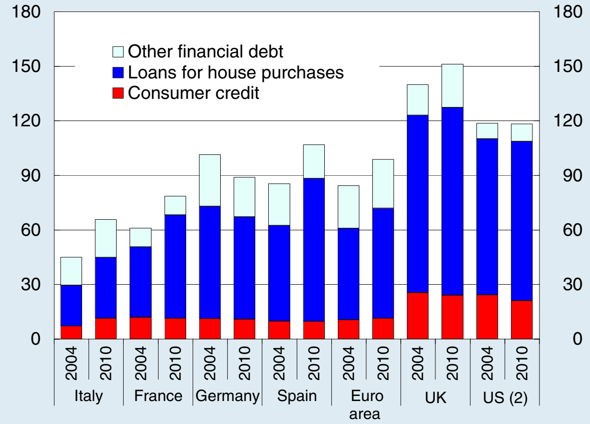
Subrogation mortgages declined from 16 per cent of total new lending for house purchases in 2009 to 13 per cent last year, while replacement mortgages remained stable at about 3 per cent. Renegotiations with the borrower's own bank, which do not require a new contract, involved 2 per cent of outstanding mortgages.

In 2010, more than 80 per cent of new mortgage loans were at variable rates, double the percentage in the euro area. In the final part of the year expectations of future monetary policy rate hikes prompted households to reduce their requests for variable-rate loans. Many households had recourse to loans that cap the increase in instalments. According to a survey of over 400 Italian banks conducted by the Bank of Italy's branches, in 2010 the share of new mortgage loans providing for a cap on interest rates increased to 23 per cent and the percentage of those allowing the term of the loan to be lengthened or repayments to be suspended at no additional cost rose to 26 per cent.

Figure 14.2

Households' debt (1)

(as a percentage of disposable income)



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

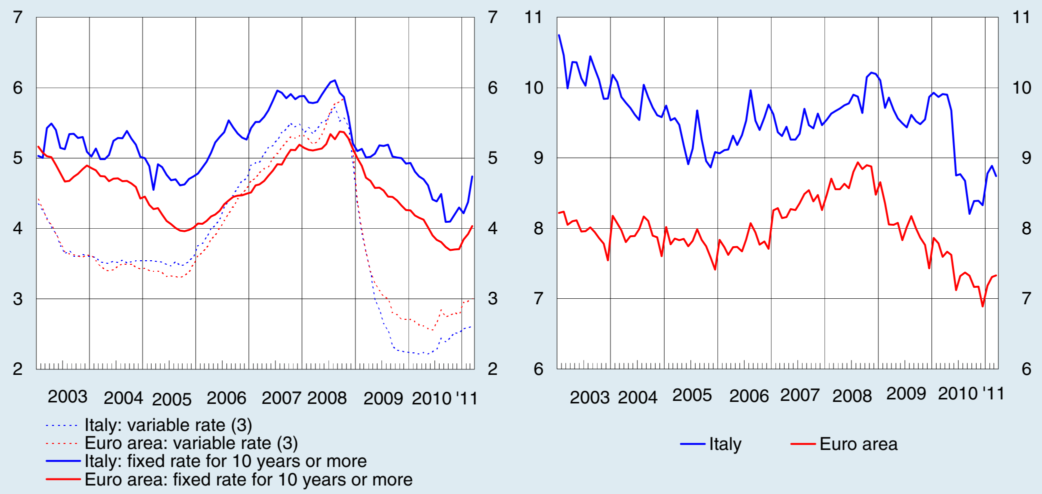
Banks continued to be highly selective in their mortgage lending. The average loan-to-value ratio, which had been close to 65 per cent before the crisis, fell further to 61 per cent.

Figure 14.3

Interest rates on bank loans to households (1)

(monthly data referring to new transactions; per cent)

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



Source: ESCB harmonized statistics.
(1) Consumer households, producer households and non-profit institutions serving households. Contracts concluded during the reference period or which constitute a renegotiation of previous terms and conditions. – (2) APRC on new loans. The APRC includes ancillary expenses (administrative expenses, loan examination fees and insurance). It is calculated as the average rate across all maturities, weighted by loan amounts. From June 2010 interest rates on credit cards are not included. – (3) Variable rate or renegotiable within one year.

Interest rates on mortgage loans. – In 2010, the interest rates on new variable-rate mortgages rose slightly, by 0.3 percentage points, following the trend of the reference rate (three-month Euribor); the increase was in line with that for the euro area (Figure 14.3a). By contrast, the cost of new fixed-rate mortgages for terms of over ten years fell by 0.6 percentage points both in Italy and in the euro area thanks to the decline in the corresponding reference rates (ten-year interest rate swaps); from the end of 2010 onwards this trend went rapidly into reverse. At the end of 2010, the difference between the cost of a fixed-rate mortgage for a term of more than ten years and a variable-rate mortgage was 1.8 percentage points in Italy, almost one point less than a year earlier but still twice as large as in the euro area.

Consumer credit. – In the course of 2010 consumer credit slowed steadily; the growth rate was basically nil at the end of the year and turned negative in the first few months of 2011 (Table 14.2). The slowdown was sharpest for loans granted by banks. Loans for specific purposes diminished significantly, in line with the negative trend in spending for durable goods and, particularly, in new car registrations. By contrast, general-purpose credit continued to expand both in the form of personal loans and in that of loans backed by the assignment of one-fifth of the borrower's salary or pension.

Interest rates on consumer credit. – Bank interest rates on new consumer credit transactions declined before turning upwards at the end of the year (Figure 14.3.b). Taking into account a statistical break in the data series in June 2010, the cost of consumer credit is estimated to have come down by about half a percentage point (to 8.3 per cent at the end of the year).

Indebted households' vulnerability

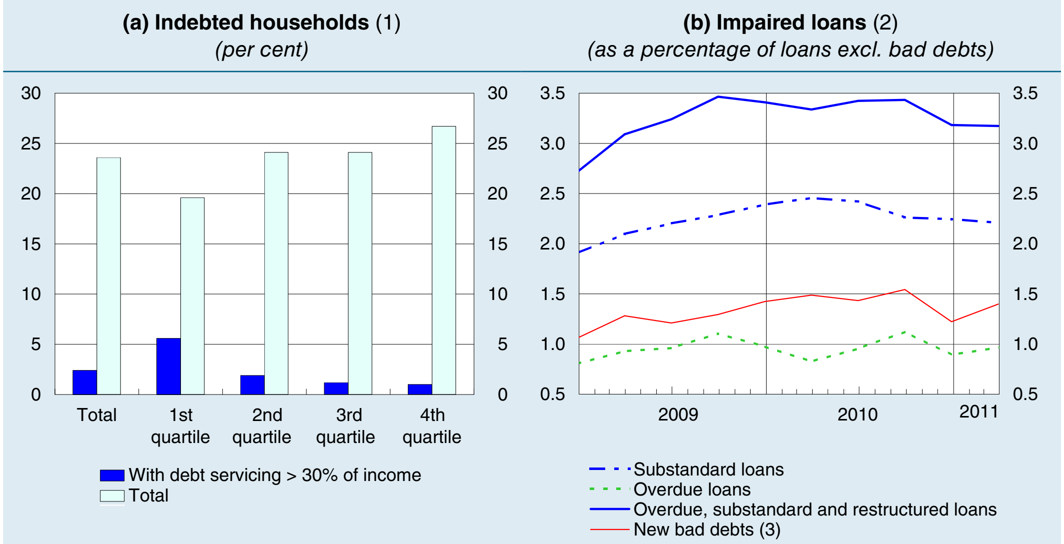
Despite the extremely weak growth in households' income, the steep drop in interest rates and the measures taken in the two years 2009-10 to assist households with mortgages helped to avert an increase in the burden of debt servicing in relation to income. The Bank of Italy's Survey on Household Income and Wealth found that debt servicing for mortgage loans for principal residences, which stood at about 17 per cent of the income of households that had an outstanding mortgage at the end of 2008, decreased in the next two years.

According to the Survey, total debt servicing exceeds 30 per cent of income for 2.4 per cent of Italian households, or 600,000 households in all (Figure 14.4.a). More than half of these households belong to the lowest income quartile and are particularly vulnerable to a drop in income or to increases in loan instalments due to changes in interest rates. These households account for just over one-tenth of total household debt.

In 2010, households with mortgages that from January 2009 onwards suffered an event that reduced their income significantly had recourse to a moratorium on repayments for at least twelve months, an initiative promoted by the Italian Banking Association (ABI) in agreement with the main consumer associations. The moratorium covered mortgage loans of not more than €150,000 for the principal residence of borrowers with income below €40,000. Up to March 2010, some 43,000 households had benefited from the moratorium; their residual mortgage debt totalled €5 billion, just under 2 per cent of the amount outstanding. On the basis of data gathered from intermediaries and the statistics supplied by ABI, it is estimated that the moratoria on mortgage loans in arrears amount to less than one-tenth of the total mortgage loans with overdue instalments.

Figure 14.4

Vulnerability of indebted households



Sources: Banca d'Italia, *Survey on Household Income and Wealth* and supervisory reports.
(1) Percentage of total households and by quartile of equivalent income. The data refer to 2008. Households with a loan of whatever type for family reasons are considered. Income is gross of financial expense. – (2) Loans made by banks and financial companies. – (3) Quarterly data, seasonally adjusted. Flow of adjusted bad debts as a percentage of loans not classed as adjusted bad debts at the end of the previous quarter, calculated on an annual basis.

The measures to support mortgage borrowers and selectiveness in granting credit, which characterized the period after the crisis broke out, also affected the trend in loans on which intermediaries recorded repayment difficulties, which was less negative in 2010 than in the previous year (Figure 14.4.b). Overdue loans remained stable in relation to total loans, at about 1 per cent. The ratio of substandard loans, for which banks report temporary repayment difficulties, edged down from 2.4 to 2.2 per cent. The ratio of new bad debts to total loans fluctuated around 1.4 per cent, still higher than in the period before the crisis, when it stood at just below 1 per cent.

FIRMS

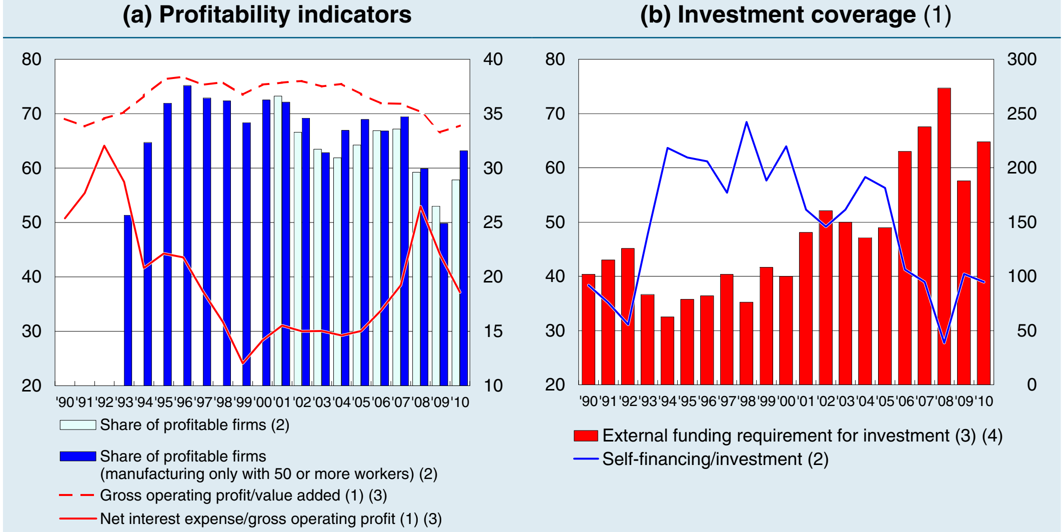
Profitability, financing needs and debt

The external funding requirement. – In 2010, non-financial corporations recouped only part of the previous year's sharp contraction in cash flow. According to national accounts data, gross operating profit rose by 3.7 per cent, but in relation to value added remained close to the historically low level recorded in 2009 (Figure 14.5.a). The decline in interest rates permitted the burden of net interest expense to decrease further, to 18.6 per cent of gross operating profit.

Figure 14.5

Profitability and the external funding requirement

(per cent; indices)



Sources: Based on data from Istat and Banca d'Italia, *Survey of Industrial and Service Firms*.
(1) Estimates based on national accounts data for non-financial corporations, 1990-2009. The data for 2010 are estimated on the basis of the national accounts for that year. Investment includes inventories. – (2) Left-hand scale. – (3) Right-hand scale. – (4) Indices, 2000=100.

Against the background of a modest rise in profitability, the recovery in investment meant a decline in firms' ability to finance their capital expenditure with internal resources (Figure 14.5.b). Also reflecting the expansion of productive activity, the external financing needs grew from €26 billion to €54 billion (Table 14.3).

In recent years the external funding requirement of many firms has been affected by the lengthening of the time for payment of trade credit. Data from the Survey of Industrial and Service Firms with 20 employees or more indicate that the average time to payment, including delays, increased to 104 days, against an average of 100 in the period 2003-06; the payment terms of accounts receivable from general government entities remains twice as long as the average. Compared with the pre-recession years, the difference between accounts receivable and payable, a measure of the external financing need generated by the mismatch between receipts and outlays connected with the trade cycle, widened in 2010 by about half a percentage point of turnover to 5.2 per cent.

Firms' debt and financial structure. – In 2010, firms' financial debt grew by 1.5 per cent to €19 billion. The increase was largest in the medium- and long-term component, in the form both of bank debt and bonds (Table 14.3). The level of indebtedness remained at historically high levels: leverage, defined as the ratio of financial debt to the sum of financial debt and equity at market prices, rose by more than one percentage point, to 46.8 per cent (Figure 14.6).

At the end of 2010, Italian firms' leverage ratio was more than 4 percentage points above the euro-area average and about 12 points higher than in the United States. Compared with other countries, a larger portion of the debt had a maturity of less than twelve months: 37 per cent in Italy, against a euro-area average of 28 per cent.

Table 14.3

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

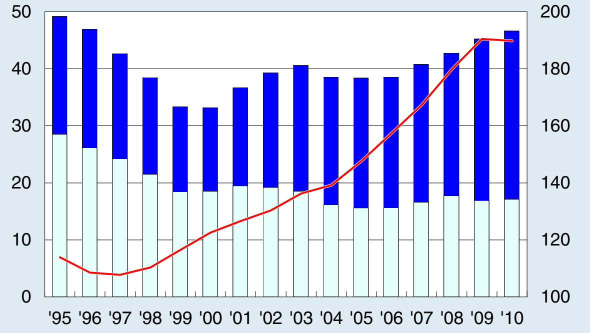
	End-of-period stocks			Flows	
	Dec. 2010	Percentage composition		Dec. 2009	Dec. 2010
		Dec. 2009	Dec. 2010		
ASSETS					
Cash and sight deposits	218,503	15.0	15.3	17,627	4,325
Other deposits	18,606	1.1	1.3	-1,476	3,107
Short-term securities	545	0.1	0.0	-1,360	-700
Medium- and long-term securities	77,833	4.5	5.5	13,187	-3,289
of which: Italian government	*29,316*	*2.3*	*2.1*	*186*	*-1,127*
Italian corporate	*18,462*	*0.1*	*1.3*	*2,662*	*-2,442*
foreign issuers	*15,228*	*1.1*	*1.1*	*366*	*-712*
Shares and other equity	497,897	37.4	34.9	-34,027	-10,498
of which: foreign	*221,707*	*14.0*	*15.5*	*14,365*	*15,941*
Investment fund units	2,144	0.2	0.2	-9	-252
Accounts receivable	516,453	35.6	36.2	-26,800	6,216
Short-term foreign financial credits	18,365	1.3	1.3	12,938	-56
Other financial assets (2)	76,093	4.9	5.3	4,389	5,173
Total assets	**1,426,440**	**100.0**	**100.0**	**-15,531**	**4,027**
of which: external	*345,132*	*22.5*	*24.2*	*37,278*	*17,014*
LIABILITIES					
Total financial debt	1,300,811	36.7	37.5	2,162	19,480
of which: external	*177,969*	*5.7*	*5.1*	*3,502*	*-9,683*
Short-term debt (3)	476,789	13.7	13.8	-55,437	-2,761
of which: to Italian banks	*320,537*	*9.1*	*9.3*	*-46,846*	*1,481*
Medium- and long-term debt (4)	728,722	20.6	21.0	43,329	10,656
of which: to Italian banks	*548,117*	*15.2*	*15.8*	*32,762*	*18,405*
Securities	95,300	2.4	2.8	14,270	11,586
Shares and other equity	1,488,381	44.4	43.0	43,195	22,472
of which: foreign	*238,407*	*6.8*	*6.9*	*15,576*	*8,259*
Accounts payable	497,632	13.9	14.4	-36,095	13,000
Other financial liabilities (5)	178,050	5.1	5.1	1,593	3,113
Total liabilities	**3,464,874**	**100.0**	**100.0**	**10,855**	**58,066**
of which: external	*448,365*	*13.3*	*12.9*	*16,308*	*5,367*
BALANCE	**-2,038,296**			**-26,387**	**-54,055**

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

Faced with a rise in interest rates, Italian firms' high leverage and the large short-term component of their debt constitute factors of fragility. The potential impact of an increase in interest rates also depends on the share of medium- and long-term bank debt at variable rate, which is large in Italy: more than 95 per cent of the new loans granted in the last five years carry a variable rate, compared with 89 per cent in the euro area.

Figure 14.6

Corporate debt (1)
(per cent)



Sources: Bank of Italy and Istat.
(1) The data relate to the non-financial corporations sector. – (2) Left-hand scale. Leverage is calculated as the ratio of financial debt to the sum of financial debt and shareholders' equity at market prices. – (3) Right-hand scale. Value added for 2010 is estimated from national accounts data.

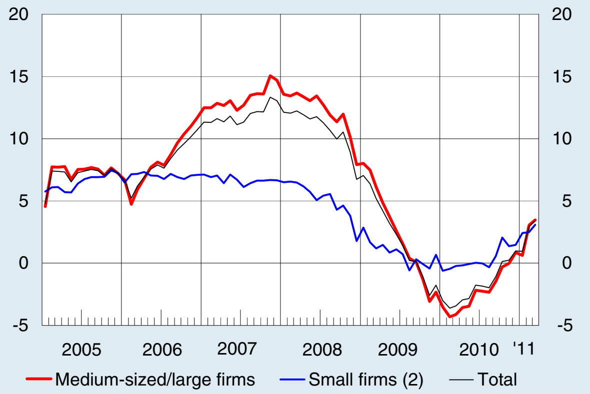
The ability to absorb an increase in interest rates is more limited among the smallest firms. According to the 2009 financial statements in the Cerved database, the leverage ratio of firms with fewer than ten workers was more than 12 points higher than the average and their interest expense was equal to 38 per cent of gross operating profit, high also by comparison with the preceding years.

Credit

Credit demand and supply. – After shrinking continuously for a year, bank lending to firms, net of repos and bad debts, began to expand again in September 2010. The twelve-month rate of growth in lending was equal to 0.9 per cent at the end of 2010; it gained pace in the first few months of this year, rising to 3.3 per cent in March (Table 14.4), corresponding to an annual net flow of about €27 billion. Loans granted by financial companies, consisting mainly of leasing and factoring transactions, displayed a similar trend.

Figure 14.7

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



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

The recovery in lending has involved small and larger firms alike (Figure 14.7). It has been more pronounced for industry, while lending to construction firms has remained very sluggish.

The growth in credit chiefly reflects resurgent demand for new loans. Whereas the growth in 2010 was concentrated in term loans, in the first few months of this year there was a marked recovery in overdrafts, advances and factoring, suggesting that financing needs connected with the production cycle have become predominant.

Table 14.4

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

	Dec. 2007	Dec. 2008	Dec. 2009	Dec. 2010	March 2011
			Banks		
Branches of economic activity (2)					
Manufacturing	11.2	6.0	-7.8	-1.6	2.9
Construction	17.1	13.1	2.0	-0.1	0.5
Services	12.4	6.8	-4.6	-1.1	1.7
Other	9.4	9.5	6.0	8.8	12.3
Technical forms					
Advances and overdrafts (3)	9.1	8.5	-19.0	-1.2	3.3
Term loans	11.5	7.4	5.7	5.0	4.2
Other loans	14.1	5.7	3.6	-4.1	1.0
Total	**12.1**	**7.0**	**-3.0**	**0.9**	**3.3**
			Financial companies (4)		
Leasing	13.0	9.5	-4.0	0.5	1.6
Factoring	15.9	13.1	-14.7	4.6	10.3
Other	-1.6	14.1	-22.8	59.2	51.6
Total	**12.8**	**10.5**	**-7.8**	**3.5**	**5.5**
			Banks and financial companies (4)		
Total	**12.3**	**7.7**	**-3.6**	**1.3**	**3.5**

Sources: Supervisory reports and Central Credit Register.
(1) Data refer to the sectors of non-financial corporations and producer households. Loans exclude repos and bad debts. The data for March 2011 are provisional. The percentage changes are adjusted for the accounting effects of reclassifications and securitizations (except for those broken down by technical form). – (2) Data taken from the Central Credit Register. – (3) Up to December 2008, advances are included in *other loans*. – (4) Data refer to intermediaries entered in the register under Article 107 of the Consolidated Law on Banking and, up to 2008, are taken from the Central Credit Register.

On the supply side, banks maintained highly prudent lending standards, although they did gradually ease the rigid stance they had maintained in 2009. Recent surveys indicate the persistence of restrictive tendencies which, compared with the past two years, mainly concern the terms and conditions at which loans are granted rather than the availability of credit per se.

The Survey of Industrial and Service Firms shows that in 2010 the percentage of firms that received a request for early loan repayment fell by one half from the previous year, to 4 per cent. The share of firms that reported having had their applications for loans rejected in full or in part declined by one percentage point to 6 per cent; these firms were about 20 per cent of those that actually asked banks for new loans. The difficulty of accessing credit remains greater in the South and, more than in 2009, also involved medium-sized and large firms. Firms of all sizes reported that the terms and conditions for loans worsened in the second half of the year, primarily as regards ancillary costs, including those tied to the complex nature of the information that banks request in order to grant a loan.

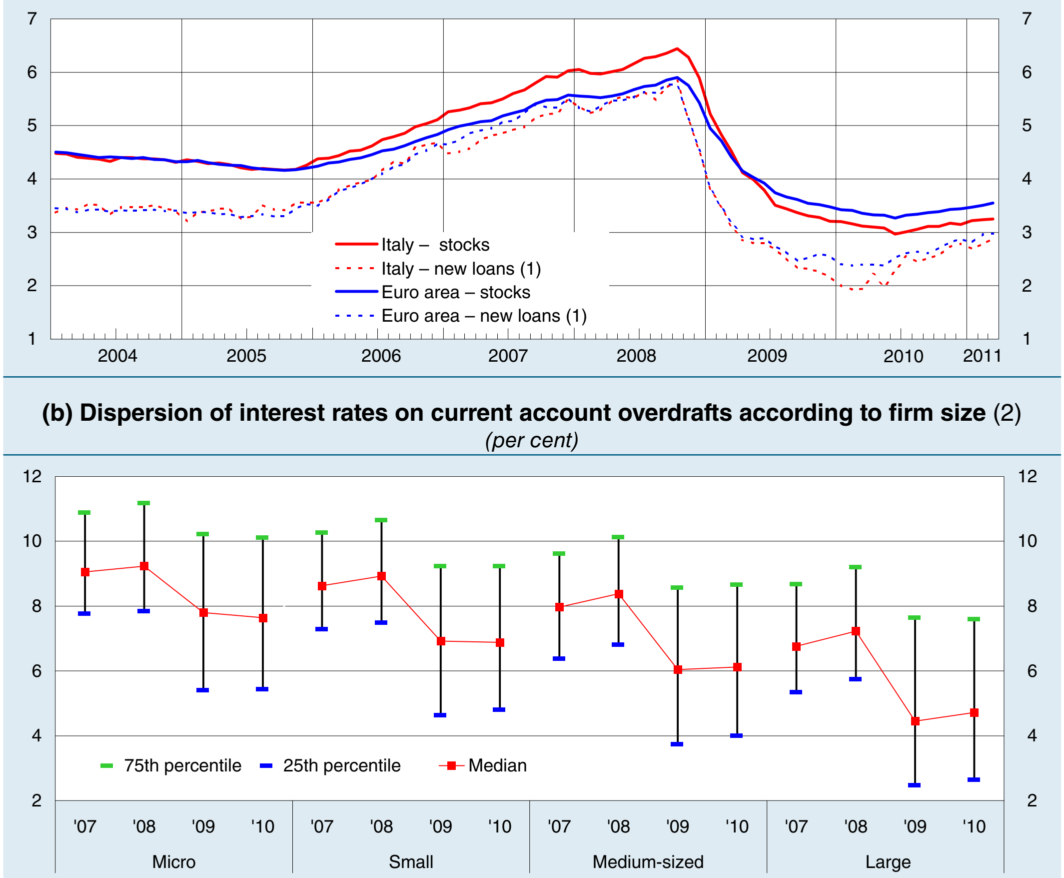
Bank lending rates. – The cost of bank credit fell to an historic low in the central months of the year, when the average rate on the stock of loans to Italian non-financial corporations touched 3.0 per cent (Figure 14.8.a). Interest rates have turned upwards since then, although they have stayed below the euro-area average. In March 2011, the average rate on new loans other than overdrafts stood at 2.9 per cent, nearly 1 percentage point higher than a year earlier.

The difference between the nominal interest rates on current account overdrafts for micro firms, with fewer than ten workers, and large firms, with 250 or more, is equal to about 3 percentage points, a little higher than in the years preceding the crisis (Figure 14.8.b). In 2010, the dispersion of rates around the median remained high for all size classes of firms.

Figure 14.8

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

(b) Dispersion of interest rates on current account overdrafts according to firm size (2)
(per cent)



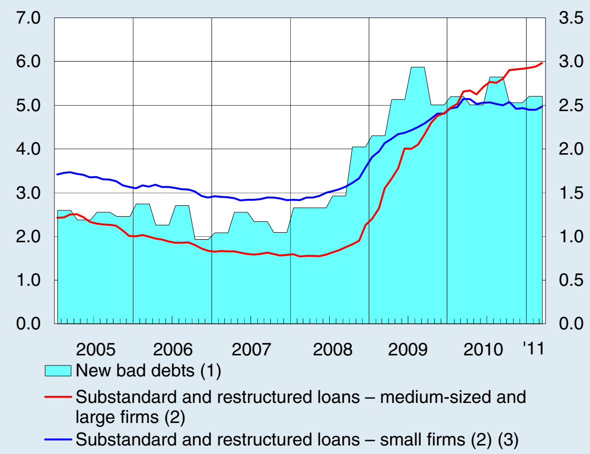
Sources: ESCB harmonized statistics, *Rilevazione analitica sui tassi di interesse*, and Cerved.
(1) New loans. Excludes current account loans. – (2) The interest rates are calculated net of fees and charges. The size classes are defined on the basis of number of workers, turnover and assets.

Measures to support access to credit. – In 2010, many initiatives were continued to mitigate the financial strain caused by the crisis. The main ones, addressed to small and medium-sized firms, made it possible to suspend loan repayments for one year and strengthened the public guarantee instruments. Banks and firms made ample use of these measures, which in some cases were revised or extended in order to enhance their effectiveness. The measures had a significant quantitative impact. The financial resources from which small and medium-sized firms benefited are estimated at more than €35 billion; medium- and long-term loans are reckoned to account for more than half of the total volume of loans disbursed by the banking system from 2009 to the present.

Firms' financial condition and repayment difficulties. – The feeble recovery and uncertainty as to levels of activity and revenues did not allow a substantial improvement in the financial condition of firms, which remained fragile on the whole. Signs of strain are visible in the frequency of business-to-business payment delays, firms' persistent difficulty in repaying bank loans and the still high rate of increase in bankruptcies.

Figure 14.9

Firms' bank loan repayment difficulties
(percentage of loans)



Source: Central Credit Register.
(1) Right-hand scale. Seasonally adjusted quarterly data. Flow of adjusted bad debts as a percentage of loans not classified as adjusted bad debts at the end of the previous quarter, calculated on an annual basis. – (2) Left-hand scale. – (3) Limited partnerships, general partnerships, informal partnerships, de facto companies and sole proprietorships with fewer than 20 workers.

The Survey of Industrial and Service Firms shows that in 2010 the share of trade payables settled after the due date increased by more than 1 percentage point to 28 per cent; the average delay exceeded 60 days. Central Credit Register data on trade debtors indicate that payment delays on the part of construction firms and companies based in the South remained considerably longer than average.

In March 2011, the share of loans on which intermediaries recorded temporary repayment difficulties (substandard and restructured loans) reached 5.8 per cent, a five-year high. Exposures to firms in highly perilous financial circumstances fuelled an annual flow of about €23 billion of adjusted new bad debts in 2010; in the first quarter of 2011, new bad debts amounted to 2.6 per cent of the stock of performing loans at the beginning of the year, not far from the peak reached during the crisis (Figure 14.9).

The finances of large firms and equity capital

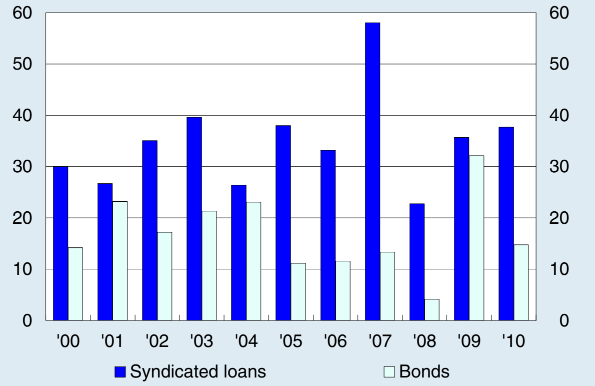
Bonds and syndicated loans. – In 2010, the percentage of firms' financial debt in the form of securities rose to 7.8 per cent, higher than in the past but still low by international standards. Italian firms had less recourse to the bond market than in the previous year. According to Dealogic data, fifteen industrial groups made gross issues on the international markets totalling €14.8 billion, compared with sixteen issuers and €32 billion in 2009 (Figure 14.10). Issuers also included companies that do not ordinarily tap the bond market: the issues of the ten industrial groups that have placed the most securities since 2000 made up two-thirds of the total, compared with an average of 90 per cent between 2007 and 2009.

As in 2009, there was a high level of recourse to syndicated loans. Dealogic data show that gross disbursements rose from €36 billion to €38 billion. In contrast with the pre-crisis years, the new loans were mainly intended to refinance maturing loans and not to finance mergers or acquisitions. The leveraged loan segment, i.e. loans to highly indebted companies, remained small at 7 per cent of the total, compared with an average of 22 per cent in the period 2003-07.

Figure 14.10

Bonds and syndicated loans

(gross issues and new loans; billions of euros)



Source: Dealogic.

Mergers and acquisitions. – After a sharp slump in activity in the market for corporate control in 2009, last year saw a slight recovery in mergers and acquisitions. Thomson Reuters Datastream surveys show that Italian non-financial corporations announced 146 mergers or acquisitions of majority interests, compared with 138 in 2009.

The total volume of transactions came to €3.1 billion, a little higher than in 2009 but well below the average of €6.1 billion in the period 2003-07. These transactions appear to have had a limited impact on credit demand, in part owing to the way they were carried out: the proportion of transactions settled in cash, for which firms usually resort to borrowing, is estimated to have fallen to 50 per cent.

Equity capital. – Firms' shareholders' equity grew by €22 billion in 2010, compared with €43 billion in 2009 (Table 14.3). The abrupt slowdown partly reflected the decline in equity fund-raising; capital increases by listed companies amounted to just over €1 billion, compared with €13 billion in 2009. There were eight IPOs (compared with four in 2009), most of them carried out on the two stock markets reserved to small and medium-sized firms.

According to data published by the Italian Private Equity and Venture Capital Association (AIFI), investment by companies of the sector held at the previous year's modest level, totalling about €2.5 billion. Expansion deals, typically designed to finance mature firms, absorbed nearly a quarter of the resources invested, compared with 14 per cent in 2009. The number of early-stage transactions also grew, but investment in this segment remains very low by international standards. After declining in 2009, fund-raising by firms of the sector more than doubled to €2.2 billion; the increase is largely due to Fondo Italiano di Investimento, which began operating at the end of the year.

15. THE FINANCIAL MARKETS

The Italian financial markets were adversely affected in 2010 by the worsening of the sovereign debt crisis in the euro area, although the impact was attenuated by fiscal rigour and the sound fundamentals of the Italian banking system.

The pressures grew acute at the beginning of May, forcing Greece to request external financing. They eased temporarily following the announcement within the month of a series of support measures by the EU and the IMF, but returned more intense than ever in November, in the days preceding the Irish government's request for financial support.

The various segments of the Italian financial market were affected to differing degrees. The yield spread between Italian and German ten-year government bonds widened to more than 150 basis points in early May and in the subsequent months kept around that level, albeit with ample fluctuations. On the bond and share markets there were significant setbacks for banks and financial companies, with their particular exposure to the sovereign debt risk. As in the rest of the euro area, bond issues by banks and other financial corporations contracted; overall, the sector recorded net redemptions. Issues by non-financial corporations remained substantial.

Risk premiums on the bonds of both bank and non-financial issuers increased. The Italian share index fell, while the euro-area index was unchanged for the year.

In the first few months of 2011, euro-area financial market tensions eased. They reappeared in some countries in mid-April as the Portuguese government requested external financial support and the fears of Greek public debt restructuring spread.

Public sector securities

Supply and demand. – Net issues of Italian public sector securities fell from €86 billion in 2009 to €77 billion last year. This mainly reflected the reduction in the overall general government borrowing requirement. At the end of 2010, the stock of public securities outstanding was equal to 100.1 per cent of GDP, up from 96.9 per cent twelve months earlier.

The average residual maturity of government securities increased by two months to seven years and one month, owing to increased issues of CCTs, while their average duration shortened by two months to five years, reflecting the rise in interest rates. Net redemptions of CCTs fell from €20 billion to €7 billion and those of BOTs rose from €8 billion to €10 billion, while net issues of CTZs fell from €17 billion to €6 billion and those of BTPs from €100 billion to €89 billion. Within the BTP segment, net issues of ten-year paper rose from €11 billion to €29 billion, while for shorter maturities they fell from €30 billion to €20 billion and net issues of securities indexed to euro-area inflation were reduced to an insignificant level, falling from €16 billion to €1 billion. Net issues of Republic of Italy bonds came to €2 billion, after being practically nil in 2009.

Italian local authorities continued to make net redemptions, amounting to €2 billion compared with €1 billion in 2009; new issues were negligible at €100 million. By the end of the year local government securities had fallen from 2.3 to 2.1 per cent of total Italian public sector securities outstanding.

Given low short-term interest rates, households and firms made net disposals of BOTs, CCTs, BTPs and CTZs (€17 billion, €15 billion, €12 billion and €8 billion respectively). Banks made net purchases of BTPs, BOTs and CCTs (€33 billion, €7 billion and €6 billion). Investment funds made net disposals of CCTs and BOTs (€5 billion and €2 billion) and net purchases of BTPs and CTZs (€3 billion and €2 billion). Foreign investors continued making substantial net purchases of Italian government securities (€64 billion), mainly BTPs and CTZs. During the year the share of all Italian public sector securities held by non-residents rose by about 2 percentage points to 52 per cent. Liquidity in the secondary market remained high.

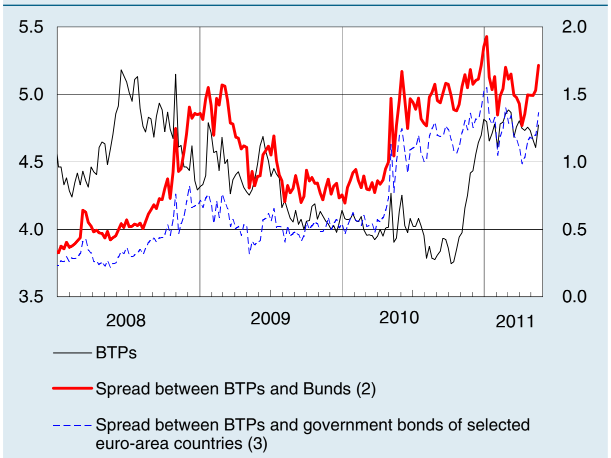
Interest rates. – Rates on Italian government securities fell, albeit with fluctuations, until mid-October last year, but then rose rapidly. Over the twelve months, ten-year rates gained 0.7 percentage points, rising to 4.8 per cent at the end of the year (Figure 15.1). The rise reflected an increase in the risk premium demanded by investors for holding Italian government paper, which more than offset the slight fall in the yields on public sector securities in the euro area stemming from a flight to quality towards the government bonds considered less risky, highly expansionary monetary policy and low inflation expectations. The real ten-year rate, derived from the price of the ten-year bond indexed to euro-area consumer prices, rose by 0.9 points during the year to 2.8 per cent at the end of December. In the first four months of 2011 the yield on the benchmark ten-year bond remained practically unchanged.

The yield spread between the benchmark ten-year BTP and the corresponding German Bund widened by more than one percentage point to 185 basis points at the end of the year. After holding basically stable in the first quarter, the spread increased in April as the rate on the Bund fell sharply, reflecting investors' strong preference for what are considered

Figure 15.1

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

(end-of-week data; per cent 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 the euro-area countries that were rated AAA by all of the main agencies at the end of 2009 (Austria, Finland, France, Germany and the Netherlands); right-hand scale.

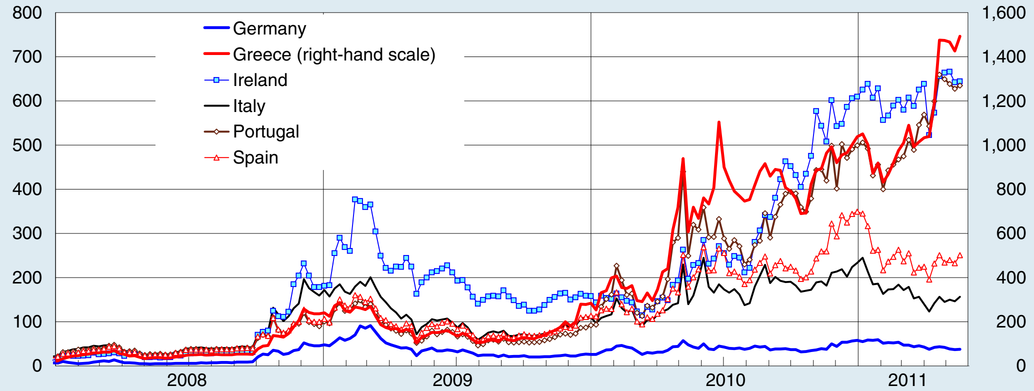
to be safer assets. The propagation of the tensions triggered by the Greek debt crisis was averted by a set of measures for fiscal adjustment in that country and by extraordinary intervention in May by the EU authorities, the ECB and the IMF (see Banca d'Italia, *Financial Stability Report,* 1, 2010). A second, less pronounced, widening came in the fourth quarter, when sovereign yield spreads were affected by the discussion of new rules for crisis resolution in the euro area that would entail government bond-holders' participation in any losses. On 30 November, the benchmark BTP-Bund spread reached 200 basis points, the widest since the introduction of the single currency.

In the middle of January, the spread began to narrow again, albeit with significant fluctuations, as action to increase the financial resources available for financial support to euro-area countries with severe public finance problems began to take shape. It ceased narrowing in April following the new pressures on the sovereign debt of Portugal and Greece. Comparable indications derive from the spreads on five-year credit default swaps for Italian government bonds (Figure 15.2).

Figure 15.2

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

(end-of-week data; basis points)



Source: Thomson Reuters Datastream.

The volatility of interest rates on long-term euro-denominated government securities implied by the prices of options on ten-year Bund futures increased suddenly in late April 2010 and remained high for the rest of the year before coming back down early in 2011.

Corporate bonds and bank bonds

Issuance. – The Italian private sector made net bond redemptions worth €36 billion in 2010, compared with net issues of €138 billion in 2009 (Table 15.1). This sharp turnaround was due to substantial net redemptions by non-bank financial corporations (€36 billion) and banks (€12 billion), in line with the euro-area trend. The result for the non-bank corporations reflected a decrease in securitization issues for use in ECB refinancing operations. The banks' net redemptions depended significantly on decreased international bond market issuance.

Net issues by non-financial corporations remained substantial, slipping only from €14 billion to €12 billion. About half the amount was accounted for by four major groups (Enel, Eni, Autostrade and Telecom Italia). The share issued by small firms remained limited. Issuance continued strong in the first four months of 2011 owing to placements by Terna and Telecom Italia.

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
	2008	2009	2010	2008	2009	2010	2010
Banks	122,368	79,081	-11,799	740,520	819,601	807,045	52
Other financial corporations	70,320	44,212	-36,283	235,714	279,688	243,440	16
Non-financial corporations	67	14,496	11,585	62,340	77,036	88,818	6
Total	192,755	137,789	-36,497	1,038,574	1,176,325	1,139,303	74
Memorandum item:							
International market (3)	152,629	116,270	14,659	959,468	1,113,162	1,052,839	68

(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.

Italian asset-backed securities (i.e. securities issued by special purpose vehicles and covered bonds, which are secured by assets that remain on the issuer's balance sheet) recorded net redemptions of €28 billion last year, compared with net issues of €40 billion in 2009. The reversal was due to decreased creation of securitized instruments to be used as collateral in ECB refinancing operations by banks, which made net redemptions of €40 billion. By contrast, net covered bond issues doubled to €11 billion in 2010 and accelerated further in the first four months of 2011, when they came to €13 billion. The new securitizations mostly involved residential mortgage-backed securities.

Gross issues of Italian commercial paper remained substantial last year at €201 billion, compared with €215 billion in 2009, owing above all to placements by Intesa Sanpaolo, which accounted for a third of the total, and by Eni, Enel and Unicredit.

Yields. – The cost of funds raised via euro-denominated bond issues by investment-grade non-financial Italian and foreign corporations (rated at least BBB- or Baa3) declined by about 0.3 percentage points to 3.3 per cent. The fall in the yield on the government securities of the countries considered less risky more than offset the widening of risk premiums to 1.3 from 1.1 percentage points (Figure 15.3). The cost of bond issues varied significantly in the course of the year, hitting an historical low of 2.7 per cent at the end of August before rising again in the final part of the year. The returns on high-yield bonds fell more sharply, from 10.2 to 8.3 per cent on average for the year. In the first four months of 2011, the yields on investment-grade private sector bonds turned back upwards, rising by 0.5 percentage points in response to the rise in the rates on euro-area government securities.

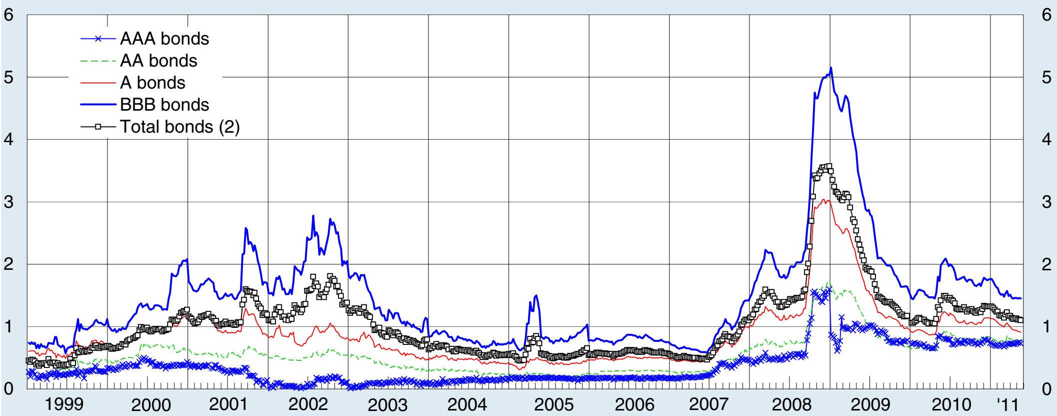
The yield spread on investment-grade Italian corporate bonds widened by 0.6 percentage points in 2010, a larger increment than the 0.4-point rise recorded for comparable firms in other euro-area countries, reflecting the growth gap between Italy and the euro area. In the first four months of this year, however, spreads narrowed by 0.3 points, the same as for other euro-area firms.

The mounting pressure on the sovereign debt of some euro-area countries worked to the detriment of the yield spreads on the bonds of the leading Italian banks, which increased by 0.7 percentage points overall in 2010, against a rise of just 0.2 points for French banks and a decrease of 0.1 points for German. In January-April 2011, the spreads for Italian banks narrowed slightly, in line with those for other euro-area banks.

Figure 15.3

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

(end-of-week data; percentage points)



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

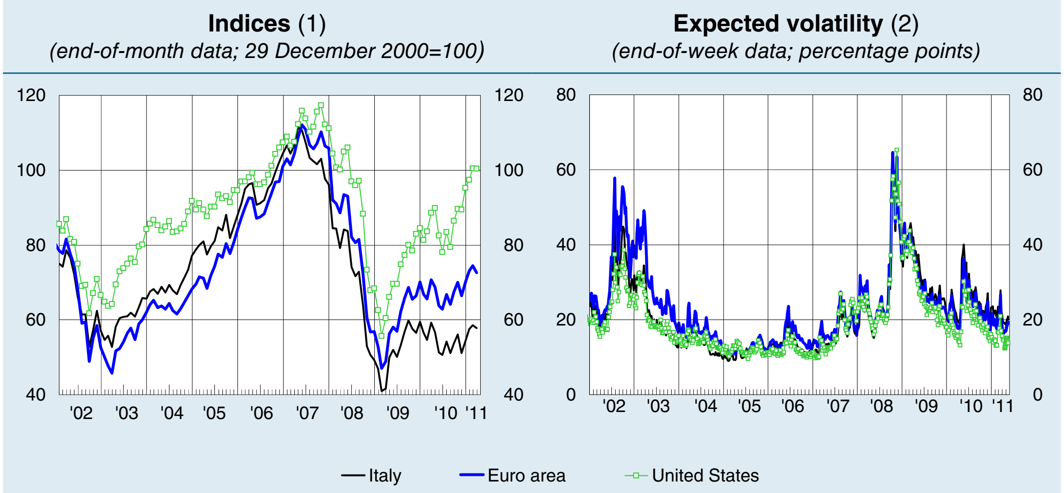
The equity market

Share prices and trading. – The general Italian share price index lost 9 per cent last year, while the main euro-area index remained broadly unchanged (Figure 15.4). The fall of the stock market in Italy mainly reflected the poor performance of financial shares, which account for a larger portion of the Italian index. In the first four months of 2011, the index rose by 9 per cent, more than 2 points better than the euro-area index, although there were sharp ups and downs owing to the protracted strains in the market for the government securities of the euro-area countries deemed most risky, the turmoil in North Africa and the earthquake in Japan.

Automotive, consumer products and basic materials shares rose in 2010, gaining 46, 32 and 22 per cent respectively. As in other countries, the impact of the financial crisis and fears for the sustainability of the sovereign debt of some euro-area countries heavily penalized bank and insurance shares, which lost 30 and 27 per cent respectively. The overall fall in the Italian share index was due mainly to a sharp increase in the risk premium demanded by investors for holding equity and to the rise in long-term interest rates, offset only in part by an improvement in current and expected earnings.

Figure 15.4

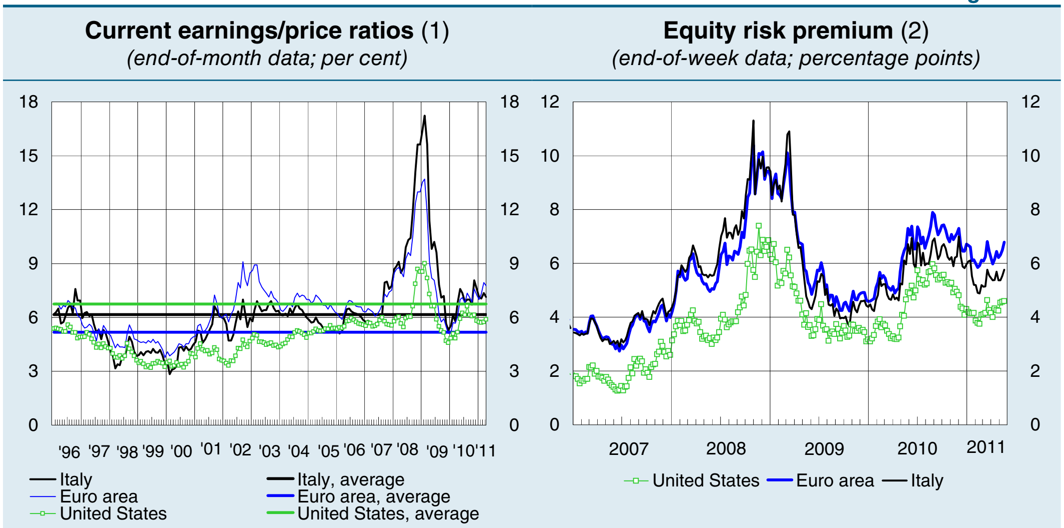
Share markets



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

The expected volatility of share prices jumped in April 2010 in connection with the Greek sovereign debt crisis, then subsided by September to the levels registered at the start of the year. In March 2011, it rose temporarily with the resurgent pressure on the sovereign debt of some euro-area countries. At the end of 2010, the current earnings-price ratio of Italian listed companies was 7.6 per cent, more than 2 percentage points higher than at the end of 2009 and 1.5 points higher than its average since the mid-1980s. Taking short-term earnings expectations into account, the risk premium demanded by investors for holding shares was 5.8 percentage points, down from 5.9 in 2009; this was some 2 points greater than the average for the past ten years (Figure 15.5).

Figure 15.5



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

Supply and demand. – The number of initial public offerings increased modestly in 2010, mostly involving small companies. There were nine IPOs on Borsa Italiana (seven in 2009); seven were in the segments for small and medium-sized firms (two in the MAC alternative capital market segment and five in the AIM Italia alternative investment market segment). The funds raised by IPOs came to €2.3 billion, compared with €160 million in 2009. Fund-raising through capital increases by listed companies was down sharply, from €18.5 billion to €7.2 billion (Table 15.2); 79 per cent of this was raised by banks, which strengthened their capital bases for the third year running. There were four more new listings in the first four months of 2011. The number of IPOs also rose last year in the euro area as a whole, from 34 to 84; in the first quarter of 2011 there were 21.

Table 15.2

Main indicators of the Italian stock exchange

(millions of euros, except as indicated)

	2005	2006	2007	2008	2009	2010
Annual change in prices (1)	13.9	19.0	-8.0	-48.7	20.7	-8.7
Listed Italian companies (number at end of year)	275	284	301	294	291	291
of which: in the STAR segment	*70*	*75*	*82*	*75*	*72*	*74*
Total market capitalization (2)	676,606	778,501	733,614	374,702	457,126	425,099
as a percentage of GDP	*47.3*	*52.4*	*47.4*	*23.9*	*30.1*	*27.4*
percentage breakdown: (3)						
industrials	*26*	*29*	*31*	*33*	*37*	*41*
insurance	*12*	*10*	*10*	*11*	*9*	*7*
banking	*32*	*33*	*30*	*25*	*26*	*20*
financials	*4*	*4*	*4*	*3*	*2*	*3*
services	*26*	*24*	*26*	*28*	*26*	*28*
Total	**100**	**100**	**100**	**100**	**100**	**100**
Gross share issues (4)	12,599	6,098	5,441	7,700	18,541	7,212
of which: in the STAR segment	*279*	*290*	*409*	*238*	*97*	*50*
Market value of newly-listed companies (5)	6,405	12,919	11,178	464	561	8,060
of which: foreign companies	..	..	..	..	*51*	..
of which: in the STAR segment	*797*	*3,620*	*4,243*	..	*226*	..
Dividends distributed (6)	22,907	28,317	30,625	39,072	21,309	16,024
Earnings/price ratio (7)	5.2	5.8	7.8	15.6	5.3	7.6
Dividend yield (7)	3.0	3.2	3.7	8.0	5.0	3.8
Turnover:						
spot market (8)	*893,853*	*1,078,390*	*1,513,634*	*993,511*	*645,993*	*715,147*
FTSE MIB index futures (9)	*585,445*	*761,580*	*954,524*	*698,258*	*418,714*	*560,207*
FTSE MIB index options (9)	*209,526*	*262,312*	*368,966*	*268,264*	*140,345*	*174,918*
Turnover ratio (10)	144	148	200	179	155	162

Sources: Borsa Italiana, Thomson Reuters Datastream and World Federation of Exchanges.
(1) Percentage change in the FTSE MIB index over the year. – (2) End-of-period data. Italian companies. – (3) Does not include the Expandi Market. – (4) The value of share issues is obtained by multiplying the number of shares issued by the issue price. Italian companies. – (5) Sum of the market values of each company on the placement date. – (6) Sources: to the end of 2007, based on Borsa Italiana data; from 2008 and 2009, World Federation of Exchanges data; for 2010, Borsa Italiana data. – (7) End-of-period data. Per cent. Current earnings and dividends. – (8) Italian companies. – (9) Starting June 2009, replaces the contract on the S&P MIB index. – (10) Turnover as a percentage of average market capitalization for the year. Italian companies.

At the end of the year, 291 Italian companies were listed on Borsa Italiana, unchanged from twelve months earlier, and 41 foreign companies. Because of the fall in share prices and despite capital increases, the total capitalization of the Italian companies fell from €457 billion to €425 billion and from 30 to 27 per cent of GDP. The ratio of market capitalization to GDP at the end of the year was considerably higher in the other advanced countries: 43 per cent in Germany, 71 per cent in the four European countries of the NYSE Euronext platform (Belgium, France, the Netherlands and Portugal), 118 per cent in the United States and 134 per cent in the United Kingdom.

The volume of transactions in exchange-traded funds and exchange-traded commodities on Borsa Italiana increased by some 40 per cent last year, from 2.5 million to 3.4 million, and their value rose from €54 billion to €78 billion.

BANKS AND NON-BANK INTERMEDIARIES

16. THE FINANCIAL SYSTEM

Developments over the year

In 2010, the Italian financial system continued to contend with the effects of the crisis and the weakness of macroeconomic conditions. The tensions regarding the state of the public finances of some euro-area countries affected banks' liquidity position and funding costs. The slowness of the economic recovery weighed on credit quality and profitability. The first few months of this year brought signs of improvement in the conditions of access to wholesale funding markets, in part following the completion or announcement of capital increases by several major banking groups.

Bank lending returned to growth, mainly as a consequence of the upturn in lending to firms by the five largest banking groups. The increase in loans reflected the pick-up in demand and was financed chiefly with wholesale funds. In 2010, credit supply conditions continued to be adversely affected by the riskiness of loans and the liquidity and capital positions of the banks. After deteriorating sharply in 2009, the quality of credit remained low, although the growth of impaired loans slowed. The ratio of new bad debts to outstanding loans remained unchanged.

Banks' profitability remained low; earnings diminished and the return on equity fell from 3.8 to 3.4 per cent. The narrowing of the spread between lending and deposit rates led to a further reduction in net interest income; the strains in the markets caused a marked contraction in trading income, offset by an increase in fees. Even though loan loss provisions decreased in amount, their ratio to operating profit remained at the high levels of 2009.

Lower dividend payout ratios, capital increases and sales of non-strategic assets helped to strengthen banks' capital bases. At the end of 2010, the core tier 1 capital ratio stood at 8.3 per cent for the banking system as a whole and 7.4 per cent for the five largest groups. Italy's large banks are less well capitalized than their counterparts abroad, the difference partly reflecting the massive public recapitalizations of some of the foreign banks. However, the capital increases launched this year should narrow the gap significantly.

Banking supervision benefited from integration between micro- and macro-prudential analysis and between off-site and on-site controls. Supervisory activity concentrated above all on credit risk, but special attention was also paid to intermediaries' exposure to liquidity risk and interest rate risk. Checks continued to be conducted for the complete compliance of intermediaries' bylaws with the supervisory rules on corporate governance. The consistency of compensation systems with the principles established in national and international legislation was verified during inspections.

The moderate recovery in economic activity fostered an expansion in lending by non-bank intermediaries, accompanied by an increase in the risk on asset portfolios.

Supervisory activity in regard to intermediaries entered in the register under Article 107 of the Consolidated Law on Banking mainly concerned lending to households; the actions taken were designed to improve intermediaries' relations with customers and their management of distribution networks.

In 2010, there was another net inflow of resources to the Italian asset management sector, though less than in the previous year; the result stemmed mainly from the growth in net life insurance premiums written. The size of Italian institutional investors remains limited: at the end of the year they held 20 per cent of households' financial assets, a very low share by comparison with the leading countries. The net outflow of savings from Italian investment funds gained pace. For the first time the assets of funds set up abroad by Italian intermediaries exceeded those of Italian harmonized funds. The recent legislative measure to eliminate the tax disadvantages weighing on Italian funds removed one of the obstacles to the sector's growth. Individually managed portfolios recorded a net inflow of savings for the second year running. In the supplementary pension scheme sector, below-average returns with respect to 2009 were a brake on the growth of assets under management. The number of persons covered rose significantly in the case of insurance-based pension products.

Controls on asset management companies focused on real-estate funds and private-equity funds, which suffered – in some cases significantly – from the effects of the crisis and the weakness of cyclical conditions.

The structure of the financial system

Banks and banking groups. – At the end of 2010, there were 760 banks operating in Italy, 28 fewer than a year earlier (Table 16.1). During the year five new banks began to operate (two small limited company banks, one cooperative bank and two branches of foreign banks). Thirty-three banks closed as a result of 23 mergers, takeovers or asset transfers, nine liquidations and the conversion of a bank into a financial company. One payment institution was established. The number of banking groups rose by one, to 76.

The number of bank branches fell from 34,036 to 33,640, mainly owing to the closure of 415 branches by the three largest banking groups. The average number of inhabitants per branch is 1,794 (1,486 in the Centre and North and 2,948 in the South), compared with the European average of 2,131 at the end of 2009. There are more inhabitants per bank branch in Italy than in Spain (1,034) and France (1,676), fewer than in Germany (2,077).

At the end of 2010, there were 24 banks or banking groups listed on the stock exchange, down by one from a year earlier. Eight of the top twenty groups ranked by consolidated assets were not listed. The listed groups and banks held 63.9 per cent of system assets, compared with 64.3 per cent at the end of 2009; seven of them are cooperative banks.

Table 16.1

The structure of the Italian financial system

	31 December 2009				31 December 2010			
	Number of intermediaries				Number of intermediaries			
	Banking group members (1)	Investment firm group members (1)	Non-group members	Total	Banking group members (1)	Investment firm group members (1)	Non-group members	Total
Banking groups	–	–	–	75	–	–	–	76
Investment firm groups	–	–	–	18	–	–	–	19
Banks	217	–	571	788	205	–	555	760
of which: limited company banks	*191*	–	*56*	*247*	*178*	–	*55*	*233*
cooperative banks (banche popolari)	*16*	–	*22*	*38*	*17*	–	*20*	*37*
mutual banks (banche di credito cooperativo)	*9*	–	*412*	*421*	*9*	–	*406*	*415*
branches of foreign banks	*1*	–	*81*	*82*	*1*	–	*74*	*75*
Investment firms	15	20	80	115	11	22	78	111
Asset management companies and SICAVs	39	5	160	204	35	6	157	198
Financial companies entered in the special register under Article 107 of the Consolidated Law on Banking	64	–	108	172	69	–	126	195
Financial companies entered in the general register under Article 106 of the Consolidated Law on Banking	72	2	1,337	1,411	73	2	1,213	1,288
Electronic money institutions	–	–	3	3	–	–	3	3
Payment institutions	–	–	–	–	–	–	1	1
Other supervised intermediaries (2)	–	–	2	2	–	–	2	2

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

The degree of concentration of the banking system. – The numerous mergers and takeovers completed in the last decade have led to an increase in the concentration of the banking system. Between 2001 and 2009 the Herfindahl-Hirschman index, calculated on the total assets of the units operating in Italy, increased from 550 to 740 (on a scale of 10,000). Last year the index declined by 20.

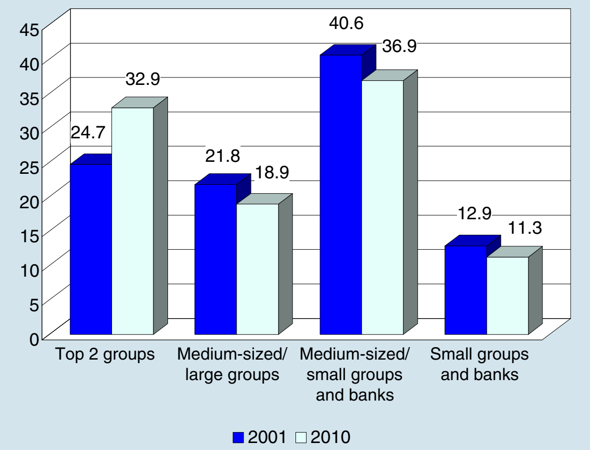
Between 2001 and 2010 the concentration of local credit markets diminished in the deposits and household loans segments. The reduction in concentration reflected the expansion of small intermediaries outside their traditional geographical areas of business, in part through acquisitions of regional or local banks. The degree of concentration rose slightly for business loans. The average number of banks per province increased from 26 to 27.

Classifying banks according to size and group affiliation, the two largest groups (UniCredit and Intesa Sanpaolo) held 32.9 per cent of system assets at the end of

2010, while the three medium-sized/large groups (Banca Monte dei Paschi di Siena, Banco Popolare and Unione di Banche Italiane) held 18.9 per cent (Figure 16.1). A third category, comprising 58 medium-sized/small groups and stand-alone banks (including specialized banks and subsidiaries of foreign groups), accounted for 36.9 per cent of the total. The remaining 11.3 per cent of the total was held by 571 small banks with predominantly local operations. Between the end of 2001 and the end of last year the portion of system assets held by the top five groups rose from 46.5 to 51.8 per cent. The increase is ascribable to mergers and takeovers during the period: at constant end-2010 group perimeters, the share would have reduced by about 10 percentage points.

Figure 16.1

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



Source: Supervisory statistical reports.
(1) Market shares of total assets, calculated using consolidated data for banking groups (with reference to Italian units only) and individual data for banks not belonging to a group.

The degree of internationalization of the banking system. – Exposures to banks and customers abroad decreased slightly as a share of the banking system's total exposures, although the proportion remained high for the largest banking groups. Italian banks' presence abroad with local units is significant in the countries of the euro area, particularly Germany and Austria, and in central and eastern Europe.

At the end of 2010, there were 23 subsidiaries of foreign companies or banks operating in Italy, two of which figured among the top ten banking groups, with 9.5 per cent of total assets. The branches of foreign banks not belonging to Italian groups numbered 76 and held 8.4 per cent of system assets (8.2 per cent at the end of 2009). Thirty-seven foreign shareholders – mainly from EU countries – held equity interests of more than 5 per cent in 47 banks.

Non-bank intermediaries. – At the end of 2010, there were 195 asset management companies in operation, six fewer than a year earlier, and three Italian SICAVs (Table 16.1). During the year fifteen asset management companies were deleted from the register, more than half of them specialized in managing open-end funds, and nine intermediaries were added, mostly operating in the closed-end fund sector. Some 40 per cent of intermediaries are specialized in managing open-end funds and other portfolios (including pension funds).

There were 111 registered Italian investment firms at the end of the year. The twelve deletions from the register during the year were the result of mergers with banks or other financial intermediaries and several voluntary liquidations. Most of the eight additions to the register concerned non-bank-controlled intermediaries active in portfolio management, investment advice and, in one case, management of alternative trading systems. The number of bank-controlled investment firms declined from 25 to 20.

The number of financial companies entered in the special register referred to in Article 107 of the Consolidated Law on Banking rose over the year by 23 to 195. The increase was due to the addition of 35 mutual loan-guarantee consortiums (compared with eight in 2009).

At the end of 2010, there were 1,288 intermediaries entered in the general register referred to in Article 106 of the Consolidated Law on Banking: 901 intermediaries that engage in financial activity on a public basis and 387 securitization vehicles. The registration requirement for the latter has recently been dropped.

The abrogation of Article 113 of the Consolidated Law on Banking resulted in the deletion of 16,900 intermediaries not operating on a public basis that had been entered in a special section of the general register referred to in that article. Also deleted were 425 money-changers, as a result of the repeal of Article 155, paragraph 5, of the Law. At the end of the year there were 633 mutual loan-guarantee consortiums and 126 credit unions (*casse peota*) entered in the other sections referred to in Article 155.

At the end of 2010, loan brokers numbered 128,681 (including 9,353 companies), financial agents 68,437 (5,050 companies) and professional gold traders 285.

17. THE ACTIVITY OF BANKS AND FINANCIAL INTERMEDIARIES

Assets

Lending to residents by banks operating in Italy, net of bad debts and repos, increased by 2.8 per cent in 2010, after falling by 0.7 per cent the year before (Table 17.1 and Figure 17.1). In March, it accelerated to a twelve-month rate of 3.4 per cent. Lending to firms grew by 0.9 per cent, compared with a 3.0 per cent contraction in 2009, while loans to consumer households also gained pace, from 3.2 to 3.9 per cent.

Table 17.1

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

	General govern-ment	Financial and insurance companies	Firms				Consumer households	Non-profit institutions serving households and units n.e.c.	Total
				medium-sized, large	small (2)				
						producer households (3)			
2009 – Dec.	5.3	-6.2	-3.0	-3.5	-0.6	1.1	3.2	3.0	-0.7
2010 – Mar.	4.1	-2.2	-2.9	-3.6	-0.2	1.4	3.8	4.9	-0.2
June	0.9	1.9	-1.8	-2.3	0.0	0.9	4.1	5.8	0.4
Sept.	3.7	3.3	0.1	-0.3	2.1	3.6	3.9	11.2	1.9
Dec.	4.0	6.8	0.9	0.6	2.4	4.4	3.9	14.4	2.8
2011 – Mar.	3.2	2.3	3.3	3.4	2.9	4.8	3.8	16.7	3.4

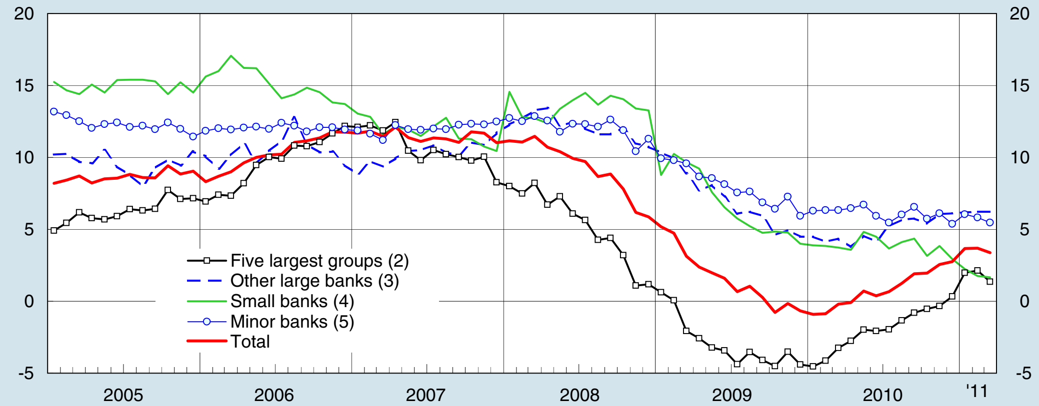
Source : Supervisory reports.
(1) Statistics for March 2011 are provisional. Loans exclude repos and bad debts. The percentage changes are adjusted for the accounting effects of securitizations and reclassifications. – (2) Limited partnerships and general partnerships with fewer than 20 workers; partnerships, de facto companies and sole proprietorships with fewer than 20 workers. – (3) Partnerships, de facto companies and sole proprietorships with up to 5 workers.

The recovery was concentrated in the medium- and long-term segment, which further increased its share of total lending. In 2010, the portion of lending with a maturity exceeding five years grew by almost 2 percentage points to 58.1 per cent, mainly owing to a change in the composition of lending to firms following debt restructuring operations. The lengthening of maturities was accompanied by an increase of over 1 percentage point in the share of collateralized loans to households and firms, which rose to 49.5 per cent.

The growth in lending reflected mainly demand factors, linked to the recovery of economic activity. The responses of the Italian banking groups taking part in the Eurosystem's quarterly Bank Lending Survey indicate that after tightening credit conditions considerably in 2009, they kept them broadly unchanged throughout 2010, although tightening them slightly more for risky borrowers, who were charged higher interest rates and asked for more collateral. According to the institutions interviewed, lending standards again reflected the constraints of capital and liquidity ratios. In the first months of this year, the banks apparently tightened conditions on new loans slightly in view of the worsening expectations for the economy and the increased cost of funding.

Figure 17.1

Bank lending by size class of bank (1)
(monthly data; twelve-month percentage changes)



Source: Supervisory reports.
(1) Statistics for March 2011 are provisional. Loans exclude repos and bad debts. Banks are classified according to the composition of banking groups at March 2011 and to unconsolidated total assets at December 2008. Percentage changes are adjusted for the accounting effects of securitizations and reclassifications. The size classification does not include branches of foreign banks. – (2) Banks belonging to the groups Banco Popolare, Intesa Sanpaolo, Banca Monte dei Paschi di Siena, Unione di Banche Italiane and Unicredit. – (3) Banks belonging to a group and independent banks with total assets amounting to between €21,532 million and €182,052 million. – (4) Banks belonging to a group and independent banks with total assets amounting to between €3,626 million and €21,531 million. – (5) Banks belonging to a group and independent banks with total assets amounting to less than €3,626 million.

Lending by banks belonging to the five largest groups, which had begun to contract in March 2009, returned to growth of 0.3 per cent in December 2010. Some of these banks stepped up their mortgage lending to households significantly, partly in order to reduce the riskiness of assets and partly to increase the stock of assets eligible as collateral in funding operations (covered bonds and securitizations).

The growth in lending by the other large banks accelerated from 4.5 to 6.1 per cent. The expansion was partly the outcome of a growth strategy involving branch purchases that increased the market shares of these intermediaries mainly to the detriment of the five largest banking groups. Lending by smaller banks continued to grow steadily (5.4 per cent compared with 5.9 per cent in 2009), thanks in part to their ability to exploit information on the quality of borrowers obtained through closer business relationships.

The contraction in lending by the branches of foreign banks continued, albeit at a much slower pace than in the previous year (down 1.2 per cent as against 11.0 per cent). The decline was mainly due to the 13.2 per cent reduction in loans to large corporations, which continued to raise funds through bond issues. There was a further expansion of over 10 per cent in lending to households.

Italian banks' holdings of debt securities grew rapidly (Table 17.2). The increase of 18.3 per cent involved principally government securities and was partly financed by using them in money market swaps, especially with central counterparties. The raising of risk premiums on government securities following the sovereign debt crisis of some euro-area countries increased the yield on these types of investments.

Table 17.2

Banks' main assets and liabilities (1)
(monthly data; twelve-month percentage changes and millions of euros)

	June 2009	December 2009	June 2010	December 2010	Stocks at December 2010
			Assets		
Cash	5.9	-11.3	4.9	-4.2	11,155
Debt securities (2)	41.1	27.6	24.0	18.3	348,363
of which: government securities	*38.2*	*34.2*	*31.1*	*26.1*	*208,235*
Loans	2.8	1.0	2.1	4.5	1,903,586
Claims on central counterparties	465.2	316.7	62.5	-16.2	38,239
External assets	2.1	-5.0	-10.9	-13.8	334,240
Claims on resident MFIs					
Loans	*15.2*	*2.7*	*-2.6*	*-5.8*	*372,696*
Securities	*49.0*	*32.3*	*1.5*	*-2.6*	*206,427*
Shares and other equity	11.3	13.3	2.7	7.2	146,251
Other assets (3)	1.3	-13.5	6.4	0.2	389,155
			Liabilities		
Deposits of residents in Italy (a)	4.0	5.1	3.2	-0.9	1,156,464
Deposits of non-residents (b)	-10.7	-8.4	-12.0	2.7	441,825
Bonds (4) (c)	7.1	4.9	-0.8	-1.2	600,655
Liabilities to central counterparties	491.5	91.9	215.0	197.0	115,872
Liabilities to the Eurosystem (d)	87.8	-50.9	5.9	79.8	51,584
Liabilities associated with sales of claims (5)	….	….	….	….	144,557
Liabilities to resident MFIs	20.9	9.9	1.0	-3.8	561,254
Deposits	*12.9*	*3.3*	*0.9*	*-4.6*	*354,828*
Bonds	*49.0*	*32.3*	*1.5*	*-2.6*	*206,427*
Capital and reserves	5.0	6.4	4.8	4.3	349,435
Other liabilities	3.8	-9.4	9.3	1.0	328,466
Memorandum items:					
Net liabilities to central counterparties (6) (e)	::	::	::	::	77,633
Total funding (f=a+b+c+d+e)	2.3	0.2	1.3	4.3	2,328,160

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

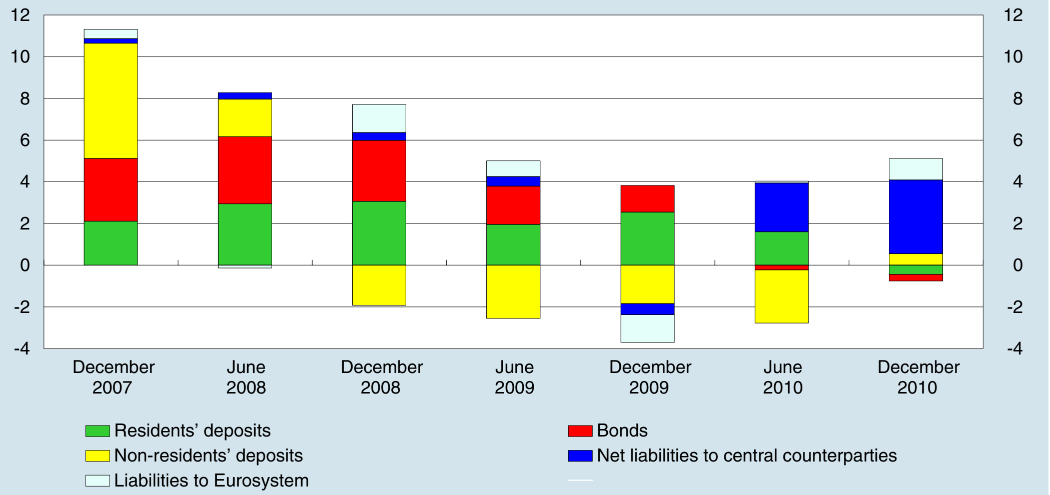
Securities currently represent 22.3 per cent of Italian banks' total assets, a share that continues to be low by international standards.

Funding and liquidity management

The Italian banking system's total funding, excluding liabilities to other Italian banks, grew by 4.3 per cent. Given the slight contraction in deposits of resident customers and bonds, the increase can be ascribed to the expansion in wholesale funding, especially such secured funding as repos (Figure 17.2). Retail funding – deposits from non-financial customers and bank bonds held by investors other than euro-area banks and money market funds – declined by 2 percentage points of total funding. In the case of Italian banks the share continues to be higher than the euro-area average, at 66.9 and 61.3 per cent respectively.

Figure 17.2

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



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

The increase in wholesale funding mainly concerned transactions with the central counterparty managing the MTS market guaranteed by government securities. The balance of Italian banks' credit and debit positions with the clearing house, which was close to nil at the end of 2009, stood at €77.6 billion in December 2010. Funding from this source also offset the reduction in other forms of wholesale funding at the height of the sovereign debt crisis. During these periods of tension the increase in money market rates prompted the banks to step up their recourse to Eurosystem refinancing operations from €28.7 billion to €51.6 billion. Although increasing in absolute value, these liabilities still represented only a small share of total Eurosystem lending, which amounted to 6 per cent in the last quarter of 2010, much less than the weight of the Italian banks in the euro-area banking system as a whole.

Non-residents' deposits increased by 2.9 per cent, mainly as a result of liabilities vis-à-vis foreign banks. These resumed growth after a long period of contraction beginning in the third quarter of 2008.

Deposits of resident customers, which had risen sharply over the previous two years, contracted by 0.9 per cent, reflecting the performance of current accounts of financial companies and households' repos. The twelve-month rate of decline eased to 0.3 per cent in March this year.

After expanding sharply in 2008 and 2009, Italian banks' outstanding bonds declined by 1.2 per cent, against growth of 4.9 per cent in 2009. This performance was due to the steady reduction not only in subscriptions by euro-area banks and money market funds from the autumn of 2008, but also in households' holdings of bonds.

The decrease in the volume of new bond issues mainly concerned unlisted securities, which are taken up largely by retail customers. Placements of listed bonds were broadly stationary, although strains on the sovereign debt market of some euro-area countries acted as a brake on issues for some months in 2010. The banks' wholesale funding capacity was boosted by placements of covered bonds, which amounted to €14 billion, almost double the figure for 2009, and increased from 4.3 to 9.3 per cent of total new issues.

After decreasing progressively from the end of 2008, the average cost of funding turned upwards in the spring of 2010, rising by 22 basis points between May and December. In the second half of the year, the spread between the interest rates on new bond issues and money market rates (six-month Euribor for variable-rate and five-year IRS for fixed-rate securities) widened by 43 basis points, mainly owing to the increase in premiums on sovereign risk.

In the first quarter of 2011, as strains on the markets eased, banks resident in Italy were able to increase considerably their recourse to the primary market for debt securities. Gross issues amounted to €69 billion or 49 per cent of total bonds maturing during the year; a substantial contribution came from international market placements, which accounted for 40 per cent, although at the cost of a substantial increase in the interest rates offered to investors.

The strains on the sovereign debt markets of the euro-area countries had adverse effects also on the short-term liquidity position of the Italian banks by shortening maturities on the wholesale money markets. A Bank of Italy poll of 32 banking groups revealed that their net liquidity position, given by the difference between their expected cash flows and the liquidity available within a period of one month, decreased considerably between May and July 2010 and deteriorated further at the end of the year. In December 2010, their net liquidity amounted to 4.7 per cent of total assets, compared with 7.4 per cent at the end of 2009. However, even in the periods of greatest strain, the ratio was always well above the low recorded in the autumn of 2008.

Risks

Asset quality and credit risk. – In 2010, against a background of weak economic recovery, the quality of credit continued to deteriorate. On the basis of Italian banking groups' consolidated reports, the amount of non-performing loans to customers (bad debts, substandard loans, restructured loans, and overdue exposures or in breach of overdraft ceilings) increased further (by 16.6 per cent), although less sharply than in 2009. The main contributory factor was the growth of 23.7 per cent in bad debts, which account for more than half of total non-performing loans; the share of substandard loans diminished. The ratio of total non-performing loans to total exposures to customers increased slightly, to 9.9 per cent (Table 17.3).

Table 17.3

Quality of loans of Italian banking groups (1)
(end-of-period data; millions of euros and per cent)

	Loans (2)	*of which: residents' share*	Percentage of total balance-sheet loans to customers		Cover ratio (3)	
	2010 (4)		2009	2010 (4)	2009	2010 (4)
	Total groups (5)					
Loans to customers	**1,962,489**	**78.6**	**100.0**	**100.0**	**4.2**	**4.6**
performing	1,767,596	78.1	90.9	90.1	0.6	0.6
non-performing	194,893	83.5	9.1	9.9	40.2	40.5
bad debts	*106,876*	*82.3*	*4.7*	*5.4*	*60.4*	*58.0*
substandard loans	*59,956*	*84.8*	*3.0*	*3.1*	*22.4*	*22.9*
restructured loans	*15,994*	*82.8*	*0.6*	*0.8*	*15.2*	*13.9*
loans overdue or breach of overdraft limits	*12,066*	*88.8*	*0.8*	*0.6*	*6.5*	*7.8*
Loans to banks	**190,228**	**35.7**			**0.3**	**0.3**

Source: Consolidated supervisory reports of banking groups only.
(1) Rounding may cause discrepancies. – (2) Loans are gross of provisions. – (3) Provisions as a percentage of total loans. – (4) Provisional data. – (5) Includes Italian groups controlled by foreign banks.

The adjusted new bad debts of banks and financial companies operating in Italy amounted to €32.8 billion, compared with €31.3 billion in 2009 and €18.3 billion in 2008. The ratio to total loans outstanding at the end of the previous year, excluding adjusted bad debts, was stationary with respect to 2009 at 1.9 per cent. The differences between the various size classes of banks remained largely unchanged: the new bad debt ratio for small and minor banks was slightly higher than for major and medium-sized institutions. In the first quarter of 2011, the ratio of adjusted new bad debts to total loans for the whole banking system stood at 1.8 per cent on an annual, seasonally adjusted basis, 0.1 per cent lower than in the previous quarter.

The flow of new bad debts could remain substantial this year too: the level of other impaired assets is substantial and a not insignificant share of performing loans is to firms in a precarious financial position. This projection is borne out by the estimated default probability of these firms by the end of 2011, which is comparable to that of the previous year. The raising of interest rates against a background of sluggish economic recovery is one of the risk factors for credit quality.

Country risk. – In 2010, the balance-sheet exposure of Italian banks and their foreign subsidiaries and branches to non-residents increased by 0.5 per cent. At the end of the year it was €669.1 billion, equal to 23.6 per cent of their total exposures. The claims on non-residents of the five largest banking groups, which account for 93 per cent of the total foreign exposure, represented 35 per cent of their total exposures.

The most substantial of these exposures were to Germany (€192.6 billion), Austria (€76.6 billion), Poland (€34.8 billion) and the United Kingdom (€34.5 billion). Claims on borrowers resident in Ireland amounted to only €10.1 billion and consisted primarily of loans to firms and securities issued by banks and financial companies.

Exposures to residents of Greece and Portugal amounted to around €3 billion each and consisted primarily of public sector or bank securities.

At the end of 2010, the balance-sheet exposure to the countries of central and eastern Europe, for the most part in the hands of the largest banking groups, stood at €162.7 billion (13.1 per cent more than a year earlier) and 5.7 per cent of the consolidated exposure of the Italian banking system. Some 60 per cent of this exposure was to countries with a fairly high credit rating, indicated by a spread on five-year sovereign credit default swaps that was smaller than the average recorded from 2010, equal to around 200 basis points.

Profitability

Italian banks' profitability remains weak, affecting their ability to increase capital through retained earnings. Profitability deteriorated further in 2010, with ROE decreasing from 3.8 to 3.4 per cent (Table 17.4). Profits declined by 4.5 per cent.

Table 17.4

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

	All banks			Main groups (2)		
	2009	2010 (3)	Change	2009	2010 (3)	Change
Net interest income (a)	56,147	52,656	-6.2	35,680	32,751	-8.2
Non-interest income (b)	37,159	37,232	0.2	22,733	23,229	2.2
of which: fees	*27,231*	*29,975*	*10.1*	*17,204*	*18,545*	*7.8*
Gross income (c=a+b)	93,306	89,888	-3.7	58,413	55,979	-4.2
Operating expenses (d)	58,211	58,858	1.1	35,733	35,668	-0.2
of which: staff costs	*32,587*	*32,983*	*1.2*	*20,330*	*20,241*	*-0.4*
Operating profit (e=c-d)	35,095	31,029	-11.6	22,680	20,312	-10.4
Allocations to provisions and net value adjustments (f)	23,692	21,088	-11.0	16,699	14,601	-12.6
of which: in respect of loans	*20,600*	*17,915*	*-13.0*	*14,625*	*12,140*	*-17.0*
Ordinary profit (g=e-f)	11,402	9,941	-12.8	5,981	5,710	-4.5
Extraordinary profit (h)	1,811	1,766	-2.5	1,735	1,556	-10.3
Gross profit (i=g+h)	13,214	11,707	-11.4	7,716	7,266	-5.8
Taxes (l)	4,670	4,269	-8.6	2,033	2,071	1.9
Profit from asset classes in the process of being liquidated (after tax) (m)	395	1,108	180.5	403	801	98.9
Minority interest profit (n)	663	641	-3.3	460	413	-10.2
Parent company profit (o=i-l+m-n) (4)	8,275	7,905	-4.5	5,625	5,584	-0.7
Indicators *(per cent)*						
Ratio of non-interest income to gross income	39.8	41.4		38.9	41.5	
Cost/income ratio (5)	62.4	65.5		61.2	63.7	
Value adjustments in respect of loans/Operating profit	58.7	57.7		64.5	59.8	
ROE	3.8	3.4		4.1	3.9	

Sources: Consolidated supervisory reports for banking groups and individual supervisory reports for banks not belonging to groups.
(1) Rounding may cause discrepancies. The composition of the banking groups is that at the end of 2010. – (2) Five largest groups by total assets as of December 2010. – (3) Provisional data. – (4) Includes the after-tax profit of banks not belonging to groups. – (5) Ratio of operating expenses to gross income.

Net interest income decreased by 6.2 per cent. Since the volume of lending was unchanged, the reduction was largely due to a further narrowing of the spread between lending rates and deposit rates, which were close to zero. Non-interest income was broadly unchanged, as a sharp drop in trading income due to financial market strains was offset by an increase in net income from fees.

Gross income diminished by 3.7 per cent; there was a small increase in the contribution of non-interest income, to 41.4 per cent. Operating expenses, which had fallen sharply in 2009, rose by 1.1 per cent owing to the 1.2 per cent growth in staff costs. Operating profit fell by 11.6 per cent.

Provisions and value adjustments decreased by 11.0 per cent. Those in connection with the deterioration in loan quality were reduced by the largest amount (13.0 per cent), partly owing to the slower growth in non-performing loans in 2010. However, loan write-downs continued to absorb a large proportion of operating profit (57.7 per cent).

The decline in profit was attenuated by the increase in proceeds from asset classes in the process of being liquidated. Banks' tax liabilities absorbed 36.5 per cent of gross profit, about 1 percentage point more than in 2009.

Capital

In 2010, Italian banks continued to improve their capital position, particularly the components most able to absorb losses. At the end of the year, consolidated regulatory capital amounted to €228.0 billion, up by 4.3 per cent from the end of 2009 (Table 17.5). The increase mainly concerned tier 1 capital, which was boosted by 4.8 per cent to €169.8 billion, by the allocation of earnings to reserves, capital increases and issues of hybrid instruments. Supplementary capital rose by 3.3 per cent to €64.2 billion owing to issues of subordinated liabilities to replace maturing debt. Risk-weighted assets remained stationary overall; those of the five largest banking groups fell by 2.5 per cent.

Table 17.5

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

	Banking system		Main groups (2)	
	2009	2010	2009	2010
Allocations to regulatory capital	5,988	5,171	3,584	3,195
Regulatory capital	218,621	227,957	131,662	136,291
Core tier 1 capital ratio (%)	8.2	8.3	7.2	7.4
Tier 1 capital ratio (%)	8.9	9.3	8.3	9.0
Total capital ratio (%)	12.0	12.4	11.8	12.6
Financial leverage (3) (4)	19	19	22	22
Excess capital	72,699	81,558	42,595	49,454

Sources: Consolidated supervisory reports for banking groups and individual supervisory reports for banks not belonging to a group.
(1) Excludes the Italian branches of foreign banks. – (2) Five largest groups by total assets as of December 2010. – (3) Ratio of total balance sheet assets to tier 1 capital. – (4) Provisional data.

Capital ratios increased compared with the end of 2009. The core tier 1 ratio rose by a tenth of a percentage point to 8.3 per cent and the tier 1 ratio by 0.4 points to 9.3 per cent. The total capital ratio gained 0.4 points to 12.4 per cent.

Large Italian banks' capital ratios continue to be generally low by international standards, partly owing to the very substantial public recapitalizations of the leading European banks. At the end of 2010, the tier 1 ratio of a sample of twelve large European banks averaged 12.1 per cent. The leverage of Italian banks, measured by the ratio of total balance-sheet assets to tier 1 capital, is lower on average: 22 as against 29.

Basel III will have a significant impact on the Italian banking system. However, the lengthy transition envisaged by the authorities will spread its effects over time, allowing the banks to move gradually into line with the new standard, attenuating the possible restrictive effects on lending to firms.

At the beginning of this year, several large banking groups announced capital increases amounting to over €11 billion, compared with €4 billion in 2010, which some of their shareholders, including banking foundations, have agreed to underwrite. The capital strengthening achieved by this means will be accompanied by the gradual reinforcement obtained through retained earnings.

The activity of non-bank intermediaries

Asset management companies. – Asset management companies recorded net profit of €500 million in 2010, 9.3 per cent less than in 2009 (Table 17.6). The decline was largely due to the absence of some extraordinary revenues obtained in 2009. Gross operating profit and operating costs increased slightly, in concomitance with a contraction in the assets under management of Italian companies.

More than one-third of asset management companies (i.e. 68, the same number as in 2009) closed the year with a loss. More than half of them specialize in closed-end funds, especially real-estate funds, and many were only set up in recent years and have not yet obtained a sufficient volume of assets to cover costs.

The ratio of regulatory capital to the overall capital requirements rose from 5.9 in 2009 to 6.4. The growth in the ratio reflected the increase in regulatory capital from €1,770 million in December 2009 to €1,845 million in December 2010 as well as the slight decline in prudential requirements following the reduction in fixed costs. Capital and reserves increased, notably as a result of the closure of some retail real-estate funds and the consequent unwinding of units which current legislation requires asset management companies to keep and deduct from regulatory capital.

Investment firms. – Italian investment firms' profitability continued to improve in 2010, and overall net profit doubled to €116 million. ROE increased from 5.9 per cent to 13 per cent, but was still well below the average of 22.4 per cent for 2006-07, before the crisis. Although still high, the number of firms closing the year with a loss dropped to 40 from 54 in 2009 and 55 in 2008.

The improvement in gross income, which rose by 6 per cent overall, was largely due to the increase in net fee income from underwriting, portfolio management and order collection services. Operating costs remained stationary. The cost/income ratio was 71 per cent, considerably lower than in the previous year.

Table 17.6

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

	2009		2010		Percentage change
	Amount	Percentage (1)	Amount	Percentage (1)	
Fee and commission income	4,002	226.0	4,310	236.9	7.7
Fee and commission expense	2,231	126.0	2,490	136.9	11.6
Gross operating profit (2)	**1,771**	**100.0**	**1,820**	**100.0**	**2.8**
Administrative expenses	1,139	64.3	1,154	63.4	1.3
of which: staff costs	*613*	*34.6*	*624*	*34.3*	*1.8*
Other operating expenses	526	29.7	530	29.1	0.7
Total operating costs (3)	**1,204**	**68.0**	**1,233**	**67.8**	**2.4**
Other operating income	133	7.5	69	3.8	-47.8
Net operating profit	**699**	**39.5**	**656**	**36.0**	**-6.2**
Result on financial operations	107	6.1	109	6.0	1.7
Result on ordinary activities	**806**	**45.5**	**765**	**42.0**	**-5.1**
Taxes	254	14.4	265	14.5	4.0
Net profit (loss) for the year	**552**	**31.2**	**500**	**27.5**	**-9.3**

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

Given their lower exposure to market and credit risk, investment firms' total capital requirements decreased by 19 per cent. The ratio of regulatory capital to the overall requirement rose from 4.3 to 4.9.

Financial companies. – Financial companies entered in the register established by Article 107 of the Consolidated Law on Banking recorded an improvement in their volume of operations and a worsening in the risk on their assets: the flow of loans granted rose by an average of 5.8 per cent. Impaired assets increased from 8.4 to 9.1 per cent of total exposures.

Article 107 companies closed 2010 with profits down by 1 per cent with respect to the previous year. The overall gross income of financial companies increased by 2.3 per cent, insufficient to offset the 3.5 per cent rise in losses on loans. The number of companies posting a loss rose from 43 to 59, representing 24.7 per cent of the total balance-sheet assets of Article 107 companies, compared with 14 per cent in 2009. Again, loss-making companies were most numerous in the leasing and consumer credit sectors.

The solvency ratio decreased slightly from 8.2 to 7.8 per cent, which is above the regulatory level of 6 per cent.

18. INSTITUTIONAL INVESTORS

The Italian asset management industry recorded a net inflow of resources totalling €13 billion in 2010, compared with €17 billion in 2009 (Table 18.1). The result was driven by the net flow of savings into life insurance products. The returns on managed portfolios were positive on average, though less so than in 2009. Assets under management by institutional investors grew from €904 billion to €928 billion.

Table 18.1

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

	Net flows		End-of-period stocks			
	2009	2010 (1)	2009	2010 (1)	Percentage composition	
					2009	2010 (1)
Investment funds (2)	-7,449	-14,974	246,801	229,268	20.7	18.7
Insurance companies (3)	24,436	24,180	442,480	473,632	37.2	38.6
Pension funds (4)	9,081	5,813	50,029	55,842	4.2	4.6
Individually managed portfolios	6,741	6,136	450,333	467,768	37.9	38.1
Total	**32,809**	**21,155**	**1,189,643**	**1,226,510**	**100.0**	**100.0**
Consolidated total (5)	**17,325**	**12,840**	**903,616**	**927,676**	–	–
as a percentage of GDP	*1.1*	*0.8*	*59.5*	*59.9*	–	–

Sources: Based on data from Bank of Italy, Isvap, ANIA and Covip.
(1) Provisional. – (2) Italian investment funds and SICAVs. – (3) Technical provisions. 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 provisions of insurance companies deriving from the management of open pension funds.

At the end of last year investment funds, insurance companies and pension funds had 20 per cent of households' total financial assets under management in Italy, compared with about 45 per cent in France and Germany and 57 per cent in the United Kingdom. Between 2000 and 2010 the share of Italian households' portfolio entrusted to institutional investors shrank significantly owing to the contraction of investment funds, offset only in part by the expansion of insurance products. In the same period institutional investors' share grew in nearly all the other main euro-area countries and remained practically unchanged in the United Kingdom and the United States.

The overall net outflow of savings from investment funds controlled by Italian intermediaries accelerated in 2010. Italian funds continued to record net redemptions, to the benefit of funds established abroad by Italian intermediaries, whose assets exceeded those of Italian harmonized funds for the first time.

For individually managed portfolios and for insurance products, net fund-raising was on a par with the previous year's levels, consolidating the recovery from the net outflows in 2007 and 2008. Households continued to prefer products with relatively low risk and returns, such as with-profits policies. Among supplementary pension schemes, there was a further increase in enrolment in insurance-based individual pension plans and, to a lesser extent, open pension funds, while membership in occupational pension funds declined more sharply than in 2009.

Investment funds

Fund-raising and net assets. – The very substantial amount of net redemptions registered by Italian open-end investment funds (€24.4 billion, compared with €11.1 billion in 2009; Table 18.2) was offset only in part by the net inflow of savings to Italian-controlled investment funds abroad (€11.9 billion, up from €8.0 billion in 2009). The overall net outflow rose from €3.1 billion to €12.5 billion. The net redemptions were concentrated among money market funds and funds that invest chiefly in short-term government securities, while flexible funds, corporate bond funds and emerging market bond funds registered net subscriptions. The low average returns of bond funds and money market funds played a part in determining this pattern.

The share of gross fund-raising for open-end investment funds booked through banks' branch networks, which had fallen sharply in 2009, rose from 69 to 72 per cent but remained far below the levels recorded in the years preceding the financial crisis (78 per cent in 2006). By contrast, the share realized directly by fund management companies declined from 15 to 12 per cent, while that realized by Italian and foreign investment firms and through other channels remained unchanged at 16 per cent. The portion of the total gross inflow that came from households was equal to 83 per cent, virtually the same as in 2009.

Among closed-end funds, net inflows to real-estate funds jumped from €3.6 billion to €9.1 billion; almost all of the increase is ascribable to funds reserved to qualified investors. There were also much smaller net inflows into closed-end securities funds (mainly private equity funds); after net redemptions in 2007 and 2008, net subscriptions grew from €28 million to €295 million. Closed-end funds' share of the total assets of Italian investment funds rose from 13 to 15 per cent.

Supply. – The number of Italian open-end funds continued to decline in 2010, falling from 892 to 842 (Table 18.2). The decrease was mainly due to mergers between funds, in some cases following corporate reorganizations. The contraction was greater for hedge funds and other non-harmonized funds (from 280 to 249) than for harmonized funds (from 612 to 593). On the other hand, the supply of closed-end securities and real-estate funds continued to expand. Average fund size shrank drastically among money market funds (from €1.6 billion to €1.2 billion) as a result of the substantial net redemptions, while in the other main fund categories it increased or held roughly stable.

Table 18.2

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

	Number of funds (2)		Net assets		Net fund-raising (3)	
	2009	2010	2009	2010	2009	2010
Harmonized open-end funds	612	593	185,674	165,061	-6,657	-23,747
Equity	203	173	26,116	23,952	-533	-2,107
Balanced	63	53	14,206	12,726	-2,139	-1,655
Bond	185	185	75,754	74,577	1,031	-2,043
Money market	34	29	55,848	35,407	-2,223	-18,327
Flexible	127	153	13,750	18,399	-2,793	385
Non-harmonized open-end funds	280	249	29,668	29,498	-4,394	-665
Hedge funds (4)	164	145	12,085	10,586	-3,718	-1,562
of which: funds of funds	*146*	*127*	*9,601*	*8,540*	*-3,622*	*-1,189*
Other	116	104	17,583	18,912	-676	897
of which: funds of funds	*62*	*52*	*4,920*	*6,742*	*-699*	*1,710*
Total open-end funds	**892**	**842**	**215,342**	**194,559**	**-11,051**	**-24,412**
Closed-end securities funds	116	132	5,153	6,110	28	295
of which: reserved to qualified investors	*108*	*124*	*4,933*	*5,868*	*49*	*296*
Closed-end real-estate funds	267	296	26,306	28,599	3,574	9,143
of which: reserved to qualified investors	*240*	*269*	*20,017*	*22,394*	*3,563*	*9,011*
Total closed-end funds	**383**	**428**	**31,459**	**34,709**	**3,602**	**9,438**
Total	**1,275**	**1,270**	**246,801**	**229,268**	**-7,449**	**-14,974**
Memorandum items:						
Open-end funds instituted by Italian intermediaries	1,512	1,568	359,118	357,511	-2,927	-9,311
of which: foreign funds (5)	*734*	*834*	*159,182*	*175,863*	*8,000*	*11,886*
of which: hedge funds	*27*	*26*	*4,666*	*2,614*	*-349*	*-478*

Sources: Bank of Italy and Assogestioni.
(1) Italian investment funds and SICAVs. – (2) For Italian funds, those in operation at the end of the year indicated. For foreign funds, those acquired by Italian investors. – (3) For closed-end funds, net fund-raising is calculated as the difference between new subscription commitments received and any redemptions made by asset management companies, as shown in supervisory reports. – (4) Side-pocket accounts are included in net assets and net fund-raising; they are not included in number of funds. – (5) Funds run by management companies resident in Luxembourg or Ireland. Net assets and net fund-raising refer to the value of units held and subscribed, respectively, by Italian investors.

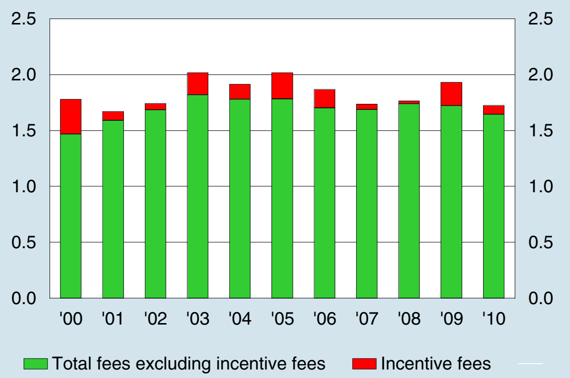
Yields and fees. – In 2010, Italian harmonized funds returned an average of 2.5 per cent net of taxes and fees. The result was better for equity and balanced funds (8.8 and 4.0 per cent respectively), more moderate for bond and flexible funds (1.6 and 1.3 per cent) and slightly negative for money market funds (-0.3 per cent).

The total fees charged to harmonized investment funds remained stable at €2.2 billion, of which €1.8 billion in management fees. After increasing sharply in 2009, the ratio of total fees to average net assets for the year diminished by 0.21 percentage points to 1.72 per cent (Figure 18.1). Incentive fees accounted for almost all of the decrease, falling from 0.21 to 0.08 per cent of average net assets. The incidence of the remaining fees was about the same as in 2009.

The Italian investment fund industry. – The role of Italian intermediaries in the European investment fund market continues to be modest. The assets of funds controlled by Italian groups can be estimated to have represented just 5 per cent of the total assets of European open-end funds in 2009, much less than German and French groups (20 per cent each) and British groups (16 per cent); the assets under management were equal to 23 per cent of GDP in Italy, against 85 per cent in France, 70 per cent in the United Kingdom and 60 per cent in Germany.

Figure 18.1

Italian securities investment funds: total fees (1)
(per cent)



(1) Simple average of total fees paid by the individual funds, calculated as the percentage ratio of total annual fees to average net assets for the year. For continuity with the data for 2000-02, securities brokerage commissions are excluded. The data refer to harmonized investment funds and SICAVs. The data for the last two years are provisional.

In recent years the assets of foreign-controlled open-end funds have grown significantly as a share of the total assets of funds marketed in Italy: according to Assogestioni data, between 2006 and 2010 their share increased from 14 to 24 per cent.

Competition in the asset management sector in Europe is likely to receive a boost from Directive 2009/65/EC (the UCITS4 Directive), which is designed to enhance market integration and investor protection. The ability of the Italian investment fund industry to compete in the European markets, in part by taking advantage of the possibilities offered by the new regulatory framework, will depend largely on the strategic choices of Italy's banking groups, which play a preponderant role in the ownership of asset management companies and the distribution of their products.

At the end of last year 503 of the 842 Italian open-end funds were controlled by Italian banking groups; they accounted for about 80 per cent of total assets. The share of gross fund-raising carried out through bank branches is particularly large for these funds (76 per cent in 2010, against 39 per cent for other funds). In the past years, parent companies' supply policies, aimed at increasing the volume of funds raised from customers, have fostered a flow of savings out of investment funds and into banking product such as bonds and deposits. Between 2006 and 2010 bank-controlled open-end funds recorded net redemptions averaging 21 per cent of their assets, compared with 3 per cent for all other funds.

At the end of 2009, the Bank of Italy issued supervisory provisions concerning bank parent companies' direction and coordination of their asset management subsidiaries. The provisions are intended to enhance the value of asset management companies' independence within groups and regard, specifically, the financial resources to be provided to the companies and standards for the remuneration of distribution networks and the adoption of corporate governance best practices.

Most of the regulatory obstacles to the growth of the investment fund industry in Italy have fallen in the past few years. In particular, the tax disadvantages under which Italian funds had been labouring have been eliminated by recent legislation bringing the taxation of Italian funds into line with that of harmonized foreign funds with effect from 1 July. Under Law 10/2011, the taxation of Italian funds will change from annual taxation levied on the accrued income of the fund to a tax levied on the investor at the time income is received. The previous tax rules resulted in some funds, particularly equity funds, accumulating a large tax credit, an illiquid, non-earning asset item that weighed down their financial performance. From 1 July onwards, that item can be offset by tax withheld by the asset management company, as withholding agent, on income paid out to investors.

Private equity funds. – Between 2000 and 2010, the number of asset management companies running private equity funds rose from 11 to 68, the number of funds in operation increased from 7 to 126, and their assets grew from €580 million to €5.8 billion. Including amounts only pledged but subject to a capital call by fund managers in order to carry out new investments, the resources of these funds amounted to €14.3 billion. At the end of 2010, shares made up some 55 per cent of the funds' assets; the remainder consisted in investment fund units (19 per cent), government securities and liquidity (6 per cent) and other assets, mainly claims on investee companies (20 per cent).

Exchange-traded funds and exchange-traded commodities. – At the end of April 2011, 462 traditional ETFs and 68 structured ETFs were listed on Borsa Italiana. The portion of their assets deposited with Monte Titoli amounted to €19.0 billion for the former and €0.9 billion for the latter (up from €15.0 billion and €0.8 billion in April 2010). ETCs, financial instruments whose value is linked to the movement in the prices of one or more commodities, numbered 95 and had assets of €2.4 billion (compared with €1.4 billion in April 2010). At the end of 2010, households owned 32 per cent of the traditional ETFs and 28 per cent of the structured ETFs on deposit with Italian banks; banks and insurance companies owned most of the rest.

Individually managed portfolios

Individually managed portfolios offered by banks, asset management companies and investment firms raised net new resources amounting to €6.1 billion, somewhat less than the previous year (€6.7 billion). The net outflow of savings from the portfolios managed directly by banks was more than offset by the net inflow registered by asset management companies. The assets of individually managed portfolios grew by 3.9 per cent to €468 billion, or 12.8 per cent of Italian households' total financial assets.

The yield – the percentage increment in net assets less net fund-raising – was 2.5 per cent last year (compared with 7.1 per cent in 2009), a similar figure to the overall return on investment funds.

The portion of individually managed portfolios invested in Italian government securities and foreign investment funds grew, while that consisting in shares, Italian investment funds and other debt securities shrank. Between 2006 and 2010, the portion invested in Italian government securities increased by 13 percentage points to 37 per cent, while the investment fund component fell by 15 points to 26 per cent; over the same period the portion invested in shares, bonds and other financial assets edged up from 35 to 37 per cent.

Insurance companies

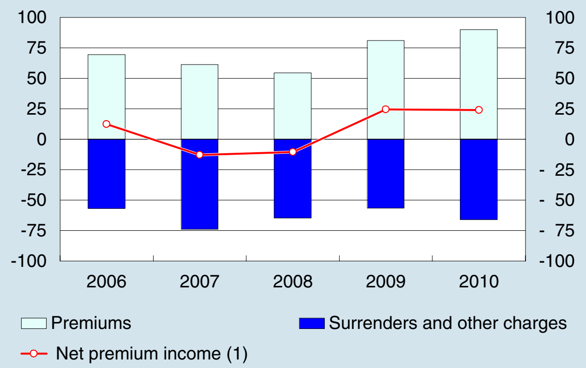
Insurance companies' gross premium income increased at a rate of 8.4 per cent, slowing from 28.1 per cent in 2009. The bulk of the growth came from the life sector, which gained 11.1 per cent; following two years of contraction, the non-life sector showed a modest increase of 2.2 per cent.

Among the products of the life sector, premiums net of surrenders and charges for claims and payments falling due amounted to €24 billion, as in 2009 (Figure 18.2). The net inflow of savings diminished significantly in the second half of the year, nearly drying up in the fourth quarter. Savers continued to prefer products with a guaranteed minimum return, such as with-profit policies (net premium income of €32 billion), and to disinvest from riskier products, such as unit-linked and index-linked policies (minus €9 billion). In the latter sector, however, the net outflow was less than in the previous year, thanks in part to the sale of products offering forms of protection for the capital invested. As in 2009, the flow of savings to life insurance products was sustained by fund-raising through banks' branch networks.

Figure 18.2

Life insurance premium income

(annual data; billions of euros)



Source: ANIA.
(1) Premiums less surrenders and charges in respect of claims and payments falling due.

Sales of pension-related insurance products expanded again. Gross premium income from individual retirement plans grew by 16.8 per cent, more than twice as much as in 2009, almost all the increase coming from with-profits policies. The flow of resources to open pension funds instituted by insurance companies and to the guaranteed sub-funds that insurance companies manage on behalf of occupational pension funds grew by 9.1 per cent; their year-end assets amounted to €6.6 billion (€3.7 billion for open and €2.9 billion for occupational pension funds).

Insurance companies' technical provisions grew by 7 per cent, compared with 10 per cent in 2009, to €474 billion. There was an increase of 9 per cent in those of the life sector and a decrease of 4 per cent in those of the non-life sector. The latter development was entirely due to the fact that two insurance companies acquired by foreign companies are no longer subject to Italian supervision; excluding their provisions, the non-life sector recorded an increase of about 1 per cent.

The market indicators for listed insurance companies, which in 2009 had recouped some of the ground lost at the height of the financial crisis, turned downwards again, in line with the Italian financial sector as a whole. Italian insurance shares underperformed the euro-area insurance share index; they were affected by the downgrading of some companies' credit ratings. Companies' profits for the year did not match the results recorded in 2009 because of the reduction in profits on financial operations.

Insurance companies in Italy are less exposed than those in the other main countries to equity investment risks. According to OECD data, at the end of 2009 deposits and bonds made up about 60 per cent of insurance companies' total financial assets in Italy, compared with 40 per cent in Germany, 50 per cent in the United Kingdom and 55 per cent in France and the United States; shares and investment fund units accounted for 25 per cent in Italy, against approximately 30 per cent in the other countries.

Pension funds

The assets of supplementary pension schemes (pension funds and insurance-based individual pension plans) grew by 13.6 per cent to €67 billion, or 4.3 per cent of GDP (Table 18.3), thanks to the inflow of fresh resources and the revaluation of investment portfolios. The number of workers enrolled increased by 4.3 per cent overall to 5.3 million, increasing again both for insurance-based individual pension plans (14.6 per cent) and, more moderately, for open pension funds (3.4 per cent), but declining by 1.4 per cent for occupational pension funds. Among the main segments, the growth was concentrated in those with guaranteed minimum returns (such as individual pension plans implemented with traditional life policies and the guaranteed sub-funds of pension funds), a pattern fostered by savers' heightened risk aversion in the wake of the financial crisis.

Table 18.3

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

	Number of funds (2)		Persons enrolled (3)		Total assets	
	2009	2010 (4)	2009	2010 (4)	2009	2010 (4)
Pension schemes set up after the 1993 reform	190	183	4,382,245	4,603,954	33,992	41,126
Occupational pension funds	39	38	2,040,150	2,010,904	18,757	22,384
Open pension funds	76	69	820,385	848,415	6,269	7,533
Individual pension plans	75	76	1,521,710	1,744,635	8,966	11,209
Pension funds set up before the 1993 reform	391	375	673,039	667,930	24,864	25,753
Total	**581**	**558**	**5,055,284**	**5,271,884**	**58,856**	**66,879**

Source: Based on Covip data.
(1) Excludes the Bank of Italy staff pension fund. Figures for the number of funds and total assets do not include data for FondInps. – (2) The data for insurance-based individual pension plans and the total only include plans compliant with the requirements of Legislative Decree 252/2005. – (3) Excludes double-counting due to persons being enrolled simultaneously in individual pension plans compliant with Legislative Decree 252/2005 and in other individual pension plans. For funds set up before the 1993 reform, estimates. – (4) Provisional data.

A study conducted by Covip found that the number of members who suspended contributions to their pension fund or individual pension plan rose significantly between 2007 and 2010, presumably reflecting the drop in disposable income during the years of the financial and economic crisis: in 2010, an estimated 13 per cent of payroll workers and 38 per cent of self-employed workers enrolled in a scheme failed to pay in contributions.

Pension funds' financial results were positive on average, though they failed to match those of the previous year, reflecting modest revaluation gains on assets. According to Covip data, the average return (net of management fees and taxes) was

3 per cent for occupational pension funds and 4.2 per cent for open pension funds, compared with 8.5 and 11.3 per cent respectively in 2009. Since they were instituted in 1999, the two forms of pension fund have achieved average annual returns of 3.1 and 2.3 per cent respectively.

Last July, Covip issued new provisions regarding the information that must be given periodically to members of pension funds and individual pension plans. These rules are intended to give members a clearer picture of their accrued position, of the scheme's operating results and of the costs borne by the individual subscriber.

At the end of April 2011, the summary cost indicator, which measures the reduction in the annual percentage yield resulting from the costs borne by the subscriber (except incentive fees) was virtually unchanged from a year earlier. For a 35-year holding period, it averaged 0.2 per cent for occupational pension funds, 1.1 per cent for open pension funds and 1.6 per cent for individual pension plans.

Compared with the countries where the supplementary pension fund sector is more highly developed, in Italy pension funds invest more in debt securities and less in shares and investment fund units. At the end of 2010, some 64 per cent of the total assets of pension funds set up after the 1993 reform was invested in bonds, 19 per cent in shares, 12 per cent in investment fund units and the remainder in deposits and other financial assets (Table 18.4). On the basis of OECD data for 2009, bonds made up a little more than 20 per cent of total assets in the United Kingdom and United States and about 40 per cent in the Netherlands, while shares accounted for about 50 per cent in the UK, 60 per cent in the US and 40 per cent in the Netherlands, the remainder being invested in other financial assets and real estate.

Table 18.4

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

	2009				2010 (2)			
	Pension funds			Non-INPS social security institutions (4)	Pension funds			Non-INPS social security institutions (4)
		Set up before the 1993 reform	Set up after the 1993 reform (3)			Set up before the 1993 reform	Set up after the 1993 reform (3)	
Liquidity	**3,937**	**2,548**	**1,389**	**4,765**	**3,887**	**2,096**	**1,791**	**4,556**
Securities portfolio	**40,008**	**16,232**	**23,776**	**20,511**	**46,212**	**17,842**	**28,370**	**23,650**
Bonds	27,088	10,627	16,461	12,221	30,546	11,318	19,228	13,136
Shares	6,375	1,429	4,946	1,774	7,392	1,719	5,673	1,884
Investment fund units	6,545	4,176	2,369	6,516	8,274	4,805	3,469	8,630
Other financial assets	**2,653**	**2,653**	**..**	**4,909**	**2,551**	**2,624**	**-73**	**4,586**
Real estate	**3,431**	**3,431**	**–**	**9,377**	**3,191**	**3,191**	**–**	**8,721**
Total assets	**50,029**	**24,864**	**25,165**	**39,562**	**55,842**	**25,753**	**30,089**	**41,513**

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 *Other financial assets* is net of liabilities. – (4) Data for 13 institutions.

Efficient financial operations depend in part on having governance arrangements that can resolve conflicts of interest and ensure that boards of directors and control bodies have adequate professional expertise. Despite the progress made following the reforms introduced by Decree Law 252/2005, there are still some elements of weakness in the organizational structure of pension funds. An analysis of the legislative framework governing occupational pension funds and their bylaws shows that stringent professional expertise requirements only apply to half of the members of the board of directors, without specific attention to initiatives for professional training and refresher courses. In addition, in the case of a conflict of interest, the person involved is merely required to disclose the situation.

19. SUPERVISION

International cooperation

The G20 summit in Seoul in November marked a crucial step forward in the action plan approved two years earlier in Washington to forge a sounder financial system and reduce global systemic risk. The summit approved the Basel Committee's proposed reform of capital and liquidity requirements for banks, known as Basel III, and the Financial Stability Board's recommendations for reducing moral hazard at institutions too big or complex to fail. The G20 heads of state and government also undertook to make sure that the implementation of the reforms will be uniform from country to country, thus ensuring a level playing field and averting the risk of market fragmentation and regulatory arbitrage.

Strengthening of prudential regulations on capital and liquidity. – In December the Basel Committee released its new capital and liquidity requirements.

The aims of the new rules are: increased quality and quantity of capital, limits to leverage, attenuation of prudential rules' pro-cyclicality, and more attentive control of liquidity risk. The new standards will be phased in gradually between the start of 2013 and 2019 to enable the banks to comply with the new, more severe requirements without jeopardizing their ability to sustain the economy.

The new capital rules are designed to increase the banks' capacity to absorb losses and their resilience in times of stress. When they are fully phased in the banks will have to have the highest-quality capital, such as ordinary shares and retained earnings (so-called common equity), equal to at least 4.5 per cent of their risk-weighted assets; tier 1 capital of 6 per cent; and total capital of at least 8 per cent. The reform fosters a shift in the composition of capital towards common equity. In addition, the eligibility criteria for other capital instruments have been stiffened and the elements to be deducted have been extended and harmonized.

Further, banks must have common equity capital conservation buffers over and above the minimum amounting to at least 2.5 per cent of risk-weighted assets; otherwise they are subject to supervisory sanctions (such as constraints on dividend payments and bonuses). At times of excessive credit expansion, banks can be required to hold an extra, countercyclical capital buffer equal to 2.5 per cent of risk-weighted assets. The buffers can then be drawn down in a recession when, in the judgment of the national authorities, it is necessary to keep the supply of credit at an adequate level. The discretionary power of the authorities to determine the activation or release of the countercyclical buffer will be constrained by methodologies laid down at international level.

Capital charges were also increased against counterparty risk in connection with derivatives trading and especially high-risk exposures, such as those deriving from trading, securitizations and off-balance-sheet vehicles.

To limit the build-up of excessive leverage, a leverage ratio will be introduced, designed to subject asset growth (on- and off-balance-sheet) to the existence of an adequate capital base and to limit banks' indebtedness during cyclical expansions. Banks will have to have tier 1 capital of at least 3 per cent of non-risk-weighted assets.

To improve liquidity risk management, two quantitative rules will be introduced: a liquidity coverage ratio requiring banks to hold enough high-quality liquid resources to cope with situations of severe stress lasting 30 days without recourse to the market; and a net stable funding ratio to prevent structural imbalance in the composition of liabilities and assets for maturities up to one year.

A quantitative impact study has assessed the effect of the new rules using the data as of December 2009 of a broad sample of banks. The Bank of Italy took part in the study providing data for banks accounting for 75 per cent of the total assets of the banking system. If the reform had been in effect at that time, the banks of the G20 countries would have needed some €600 billion to reach a common equity ratio of 7 per cent (i.e. the 4.5 per cent minimum plus a 2.5 per cent capital conservation buffer). According to the study, Italian banking groups showed a common equity shortfall of €47 billion. Running the same test on the data at June 2010, which incorporate the capital strengthening of some banks, the shortfall was reduced to €40 billion. The estimate does not factor in the possible contribution of retained earnings, nor does it take account of the banks' possible strategies for adapting to the new rules.

The risks connected with systemic institutions. – In October 2010, the Financial Stability Board (FSB) issued recommendations to reduce the probability and mitigate the impact of the default of systemically important financial institutions (SIFIs). The framework calls for action in five areas: the enactment of measures to increase the SIFIs' loss absorption capacity; improvements to resolution regimes to minimize disruptions to the financial system and costs to taxpayers; more intensive and effective supervision; stronger robustness standards for core financial infrastructure to reduce contagion risks; and peer reviews by the FSB to assess the effectiveness and consistency of national policy measures for global SIFIs. The FSB will present a progress report on implementation at the G20 summit this November.

The FSB confirmed that one of the main problems in limiting the risk connected with SIFIs is the inadequacy of the tools for managing the crisis of one of them. A proper regime must be able to prevent the systemic damage caused by a disorderly collapse without risk of loss to taxpayers. To this end the authorities in all jurisdictions should have adequate tools to ensure the continued performance of the institution's essential financial and economic functions, while properly allocating losses to shareholders and some categories of unsecured creditors. By the end of this year the FSB will determine the essential features of effective resolution regimes, upon which national legislative changes should be patterned.

Supervision of SIFIs needs to be intensive and effective. The FSB, in cooperation with the IMF, has issued a set of recommendations drawn from the experience of the recent crisis. The authorities that supervise SIFIs must have a clear mandate, they must be independent and have adequate resources; they must have the tools for timely detection of risks and for taking the necessary corrective actions; prudential standards must reflect the complexity of the institutions and the financial system; supervisory regimes should be reviewed more frequently by international bodies. The FSB and the IMF will verify the implementation of the recommendations at national level to ensure proper and consistent introduction.

Reducing the systemic risk deriving from interconnections of SIFIs with other intermediaries will require strengthening market infrastructures and reforming over-the-counter derivatives, as called for by the G20. In October 2010, the FSB issued a set of recommendations for attaining the objectives set out by the G20 on schedule and in uniform fashion. The implementation of the recommendations by individual countries, still in an initial stage, will be reviewed periodically.

Revision of the international accounting standards. – The project for the revision of international accounting standards for financial instruments (IAS 39) proceeded. Following the publication in November 2009 of IFRS 9 – the standard governing the classification and valuation of financial assets, not yet adopted in Europe – a public consultation was held on the proposed changes regarding credit impairment and hedge accounting. The definitive text is expected to be ready in the summer of 2011. Consultations were also held on other standards, such as those on leasing, insurance contracts and netting. In an innovation, the International Accounting Standards Board formally asked all the institutions potentially affected for suggestions regarding the most efficient way to achieve an orderly transition to the new standards.

The G20 has called for convergence of the International Financial Reporting Standards and the Generally Accepted Accounting Principles of the United States. In this regard, a crucial passage in the field of financial instruments is the choice of a common accounting model adopting a mixed approach (fair value and amortized cost).

Strengthening compliance with international standards and enhancing cooperation. – As part of the framework aimed at achieving greater global compliance with the international standards on financial supervision at global level, last year the FSB conducted its peer review for Italy. The review reports on the progress made in implementing the recommendations of the IMF's 2005-06 Financial Sector Assessment Program, with special regard to the frequency of inspections and the resources allocated to them, the legal protection of the supervisory authority, and the rules on related-party transactions. The finding, released in February 2011, was that the Italian banks had withstood the worst of the crisis thanks to strict rules and supervisory controls that limited investment in the riskiest assets and to a well-balanced, retail-oriented business model.

The reform of supervision and regulatory initiatives in the European Union

The commencement of European supervision. – The new bodies envisaged by the reform of the European financial architecture became operational on 1 January 2011: the European Systemic Risk Board (ESRB), responsible for macro-prudential supervision, and the three micro-prudential European Supervisory Authorities (ESAs), one each for the banking, securities and insurance sectors. The reform lays the basis for closer coordination between national authorities and greater convergence on supervisory rules and practices.

The establishment of the ESRB provides an instrument for detecting potential sources of systemic risk that are not ordinarily captured by micro-prudential analysis.

The ESAs have several mandated tasks: (a) to develop a single rulebook on particular aspects of banking and financial regulations that will be directly applicable in all member states; (b) to take binding decisions to settle disagreements between national supervisory authorities and remedy cases of incorrect application of European rules; and (c) to adopt measures to ensure coordination between national authorities in emergencies. The ESAs can also take decisions concerning individual financial institutions in the cases expressly mentioned in the regulation (for instance, if the national authorities do not comply with the decisions of an ESA).

The new European Banking Authority, in particular, has tasks of coordination of the supervisory colleges for EU cross-border banking groups, risk analysis and monitoring, consumer protection, and management of cross-border crises (for the latter, once the European regulatory framework has been finalized).

The new European supervisory system stresses the need for close cooperation among all components. In particular, the ESRB and the EBA must coordinate activities in several specific areas: (a) systemic risk analysis and assessment in the financial sector; (b) stress testing of European banks; and (c) design of supervisory tools, such as capital buffers that can be exploited countercyclically to contain the excessive build-up of risk during expansions.

European regulatory initiatives. – Work is under way for the transposition of the Basel III prudential rules at European level. This summer the Commission will present a draft proposal for a directive. The EU has also moved ahead on the regulation of the OTC derivatives market, rating agencies, and remuneration. Work has begun on a European regulatory framework for crisis management.

In April 2011, the revision of EC Regulation 1060/2009 on rating agencies was given definitive approval. The regulation had introduced a registration requirement for credit rating agencies and controls in order to ensure that they meet standards concerning independence, safeguards against conflicts of interest, expertise and integrity, valuation methodologies, and transparency. The revised regulation gives the European Securities and Markets Authority (ESMA) powers of registration and control over EU credit rating agencies, previously assigned to national authorities.

The revision of the rules on remuneration culminated at the end of 2010 with the adoption of Directive 2010/76/EC on capital requirements (CRD3) and the issue of the implementing guidelines by the Committee of European Banking Supervisors (CEBS).

The Commission has begun work on strengthening and harmonizing the regulatory framework for crisis management in Europe and, in the second half of 2011, it will present draft legislation for uniform crisis prevention and resolution instruments, reinforced cooperation mechanisms, and procedures to guarantee that the private sector bears a fair share of the cost of crises, in line with the work of the FSB. By the end of 2012, the Commission will promote greater harmonization of insolvency rules.

The Ecofin Council of 16 and 17 June and the European Council of 7 December 2010 encouraged the Commission's actions to create a European regulatory framework for crisis management. At the same time, they reaffirmed that the financial system should help defray the costs of crises.

The Commission has presented a proposal to revise the directive on deposit guarantee schemes aimed at increasing the harmonization of depositors' protection in the EU.

Italian legislation

The measures to adapt Italian law to EC Directives 2009/27, 2009/83 and 2009/111 (collectively known as the CRD2 package) were taken in December 2010 and January 2011. The matters concerned were regulatory capital, corporate governance and liquidity risk management, securitizations, and cooperation between supervisory authorities. The Italian law also took account of the banking supervisory guidelines of the CEBS and the Basel Committee. Regulatory impact assessments were conducted.

Regulatory capital. – Regulations were enacted to enhance capital quality by specifying the characteristics (permanence, payment flexibility and loss-absorption capacity) that hybrid instruments must have in order to count as basic capital. The limits to the instruments' eligibility become progressively less stringent as their capital quality increases.

In addition to the changes consequent to the CRD2 and the CEBS guidelines, Italian regulations were also affected by changes to the "prudential filters", i.e. the adjustments made to accounting net worth for supervisory purposes in order to safeguard the quality of regulatory capital and attenuate the potential volatility that could stem from the application of international accounting standards. In May 2010, the supervisory rules on disposals of property for business use by banks or banking groups were issued. The new rules apply a filter to guarantee that the proceeds of such sales can be counted as regulatory capital only when specified standards of stability and full availability are met.

Compensation and incentives practices within banks. – Following a consultation, in March 2011 the Bank of Italy issued new provisions on compensation and incentive practices at banks and banking groups. The measures implement the CRD3 rules and incorporate the main interpretative and implementing criteria set out in the CEBS guidelines. In order to ensure a uniform, organic regulatory framework, the provisions previously in force were revoked.

Transposition of the CRD3 directive. – Significant provisions of CRD3 to be transposed by the end of 2011 concern the supervisory treatment of securitizations and the calculation of capital charges against market risk. Also, the disclosure requirements relating to market risks in the case of internal models are strengthened and transparency on the exposures stemming from securitizations is enhanced. The changes to be made to Italian supervisory regulations are currently being defined.

Completing the transposition of CRD3 will also necessitate amendments to the Consolidated Law on Banking and the Consolidated Law on Finance. Among other things, the new measures should assign specific powers of intervention to the Bank of Italy (such as the power to limit a bank's overall variable compensation when it is incompatible with an adequate level of capitalization).

The transposition of CRD3 may be the occasion for Italy, in keeping with the Basel Committee's standards and the recommendations of the IMF and the FSB, to grant the supervisory authority the power to remove banks' top officers in the interest of sound and prudent management. With a view to fostering the necessary amendments to legislation, the Bank of Italy has collaborated with the Ministry for the Economy and Finance on this matter and provided technical support.

Banks' eligible holdings and exposures to related parties. – A consultation on draft rules governing exposures to related parties was concluded in August. A second consultation document taking into account the observations received is now being drafted. Consistently with the definitive provisions, the supervisory rules on banks' eligible holdings, which are strictly bound up with the rules on related parties, will also be revised.

Credit to consumers, transparency and financial intermediation. – Legislative Decree 141 of 13 August 2010 substantially amended the Consolidated Law on Banking in order to: (a) transpose the new EU rules on credit agreements for consumers (Directive 2008/48/EC); (b) re-order the legislation protecting bank customers; and (c) reform the provisions governing non-bank financial intermediaries, financial agents and loan brokers. Legislative Decree 218 of 14 December 2010 made some corrections and amended the transitional provisions.

The implementation of Legislative Decree 141/2010 requires a series of regulatory measures. As regards credit to consumers and transparency, a ministerial decree of 3 February 2011 laid down the principles and fundamental criteria for the transposition of the directive within the narrow margins allowed by maximum harmonization. The decree also amended the resolution of the Interministerial Committee on Credit and Savings of 4 March 2003, the cornerstone of regulation on transparency and conduct of business for financial intermediaries. Also in February, the Bank of Italy issued provisions implementing the decree as far as credit to consumers is concerned.

The reform of the rules on non-bank intermediaries and financial agents and loan brokers needs to be completed with implementing provisions and the formation of the self-regulatory bodies, to which Legislative Decree 141/2010 assigns some control tasks. Under the law, this must be done by 31 December 2011. Pending completion of the reform, the previous regime remains in force.

Legislative Decree 141/2010 assigns the Bank of Italy to oversee the self-regulatory bodies, which are to have financial and organizational independence. To complete the implementation of the Decree's rules and principles on schedule, the work towards the constitution of these bodies is proceeding expeditiously.

Qualifying holdings in banks. – In December 2010, the Bank began a consultation on its proposal to the Interministerial Committee on Credit and Savings for a resolution implementing the new provisions on holding in banks that Legislative Decree 21/2010 inserted into the Consolidated Law on Banking. The new rules, which transpose Directive 2007/44/EC, also apply to the parent companies of banking groups, payment institutions, electronic money institutions, and the financial intermediaries governed by Title V of the Consolidated Law on Banking Law, as amended.

Asset management. – Regulatory provisions in this area involved adaptation to changing national and Community legislation. In April 2011, the Ministry for the Economy and Finance began a consultation on a draft legislative decree amending the Consolidated Law on Finance in transposition of Directive 2009/65/EC on harmonized collective investment undertakings (the "UCITS4" directive). The Bank of Italy, together with Consob, collaborated on the drafting of the text. The set of transposition measures also requires amendments to the regulations of the Bank of Italy and Consob, on which a consultation has recently been initiated. The Bank of Italy took advantage of the occasion to simplify and rationalize its own regulations.

In May 2011, the Treasury Department concluded its consultation on a new scheme of regulation pursuant to Article 37 of the Consolidated Law on Finance, implementing Article 32 of Legislative Decree 78/2010. The scheme amends the rules on collective asset management and the tax treatment of real-estate investment funds. In July 2010, the Bank of Italy and Consob published a joint communication on the valuation of investment funds' holdings of real estate.

Supervision of banks

Considering the weakness of the macroeconomic context, characterized by a sluggish recovery in economic activity and by renewed strains in the financial markets, supervision focused on the evolution of credit risk, on the exposure to interest rate risk and on liquidity positions. The possible effects on risk profiles and on the efficiency of internal controls deriving from banks' strategies to recoup profitability were assessed. The closest attention continues to be paid to capital adequacy.

Approach to the main risks. – Supervisory activity has been directed on a priority basis to monitoring the evolution of credit quality. Performing loan portfolios with signs of anomaly have been the object of a specific examination, conducted through both on-site and off-site activities. The analysis under way will make it possible to verify the adequacy of monitoring instruments and to gauge the risk of underestimating the deterioration in loan quality because of possible delays in classifying positions whose performance is anomalous

The effects of the significant fall in short-term interest rates in the last two years and observation of some of the banks' strategies for countering the pressure on profitability induced the Bank of Italy to focus more closely on interest rate risk. An assessment of the techniques and processes used for measuring this risk was included among the objectives of all the inspections of leading banks in 2010.

The instruments for monitoring liquidity were strengthened from the early months of 2010 onwards with a view to maintaining strong safeguards against liquidity risk. Discussions with banks' cash management and risk management units were intensified. Targeted inspections were often followed by calls for prompt corrective measures in view, among other reasons, of the new rules established by the Basel Committee. A new format for reporting banking groups' liquidity position was prepared, to acquire additional information on structural characteristics and facilitate comparison among intermediaries.

Greater use was made of banks' management data to assess risk exposures, and checks on the quality of internal data were consequently enhanced. This made it possible to anticipate and supplement the information contained in supervisory reports.

Banks' internal audit and compliance functions were asked to analyse the possible legal and reputational risks associated with marketing policies stressing the growth of fee income.

Capital strengthening. – The capital levels of banks and banking groups were assessed with respect both to the amount of risks taken on and to the quality of capital composition, with preference given to the components best able to guarantee solvency. In some cases on-site checks assessed the reliability of internal reporting and control procedures concerning the prudential aggregates. Evaluation of the prospective impact of Basel III involved a considerable effort. As a result of the analysis of the quality of capital, a re-examination of some particularly complex structured debt instruments issued in the past was initiated, to check their conformity with the new prudential rules. In part at the prompting of the Bank of Italy, numerous capital strengthening operations – capital increases for the most part – serving to hasten the convergence of the Italian banking system towards the new international standards were decided in 2010 and the early months of 2011.

Governance, compensation, organizational and control structures. – In several cases the need to strengthen banks' risk management capacity led the Bank of Italy to request the simplification of groups' structures, the elimination of overlaps and duplications, and improvements of the quality of information systems. The Bank of Italy recommended that parent companies reinforce their direction and coordination of foreign as well as domestic subsidiaries and ensure the integration of IT platforms and the uniformity of risk measurement models within the group. A request was made that corporate governing bodies be involved to a greater extent in selecting risk profiles and levels.

Further measures were taken urging complete compliance of banks' bylaws with the provisions regarding corporate governance. Cooperative banks were reminded of the need to identify suitable instruments and ensure greater participation at membership meetings and adequate representation of minority interests within the governing bodies.

More vigorous action was taken to promote the compliance of compensation systems with the principles laid down by legislation. Executive compensation and incentives policies and practices were also examined in the course of inspections. All banks were asked to improve the quality of their information to shareholders.

Checks on internal models for quantifying capital requirements for Pillar 1 risks. – Analyses of the adequacy of the internal models already validated by the Bank of Italy outnumbered new validation procedures in 2010. Aspects of particular importance in this context were the assessment of whether the conditions for extending the models in use to new portfolios, products and entities were satisfied, and checks on the internal processes for periodic revision of already validated models.

The functionality and performance of internal models were analysed by making flexible use of all the possibilities for direct interchange with the banks; there was constant coordination with foreign authorities regarding cross-border groups, both in the case in which the Bank of Italy is home supervisor and where it acts as host supervisor for the Italian subsidiaries of international groups. These assessments often indicated that there are margins for improvement in regard to organizational, quantitative and IT factors. In many cases the issue of authorizations was accompanied by the application of specific temporary measures in respect of capital (floors and add-ons to the requirements determined by the internal model) that can be removed once the model becomes fully compliant with the regulatory standards.

Supervision of Italian-controlled international groups and Italian subsidiaries of foreign banks. – The changes introduced by the Second Capital Requirements Directive (CRD2) have had a significant impact on the activity of supervisory colleges.

Since the beginning of 2011, six new colleges have been instituted (Banca Monte dei Paschi di Siena, Banco Popolare, Banca Popolare dell'Emilia Romagna, Unione di Banche Italiane, Credito Emiliano, and Mediobanca) which, in accordance with the principle of proportionality, will operate with simplified procedures. Two additional colleges (Banca Leonardo and Banca Mediolanum) will be instituted before the end of the year.

The work of all the supervisory colleges of which the Bank of Italy is a member was devoted primarily to setting up the Joint Risk Assessment and Decision (JRAD) process, through which prudential supervision of cross-border banking groups will be performed jointly by EU home and host authorities from this year on. The commitment to share analyses and methodologies, harmonize processes and coordinate activities in order to reach a common approach to assessing groups and their individual components has been especially significant for the two Italian groups most active internationally, regarding which interchange with the foreign authorities is now continuous.

Supervision of foreign banks' Italian subsidiaries brought out some problem situations with regard to the quality of the international capital adequacy assessment process (ICAAP) and, as with the rest of the banking system, the need for a general increase in capital endowment and liquidity buffers. The related interventions were coordinated with the home authorities.

Supervision of specialized banks. – Specialized banks are a set of intermediaries some of which engage in lending (leasing, factoring, consumer credit and granting of guarantees) and others in investment services. For the former, supervisory checks concerned their capacity to absorb the adverse effects of the 2008-09 recession on credit quality; special attention was paid to verifying their liquidity in relation to the structure of their liabilities, which consist mainly of interbank funds and debt securities. Banks operating in investment services have generally regained pre-crisis market shares and profitability. Analysis of these intermediaries centred on organizational safeguards and controls on operational and reputational risks, especially as regards the door-to-door marketing of products, and market risks.

Supervision of local banks. – Although the overall situation of these intermediaries was satisfactory in 2010, there was a decline in their profitability and credit quality. The deterioration stemmed not only from the difficult macroeconomic situation but also from governance and organizational structures that in some cases were not optimal. Analyses of the drivers of recent crises of local banks confirm that deterioration in the balance-sheet situation was accompanied by serious deficiencies in governance structures and control systems.

The measures taken vis-à-vis these intermediaries were geared to the different situation of each of them and directed in particular at checking the appropriateness of risk management and control systems to the banks' operational complexity. Special attention was paid to profitability, among other things with a view to capital strengthening, given a particularly rigid cost structure and a worsening trend in the quality of the loan portfolio. Supervisory action was accompanied by targeted analyses of the increase in market shares of loans to small and medium-sized enterprises and of profitability, one of local intermediaries' most vulnerable points.

Inspections. – On-site controls, the preferred means of investigating intermediaries' strategies and organization, provided information on the initiatives taken in the areas of risk management, operating processes and control systems. An assiduous presence was maintained at the major groups; for other banks, inspections were mainly conducted at those most exposed to credit risk.

In 2010, the inspections carried out at banks and intermediaries belonging to banking groups, in some cases extending to foreign components in cooperation with other authorities, numbered 159 (154 in 2009). The number of broad-spectrum inspections, mostly involving minor banks, was almost identical (116 against 115), while the number of targeted inspections diminished from 30 to 28 and that of follow-up inspections increased from six to eight. The number of on-site checks of internal risk measurement models rose from three to seven. In December, three thematic inspections were launched, in part for macro-prudential information purposes, concerning the methods of managing the loan portfolio most exposed to the risks stemming from the recent recession.

Supervision of non-bank intermediaries

Asset management companies. – In 2010, the Bank of Italy continued to monitor the risks for asset management companies stemming from the troubles of their collective investment undertakings. It also focused on the numerous extraordinary transactions carried out by intermediaries in order to rationalize and reinforce their structures.

Hedge fund managers proceeded with gradual disposals of the illiquid assets that had been placed in side-pocket accounts in 2008 and 2009. Their assets decreased by nearly half in the course of 2010.

The crisis eroded the financial soundness of closed-end funds, exposing problems in investment management in terms of conflicts of interest and in the safeguards against risk at some companies.

In the field of private equity funds, in some of which the financial situation has deteriorated owing in part to the adverse macroeconomic situation, controls concentrated on the measures taken to manage the difficulties of target companies and on disposals of holdings. The number of new initiatives fell significantly, reflecting the difficulty of obtaining bank financing and increased risk aversion among institutional investors.

The Bank of Italy examined numerous plans for the corporate reorganization of asset management companies. In the open-end fund sector (including open-end hedge funds), most of these projects are connected with consolidation in the sector or with intra-group rationalization. Some operations resulted in the creation of independent management companies not controlled by banking groups. In the closed-end fund sector, some of the changes in ownership structure were designed to relaunch the activity of operators that were having difficulty in the market.

Supervisory action aimed at ensuring that the control and governance arrangements resulting from corporate restructurings were consistent with the principles of sound and prudent management and accompanied by adequate measures to strengthen risk management and control systems.

Investment firms. – In 2010, the main focus was on the firms with the most serious problems, associated largely with anomalies in their organizational structure and technical situation. Firms were called upon to improve their governance systems and to monitor outsourced corporate functions more carefully. In some cases recurrent operating losses, due in part to the persistent effects of the crisis, and the weakness of capital bases led to changes in ownership structures, with the consequent revamping of growth strategies, or to consolidation with other companies belonging to the same banking group; in the worst cases, the deterioration in corporate conditions led to firms' exit from the market.

Supervisory interventions also regarded the investment firms most recently entered in the register, most of them small and encountering difficulty in pursuing their growth objectives. In conformity with the principle of proportionality, intervention in these cases aimed at strengthening firms' regulatory capital, to restore a sufficient buffer to absorb the losses for the year, and at ensuring complete compliance with the regulatory provisions on internal controls.

The examination of capital adequacy and risk management systems also took the ICAAP report into account; in meetings with corporate officers, firms were called on to establish more accurate risk identification procedures and more reliable risk measurement methods under adverse as well as under normal conditions, so as to make full use of the report's potential as an aid to corporate management.

Intermediaries in the special register. – Supervision of intermediaries entered in the special register referred to in Article 107 of the Consolidated Law on Banking focused on the household credit sector. Steps were taken with a view to ameliorating relations with customers and reinforcing the organizational safeguards bearing on the operation of the distribution network.

With regard to mutual loan-guarantee consortiums, whose importance within the special register grew considerably during the year, supervisory action mainly concerned the problems of governance structures, organization, capital adequacy and internal control systems. The sector is characterized by highly risky assets and poor profitability.

Intermediaries in the general register, loan brokers and financial agents. – Supervision of intermediaries entered in the general register referred to in Article 106 of the Consolidated Law on Banking concentrated on the most problematic sectors: money-broking and the issue of guarantees on a public basis. Money-transfer providers received ongoing attention.

Checks were undertaken on the basis of the results of the statistical reports transmitted by intermediaries in 2010, with particular reference to satisfaction of the minimum capital requirements. Some intermediaries were deleted from the register for failure to comply with the reporting requirement.

Checks were conducted on loan brokers and financial agents, including on a sample basis, to verify that they actually satisfied the requirements that they had self-certified upon entry in the register and that they sent the required annual communications.

Crisis procedures involving banks and non-bank intermediaries

Seventeen crisis management procedures were initiated in 2010 and five more through April 2011. Most involved small intermediaries; in one case a bank with inter-regional operations was put into special administration.

The banks subjected to crisis procedures in 2010 numbered eleven, including seven mutual banks; the non-bank intermediaries included two investment firms, one asset management company and, for the first time, an electronic money institution. The need for prompt action to safeguard the company's situation made it necessary in two cases to put the intermediary under provisional administration, which was followed by special administration.

In the first few months of 2011, a bank controlled by a Libyan entity covered by the international asset freeze proclaimed in the wake of the political crisis in that North African country was put into special administration. In the same period, an asset management company operating in the private equity sector was put into special administration, and compulsory administrative liquidation began for a Calabrian mutual bank already under special administration, and for the Italian branch of a French investment firm (after the French authority ordered the firm's liquidation).

In 2010 and the first four months of 2011, eight special administration procedures were closed. Three ended with return to ordinary management following the remedial action carried out by the special administrators and two – involving mutual banks – with merger into another bank of the same category. In three cases it was necessary to proceed with compulsory administrative liquidation, carried out with the intervention of intermediaries that ensured protection of the depositors' and customers' rights. The depositor-guarantee schemes played an important role, in different ways, in resolution of the bank crises.

In some cases the special administrators had to cope with major liquidity strains, which on three occasions made it necessary to suspend payments. It is more difficult than in the past to resolve crisis situations through transactions that involve other intermediaries, with the partial exception of mutual banks, which sometimes resulted in lengthier proceedings. In some cases recourse to the procedure for redundant personnel was necessary.

At 30 April 2011, there were 57 crisis procedures in course: 18 special administrations (15 banks, one parent company, one asset management company and one electronic money institution) and 39 compulsory administrative liquidations (17 banks, three asset management companies, 18 investment firms, one branch of a French investment firm). The company set up to realize the problem assets acquired as a result of the public interventions to restructure the Banco di Napoli group continued its activity.

Transparency, customer protection and financial education

The Bank of Italy worked for customer protection on several fronts last year. The activity of the Arbitro Bancario Finanziario (ABF) expanded, checks on compliance with the rules on transparency and fairness in intermediary-customer relations were stepped up, and more work was done for the financial education of the public.

Alternative dispute resolution. – The ABF, the alternative dispute resolution mechanism instituted pursuant to Article 128-*bis* of the Consolidated Act on Banking, completed its first year of activity in 2010. Its mission is to settle disputes between customers and intermediaries impartially, rapidly and efficaciously, making its decisions in complete autonomy. The large number of appeals submitted to it to date attest to customers' considerable interest in the new mechanism.

Checks on compliance with the transparency rules and complaints handling. – Supervisory activity for constant monitoring of compliance with the rules on transparency and fairness was intensified with respect to 2009. With effect from January 2010, intermediaries had to comply with the provisions on these matters issued by the Bank of Italy in July 2009. Both on-site and off-site checks were aimed at verifying compliance with the new rules, not only for public notices and contracts with customers but also as regards organization and internal controls. Special importance was also attached to analysis of the manner of communication with customers, in order to verify its substantial fairness.

During the year the Bank of Italy received more than 5,700 complaints, 45 per cent of them concerning credit management (overdrafts, mortgage loans, consumer credit) and 10 per cent bearing on payment services and instruments (credit transfers, ATM cards, credit cards and cheques). The total number of complaints decreased by 15.8 per cent compared with 2009 owing to the smaller number of complaints concerning investment services, current accounts, mortgages and other loans. In addition to the above total, there were about 1,000 complaints regarding the alleged misreporting of customer data to the Central Credit Register.

Revision of the rules against usury. – In 2010, performance of the quarterly survey of average overall effective rates for anti-usury purposes was accompanied by the provision of extensive assistance to reporting intermediaries and other operators in order to resolve interpretative and reporting questions, on the basis of the instructions issued in August 2009.

Shortcomings in the legislation in force had been detected some time ago, requiring a revision of Law 108/1996. A first change has been introduced with Decree Law 70/2011, which modified the mechanism for calculating the usury threshold rates. The objective is twofold: to avert credit rationing by raising the threshold in the event of low market rates, and to limit the differential between the average and the threshold rates (now set at a maximum of 8 percentage points). These measures are a deterrent to possible opportunistic conduct on the part of intermediaries that apply very high interest rates without a proper assessment of counterparties' creditworthiness.

Further changes remain to be made in order to overcome problems in application (for example, with reference to financial products whose characteristics are not standardized, not readily comparable and in continual evolution) and to clarify the conditions under which some items (such as penalty interest and loan-broking charges) qualify as usurious.

Financial education. – The Bank of Italy is continuing its efforts in the field of financial education at national and international level. With a view to promoting familiarity with economic and financial issues, the educational project addressed to Italian students was renewed for its third edition. The programme of work for the 2010-11 school year, agreed with the Ministry for Education, Universities and Research, increased the number of classes participating at national level, updated the teaching material, revised the questionnaires for evaluating the efficacy of the initiative, and extended the subject matter to include price stability.

Money laundering and terrorist financing

The Bank of Italy continued its action to prevent and suppress money laundering and the financing of terrorism in 2010 with regulatory activity, controls and cooperation with other Italian and international authorities. In August, at the proposal of the Financial Intelligence Unit, the Bank issued its instructions on anomaly indicators to facilitate the detection and assessment of transactions suspected to involve money laundering or terrorist financing.

In March this year, following the consultation held in 2010, in accord with Consob and Isvap the Bank issued its provisions on organization, procedures and internal controls that banks and other intermediaries must adopt to combat money laundering and terrorist financing. In accordance with the principle of proportionality, the provisions are applied with regard to the size and operational characteristics of the intermediary to which they are addressed. The measure does not require intermediaries to adopt more complex or ramified organizational arrangements than they already have but takes account, in assigning tasks and responsibilities, of existing structures. It does call for instituting an anti-money-laundering function. There are special provisions addressed to banking groups, including international groups.

On-site and off-site controls for compliance with the anti-money-laundering rules are an integral part of supervisory activity. Investigations preliminary to supervisory authorizations weigh the institution's compliance with the provisions to combat money laundering. Controls are targeted according to the supervised institutions' foreseeable exposure to the risk of money laundering and criminal infiltration.

Last year, checks were carried out as part of ordinary supervisory inspections, targeted inspections at bank headquarters, and controls at individual branches. Off-site controls included analysis and assessment of the reports transmitted by the judicial authorities and the FIU and of those submitted by intermediaries themselves under Article 52 of Legislative Decree 231/2007.

The Bank intervened with intermediaries, calling for corrective measures and monitoring their implementation. For infractions, in one case an intermediary was temporarily prohibited from carrying out new transactions and in one case a branch was closed. The detection of serious anomalies in anti-money-laundering compliance in a bank was considered among the conditions for activating the special administration procedure.

Sanctions

Stepped-up controls on intermediaries, attention to consumer protection and market integrity and strict enforcement in general resulted in an increase in sanctions imposed by the Bank. The total amount of fines practically doubled in 2010, from €9.7 million to €18.2 million, and the number of sanction procedures also rose, from 113 to 145. The fines were levied on more than 1,000 natural and legal persons. Another 49 sanction procedures were terminated with no action taken. The increase in the amount of fines was due to the fact that some of the infractions sanctioned in 2010 – notably those committed by intermediaries subjected to crisis procedures – were particularly serious.

Looking ahead, reinforced sanction regimes are one of the objectives of the recent reform of the financial sector to ensure the soundness and stability of the system. At European level, a plan to reinforce and harmonize sanction regimes so as to enhance their effectiveness, proportionality and power of deterrence is now under study. It will presumably have a substantial impact on Italian procedures.

In any case, the Bank of Italy has begun its own project to reform sanction procedures. The aim is to simplify and rationalize proceedings and integrate the sanction instrument more closely into overall supervisory activity.

Deletions from the register. – In 2010, at the Bank of Italy's proposal the Ministry for the Economy and Finance ordered the deletion of 65 intermediaries from the general register under Article 106 of the Consolidated Law on Banking. The irregularities that resulted in the procedures included such violations as unauthorized raising of funds from the public, repeated non-compliance with reporting requirements to the Bank of Italy, and lack of the minimum capital and liquidity to engage in the granting of credit in the form of guarantees.

With the enactment of Legislative Decree 218 on 14 December 2010, the Bank of Italy retains the power to propose to the Ministry the deletion of financial intermediaries from the general register until the amendment to Title V of the Consolidated Law on Banking (under Legislative Decree 141/2010) becomes fully effective. The amendment introduces a more diversified set of controls over the intermediaries entered in the single register, with broader instruments for intervention in case of irregularities.

Controls resulted in the deletion of 83 loan brokers for failure to meet the integrity requirements in 2010 and the cancellation of 59 more for non-fulfilment of the requirements for entry. Following verification of financial agents' actual performance of their supposed activity last year, 13,081 were purged from the register.

THE PAYMENT SYSTEM, THE MARKETS AND THEIR INFRASTRUCTURES

20. THE LARGE-VALUE PAYMENT SYSTEM, MONEY MARKET AND FINANCIAL MARKET INFRASTRUCTURES

The authorities continued to reinforce financial market infrastructures by defining regulatory standards above all for the OTC derivatives market infrastructures, central counterparties and trade repositories.

Last March, the Committee on Payment and Settlement Systems (CPSS) of the Bank for International Settlements (BIS) and the Technical Committee of the International Organization of Securities Commissions (IOSCO) published a consultation document entitled "Principles for financial market infrastructures", updating and completing current international standards for market infrastructures. The new principles tighten the requirements for risk management and make them uniform internationally; they also apply to trade repositories.

In the field of cooperation among the authorities, the OTC Derivatives Regulators' Forum continued its activities, the aim of which is to promote procedures that are consistent at the global level both for the practices of supervision over the OTC derivatives market infrastructures and for the collection of data from these organizations by the authorities concerned.

In Europe, the reform of the system for the supervision of the banking, financial and insurance markets was completed in 2010 and entered into force on 1 January 2011. The reference body for the financial markets is the European Securities and Markets Authority (ESMA), whose mandate is to contribute to safeguarding the stability of the European Union's financial system by ensuring the integrity, transparency, efficiency and orderly functioning of securities markets as well as investor protection. ESMA's activities are carried out in close cooperation with the national authorities and the central banks.

Last September, the European Commission published a proposal for a regulation on OTC derivatives, central counterparties and trade repositories which will make it compulsory to use central counterparties for standardized OTC derivatives contracts, introduce harmonized requirements for settlement and guarantee infrastructures, and make it compulsory to register all OTC derivatives contracts with trade repositories.

At the European Commission work is in progress to define the legislative framework for securities settlement and centralized deposit systems, with the aim of achieving harmonized rules suitable for the systemic importance of these entities. In 2010, the Commission continued its preparation of a proposal for a directive on securities held through intermediaries (Directive on legal certainty of securities holding and transactions or the Securities Law Directive) to harmonize the rules for holding and transferring securities.

At Community level, revision has also begun of Directive 2004/39/EC on markets in financial instruments (MiFID). The aim is to strengthen the degree of harmonization of the legal framework for European financial markets, thereby reducing operating costs and improving access within Europe. Discussions are also under way on the regulation granting powers to the competent authorities of European States and ESMA (which will coordinate the initiatives undertaken by the different member states) to collect information on short selling and credit default swaps, and to limit such transactions temporarily and in exceptional circumstances (Regulation on short selling and certain aspects of credit default swaps).

In 2010, the gross settlement system TARGET2 ensured complete business continuity, with 100 per cent operational availability, a level already reached the previous year. The system was basically stable in terms of the number of payments settled and recorded an increase of nearly 7 per cent in value terms. A similar trend has marked the Italian component (TARGET2-Banca d'Italia), where the growth in the value of transactions settled can be imputed entirely to cross-border flows.

Work went forward on the Eurosystem TARGET2-Securities (T2S) and Collateral Central Bank Management (CCBM2) infrastructure projects. With T2S (to be developed by Banca d'Italia, Banco de España, Banque de France and Deutsche Bundesbank), the Eurosystem will offer a pan-European service for settlement in central bank money of securities transactions denominated in euros and other European currencies. Harmonization and standardization of operating processes will foster competition between depositories and the integration of European financial markets, thus lowering cross-border transaction costs. The platform is to be launched in September 2014.

CCBM2 (to be developed by the central banks of the Netherlands and Belgium) will be the Eurosystem's common platform for managing collateral posted by counterparties, on a domestic and a cross-border basis, to back their intraday credit and monetary policy operations. The platform is to be launched by the end of 2013.

Settlement in central bank money

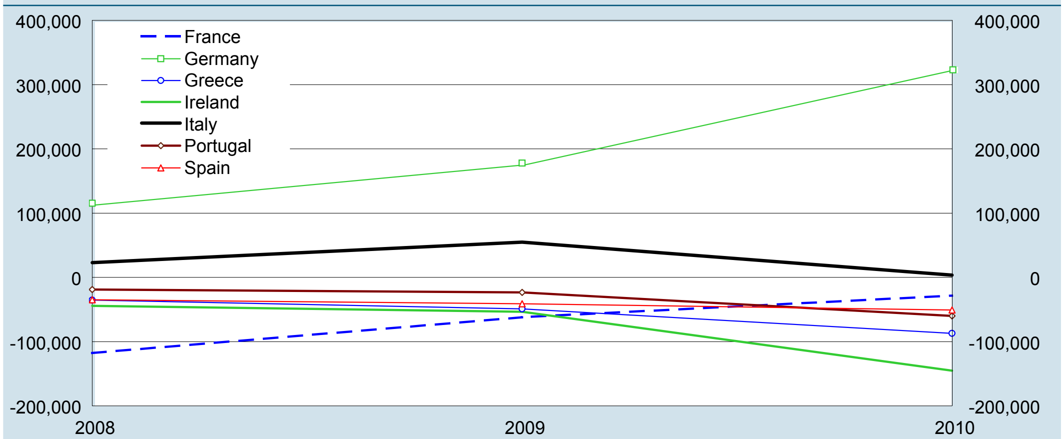
In 2010, TARGET2 settled a daily average of over 343,000 payments worth around €2,300 billion, 60 per cent by number and 90 per cent by value of the funds transfers settled in central bank money. The overall value of payments settled every four days via TARGET2 was equivalent to the GDP of the entire euro area. The remaining share of euro payments was settled via the Euro1 system operated by EBA Clearing, which settled an average of over 230,000 payments a day in 2010 (up by 1 per cent on 2009) for a total value of €241 billion (down by 5.5 per cent on 2009).

Compared with the previous year, the value of payments settled via TARGET2 on an average daily basis increased by 6.7 per cent; the number of payments settled was about the same.

Cross-border transactions settled via TARGET2 produce bilateral balances between central banks which, cleared by novation with the ECB on a daily basis, determine a single net position for each central bank vis-à-vis the ECB. This position, entered in the ECB's accounts, represents the net credit or debit of each central bank vis-à-vis the rest of the ESCB. The performance of the TARGET2 balances of the Eurosystem's national central banks showed that Italy's balance was close to zero (down from a credit position of almost €55 billion at the end of 2009; Figure 20.1). As regards the other countries, the Bank of Ireland had a net debit position of about €150 billion and the Bundesbank a net credit position of almost €330 billion.

Figure 20.1

National central banks' TARGET2 balances
(end of year data in millions of euros)



The flows handled by the Italian clearing and settlement systems run by the Bank of Italy (TARGET2-Banca d'Italia and BI-Comp) amounted to €44.6 trillion in 2010, up by 5.7 per cent compared with 2009. These flows were equivalent to 28.8 times GDP (Table 20.1).

Table 20.1

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

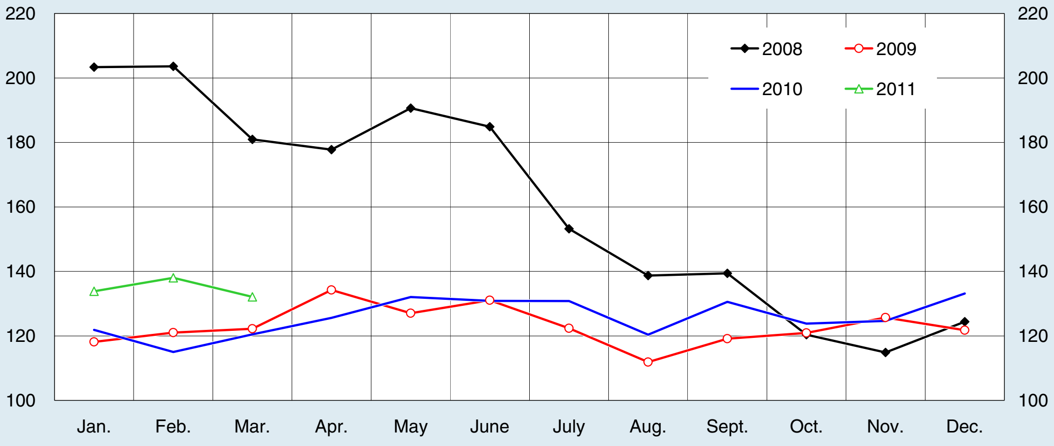
	Clearing systems (1)			Gross settlement (2) (c)	Total flows	
	BI-Comp gross flows (a)	Multilateral clearing balances				
		BI-Comp	Securities settlement and Express II (b)		(d)=(a+b+c)	(d)/GDP
2001	2,449	266	2,252	34,980	39,681	31.8
2002	2,598	276	1,954	32,145	36,697	28.3
2003	2,839	291	2,116	30,873	35,828	26.8
2004	3,011	323	2,190	31,650	36,851	26.4
2005	3,181	376	2,531	37,656	43,368	30.3
2006	3,402	420	2,818	43,635	49,855	33.5
2007	3,376	415	3,123	49,902	56,401	36.5
2008	3,449	444	4,111	46,476	54,036	34.4
2009	3,094	426	2,858	36,256	42,208	27.8
2010	3,048	469	2,568	38,984	44,600	28.8

Sources: Based on SIA-SSB, Istat and Bank of Italy data.
(1) Including transactions of the Bank of Italy, provincial treasury sections and Poste Italiane S.p.A. From 19 May 2008, with the migration to TARGET2, the balances from the provincial treasury sections are included in those of the Bank of Italy. Express II began operations on 8 December 2003 and the old securities settlement procedure ("Liquidazione titoli") was terminated on 23 January 2004. – (2) Transactions net of the balances of ancillary multilateral clearing systems. Includes incoming and outgoing cross-border payments net of transactions with the Bank of Italy. Does not include transactions settled on accounts outside BI-REL/TARGET2-Banca d'Italia.

After the large reduction starting in the second half of 2008 as an effect of the downturn in activity on financial markets caused by the global financial crisis, average daily flows settled through the TARGET2-Banca d'Italia system showed signs of picking up in 2010, compared with 2009, rising from €123 billion to €126 billion (Figure 20.2). The trend that was under way in 2009 continued with cross-border flows increasing by 9.5 per cent against a reduction in domestic payments of 2.1 per cent. In the first quarter of 2011, there was a further increase in average daily flows, to about €135 billion. The number of payments settled through TARGET2-Banca d'Italia remained about the same.

Figure 20.2

Value of transactions settled through BI-REL and TARGET2-Banca d'Italia
(monthly averages of average daily data in billions of euros, January 2008-March 2011)



The estimate for domestic and cross-border overnight money market transactions settled via TARGET2-Banca d'Italia shows that for cross-border transactions there was significant growth starting in June 2010 and a prevalence of fund-raising rather than lending activities, with average daily values reaching €8 billion for fund-raising and €5 billion for loans in some months. For both cross-border fund-raising and lending activities interest rates were below the Eonia rate, which therefore does not appear to correspond fully to the conditions on which Italian banks operate cross-border.

The Italian gross settlement system also handles payments coming from ancillary domestic systems and the transactions of Italian banks participating in ancillary foreign systems. One of the most important domestic systems is Express II, which includes large foreign intermediaries and accounts for more than 30 per cent of all the payments settled via TARGET2-Banca d'Italia. In 2010, following a sizeable reduction in 2009, the average daily value of the payment flows from Express II increased slightly from €42 billion to €46 billion.

The volume of intraday liquidity available to banks (i.e. the value of collateralized lines of credit) expanded further from €40 billion in 2009 to more than €54 billion in 2010. The increase reflected the Bank of Italy's launch in June 2010 of the pooling system to manage assets guaranteeing Eurosystem credit transactions (see below).

However recourse to intraday credit was down on 2009, falling from a daily average of €8.2 to €7.3 billion. The peak drawing of intraday credit, which averaged around €14 billion, continued to come in the first few hours of the trading day and can be explained by the settlement of the balances from the night cycle of Express II and fund-raising by some foreign bank branches in Italy on behalf of their parent banks. The use of intraday credit was concentrated among just a few banks; in fact three intermediaries accounted for 90 per cent of the total.

Collateral assets. – The collateral posted at European level against Eurosystem lending amounted to €2,176 billion at the end of 2010, 4 per cent less than a year earlier. Cross-border collateral accounted for 36 per cent of the total – 24 per cent via the Correspondent Central Banking Model (CCBM), 5.2 per cent via links between central depositories, and 6.8 per cent via direct access to central depositories abroad. Recourse to cross-border collateral continues to fall, in percentage terms, following greater use of domestic assets.

During the year, Italian banks held a daily average of about €100 billion in collateral assets with the Bank of Italy against monetary policy operations and intraday credit (Table 20.2), an increase of 36 per cent over 2009. The increase mainly involved tradable domestic assets, whose nominal value rose on average from about €38 billion to €62 billion. The increase was due to some intermediaries depositing collateral deriving from the securitization of their own loans and also as a result of the shift to pooling.

Table 20.2

Collateral assets deposited with the Bank of Italy
(average stocks in millions of euros)

	Intraday credit and monetary policy repos						Italian securities as collateral with foreign NCBs via CCBM
	Securities				Bank loans	Total collateral assets	
	Italian	CCBM	Links	Total			
2009	37,751	3,015	11,064	51,830	21,538	73,368	54,906
2010	61,548	2,840	12,083	76,471	23,374	99,845	39,861
2010 – Q1	40,279	3,128	10,203	53,610	21,559	75,168	48,446
Q2	41,866	3,458	11,983	57,307	22,172	79,479	44,437
Q3	84,234	2,875	14,157	101,267	23,550	124,816	36,519
Q4	79,135	1,910	11,949	92,994	26,216	119,210	30,279
2011 – Q1	73,064	1,944	13,408	88,417	24,710	113,127	27,321

Rounding may cause discrepancies in totals.

On 26 June 2010, the Bank of Italy imposed pooling as the only way to manage collateral. The system is based on the use of pledges and the constitution of a single group of assets to guarantee various credit transactions indifferently, making it possible to economize and simplify the management of collateral and the settlement of credit transactions. In the second half of 2010, the value of collateral at the end of the day, net of haircuts, averaged €94 billion, an increase on 2009 as a result of pooling; of the total about 35 per cent was used for monetary policy operations and 65 per cent for intraday liquidity.

To guarantee Eurosystem lending operations, Italian banks' holdings at the Bank of Italy mainly consist of asset-backed securities (ABS) and bank loans. These two asset classes, which accounted for 62 and 25 per cent respectively of the total value of collateral net of haircuts at the end of June 2010, accounted for 41 and 31 per cent at the end of March 2011. The contraction in the value of ABSs was due to the introduction of stricter qualifying criteria as of January 2011. The distribution by class of financial instrument used by banks shows a marked polarization: some banks use securitizations of their own loans almost exclusively; others mainly use ABSs and bank loans; still others, finally, use only government securities to obtain intraday liquidity to settle their balances during the night cycle of securities settlements.

The interbank deposit market (e-MID)

In 2010, trading in unsecured monetary deposits on the e-MID market settled at a daily average of €5.1 billion, 6 per cent less than in 2009. There were fewer transactions in the first half of the year when there was a high proportion of transactions concluded on a bilateral basis (requests for quotes, RFQs). Starting in July, at the same time as the expiry of the extraordinary one-year refinancing operation, which was not renewed by the Eurosystem, there were signs of a moderate recovery in activity on the e-MID market.

There were also signs of weakness in the collateralized money market, the General Collateral repo market and the Collateralized Interbank Market (MIC). By contrast, Italian banks traded more in the over-the-counter segment of the unsecured deposit market.

In the first quarter of 2011, average daily trading in unsecured e-MID contracts amounted to €4.9 billion; bilateral trades remained at the low levels recorded in the second half of 2010. Contracts traded in the overnight segment of the e-MID market accounted for 94 per cent of the total, compared with 90 per cent in 2009.

There were profound changes in the Collateralized Interbank Market, which began trading in 2009 at the initiative of the Bank of Italy to restore the orderly functioning of the interbank market at the longest maturities. On 11 October, the management of the guarantee scheme passed from the Bank of Italy to the Cassa di compensazione e garanzia S.p.A. (CC&G), except for contracts traded before that date and in force until 31 December, for which the previous arrangements remained valid; the market is now called the New MIC.

The New MIC is characterized by a broadening of tradable maturities – including those of less than one week – and by a reduction in the range of eligible assets in line with those accepted by the Eurosystem to guarantee refinancing operations. The New MIC is a transitory solution on the road towards a new collateralized market, which will benefit from advanced guarantee management systems (based on tri-party repo schemes) currently under development by the Monte Titoli company.

The wholesale market in government securities

In 2010, the average daily volume of trading on the MTS Cash market in government securities was €3.4 billion, an increase of 25 per cent compared with 2009. During the year, trading fluctuated in conjunction with the worsening of the difficulties of some countries in the euro area in managing their public debt.

As trading picked up there was a progressive reduction in the bid-ask spreads and an increase in the volumes quoted. Following the positive performance of the first quarter, in a phase of greater pressure on the sovereign debt of other countries, there was a deterioration in quotation standards similar to that which occurred after the failure of Lehman Brothers.

In the first quarter of 2011, daily trades on the MTS Cash market exceeded €4.9 billion, in connection with greater activity in BOTs and CCTs; the depth of the market showed further signs of improvement, returning to the average levels recorded in 2007; quotation activity picked up from the minimum levels recorded in December 2010.

In 2010, total volumes traded on the BondVision exchange, the MTS Group's platform for institutional investors (investment funds, asset management companies and insurance companies) and smaller banks stabilized at the levels reached in 2009.

Trading volume in the repo segment stayed at the same level as in 2009 (€61 billion a day on average), although there was a significant shift between the two underlying segments. In conjunction with the previously mentioned reduction, from €37 billion to €29 billion, in the contracts concluded in the General Collateral segment in relation to a basket of Italian government securities, there was an increase, from €24 billion to €32 billion, in the Special Repo segment, where contracts on specific securities are traded, generally to hedge cash market positions.

During the year, growth in activity in the Special Repo segment contributed to the greater propensity of operators to assume short positions on securities, given a broad and efficient securities lending market. Securities shortages frequently led to an increase in the specialness between average interest rates in the General Collateral and Special Repo segments; during 2010 it averaged 17 basis points.

The Continuous Linked Settlement (CLS) system

The CLS system, launched in 2002, handles foreign exchange transactions in 17 currencies via a Payment-versus-Payment mechanism. In recent years, the system has expanded its activity connected with exchange operations, with positive effects deriving from the elimination of the related risk. Moreover, since 2007 CLS has also settled payments deriving from some categories of OTC derivatives contracts, notably credit default swaps.

In 2010 the average daily value of payments made by CLS (equivalent to $4,129 billion) increased by $737 billion and by 22 per cent; indirect participation continued to increase.

Central depository, settlement and guarantee systems

The range of services provided by the central depository and settlement system was broadened further with the launch of initiatives to register contracts electronically; the activity remains concentrated, however, on a limited number of operators.

In Italy, the main initiatives of post-trading firms were taken by Monte Titoli S.p.A., which announced it was developing a tri-party collateral management service (X-COM) which will allow members to lend and borrow securities in support of their own investment and financial strategies with greater flexibility than with the traditional forms of bilaterally-based repos. Monte Titoli has also indicated its intention to join the T2S in the first migration window, beginning the necessary activities in cooperation with the suppliers and users of settlement services in the context of the National User Group.

Central depository services. – In 2010, the value of the financial instruments managed by Monte Titoli increased by 6.6 per cent to €2,705 billion at face value and by 5.5 per cent to €2,980 billion at market prices.

Securities settlement. – In 2010, the average daily value of transactions handled by the Express II settlement system was €186 billion, up by 4.6 per cent from 2009. By contrast, the number of transactions decreased by 11 per cent, falling to a daily average of about 96,000. There was a further increase in the share of transactions guaranteed by central counterparties.

The system has both net and gross payment services. During 2010, the transactions going into the net system, for the most part the transactions concluded on the markets, decreased in number from 100,000 to 87,000 and in value from €148 billion to €144 billion; transactions guaranteed by central counterparties increased from 51.6 per cent to 57.7 per cent of the total.

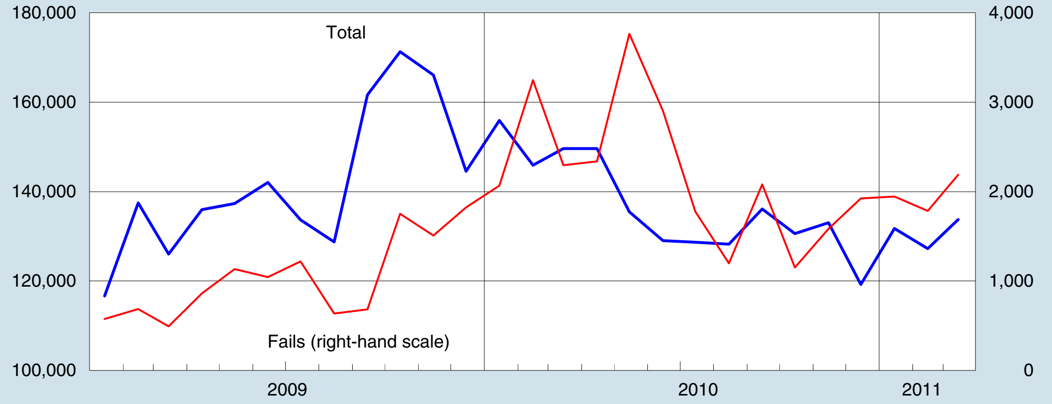
By contrast, the gross payment system grew, reflecting the expansion of failed transactions in the net cycles and intermediaries' preference for OTC and overnight repo trades. The average daily value of transactions rose from €29.3 billion to €42 billion, and the number of transactions from 6,200 to 9,000. In connection with the debt crises in some countries, there were securities shortages in the net night cycle, in which 79 per cent of the value of transactions was settled in 2010 against 86.8 per cent in 2009; in the subsequent cycles, the results in 2010 were closer to those of the previous year (94.3 and 98.4 per cent at the end of the net cycle and at the end of the day respectively).

Although the proportion of fails in the total flows of transactions in government securities into the system increased, it remained at a fairly low level (1.6 per cent in value against 0.8 per cent in 2009; Figure 20.3), with values peaking at the moments of greatest strain for some countries' sovereign debt.

Clearing and guarantee services. – CC&G's activity increased overall: despite a contraction in the cash share market, there was a large increase in the volume of business on the derivatives and bond markets.

Figure 20.3

Government securities: amounts entered into the net settlement cycle
(monthly averages of daily data in millions of euros)



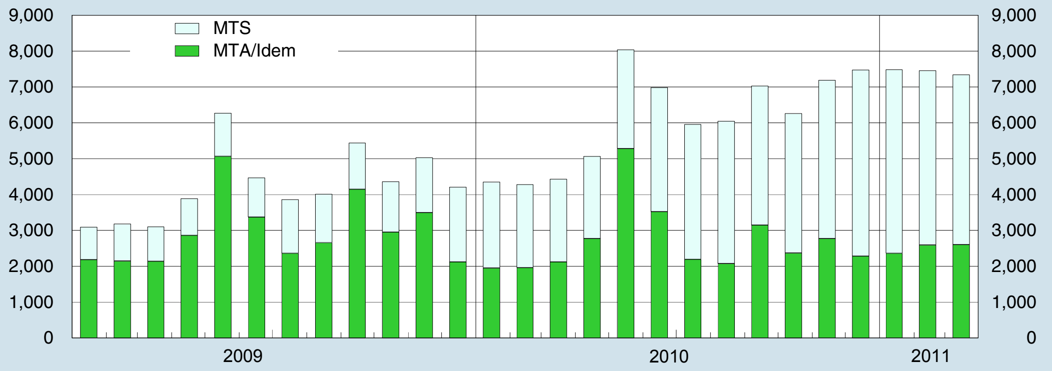
Source: Monte Titoli S.p.A.

On the cash share market, CC&G handled 65.3 million contracts, 1.3 per cent fewer than the previous year. Trading on the Idem derivatives market increased considerably in terms of both number of contracts (to 44.2 million, up by 4 per cent from 2009) and value (to €884.3 billion, up by almost 26 per cent). On the government securities market, CC&G's activity was marked by an increase of about 35 per cent in the value guaranteed. The positive trend in activity on the markets guaranteed by the central counterparty was confirmed in the first three months of 2011.

The overall increase in activity on the markets guaranteed by CC&G, together with their pronounced volatility, resulted in a substantial increase in the average initial margins required: the guarantees stabilized at a daily average of about €6.1 billion (€4.2 billion in 2009). The margins deposited by the participants were in cash for 85 per cent and in securities for 15 per cent. The largest increase was in the margins for bonds, which rose to 56 per cent of the total (30 per cent in 2009). This increase was partly due to the extension of the activity of the central counterparty to Borsa Italiana's MOT market with effect from November 2010 (Figure 20.4).

Figure 20.4

Initial margins
(monthly averages of daily data in millions of euros)



Source: Cassa di compensazione e garanzia S.p.A.

21. RETAIL PAYMENT SERVICES AND THE STATE TREASURY SERVICE

Retail payment services and systems in the framework of European harmonization

For a number of years the retail payment services industry, central banks and other authorities in Europe have been taking measures to enhance the efficiency and reliability of services to households, firms and general government. A key objective is to increase the use of electronic payments, which are more efficient and secure than paper instruments (cash and cheques). The economic impact of the project is significant, especially in countries like Italy where the propensity to use cash remains high.

An important aspect of this drive is the creation of the Single Euro Payments Area (SEPA), initiated by the European banking industry at the instance of the authorities. This year, a Community regulation is to be issued making it compulsory for national payment schemes to migrate to their pan-European counterparts – the SEPA Credit Transfer (SCT) and SEPA Direct Debit (SDD) – in order to eliminate the delays in adopting the new harmonized standards.

In December 2010, two years after the beginning of the migration, SCTs accounted for about 13 per cent of all credit transfers within the euro area; in Italy the share was 6 per cent. The use of SDDs, introduced in November 2009, is still practically negligible. However, the migration should be furthered by Regulation 2009/924/EC on cross-border payments, which came into force in November 2010 and makes it obligatory to join the pan-European scheme.

The migration of payment cards to the SEPA security standards (chip cards) continued. By the end of the year, more than 60 per cent of the cards in circulation in Italy and 85 per cent of ATMs and POS terminals conformed to the standard.

Progress towards SEPA has been accompanied by adjustment of the European legal framework and adaptation of national law. The new rules on payment services contained in Directive 2007/64/EC and Regulation 2009/924/EC change the structure of the retail payment market with a view to improving transparency, fostering competition and increasing consumers' confidence in electronic instruments. Competition is fostered in part by the entry of new entities, such as payment institutions, authorized to provide payment services together with other goods and services. The growth potential of the payment market will be further increased with the transposition of Directive 2009/110/EC, which broadens the notion of electronic money and extends the operating scope of electronic money institutions.

The adaptation of European clearing and settlement mechanisms (CSMs) to SEPA instruments proceeded last year. At the end of January 2011, nine links were operational, involving a total of eight European CSMs. These include the link between the Italian CSM (ICBPI/BI-COMP) and the Dutch Equens and Austrian STEP.AT systems. At the end of March, of the 18 euro-area CSMs already handling SCTs, only 13, including two Italian operators, had reported to the European Payments Council that they offered users the new SDDs.

Payment instruments

Economic developments. – The overall value of retail payments in Italy grew last year after declining in 2009, when GDP contracted. There was a further reduction in the use of paper instruments, especially cheques, in favour of electronic payments (notably online credit transfers and prepaid cards), although their use is still very modest by European standards. Cashless payments numbered more than 4 billion, up by slightly more than 1 per cent from 2009. Their total value increased by about 5 per cent.

The number of cheques paid continued to decline, by 6 per cent, following average annual contractions of 12 per cent over the previous three years. The number of non-preauthorized bank receipts, generally used in business-to-business transactions, declined by 7 per cent. By contrast the number of automated credit transfers rose sharply (11 per cent), and that of direct debits, used mainly to pay utility bills, continued to increase (by 3 per cent).

Most of the SCTs ordered by Italian banks in 2010 were settled through the pan-European STEP2 system (72 per cent against 68 per cent in 2009). The number of SCTs executed in Italy's BI-COMP retail payment system increased by 170 per cent to 5.9 million. The number addressed to participants in the two foreign systems that are interoperable with BI-COMP (Equens in the Netherlands and STEP.AT in Austria) rose by nearly 20 per cent to 312,000 for a value of €1.8 billion.

The number of debit, credit and pre-paid card transactions gained 4 per cent, compared with an annual average of 5.5 per cent over the three previous years. The fastest growth was again recorded by pre-paid cards (31 per cent), while debit- and credit-card transactions rose by 1 and 5 per cent respectively.

Developments in the retail payment market. – There were an average of 66 cashless payments per capita in Italy last year, compared with 176 in the euro area as a whole in 2009. The regional difference within Italy was significant (84 transactions per capita in the Centre and North against 39 in the South), but overall the use of electronic instruments remains modest even in the parts of Italy with levels of income comparable to those of the more advanced regions of Europe. The relatively widespread reliance on cash is reflected in the heavy use of ATM cash withdrawals, whose number rose by 4 per cent and whose average amount also increased, by 2.7 per cent to €180, far above the average of €120 in the euro area and €109 in the EU as a whole. Payment-card cash withdrawals accounted for 55 per cent of the entire value of ATM and POS transactions in 2010 in Italy (and 62 per cent in the South).

One of the main structural trends in the retail payment market is the growth in on-line transactions, which increased in number to 226 million last year, although they still account for only 6 per cent of all cashless payments. On-line transactions using pre-paid cards grew in number by 33 per cent in 2010, those using credit cards by 15 per cent, and on-line credit transfers by 24 per cent. The percentage of payments made on-line varies with the type of instrument: for pre-paid cards, 50 per cent; for automated transfers (largely used for business-to-business payments), 25 per cent; and for credit cards, 9 per cent. Reports from banks on a regional basis indicate that the share of payments settled on-line is correlated positively with income and education and also depends on the yields offered on current accounts.

More innovative instruments, such as mobile payments via cell phone, remain embryonic. They could be fostered by the progressive market entry of payment institutions and the possibility for telecommunications companies to provide digital services for the purchase of goods and services.

The use of electronic payment instruments depends crucially on security. In Italy, the proportion of fraud in payment card transactions fell to 0.046 per cent last year, from 0.051 per cent in 2009. Debit cards – whose use at retailers generally involves microchip plus PIN number – had a lower fraud rate of 0.019 per cent.

The fees for payment services are an essential way of signalling to the market which instruments are most efficient and fostering their large-scale use. Last year, the average fees to customers for the main retail payment services – cards, credit transfers and direct debits – generally declined (by 0.5 per cent), in parallel with the increase in the use of electronic payments and the reduction of interbank fees consequent to rulings of the European and Italian antitrust authorities.

However, the still low utilization of electronic payments prevents Italy from deriving the full benefit of the substantial economies of scale to be had from innovative instruments. It is also the source of the difficulty in providing incentives in the form of low fees, especially for micropayments. On the supply side, a transparent payment fee structure that properly reflects the cost components for each type of product would encourage the use of the most efficient instruments. And on the demand side, the development within firms of technologically integrated management of trade and cash flows would lower the costs of the accounting procedures – matching and rectification – that underlie payment operations.

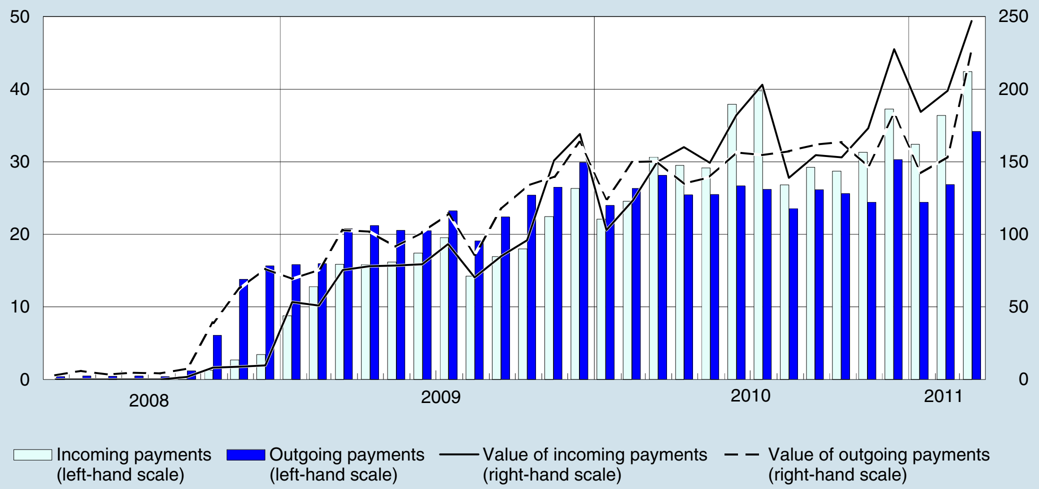
The preliminary findings of a Eurosystem survey of intermediaries and merchants indicate that the cost of retail payment services in Italy amounts to over 1 per cent of GDP and that more than half of this is determined by the use of cash. Even though it is the most burdensome means of payment owing to its high costs of production and handling, as well as the danger of counterfeiting, cash is by far the most commonly used instrument for micropayments (90 per cent of such transactions), in part because consumers do not clearly perceive the underlying costs. Debit (and pre-paid) cards are the most efficient substitute for cash. Among the instruments used for large payments (cheques, credit transfers and direct debits), the most costly is the cheque.

BI-COMP operations. – The value of transactions handled by the BI-COMP clearing and settlement system, equal to over €3 trillion, declined by 1.5 per cent in 2010 (Table 20.1), while they increased in number by 1.9 per cent to more than 2 billion. The shift towards electronic payments continued, and they now make up 97.5 per cent of the total.

SEPA credit transfers settled through BI-COMP numbered 6.3 million last year, or 1.7 per cent of all the credit transfers handled by the clearing and settlement system. This figure includes SCTs transferred to and from the Dutch Equens and the Austrian STEP.AT clearing and settlement mechanisms (Figure 21.1). The flows to and from these two interoperable systems increased to 10.8 per cent of all the SCTs handled by BI-COMP, and 11.6 per cent by value. A total of 367,000 payments ordered by participants in the two foreign CSMs were settled and 312,000 payments ordered by BI-COMP participants, for values of €1.9 billion and €1.8 billion respectively.

Figure 21.1

SCT interoperability of ICBPI/BI-COMP with Equens and STEP.AT
(monthly data; thousands of payments and millions of euros)



Source: Based on data from Istituto Centrale delle Banche Popolari Italiane.

The interbank database on irregular cheques and payment cards. – Reports on file with the database declined in 2010. The number of persons registered for lack of funds or authorization fell by 8.9 per cent and that of bad cheques by 12.4 per cent. The ratio of the value of bad cheques to those regularly debited to the account-holder diminished less sharply (by slightly under 5 per cent) because the number of regular cheques also fell, by 5.7 per cent. The total value of the bad cheques registered declined to just over €1.1 billion (0.15 per cent of GDP). Geographically, as in years past, the South accounted for most of the irregular cheques (Table 21.1).

The number of persons whose payment cards are revoked for non-payment or lack of funds continues to rise. At the end of 2010 the payment card section of the database covered some 279,000 persons, 8 per cent more than a year earlier, and once again two-thirds of the newly registered were domiciled in the Centre and South.

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	13,866	39,624	14.9	188.7	16.7	4,762
North-East	6,686	19,658	7.4	128.9	11.4	6,556
Centre	15,574	52,829	19.9	245.4	21.7	4,645
South	40,812	148,264	55.9	546.4	48.4	3,685
Foreign	1,443	4,956	1.9	20.1	1.8	4,070
Total	**78,381**	**265,331**	**100.0**	**1,129.5**	**100.0**	**4,257**

(1) At 31 December 2010. Rounding may cause discrepancies in totals.

The State treasury service and public payments

In March 2011, the Bank of Italy and the Ministry for the Economy and Finance signed the agreement for the new procedure governing the Treasury's payments account with the Bank. A ministerial decree will set the date for its entry into force. The new system, envisaged by Law 196/2009 on Public Accounting and Finance, should reduce the volatility and the unpredictability of the balance on the account and enhance the efficacy of Eurosystem monetary policy.

A ceiling of €1 billion is set on the account balance, far less than the amount of liquidity currently held by the Treasury, with remuneration fixed at the minimum rate on the ECB's latest main refinancing operation. The non-remuneration of any balance above the ceiling will be an incentive for the Ministry to invest excess funds in the money market. The Bank and the Ministry will exchange and compare infraday data on the balance on the Treasury payment account and forecasts for longer time horizons consistent with transactions on the account.

The principles of the Digital Administration Code (Legislative Decree 235/2010) underscore the key role that stepped-up use of electronic instruments can play in government's relations with households and firms, in particular payment and collection procedures. The Computerized Public Administration Payment System, which includes the State Accounting Department, DigitPA, the State Audit Office and the Bank of Italy, has initiated a project to revise revenue collection procedures and instruments, taking advantage of the new payment service instruments available. In 2010, the State treasury service and public payments service operated by the Bank of Italy made some 65 million payments (59 million in 2009), virtually all by electronic procedures. The non-automated transactions (1.5 million, or 2.44 per cent of the total) will be reduced by the new procedures introduced in January 2011 for central disbursement of salaries and benefits to central government employees and the computerization of the expenditure orders issued by local managers of central government departments.

The General Government Transactions Information System (SIOPE) tracks the payment inflows and outflows of some 13,000 general government entities for national accounts purposes. It allows for constant monitoring of the accounts by the Ministry for the Economy and Finance. The System's data quality and reliability have eliminated the need for local bodies to send paper accounts to the Ministry for drafting public finance documents. Starting this year, pursuant to a ministerial decree of 23 December 2009, they are required to attach to their budgets and financial reports the tables drawn from the SIOPE website managed by the Bank of Italy and to justify any discrepancies between the latter and the former. In order to facilitate this task, the website has been revised and its functions enhanced.

THE GOVERNOR'S CONCLUDING REMARKS

When I first took the floor before this annual meeting on 31 May 2006, I said that I felt that one of my duties was to lead the Bank of Italy towards change, in all its vast field of action, "contributing substantively to the formulation and implementation of monetary policy in the euro area; expanding and strengthening banking supervision while adapting it to the new international rules; making the Bank once again the trusted, independent advisor to Parliament, the Government and the general public".

The Bank responded. It answered the call thanks to its wealth of skills; thanks to its independence.

In these last five years we have changed the structure, organization and work procedures of the Bank.

The number of branches has passed from 97 to 58. We now have a more efficient network, better able to respond to the needs of the local communities.

The Italian Foreign Exchange Office (UIC) has been closed. The Financial Intelligence Unit has been instituted with the task of preventing and combating money laundering and the financing of international terrorism.

The Bank of Italy and UIC together employed almost 8,500 people in 2005; the number now stands at just over 7,000.

The path of change will be pursued with determination, with a spirit of innovation. We are counting on everyone's active collaboration.

The Bank's staff is its greatest asset. We are continuing to refine our recruitment procedures and focusing on professional development, well aware that our institution's future rests on the knowledge and skills of the men and women who work here.

On 18 December, Tommaso Padoa-Schioppa passed away, all too soon. He joined the Bank of Italy in 1968 and left almost thirty years later as Deputy Director General to serve successively as Chairman of Consob, member of the Executive Board of the European Central Bank and Minister for the Economy and Finance. His death deprives our country of his gifts of intelligence and passionate civic commitment. We will be holding a conference in his memory here in December, a year after his decease.

The Bank of Italy has been a precious source of dedicated public servants for Italy and Europe. Merit and independence: these are the essential conditions for the credibility of its analyses and for the effectiveness of its action. These are values to be preserved if the country is to continue to benefit from an authoritative voice with no vested interests. These have been the guiding principles of my mandate.

The world after the crisis

The economic policy response to the 2008-09 crisis was rapid, effective and coordinated internationally. Support from budgetary policies and the injection of liquidity to sustain the markets were unprecedented. The collapse of the international financial system was averted. There are some lessons to be drawn from this crisis: the social safety net, which held, is essential; bank failures must be managed; international cooperation, indispensable during the emergency, remains so when reconstructing the system.

In 2010, the global economy returned to growth at a rate of almost 5 per cent. In the emerging countries huge numbers of people are leaving poverty behind, even though this process is being held back by rising food prices. Overall the financial system is gradually recovering.

But the legacy of the recession is a heavy one. The most advanced economies, with the exception of Germany, are struggling to return to the previous rates of growth; the recovery is still too weak to reduce unemployment. In the emerging countries, with growth rates close to 10 per cent in some cases, signs of inflation are beginning to appear; in several of these countries inflows of capital have reached the high levels prevailing before the crisis.

The economic policies energetically applied in the advanced countries to counter the worst effects of the crisis have reached their limits. The public debt of these countries, equal to 73 per cent of GDP in 2007, will exceed 100 per cent this year. The risk premiums on public debt are growing everywhere, dramatically so in the economies where the public finances have deteriorated the most. In the euro area, the sovereign debt crisis of three countries – which together account for 6 per cent of the area's GDP – can potentially have significant systemic effects.

Public finances must be brought under control. A prolonged expansionary policy undermines the sustainability of the debt and damages economic growth. In Europe a start has been made on adjustment. This could not be postponed, despite the weakness of the recovery.

The emerging economies' prompt return to growth, adverse climatic events and socio-political upheaval in the Mediterranean and Middle East have pushed up the prices of energy sources and food, by more than 30 per cent in the last six months.

The risk of inflation is rising. There is now a greater need to proceed with monetary policy normalization so as to prevent expectations of higher inflation from becoming entrenched.

External current account imbalances between large debtor and creditor countries, one of the factors underlying the crisis, have begun to increase again. Differences in the propensity to save and in the composition of domestic demand are the main causes, together with rigid exchange-rate policies.

Today the Group of Twenty is committed to a global economic policy promoting strong, sustainable and balanced growth.

However, the imbalances in international payments are set to last and they must be funded. It is therefore crucial that the financial system is solid. The reform of the rules remains a priority on the international agenda. It must be completed.

The reform of finance

Important steps have already been taken. Thanks to unprecedented international cooperation, the measures adopted will make the financial system much more resilient. All the leading countries have revised their systems of regulation and supervision in three directions: to reduce the risks for stability, increase cooperation among authorities, and broaden the scope of the rules.

Basel III has established higher requirements for banks' capital and raised its quality. It has placed restrictions on financial leverage and introduced new liquidity rules.

We have eliminated many of the perverse incentives that encouraged the assumption of excessive risks in securitizations, by revising the role of rating agencies and reviewing accounting standards and prudential rules.

Transparency and the reduction of systemic risk are guiding the reform of over-the-counter derivatives: the standardization of contracts, centralized clearing, more demanding capital requirements, and the obligation to provide information to trade repositories are the pillars of the new system.

The reform has not yet been completed, however: it is necessary to tackle and reduce the moral hazard associated with systemically important financial institutions; it is necessary to increase the transparency and reduce the risks generated by the shadow banking system, a grey area between the regulated and the unregulated sectors.

Either because they received public support at the height of the crisis to prevent failures with devastating consequences or because governments provided them with more or less explicit guarantees, it is widely believed that the largest banks cannot fail. This leads to serious competitive distortions but above all to the unacceptable idea that profits are private and losses public.

Systemically important financial institutions must be allowed to fail if necessary, in an orderly manner, while preserving the essential banking and payment system functions and with the costs of their collapse not borne by the taxpayers but by the shareholders and certain categories of creditors. Beginning with those of a global size and nature, they will also have to be able to absorb larger losses. Common equity remains essential to the achievement of this objective.

The supervision of these institutions will have to be enhanced, made commensurate with the risks they can create. In many countries this will require a significant increase in the authorities' powers and independence.

The Financial Stability Board will present detailed recommendations at the G20 summit in November.

Before the crisis, much of the financial leverage and liquidity risk originated within the shadow banking system. The first objective of the Financial Stability Board is to establish the capacity to assess the risks in this sector adequately. Rules will then be introduced for the activities of the shadow banking system that can generate systemic risks. In tracing the new perimeter of regulation, the FSB will concentrate on those currently unregulated bodies that engage in credit intermediation with maturity transformation that are currently unregulated and are therefore subject to liquidity risks. The extension of the perimeter should follow the principle that similar activities and risks must be subject to the same rules.

It is now essential to ensure the complete implementation of the new rules, as scheduled and in all the different jurisdictions. The United States and Europe have a key responsibility. National interests must not prevail, otherwise the credibility of the reform and financial stability itself will be undermined. Intermediaries cannot call for shared rules to ensure a level playing field and at the same time seek competitive advantages through their less strict application at national level.

The euro and Europe

The euro-area budget deficit should be about 4.5 per cent of GDP this year, less than half those of the United States and Japan; at 88 per cent the public debt is lower than that of the United States and far below the Japanese level; the external current account is nearly in balance. The economic recovery is gathering strength, with GDP growth not far from 2 per cent expected this year.

The Economic and Monetary Union is nonetheless faced with the most difficult test since its creation.

In three years the public debts of Ireland, Greece and Portugal have grown in relation to GDP by 71, 37 and 25 percentage points respectively.

The European surveillance of national budgetary policies revealed itself to be inadequate; it had been weakened at the initiative of the three largest countries in the middle of the last decade, precisely when it became essential. A simple accounting exercise shows that if the rules of the Stability and Growth Pact had always been obeyed, on the eve of the crisis the ratio of public debt to GDP would have been over 10 percentage points lower in the euro area and 30 points lower in Greece. Even assuming that the worsening of budget deficits during the crisis was inevitable, at the end of last year no country's debt would have been more than 100 per cent of GDP.

For a long time the single currency concealed the differences between member countries' underlying conditions and economic policies and the absence of really binding common rules. For a long time risk premiums did not reveal the truth.

The global crisis has accentuated the perception of risk by some investors and disclosed weaknesses in the architecture of the Union. The yield spreads on member countries' securities have widened; the process was sometimes so sudden that some market segments risked paralysis.

National governments and European authorities responded to the emergency with exceptional measures, so as to limit the risk of contagion and safeguard the area's financial stability. In cooperation with the International Monetary Fund, loans were granted, conditional on rigorous adjustment plans that the countries in difficulty have undertaken to comply with.

There are no shortcuts available. The response to the debt crisis is first and foremost in national policies, in the complete implementation of the adjustment plans that have been agreed. Solidarity among the member countries of the Union must be matched by a sense of responsibility and compliance with the rules. The financial support of euro-area governments allows countries to proceed with adjustments sheltered from market volatility. It is not a fiscal transfer between countries and is subject to stringent conditions.

The return to financial health is possible. In the last few months I have frequently recalled Italy's experience at the beginning of the 1990s, when the country was faced with a major crisis of confidence in the sustainability of the public debt. Every year, we had to place securities on the market worth, in real terms, ten times Greece's current annual borrowing requirement and twice its value in relation to GDP. Italy overcame this crisis without any assistance from abroad, thanks to an ambitious budgetary consolidation plan, important structural reforms, and a programme of privatizations amounting to around 10 per cent of GDP.

Beyond the emergency, some important steps have already been taken to tackle the known but long neglected underlying weaknesses of the European architecture.

The proposals of the EU Commission and Council reinforce surveillance over budgetary policies. They can be made more ambitious by making procedures more automatic so as to shield them from the arbitrary nature of political negotiations. The European Parliament can have an important influence in this regard.

As was hoped, rules similar to those governing national budgets will be extended to the surveillance of situations of macroeconomic imbalance, with special consideration for the state of member countries' external accounts.

A commitment to reinforce the competitiveness and convergence of the national economies has been undertaken with the Euro Plus Pact, which nevertheless needs to be made more binding.

The new European supervisory authorities began operating at the start of the year. The European Systemic Risk Board (ESRB) is laying the foundations of the system to prevent and, where necessary, manage situations that are critical for financial stability. The European Banking Authority (EBA) will consolidate supervisory rules and practices, which are currently fragmented at national level.

Monetary policy

The Eurosystem has played a crucial role in countering the effects of the crisis. The credibility it has gained over the years has enabled it to keep inflation expectations steady and to act with the speed and flexibility demanded by extraordinary circumstances.

Thanks to measures designed to ensure the supply of liquidity to the markets, the European Central Bank has avoided the collapse of the financial system. It has rapidly reduced the policy rate to 1 per cent, the lowest level ever reached by official rates in the euro-area countries.

Since the end of last year, the large rises in raw material prices have pushed the inflation rate to over 2 per cent. The ECB Governing Council has re-asserted its determination to prevent international price trends from provoking, apart from the inevitable short-term effects, a deterioration in inflation expectations. At its meeting in early April the Council raised official rates by 25 basis points. Even with this measure, monetary conditions remain accommodating.

The grave repercussions of the sovereign debt crisis for the functioning of the financial sector have necessitated exceptional measures, as at the height of the financial crisis in 2008 and 2009. Extraordinary measures to refinance the banking system that had been discontinued earlier have been revived; a programme of purchases of sovereign debt securities issued in the euro area (the Securities Market Programme) has been launched.

These measures are by nature temporary and designed to safeguard the mechanism by which monetary policy impulses are transmitted to the economy; in the case of the SMP, moreover, they are for a limited amount and the effects on the monetary base are fully sterilized.

The ECB has the task of ensuring price stability in the medium term; monetary stability represents its fundamental contribution to growth. Future monetary policy decisions will always be guided by this primary objective. Neither the existence of sovereign risks nor some banks' abnormal dependence on ECB financing can divert it from this objective.

It falls to the national governments to speed up the consolidation of their public finances and implement structural reforms that will raise the potential growth rate of their economies. It falls to the financial intermediaries to continue resolutely towards restoring healthy balance sheets and strengthening their capital base.

The Italian economy

Italy's budget deficit, which this year is close to 4 per cent of GDP, is smaller than the euro-area average. According to official forecasts it will be brought below 3 per cent in 2012. The debt, however, is approaching 120 per cent of GDP.

The objective of achieving budget balance in 2014 is appropriate, as is the plan to bring the definition of the budget adjustment package for 2013-14 forward to this June.

Thanks to the social security reforms introduced in the middle of the 1990s, to a banking system that has not needed government bail-outs, and to prudent management of expenditure during the crisis, the effort we are required to make is less than for many other advanced countries.

Without sacrificing capital expenditure more than the current planning scenario already envisages and without increasing revenue, primary current expenditure must be further reduced, by more than 5 per cent in real terms in the period 2012-14, returning to the same level, in relation to GDP, as at the beginning of the last decade.

It would be inadvisable to seek a permanent and credible reduction of expenditure by cutting items uniformly across the board: this would make it impossible to allocate resources where they are most needed; it would be difficult to sustain over the medium term; it would penalize the more virtuous government departments. A budget of this kind would weigh on the already weak economic recovery, subtracting about 2 percentage points of GDP over the three years.

What is needed, instead, is a skilfully designed package, based on a thorough analysis, item by item, of the accounts of the public-sector agencies, allocating funds according to today's objectives regardless of past expenditure; refining the indicators of efficiency for the various public service centres (offices, schools, hospitals, courts) so as to introduce widespread improvements in the organization and functioning of the units; maintaining the drive to make the public administration more efficient; and channelling a part of the resulting savings towards investment in infrastructure.

Substantial reductions should be made in the high rates of taxation of labour and corporate income, offsetting the loss of revenue by making further progress against tax evasion, beyond the truly appreciable amounts the authorities have recently recovered.

Timely, structural budget measures that are credible in the eyes of international investors and designed to foster growth could, among other things by significantly reducing the risk premiums weighing on Italian interest rates, greatly limit the adverse effects on the economy.

Fiscal federalism can help by making all levels of government accountable, imposing strict budget constraints and involving citizens more closely in public affairs. There are two essential conditions for this: offsetting the new local taxes with cuts in central government taxes, not summing them; and providing for strict monitoring to ensure legal conduct on the part of the bodies accountable, under decentralization, for spending.

Growth

Since the start of the recovery, two summers ago, the Italian economy has recouped only 2 of the 7 percentage points of output lost in the recession. In the first quarter of this year its growth rate was barely positive.

In the course of the past ten years, Italy's gross domestic product has increased by less than 3 per cent; that of France, with about the same population, by 12 per cent. The gap perfectly reflects the difference in hourly productivity – stationary in Italy, up by 9 per cent in France. Italy's disappointing result applies to the country as a whole, North and South alike.

If productivity stagnates, our economy cannot grow. The productive economy loses competitiveness; widening deficits appear in the current account of the balance of payments. Foreign direct investment dries up. In the course of a decade, Italy received foreign direct investment inflows equal to 11 per cent of GDP, compared with 27 per cent in France.

Wage growth is modest in Italy, as it cannot diverge too sharply from productivity growth: this has repercussions on domestic demand. The real earnings of employees in Italy have been virtually stationary over the past decade, compared with a gain of 9 per cent in France; real household consumption, which has risen by 18 per cent in France, has grown by less than 5 per cent in Italy and only by eroding the propensity to save.

Productivity in Italy is stagnating because the system has not yet adapted sufficiently to the new technologies, or to globalization. Understanding the reasons for this has been the aim of much of the research conducted by the Bank of Italy in recent years. I have reported on it several times, most notably in these annual remarks. Our analyses point the finger at Italy's productive structure, which is more fragmented and static than in other economies; and at government policies that fail to encourage, and often hamper, its development.

The problem of the inefficiency of civil justice has to be tackled at the root. Ordinary lower court cases are now estimated to last more than 1,000 days, putting Italy in 157th place out of the 183 countries covered in the World Bank's rankings. The consequent uncertainty is a major factor of friction in the economy as well as the source of injustice. According to our estimates, the shortcomings of the civil justice system in Italy could subtract up to one percentage point a year from GDP growth.

We must proceed with the reform of the education system, on which a start has been made, in order to raise our levels of academic achievement, which are among the lowest in the Western world even with equal expenditure per student. The disparities within Italy remain unacceptably wide, between North and South and between different schools within the same area, even at the level of compulsory education. At the university level, more competition between institutions is desirable in order to establish centres of excellence that can compete in the world arena. The number of university graduates is still low by international standards. According to OECD estimates, the gap between the Italian education system and global best practices could depress the rate of GDP growth by as much as one percentage point in the long run.

Competition, which is well rooted in a good part of industry, is making very slow headway in services, especially public utilities. What is wanted is not unrestrained privatization but a system of regulated competition in which the customer, the citizen, is better protected. The challenge of growth cannot be left solely to the enterprises and workers that are directly exposed to international competition, while positional rents and monopoly advantages in other sectors depress employment and undermine the country's overall competitiveness.

Italy lags behind the other main European countries in its endowment of infrastructure, despite having had a higher ratio of public infrastructural spending to GDP from the 1980s until 2008. Under the Government's programmes the ratio is set to fall to 1.6 per cent in 2012, down from 2.5 per cent in 2009; on average in the euro area, the planned expenditure for 2012 is 2.2 per cent of GDP, down from 2.8 per cent in 2009. Uncertainty in planning, deficiencies in project evaluation and public works selection, fragmentation and overlapping of powers, and inadequate rules on contract awards and project controls result in public works that are less useful and more costly than elsewhere.

The execution time for projects financed by the European Regional Development Fund is nearly twice as long as scheduled in Italy, compared with average overruns of just one quarter in the rest of Europe, and cost overruns are 40 per cent as against 20 per cent. In high-speed rail projects and for motorways, the average cost per kilometre and the realization time are greater than in France and Spain to an extent only partially justified by the different topographical conditions.

It is essential to restore efficiency in expenditure, in order among other things to make the most of project financing and Community resources, which do not burden the Italian public finances.

To date, only about 60 per cent of the motorway network enlargements provided for in the 1997 agreement between the National Road Agency and the main motorway concessionary have been completed, and under 30 per cent of those decided in 2004, while the latest plan, that of 2008, is still under study. The works to be realized are worth €15 billion. Only 15 per cent of the Community structural funds at our disposal has been spent; the unspent portion amounts to €23 billion, to be associated with the required national cofinancing. Speeding these projects up would have a considerable impact on economic activity.

The spread of part-time and fixed-term employment contracts in the past fifteen years has helped to raise the employment rate, but at the cost of creating a pronounced dualism within the labour market: on the one hand the better-protected workers with permanent jobs and on the other a vast area of precarious employment, especially among young people, with little protection and low earnings. A more balanced approach to labour market flexibility, which today depends almost entirely on entry mode, would let young people set their sights higher. It would spur firms to invest more in the training of human resources, to integrate them into the production process and to offer them better career prospects.

The industrial relations system must foster the modernization and competitiveness of the productive economy, in the interests of both sides. Steps have been taken to strengthen the role of company-level bargaining, but the predominance of industry-wide bargaining and the lack of definite rules governing trade union representation still limit the possibility of workers' entering into commitments vis-à-vis their firms and weaken their ability to affect their own wages and job security.

Women's low labour market participation is a crucial weakness of the Italian economy, and one on which we are now concentrating our research effort. Today, 60 per cent of Italy's university graduates are women. They earn their degrees faster and with a better academic performance than their male fellow-students; and they are less and less restricted to the traditional women's disciplines in the humanities. Yet the employment rate for women is still no more than 46 per cent, 20 points less than for men. It is lower than in practically every other European country, especially in the higher positions and among women with children. Holding education and experience constant, women's earnings are 10 per cent lower than men's. Women still devote a great deal more time to home and family in Italy than in other countries. Greater availability of services would help, as would the organization of work to facilitate the reconciliation of family and job commitments and an attenuation of the implicit tax disincentives for women's work.

The social safety net must guarantee adequate income support to anyone who loses a job and is actively seeking another. The fate of those working for firms that can no longer survive in the marketplace must be made less dramatic, in order not to impede the natural turnover of enterprises.

Enterprise and finance

Italy's entrepreneurs and workers have the skills and the energy to lift the pace of growth. In spite of crisis and recession, our business surveys of recent years have revealed great vitality in many enterprises.

But those skills and those energies are fragmented.

Italian firms, on average, are 40 per cent smaller than their euro-area counterparts. The top 50 European corporations by sales include 15 German and 11 French but just 4 Italian firms. Italy's industrial structure seems static; rarely do firms grow and move up to the next size class.

In the early 1960s, plants with over 100 workers employed 43 per cent of Italy's manufacturing workers, as against over 60 per cent in France and Germany. Since then the employment share of large plants has declined much more sharply in Italy than in France or Germany, to under 30 per cent.

The flexibility typical of small firms, which in the past helped to sustain Italian competitiveness, is no longer enough today. We need more medium-sized and large firms that can move rapidly and effectively into international markets and exploit the efficiency gains offered by technological innovation.

When one of our firms has a chance to expand, it may be deterred not only by a fiscal, regulatory and administrative framework still perceived as uncertain and costly but also by corporate structures that are often kept impermeable to outsiders. Widespread family control of businesses is not a specifically Italian phenomenon; what is, is the restriction of management to the family circle. Sixty per cent of all Italian manufacturing firms with ten or more workers are exclusively family controlled and managed, compared with under 30 per cent in Germany and France. These firms have less propensity to innovate, engage less in research and development, and rarely penetrate emerging markets.

The average Italian firm has less equity capital than its counterparts in the other advanced countries. There is little diversification of sources of funding – consisting largely in bank credit – and the incidence of short-term debt is high.

To encourage recourse to equity capital, as part of a comprehensive redistribution of public revenue and expenditure the taxation of the share of profit corresponding to the remuneration of equity should be reduced. Including the regional tax on productive activity, the statutory tax rate on company income in Italy is nearly six percentage points above the euro-area average.

Banks and banking supervision

Banks have stepped up their lending to firms markedly, in response to the recovery in demand for working capital: the increase amounted to 5.2 per cent on an annualized basis in the three months ended in April; the rate of growth in the twelve months to April was 4.4 per cent, the highest among the main countries of the euro area.

The ratio of new bad debts to outstanding loans remained high in 2010, at 1.9 per cent, though far below the figure recorded after the recession of the early 1990s. The data for the first few months of this year signal improvement.

Many intermediaries have supported customers by granting debt restructurings or loan repayment moratoria. Such measures, which rarely provide for capital increases or new business plans, must be targeted at firms actually capable of overcoming the crisis and not be merely a way for banks to put off booking losses.

Small banks have provided support to the economy, including during the recession. They have expanded their business both outside their territory and with large customers. They must now make their governance arrangements, organizational structures and credit risk control systems adequate to their larger shares of intermediation.

The cost and availability of the funds that banks can raise on the markets have been affected by the pressures on sovereign debts. Our leading banks have nearly completed their funding programmes for this year, albeit at higher costs and with 40 per cent in the form of covered bond issues.

A third of the bank bonds now outstanding will mature by the end of 2012; this is a significant share but similar to that of the main European banks. Compared with the intermediaries of other countries, which rely more heavily on wholesale funding, our banking system benefits from a broad base of retail funding, which is relatively less sensitive to the volatility of the markets.

Italian banks' liquidity position, monitored constantly by the Bank of Italy, has remained balanced as a whole. Their holdings of assets eligible as collateral in Eurosystem refinancing operations are substantial; recourse to such operations is more limited than that of other euro-area banking systems.

Since last year the Bank of Italy has asked banks to strengthen their capital bases. Shareholders, banking foundations and investors have responded readily.

Between October 2010 and April of this year capital increases totalling more than €11 billion were launched. The majority of these operations will be completed by the autumn. They make it possible to approach the objective set by Basel III for 2019.

It is commonly thought that an increase in banks' equity translates into higher costs for customers and ends up braking the growth of the economy. However, quantitative studies show that a stronger capital base for banks has a positive net effect on the economy: it increases the system's ability to withstand adverse shocks and reduces the likelihood of crises; for individual intermediaries, it reduces the risk premium on fund-raising and the cost of equity capital itself.

A recovery in earnings makes it possible to increase capital internally. In 2010 the five largest Italian banking groups' return on equity was again about 4 per cent, compared with an average of 7.8 per cent for twelve large European intermediaries. Sluggish asset growth, higher funding costs and low credit quality were the main factors.

The gains in operating efficiency achieved before the crisis must not be lost. The rationalization of distribution networks must continue.

Good governance encourages investors to supply capital.

Cooperative banks listed on the stock exchange need more effective controls on the activity of directors, greater participation of the shareholders in the annual meeting, including by means of proxies. As I have had occasion to remark in the past, a legislative measure is necessary; amendments to bylaws, which we have nonetheless called for, cannot be the definitive solution.

The quality of the banking foundations' governance and internal control arrangements, the safeguards to preserve their independence and prevent conflicts of interest, and the efficiency and transparency of their financial operations are crucial in order to reconcile their holding bank equity with banks' operating autonomy.

In our country there was no banking crisis. However, the recession, by aggravating weak situations that already existed, has produced a rise in the number of provisional management, special administration and liquidation procedures. In line with international guidelines, we now have to revise the framework of rules in two ways: expanding the spectrum of crisis resolution measures; and giving the Bank of Italy, as supervisory authority, the power to remove corporate officers responsible for conduct harmful to the sound and prudent management of a bank.

Suitable rules alone are not enough to ensure good supervision: without strong operating practices, without stringent and efficacious action, crises will not be averted. This has been made abundantly clear by the dramatic recent experiences.

With the Bank of Italy's supervisory role, our country has been able to count on a solid tradition.

We have strengthened the most valid aspects of that tradition: the principles of a rigorous supervisory approach that was never converted to the "light touch"; supervision ready to persuade if possible, to prescribe if necessary, within the limits of law, performed by well-prepared and upright public servants.

On-site supervision is now more closely targeted and more selective, with better use made of our resources. Targeted inspections and thematic inspections, which enable us to assess the same risk profile for multiple intermediaries, have taken their place alongside the all-encompassing inspections carried out at long intervals.

We have forcefully safeguarded the principles of transparency and begun an open dialogue with the banking industry and the public, making good use of consultations on our measures.

We are acting to strengthen the protection of banks' customers, at one and the same time a civil value and an essential component of confidence in the banking system, failing which there can be no lasting stability.

In this delicate phase in which the system is called upon to implement new, stricter international rules, the Bank of Italy is acting on two fronts: on the one hand, we are working in international fora to see that the rules take the specific characteristics of Italian banks into due account; on the other, we have worked closely with our banks to ensure that they fully conform with the evolving rules, especially the definition of capital components, and accordingly are able to stand up well under international examination.

The results of this action up to now have been encouraging. It is in the interest of all to preserve them.

* * *

The Governor's annual concluding remarks have always represented an occasion for voicing assessments. This time they also provide the chance to look back over these five years.

My constant theme has been the problem of our country's economic growth. It is not a new problem, but I do claim for the Bank of Italy the credit for having made it the top economic policy priority. What kind of country will we leave to our children? Many times we have pointed to objectives, suggested lines of action, indicated areas for intervention. Five years on, seeing how little of all this has been translated into reality, the "useless sermons" of a far more illustrious predecessor of mine come to mind.

Why doesn't the political system – which alone has the power to translate analysis into law – take to heart Cavour's dictum that "reforms, when enacted in time, do not weaken authority but reinforce it"?

Thanks to hard work, ingenuity and sacrifice, in the 150 years of its history as a nation Italy has made enormous progress in the material conditions of life. We have experienced periods of booming growth. During the first fifteen years of the twentieth century per capita gross domestic product increased by 30 per cent. In the fifteen years following the Second World War, it rose by 140 per cent. In each of these historical periods Italy demonstrated a fundamental unity of purpose: in its capacity to withstand the trials of the First World War and in the civic and moral mobilization that, notwithstanding the heterogeneous political forces involved, resulted in our Republican Constitution.

In other periods in our history, progress and growth were hampered by divisions, factional strife, a weakening of trust between the citizens and the State. Many disparities, above all that between North and South, have been overcome only in part. Diversity has been one of Italy's historical characteristics, more than in other countries. Not infrequently, instead of being a source of enrichment the differences have been transmuted into mutual vetoes, the blockage of development.

Our condition today is better in many respects. In large part, age-old conflicts have been superseded. The progress towards ever more advanced forms of integration in Europe and a new, shared diagnosis of the problems afflicting the economy in Italy offer good starting points. We must achieve unity of purpose on the fundamental lines of action. What unites us is more powerful than what divides us.

Today, first of all the public budget must restored to its proper role as a factor of stability and an engine of economic growth, bringing it into balance without delay, revising the composition of spending to favour growth, and easing the heavy tax burden on so many honest workers and entrepreneurs.

Economic growth does not stem solely from economic factors. It depends on public institutions, on citizens' faith in them, on shared hopes and values. It is these same factors that determine the progress of a nation. To cite Cavour again: "A nation's political resurgence can never be divorced from its economic resurgence. … Civic virtues, wise laws affording equal protection to each and every right, sound political arrangements, essential to the betterment of a nation's moral condition – these are also the prime cause of its economic progress." The intertwined vested interests oppressing the country in so many ways must be eliminated. This is an essential condition for joining solidarity with merit, equity with competition, for renewing the country's prospects for growth.

In March 2006, in my very first public speech as Governor of the Bank of Italy, I noted that the Italian economy appeared to be weighed down, but that its structural lags were not to be taken as signs of inevitable decline. They could be faced and matters clearly explained to the public, even when the solutions ran counter to the short-term interests of some segments of society. A few weeks later I opened my address to you in this forum with the words "Returning to growth". It is with these same words that I would like to close these concluding remarks.

THE BANK OF ITALY'S ANNUAL ACCOUNTS

22. MANAGEMENT REPORT AND ANNUAL ACCOUNTS[1]

The Bank of Italy's annual accounts consist of the balance sheet, the profit and loss account and the notes to the accounts. Amounts are presented in euros in the official accounts and in thousands of euros in the tables of the notes.

In February, the Bank sends the balance sheet to the European Central Bank for consolidation with those of the other Eurosystem central banks.

The draft annual accounts are transmitted to the Ministry for the Economy and Finance under Article 117 of Royal Decree 204/1910 (Consolidated Law on the Bank of Issue).

The management report provides information on events in 2010 that influenced the Bank's operations and had an impact on the annual accounts. In addition to the Annual Report, the documents used by the Bank to report on its activity are: the *Report to Parliament and to the Government*, the *Bollettino di Vigilanza*, and periodic and occasional testimony before Parliament by the Bank's highest officers.

[1] This abridged English version of the Bank's annual accounts does not contain all the information required by law in the Italian version, nor is it accompanied by the audit report issued by PricewaterhouseCoopers. The complete Italian version can be found on the Bank of Italy's website (www.bancaditalia.it).

MANAGEMENT REPORT

The year ended 31 December 2010 closed with a net profit of €852 million (€1,669 million in 2009). The gross profit before tax and transfers to/from the provision for general risks was equal to €3,127 million (€3,174 million in 2009). Direct taxes for the year amounted to €925 million.

The Bank's institutional structure

Information on the Bank's functions and more details on its system of governance can be found on its website (www.bancaditalia.it), where information on the organization, organization chart and branch network are also available.

On 31 May 2010, the shareholders' meeting renewed the appointments of the members of the Board of Auditors for the three years 2010-12 and appointed PricewaterhouseCoopers, winner of the public tender announced by the Bank in 2009, to audit the Bank's accounts for the years 2010-15. The appointment of this firm of auditors was approved by the Council of the European Union following a resolution adopted by the Governing Council of the European Central Bank.

Organizational developments

The reform of the Bank's branch network was completed in 2010 with the specialization of six branches in cash management functions.

This year has seen the preparation of an organizational intervention involving the Accounting Area of the Head Office and aimed at strengthening the performance of the tasks associated with safeguarding the Bank's financial condition and operating results, providing support for the improvement of corporate efficiency, and protecting against risks of an accounting, tax and procurement nature.

Human, logistical and IT resources

At 31 December 2010, the Bank had 7,162 employees: 4,364 working at the Head Office and 2,798 at branch offices. Managers and officers accounted for respectively 8.6 and 20 per cent of the personnel. The staff's average age was 48.7 years and more than one third of the Bank's employees were women.

The total number of staff decreased by 361 compared with the end of 2009. In 2010 there were 150 new appointments, of whom more than two-thirds for positions requiring a university degree. Of the 511 terminations, 32.3 per cent referred to branch employees who accepted early retirement. Staff numbers showed a further fall of 119 in the first two months of 2011, of whom 56 were employees at branches specialized in cash management who accepted early-retirement incentives.

Table 22.1

Composition of the Bank's staff

	At 31 December 2010					At 31 December 2009				
	Men	Women	**Total**	At branches	At Head Office (1)	Men	Women	**Total**	At branches	At Head Office (1)
Managers	495	124	**619**	135	484	522	131	**653**	156	497
Officers	935	498	**1,433**	381	1,052	968	482	**1,450**	389	1,061
Coadjutors	767	510	**1,277**	540	737	763	510	**1,273**	544	729
Other	2,504	1,329	**3,833**	1,742	2,091	2,756	1,391	**4,147**	1,953	2,194
Total	**4,701**	**2,461**	**7,162**	**2,798**	**4,364**	**5,009**	**2,514**	**7,523**	**3,042**	**4,481**

(1) Includes members of the staff assigned to the Financial Intelligence Unit and the representative offices abroad and those seconded to other organizations.

Training involved 5,350 employees in 2010 (about 75 per cent of the staff). Overall there were more than 172,000 hours of training, corresponding to about 32 hours per participant.

In performing their functions, the Bank's employees are required to comply with the general principles which are laid down in a code of conduct and which take account of the institution's public nature and the importance of the tasks entrusted to it.

Information technology plays a major role in support of the Bank's activity.

In Europe in 2010 a new version of the TARGET2 euro gross settlement system was released into production and work continued on designing the architecture and building the new European platform for the settlement of securities transactions, TARGET2-Securities. In Italy, the system for single-treasury-account transfers over the national interbank network by the banks providing treasury services to local authorities was released into production.

During the early months of 2011, the Bank's IT services were also involved in the project to develop a new geographical telecommunications network for the ESCB. In Italy, a start was made on the plan to upgrade the procedures for the Bank's participation in the Collateral Central Bank Management (CCBM2) common technical platform for the management of the assets conferred by banks as collateral for Eurosystem lending operations.

The Bank administers its logistical resources with the aim of guaranteeing the efficient operation of all premises for institutional use and maximizing the value of its real-estate portfolio and the quality of work environments, including from the point of view of security and safety. In order to rationalize the Bank's property portfolio, a public tender has been announced to select a company qualified to provide advice on enhancing the value and disposing of real estate to be entrusted with the sale of Bank buildings no longer needed following branch closings.

Expenditure

The control of expenditure also makes use of management tools such as budgets, and their approval by the General Council, and cost accounting. The latter is based on principles agreed among the central banks of the Eurosystem with the aim of making their costs comparable, facilitating assessments of relative efficiency and contributing to the determination of the charges for the services offered.

In view of the important changes that have affected expenditure activity, the organizational model of the Bank's procurement has been revised, with the centralization of powers in a small number of units. The new arrangements – based on a general buyer charged with carrying out the procedures involved in the purchase of goods and services for the units of the Bank other than those that handle specialized investments (IT, property and banknote printing) – are intended to strengthen the organizational safeguards on activities characterized by legal and administrative complexity, promote the specialization and development of human resources and encourage a unitary approach to the Bank's procurement activity in order to create the conditions for further savings.

The outcome of the spending commitments for 2010 was less than the budget figure and down on the outcome for 2009. The divergence with respect to the budget forecasts was due, in particular, to the decrease in the quantity of banknotes produced for the ECB and the postponement of initiatives and projects involving IT and property. The divergence with respect to the outcome for 2009 reflected not only the first savings from the closure of branches but also the reduced investment in cash handling equipment.

Important innovations were introduced in the budget for 2011 with regard to both its preparation and its contents. Cost centres were given the objective of imposing a significant curb on operating costs.

The guidelines laid down by the Bank proved consistent with the principles subsequently established by Law 122/2010, which ratified Decree Law 78/2010 (Urgent measures concerning financial stabilization and economic competitiveness). The budget for 2011 approved by the General Council entailed a reduction of 10.5 per cent in the allocations for purchases of goods and services compared with 2010, excluding spending on banknote production, whose amount depends on the quantities established by the ECB.

In application of the same principles – of which the Bank, in accordance with Article 3.3 of the above-mentioned decree, takes account in its rules and regulations – in December 2010 the General Council approved a reduction of 10 per cent for the three years 2011-13 in the emoluments payable to the members of the Governing Board.

As regards the curbing of staff costs, in March 2011 the General Council, bearing in mind the provisions of Decree Law 225/2010, ratified by Law 10/2011, approved a freeze on salary adjustments except for the recognition of a contract hiatus indemnity. In addition, salaries above €90,000 were reduced by 5 per cent of the part exceeding that threshold up to €150,000, and by 10 per cent of the part exceeding the latter amount.

Note issue

The Bank contributes to meeting the Eurosystem's demand for banknotes and is involved in drafting common guidelines for the quality of the banknotes in circulation and measures against counterfeiting.

The upward trend of Eurosystem note production in recent years has come to a temporary halt, owing both to the postponement of the launch of the second series of euro notes and to the substantial stocks of notes accumulated in the past. The total production requirements assigned for 2010 and especially 2011 were accordingly reduced, as were the shares assigned to the Bank of Italy. In 2010, the Bank of Italy nonetheless produced 1.2 billion banknotes in €20, €50 and €100 denominations.

The Bank's branches put 2.2 billion banknotes into circulation in 2010, for a total value of €82 billion. The return flow to the Bank amounted to 2.1 billion banknotes worth €79.8 billion; they were selected automatically at the Bank's branches.

The value of the banknotes in circulation at the end of 2010 amounted to €145.4 billion (17.3 per cent of the Eurosystem total) and was up by 1.5 per cent from €143.2 billion at the end of 2009; the amount recorded in the accounts (€138.3 billion) represented the 16.5 per cent share of total Eurosystem circulation notionally assigned to the Bank of Italy.

The new organizational arrangements and production structure of the Bank's printing works were fully implemented in 2010. The investments planned for 2011 mainly concern the adaption of the production processes to the features of the second series of euro notes, compliance with legal obligations and workplace safety.

Financial resources

Ownership of the country's official reserves (gold and claims on non-euro-area residents in foreign currency) is assigned by law to the Bank of Italy. The management of the reserves make it possible to service the Italian Republic's foreign currency debt and meet its commitments to international organizations such as the International Monetary Fund. In addition, since the nation's official reserves are an integral part of the Eurosystem's reserves, their overall level and proper management contribute to safeguarding the credibility of the ESCB. The Bank also manages a part of the reserves transferred to the ECB; in this activity it refers to guidelines laid down by the Governing Council. The foreign currency reserves are managed with the aim of guaranteeing high levels of liquidity and security, while also seeking to maximize the long-term expected yield.

The item *Gold and net foreign currency assets*, the composition of which is detailed in Table 22.2, includes the official reserves plus other claims on euro-area residents denominated in foreign currency held by the Bank and foreign currency liabilities.

At 31 December 2010, the gold and net foreign currency assets were worth €112.8 billion, compared with €86.3 billion a year earlier. The increase mainly reflected the 37.7 per cent rise in the price of gold, which boosted the value of the stock by €22.8 billion. Overall, the movements in exchange rates also contributed to the increase.

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.

Table 22.2

Gold and net foreign currency assets (1)
(millions of euros)

	31.12.2010	31.12.2009
Gold	83,197	60,410
US dollars	18,175	16,396
Pounds sterling	3,682	3,487
Japanese yen	5,571	4,524
Swiss francs	268	228
Other currencies	4	4
SDRs relating to net assets vis-à-vis the IMF	1,853	1,221
Total	**112,750**	**86,270**

(1) Valued at market exchange rates and prices. The reserves do not include financial assets (ETFs and shares/units of UCITS) denominated in foreign currency representing the investment of ordinary and extraordinary reserves, provisions and other capital funds, as they constitute a separate foreign currency item.

The Bank also holds a financial portfolio containing assets other than those linked to the management of the foreign currency reserves. The portfolio includes investments of balance-sheet provisions and reserves and of the severance pay provision. The management of the investments is subject to the ban on the monetary financing of member states and euro-area public institutions; accordingly, securities of such issuers are not acquired at issue. 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 2010, the book value of the portfolio was €119.1 billion, compared with €98.3 billion at the end of 2009. The portfolio was invested mainly in bonds (especially Italian and other euro-area-country government securities) and equities (primarily listed in the euro area). In 2010, the Bank's bond portfolio was invested mainly in securities issued by other euro-area countries. Further progress was made in implementing the strategy of geographical diversification of the equity portfolio, with an increase in the proportion of euro-area shares with respect to those of Italian issuers.

The General Council decides on the classification of securities as being held to maturity. The bulk of the portfolio (88 per cent) consists of securities held to maturity and is therefore valued at cost, subject to impairment. If all listed financial instruments were valued at market prices, the portfolio would be worth €120.4 billion.

The Bank also manages the investments of the defined-contribution pension fund for staff hired since 28 April 1993. Its investments and earmarked estate are included in the Bank's balance sheet. The fund constitutes a separate estate for administrative and accounting purposes. Investments are made observing benchmarks. At 31 December 2010, the fund's total assets and liabilities in the Bank's balance sheet amounted to €174 million. Returns on assets and exposure to risk are measured daily.

Table 22.3

Composition of the financial portfolio
(millions of euros)

	31.12.2010	31.12.2009
Government securities	111,410	90,619
Shares and other equity	5,078	5,285
Convertible bonds and warrants	–	25
Other bonds	187	231
ETFs and shares/units of UCITS	2,474	2,176
Total	**119,149**	**98,336**

Financial risks

The Bank of Italy manages financial risks on an integrated basis and assesses and controls the operational risk associated with investments of its own funds, foreign currency reserves and other portfolios in euros and foreign currency. In addition, the Bank contributes to the evaluation of the risk of assets eligible for monetary policy operations (including extraordinary operations) taking account of the underlying risks according to the guidelines agreed by the Eurosystem.

The *risks associated with managing the foreign currency reserves and the financial portfolio* derive, above all, from exchange rate risk, the price of gold and the fluctuations of the yield curves of the individual markets. Financial risks are managed with reference to the portfolio as a whole, including the component that the Bank holds to maturity. The exchange rate risk for non-euro-denominated assets included in the financial portfolio is hedged through foreign exchange forward sales. The exposure to risk is monitored on the basis of several indicators. For the bond component, first the elasticity of the portfolio's value to interest rate fluctuations is calculated (duration). Then, the maximum potential loss is estimated, separately for the various classes of financial assets and market segments, using the VaR indicator, both long-term and short-term. Estimates are also made of losses in the event of particularly unfavourable market developments with a low probability but a large impact.

Credit risk is controlled and mitigated by means of a rigorous selection of investment instruments and a prior assessment of the soundness of issuers and eligible counterparties. Category and individual exposure limits are also set and they are monitored daily.

The liquidity of the financial instruments invested in is normally very high. That of one component of the foreign currency reserves, made up of bank deposits, bank paper and commercial paper issued by international agencies and entities, is guaranteed by the maturities of these instruments.

At the end of 2010, the overall riskiness (of gold, the foreign currency reserves and the portfolio of financial assets) measured using VaR was greater than at the end of 2009, mainly owing to the increase over the year in the volatility of exchange rates, which had effects on both the foreign currency reserves and gold. The interest rate risk deriving from movements in yields mainly concerned the financial portfolio denominated in euros. The overall duration of the bond component denominated in euros shortened over the year.

The Bank of Italy bears the *risks associated with the management of monetary policy operations* as a consequence of its membership of the Eurosystem and on the basis of the decisions taken by the competent bodies of the ECB.

In the light of signs of improvement recorded in the financial markets, in the early months of 2010 the Eurosystem began the gradual phasing out of the unconventional monetary policy measures introduced in the two preceding years. Longer-term refinancing operations (LTROs) with maturities of one year and six months were suspended as were supplementary LTROs with a maturity of three months. By contrast, LTROs with a maturity equal to the reserve maintenance period were continued. In April 2010, the Eurosystem decided to reintroduce variable-rate tenders for three-month LTROs and held the first auction of this type. In February, the swap lines with the Federal Reserve and the National Bank of Switzerland were suspended.

The intensification of strains on the sovereign debt market nonetheless prevented further progress with the gradual termination of unconventional measures. In May, the ECB accordingly announced the start of the Securities Markets Programme, the aim of which was to restore the proper functioning of the monetary policy transmission mechanism by means of interventions in the euro-area public and private debt securities markets and to ensure depth and liquidity in those market segments which were subject to severe tensions. In line with the Treaty of the European Union, the Eurosystem's purchases of government securities are made exclusively on the secondary market. In order to avoid repercussions on liquidity conditions, all the purchases are fully sterilized by means of operations to re-absorb the liquidity injected.

In addition, to prevent the tensions from spreading to other markets, the Eurosystem announced the return, with effect from May 2010, to a fixed-rate tender procedure with full allotment in the regular three-month LTROs, a new six-month LTRO and the reactivation of the temporary liquidity swap lines with the Federal Reserve. As of September, the fixed rate applied to three-month LTROs is equal to the average of the rates of the main refinancing operations carried out in the same period.

In the wake of the decisions taken in 2010, the average maturity of monetary policy operations shortened. The share of main refinancing operations in total open market operations rose from 11 to 43 per cent. With conditions of excess liquidity nonetheless continuing in the system, on the last day of each reserve maintenance period fine-tuning operations were conducted via the collection of deposits by means of variable-rate tenders.

The programme of purchases of covered bonds launched by the Eurosystem in July 2009 was completed on 30 June 2010. The Bank of Italy acquired covered bonds for a total of €10.1 billion. As part of the Securities Markets Programme the Bank of Italy purchased €8 billion of euro-area countries' securities in 2010. In accordance with the decisions of the Governing Council of the ECB, the securities acquired under these programmes were classified as being held to maturity and therefore valued at cost, subject to impairment.

In order to foster the further normalization of the secondary market in covered bonds, in 2010 the Bank participated in the Eurosystem initiative to start securities lending in connection with the portfolio of covered bonds acquired for monetary policy purposes.

Table 22.4

Securities held for monetary policy purposes *(millions of euros)*		
	31.12.2010	31.12.2009
Government securities	8,018	–
Covered bonds	10,061	5,015
Total	**18,079**	**5,015**

The national central banks share the risks attached to refinancing operations and the securities acquired under the Securities Markets Programme with the whole of the Eurosystem according to its share in the ECB's capital key.

According to Article 18.1 of the ESCB Statute, lending operations by the Eurosystem must be based on adequate collateral. The measures to increase temporarily the eligible assets that the ECB Governing Council had decided in October 2008 were prolonged until December 2010. The risk exposure of the Eurosystem remained higher than before the crisis. The measures to control risk introduced in February 2009 remained in force. They provide for more restrictive criteria for the eligibility of asset-backed securities and the use of unsecured bank paper. As of 1 January 2011, in accordance with the decision taken by the Governing Council of the ECB to consider BBB- as the new minimum rating (except for asset-backed securities), the Eurosystem revised the mechanisms for controlling risks, with special reference to valuation haircuts.

Risks associated with new types of operations

In 2009, the Bank of Italy cooperated with e-MID SIM and ABI in the creation of the Collateralized Interbank Market (MIC), a segment of the interbank deposit market in which funds are traded anonymously. In October 2010, in conjunction with the start of a new market segment (NewMIC), the functions previously performed by the Bank (guaranteeing transactions and acquiring, valuing, safeguarding and administering the financial assets conferred by participants) were transferred to Cassa di Compensazione e Garanzia and Monte Titoli. The transaction guarantees provided by the Bank remained in force exclusively for contracts concluded on the MIC market until 8 October 2010, the last day of trading on that market.

Internal audit and operational risk

The Bank of Italy's internal audit system uses a function-based approach, in which each organizational unit is responsible for the management of its own risk exposure, controls, effectiveness and efficiency. The units apply operational control procedures within their own spheres of responsibility.

The structural and operational simplifications consequent on the reorganization of the Bank have made it necessary to revise thoroughly the second-level defences designed to ensure, including by means of sampling techniques and management by exception indicators, that processes are being carried out in compliance with the law and the objectives established.

In 2010, the General Council approved the creation of an advisory committee on internal auditing with the aim of strengthening the system of controls and the independence and objectiveness of the internal audit function. The committee is made up of three members of the General Council chosen by the Council, which also appoints the chairman. The members of the committee remain in office for three years and may be reappointed once. The purpose of the committee is to provide advice and support to the General Council and the Governor on matters concerning the oversight of the internal audit function; the committee is also required to provide opinions on audit policy and the annual audit plan.

The question of operational risk is a focus of attention for central banks. An initiative has been launched by the ESCB to establish a common Eurosystem frame of reference for operational risk management by national central banks. An operational risk management system consistent with this approach is now being developed.

Of particular importance for the Bank is the risk of non-compliance with tax law, which is overseen by an ad hoc unit.

For legal questions the Bank of Italy has its own team of lawyers, who are listed in a special annex to the professional register.

Environmental policy and workplace safety

Work continued in 2010 on reducing the environmental impact of the Bank's activities. Of major importance was the increase in the supply of electricity coming from renewable sources and the start made on producing energy from worn banknotes shredded at the Head Office and the branches. Upon completion of the test use of recycled paper in its offices, the Bank intends to purchase a substantial quantity in 2011. For the first time an Environmental Report was prepared in 2010 and published on the Bank's website in order to make a start on monitoring its environmental performance.

The Bank continued the drive to improve the arrangements governing workplace safety, so as to ensure the safeguarding of workers' health and safety in accordance with the highest standards. To this end, measures providing for the delegation of functions were approved, in accordance with Legislative Decree 81/2008, and plans prepared for a system for verifying the proper performance of the delegated obligations.

Highlights of the annual accounts

The main factors that influenced the results for the year are described below, with reference to the reclassified accounts shown in Table 22.5.

In 2010, gross profit before tax and transfers to/from the provision for general risks came to €3,127 million (€3,174 million in 2009). The result does not include the return on investment of the ordinary and extraordinary reserves (€463 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.

Table 22.5

Summary of the annual accounts - Reclassified (1)
(millions of euros)

	Balance-sheet aggregates	Profit and loss account			
		Interest and dividends	*Results and write-downs*	*Other components of income*	*Contribution to net profit*
2010 FINANCIAL YEAR					
Gold	83,197				
Position in foreign currency	29,553	*372*	*236*		*608*
Portfolio of financial assets	123,031	*4,088*	*-80*		*4,008*
Lending to euro-area credit institutions	47,635	*303*			*303*
Securities held for monetary policy purposes	18,079	*525*			*525*
Net intra-Eurosystem claims	3,805	*358*			*358*
Banknotes in circulation	-138,324				
Deposits for minimum reserve system	-20,226	*-265*			*-265*
General government deposits	-42,488	*-692*			*-692*
Revaluation accounts	-70,206				
Capital, reserves and provisions	-38,063				
Other net income		*-4*		*380*	*376*
Operating expense and other costs				*-1,921*	*-1,921*
Transfer from the provision for monetary policy operations				*324*	*324*
Extraordinary income and expense				*-34*	*-34*
Transfer of investment income to statutory reserves (Article 40 of the Bank's Statute)		*-480*	*17*		*-463*
GROSS PROFIT		**4,205**	**173**	**-1,251**	**3,127**
Transfer to the provision for general risks				*-1,350*	*-1,350*
Taxes on income for the year and productive activities				*-925*	*-925*
NET PROFIT		**4,205**	**173**	**-3,526**	**852**
2009 FINANCIAL YEAR					
Gold	60,410				
Position in foreign currency	25,860	*439*	*403*		*842*
Portfolio of financial assets	99,356	*3,679*	*66*		*3,745*
Lending to euro-area credit institutions	27,156	*452*			*452*
Securities held for monetary policy purposes	5,015	*36*			*36*
Net intra-Eurosystem claims	52,117	*708*			*708*
Banknotes in circulation	-132,840				
Deposits for minimum reserve system	-26,283	*-324*			*-324*
General government deposits	-31,027	*-663*			*-663*
Revaluation accounts	-44,968				
Capital, reserves and provisions	-35,881				
Other net income		*4*		*475*	*479*
Operating expense and other costs				*-2,005*	*-2,005*
Transfer from the provision for monetary policy operations				*310*	*310*
Extraordinary income and expense				*39*	*39*
Transfer of investment income to statutory reserves (Article 40 of the Bank's Statute)		*-456*	*11*		*-445*
GROSS PROFIT		**3,875**	**480**	**-1,181**	**3,174**
Transfer to the provision for general risks				*-700*	*-700*
Taxes on income for the year and productive activities				*-805*	*-805*
NET PROFIT		**3,875**	**480**	**-2,686**	**1,669**

(1) The annual accounts data refer to the end of the year. They are reclassified as follows: the *Position in foreign currency* includes the securities and other assets denominated in foreign currency (Items 2 and 3 on the asset side) net of the corresponding liabilities (Items 6, 7 and 8 on the liability side); the *Portfolio of financial assets* includes bonds, shares and other equity, and other assets denominated in euros and foreign currency allocated to Items 4, 6, 7, 8 and 11.2 It also includes the equity interest in the ECB (Item 9.1); the *Intra-Eurosystem claims* (Items 9.2 and 9.4 on the asset side) are shown net of the debt related to the adjustment of the note issue (Item 9.2 on the liability side). With reference to the balance-sheet aggregates that include shares and other equity, the column *Interest and dividends* includes income from ETFs and shares/units of UCITS; net income from fees and commissions, the pooling of monetary income and other withdrawals from provisions are included under *Other net income*.

The profit on ordinary operations, consisting of interest and dividends, rose from €3,875 million to €4,205 million, as a result both of the increase of €251 million in net interest income, due mainly to the larger stock of securities denominated in euros, and of the increase of €79 million in dividends, due to the larger dividend paid by the ECB.

The contribution from trading and the valuation of financial positions in euros and foreign currency was positive but smaller than in the previous year (€173 million, compared with €480 million). The result for 2010 reflected the decrease of €179 million in profits from trading, especially in respect of foreign currency securities, and the increase of €128 million in write-downs for the prices of securities, primarily those denominated in euros.

Other net income contracted by €95 million, basically owing to the decrease in the pooling of monetary income. Operating expense and other costs decreased by €84 million; in particular, there was a decline of 3.1 per cent in staff wages and salaries and related costs – as a consequence of the reduction in staff numbers – and of 2.9 per cent in administrative expenses.

The balance of extraordinary income and expense was €34 million of extraordinary expense, mainly as a consequence of the transfer of €23 million to the provision for retirement incentives in connection with the changes in pension law and the completion of the branch reorganization plan, which involved the specialization of some branches in cash management functions.

In 2010, the profit and loss account again benefited from an extraordinary contribution (€324 million, compared with €310 million in 2009) stemming from the reduction in the size of the provision for counterparty risk deriving from monetary policy operations, created in 2008 throughout the Eurosystem.

A transfer of €1,350 million was made to the gross profit to the provision for general risks in view of the need to strengthen the capital protection against the risks involved in the Bank's activities and take account of the withdrawals that had been necessary in earlier years.

Taxes for the year amounted to €925 million (€805 million in 2009). Consequently net profit for 2010 amounted to €852 million (€1,669 million for 2009).

Post-balance-sheet events

With effect from 1 January 2011, following the entry of Estonia into the euro area, the Bank of Italy's share of the capital of the ECB, considering only the Eurosystem national central banks, declined from 17.9056 to 17.8598 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.

On 22 March 2011, the Bank and the Ministry for the Economy and Finance renewed the agreement on the management of the Treasury payment account. The new agreement governs the conditions for keeping the account and establishes a ceiling on the amount that can earn interest and liquidity transfer procedures serving to stabilize the balance and thus promote the efficiency of the money and financial markets and facilitate the conduct of monetary policy.

In the same month, in connection with the enlargement of the IMF's New Arrangements to Borrow, the Bank of Italy signed an agreement providing for it to grant loans up to €8.11 billion to the IMF on behalf of the Republic of Italy. These loans, which were disbursed at the end of March, are backed – under Decree Law 225/2010, ratified by Law 10/2011 – by a government guarantee for the repayment of the principal and the payment of accrued interest and any exchange losses.

On 29 April 2011, the exchange rates of the US dollar, pound sterling, yen and Swiss franc against the euro stood at $1.486, £0.8917, ¥120.67 and CHF1.2867 respectively, a depreciation compared with the values obtaining at the end of 2010 ($1.3362, £0.86075, ¥108,65 and CHF1.2504).

ANNUAL ACCOUNTS
for the year ended 31 December 2010

BALANCE SHEET

ASSETS	Amounts in euros 31.12.2010	31.12.2009
1 GOLD AND GOLD RECEIVABLES	**83,197,329,389**	**60,410,210,727**
2 CLAIMS ON NON-EURO-AREA RESIDENTS DENOMINATED IN FOREIGN CURRENCY	**35,723,586,322**	**31,782,352,237**
2.1 Receivables from the IMF	9,463,179,182	8,379,559,058
2.2 Securities	23,617,185,615	21,567,519,807
2.3 Current accounts and deposits	2,116,606,678	1,524,717,296
2.4 Reverse operations	523,390,279	306,591,246
2.5 Other claims	3,224,568	3,964,830
3 CLAIMS ON EURO-AREA RESIDENTS DENOMINATED IN FOREIGN CURRENCY	**2,064,934,258**	**1,658,245,926**
3.1 Financial counterparties	2,064,934,258	1,658,245,926
3.1.1 Securities	*352,685,511*	*445,534,706*
3.1.2 Reverse operations	–	–
3.1.3 Other claims	*1,712,248,747*	*1,212,711,220*
3.2 General government	–	–
3.3 Other counterparties	–	–
4 CLAIMS ON NON-EURO-AREA RESIDENTS	**6,141,997**	**11,014,687**
4.1 Claims on EU central banks	–	–
4.2 Securities	–	–
4.3 Other claims	6,141,997	11,014,687
5 LENDING TO EURO-AREA CREDIT INSTITUTIONS RELATED TO MONETARY POLICY OPERATIONS	**47,635,200,000**	**27,156,064,391**
5.1 Main refinancing operations	16,557,600,000	1,945,114,474
5.2 Longer-term refinancing operations	31,012,600,000	25,192,669,720
5.3 Fine-tuning reverse operations	65,000,000	–
5.4 Structural reverse operations	–	–
5.5 Marginal lending facility	–	–
5.6 Credits related to margin calls	–	18,280,197
6 OTHER CLAIMS ON EURO-AREA CREDIT INSTITUTIONS	**2,953,924,041**	**359,247,972**
7 SECURITIES OF EURO-AREA RESIDENTS	**84,404,194,819**	**50,708,551,385**
7.1 Securities held for monetary policy purposes	18,078,655,667	5,014,842,548
7.2 Other securities	66,325,539,152	45,693,708,837
8 GENERAL GOVERNMENT DEBT	**17,642,087,699**	**17,793,527,911**
9 INTRA-EUROSYSTEM CLAIMS	**11,842,591,654**	**63,211,185,171**
9.1 Participating interest in the ECB	944,718,371	736,441,704
9.2 Claims arising from the transfer of foreign reserves to the ECB	7,198,856,881	7,198,856,881
9.3 Net claims related to the allocation of euro banknotes within the Eurosystem	–	–
9.4 Other claims within the Eurosystem (net)	3,699,016,402	55,275,886,586
10 ITEMS IN COURSE OF SETTLEMENT	**6,039,592**	**2,902,400**
11 OTHER ASSETS	**47,484,540,738**	**48,163,015,789**
11.1 Euro-area coins	20,565,077	28,775,838
11.2 Financial assets related to the investment of reserves and provisions	35,214,630,881	34,882,726,470
11.3 Intangible fixed assets	32,700,990	35,251,380
11.4 Tangible fixed assets	3,328,644,020	3,425,586,198
11.5 Accruals and prepaid expenses	2,461,808,974	1,678,069,883
11.6 Deferred tax assets	5,574,078,516	6,019,937,451
11.7 Sundry	852,112,280	2,092,668,569
TOTAL	**332,960,570,509**	**301,256,318,596**

THE ACCOUNTANT GENERAL: Claudio Clemente

THE GOVERNOR: Mario Draghi

Audited and found correct - 30 March 2011

THE BOARD OF AUDITORS: Giovanni Fiori, Elisabetta Gualandri, Gian Domenico Mosco, Sandro Sandri, Dario Velo

BALANCE SHEET

LIABILITIES	Amounts in euros 31.12.2010	31.12.2009
1 BANKNOTES IN CIRCULATION	**138,324,110,460**	**132,840,084,030**
2 LIABILITIES TO EURO-AREA CREDIT INSTITUTIONS RELATED TO MONETARY POLICY OPERATIONS	**22,740,415,968**	**34,313,124,121**
2.1 Current accounts (covering the minimum reserve system)	20,225,850,292	26,282,720,647
2.2 Deposit facility	2,514,565,676	8,030,403,474
2.3 Fixed-term deposits	–	–
2.4 Fine-tuning reverse operations	–	–
2.5 Deposits related to margin calls	–	–
3 OTHER LIABILITIES TO EURO-AREA CREDIT INSTITUTIONS	**–**	**–**
4 LIABILITIES TO OTHER EURO-AREA RESIDENTS	**42,517,726,431**	**31,027,160,253**
4.1 General government	42,488,335,099	31,026,787,668
4.1.1 Treasury payments account	*42,331,626,712*	*29,708,702,789*
4.1.2 Sinking fund for the redemption of government securities	*9,037,705*	*37,489,791*
4.1.3 Other liabilities	*147,670,682*	*1,280,595,088*
4.2 Other counterparties	29,391,332	372,585
5 LIABILITIES TO NON-EURO-AREA RESIDENTS	**2,948,762,188**	**312,071,832**
5.1 To EU central banks	93,350	30,803
5.2 Other liabilities	2,948,668,838	312,041,029
6 LIABILITIES TO EURO-AREA RESIDENTS DENOMINATED IN FOREIGN CURRENCY	**623,221,654**	**419,385,594**
6.1 Financial counterparties	–	–
6.2 General government	623,221,654	419,385,594
6.3 Other liabilities	–	–
7 LIABILITIES TO NON-EURO-AREA RESIDENTS DENOMINATED IN FOREIGN CURRENCY	**2,275,816**	**2,225,172**
7.1 Deposits and balances	2,053,973	1,903,635
7.2 Other liabilities	221,843	321,537
8 COUNTERPART OF SDRs ALLOCATED BY THE IMF	**7,609,875,892**	**7,158,754,663**
9 INTRA-EUROSYSTEM LIABILITIES	**7,092,746,655**	**10,358,203,300**
9.1 Liabilities in respect of debt certificates issued by the ECB	–	–
9.2 Net liabilities related to the allocation of euro banknotes within the Eurosystem	7,092,746,655	10,358,203,300
9.3 Other liabilities within the Eurosystem (net)	–	–
10 ITEMS IN COURSE OF SETTLEMENT	**31,089,617**	**16,294,725**
11 OTHER LIABILITIES	**1,949,098,444**	**2,292,246,232**
11.1 Bank of Italy drafts	248,354,656	384,351,800
11.2 Accruals and income collected in advance	55,282,536	39,988,064
11.3 Sundry	1,645,461,252	1,867,906,368
12 PROVISIONS	**7,767,701,469**	**8,006,055,142**
12.1 Provisions for specific risks	1,190,689,395	1,454,426,090
12.2 Staff-related provisions	6,577,012,074	6,551,629,052
13 REVALUATION ACCOUNTS	**70,206,178,954**	**44,967,625,546**
14 PROVISION FOR GENERAL RISKS	**9,145,675,075**	**7,795,675,075**
15 CAPITAL AND RESERVES	**21,149,384,999**	**20,078,836,397**
15.1 Capital	156,000	156,000
15.2 Statutory reserves	13,409,718,078	12,339,169,476
15.3 Other reserves	7,739,510,921	7,739,510,921
16 NET PROFIT FOR THE YEAR	**852,306,887**	**1,668,576,514**
TOTAL	**332,960,570,509**	**301,256,318,596**

OFF-BALANCE-SHEET ACCOUNTS at 31 December 2010 amounted to **281,198,390,665** euros.

THE ACCOUNTANT GENERAL: Claudio Clemente **THE GOVERNOR:** Mario Draghi

Audited and found correct - 30 March 2011
THE BOARD OF AUDITORS: Giovanni Fiori, Elisabetta Gualandri, Gian Domenico Mosco, Sandro Sandri, Dario Velo

PROFIT AND LOSS ACCOUNT

		Amounts in euros	
		2010	2009
1.1	Interest income	4,246,495,233	4,162,813,688
1.2	Interest expense	-1,046,659,055	-1,162,505,238
1	**Net interest income**	**3,199,836,178**	**3,000,308,450**
2.1	Realized gains/losses arising from financial operations	337,418,565	536,814,031
2.2	Write-downs on financial assets and positions	-196,855,279	-76,980,116
2.3	Transfers to/from the provision for general risks for exchange rate, price and credit risks	-1,350,000,000	-700,000,000
2	**Net result of financial operations, write-downs and transfers to/from risk provisions**	**-1,209,436,714**	**-240,166,085**
3.1	Fee and commission income	26,718,544	28,539,936
3.2	Fee and commission expense	-8,276,351	-6,739,543
3	**Net income from fees and commissions**	**18,442,193**	**21,800,393**
4	**Income from participating interests**	**262,501,505**	**161,903,322**
5	**Net result of the pooling of monetary income**	**613,140,317**	**691,865,821** (2)
6.1	Interest income	951,699,657	892,751,465
6.2	Dividends from equity shares and participating interests	246,933,580	255,265,917
6.3	Gains, losses and write-downs	14,512,795	8,982,827
6.4	Other components	24,460,021	21,384,462
6	**Net income from financial assets related to the investment of reserves and provisions**	**1,237,606,053**	**1,178,384,671**
7	**Other transfers from provisions**	**2,582**	**3,176**
8	**Other income**	**72,581,736**	**70,792,383**
	TOTAL NET INCOME	**4,194,673,850**	**4,884,892,131**
9	**Transfer of investment income to statutory reserves** (1)	**-462,532,996**	**-445,165,393**
10.1	Staff wages and salaries and related costs	-693,266,035	-715,508,104
10.2	Other staff costs	-72,077,087	-82,574,180
10.3	Transfers to provisions for accrued expense and staff severance pay and pensions	-107,505,424	-174,604,867
10.4	Pensions and severance payments	-394,021,849	-333,240,852
10.5	Emoluments paid to head and branch office collegial bodies	-3,666,907	-3,812,095
10.6	Administrative expenses	-437,530,099	-450,371,883
10.7	Depreciation of tangible and intangible fixed assets	-185,656,165	-196,067,054
10.8	Banknote production services	-3,961,291	-18,220,529
10.9	Other expenses	-23,294,391	-30,531,635
10	**Expenses and charges**	**-1,920,979,248**	**-2,004,931,199**
11	**Other transfers to provisions**	**–**	**–**
12.1	Extraordinary income	21,556,011	46,423,377
12.2	Extraordinary expense	-55,755,331	-7,573,971
12	**Extraordinary income and expense**	**-34,199,320**	**38,849,406** (2)
	PROFIT BEFORE TAX	**1,776,962,286**	**2,473,644,945**
13	**Taxes on income for the year and productive activities**	**-924,655,399**	**-805,068,431**
	NET PROFIT FOR THE YEAR	**852,306,887**	**1,668,576,514**

(1) Made in accordance with Article 40 of the Statute. – (2) The amounts for 2009 that refer to the adjustments to the pooling of monetary income for prior years have been reclassified under *Net result of the pooling of monetary income*.

THE ACCOUNTANT GENERAL: Claudio Clemente

THE GOVERNOR: Mario Draghi

Audited and found correct - 30 March 2011
THE BOARD OF AUDITORS: Giovanni Fiori, Elisabetta Gualandri, Gian Domenico Mosco, Sandro Sandri, Dario Velo

NOTES TO THE ACCOUNTS

Legal basis, methods of preparation and layout of the annual accounts

Legal basis of the annual accounts. – In drawing up its annual accounts, the Bank of Italy is subject to special statutory provisions and, if they do not provide any guidance, applies the rules laid down in the Civil Code, taking generally accepted accounting principles into account where necessary.

The main statutory provisions referred to above are:

– Article 8.1 of Legislative Decree 43/1998 ("Adaptation of Italian law to the provisions of the treaty establishing the European Community for matters concerning monetary policy and the European System of Central Banks"). The Decree states that "in drawing up its annual accounts, the Bank of Italy may adapt, *inter alia* by way of derogation from the provisions in force, the methods it uses in recognizing amounts and preparing its annual accounts to comply with the rules laid down by the ECB in accordance with Article 26.4 of the ESCB Statute and the recommendations issued by the ECB in this field. The annual accounts drawn up in accordance with this paragraph, with regard in particular to the methods used in their preparation, are also valid for tax purposes". This validity is recognized by Article 114 of Presidential Decree 917/1986 (Consolidated Income Tax Law) as amended by Legislative Decree 247/2005.

  The rules adopted by the ECB are contained in Guideline ECB/2010/20 (published in OJ, L35 of 9 February 2011), which contains provisions referring mainly to items of the annual accounts concerning the institutional activities of the ESCB and non-binding recommendations for the other items of the annual accounts. The document referred to above replaced Guideline ECB/2006/16.

  On the basis of the authority granted by Article 8 of Legislative Decree 43/1998, the Bank of Italy has applied in full the accounting rules and recommendations issued by the ECB, including those on the layout of the profit and loss account in report form and that of the balance sheet. The latter is the same as that used for the monthly statement approved, pursuant to Article 8.2 of Legislative Decree 43/1998, by the Minister for the Economy and Finance;

– the Bank's Statute (approved by Presidential Decree of 12 December 2006), which lays down special rules for the allocation of the net profit for the year, the creation of special reserves and provisions, and the allocation of the income arising from the investment of the reserves.

As regards the matters concerning the preparation of the accounts not covered by the foregoing rules, the following provisions apply:

- Legislative Decree 127/1991 ("Implementation of Directives 78/660/EEC on the annual accounts of certain types of companies and 83/349/EEC on consolidated accounts pursuant to Article 1.1 of Law 69/1990"), as amended;
- Legislative Decree 87/1992 ("Implementation of Directive 86/635/EEC on the annual accounts and consolidated accounts of banks and other financial institutions and 89/117/EEC on the obligations of branches established in a Member State of credit institutions and financial institutions having their head offices outside that Member State regarding the publication of annual accounting documents"), as amended;
- Article 65 (transactions involving government bonds) of Law 289/2002, as amended by Decree Law 203/2005, ratified by Law 248/2005.

Accounting policies. – The accounting policies applied in preparing the annual accounts for 2010 are described below. Where provided for by law, they were agreed with the Board of Auditors.

GOLD, FOREIGN CURRENCY ASSETS/LIABILITIES, SECURITIES

At the start of the Third Stage of EMU (1 January 1999) gold, foreign currency assets/liabilities and securities eligible for use in monetary policy operations were adjusted to the market prices and exchange rates at that date, with the resulting unrealized gains assigned to special revaluation accounts. These unrealized revalutation gains are included in the profit and loss account on a pro rata basis in the event of disposals, redemptions and writedowns.

For gold, the unrealized revalutation 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 gold price and exchange rates communicated by the ECB; unrealized gains are included in the corresponding revaluation account, while unrealized losses are covered first by earlier unrealized gains and any amount in excess thereof is included in the profit and loss account;*
- *the 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, at amortized cost subject to impairment (verification of lasting reduction in value related to the position of the issuer);*
2) *for securities other than those held to maturity:*
   a) *equity shares, ETFs and marketable bonds, at the market price available at the end of the year; units of collective investment undertakings at the year-end value published by the management company. Unrealized gains are included in the corresponding revaluation accounts; unrealized losses are covered first by earlier unrealized gains for the relevant security and any amount in excess thereof is included in the profit and loss account. Foreign currency ETFs and units of collective investment undertakings stated in the balance sheet item* Financial assets related to investments in reserves and provisions *are not included in the net foreign exchange position but shown as a separate item;*
   b) *non-marketable bonds, at amortized cost subject to impairment;*
   c) *non-marketable shares and equity interests not represented by shares, at cost subject to impairment.*

PARTICIPATING INTERESTS

The Bank's participating interests in subsidiary and associated companies that constitute permanent investments are valued at cost subject to impairment. The participating interest in the capital of the ECB is valued at cost.

Dividends and profits are recognized on a cash basis.

The Bank's accounts are not consolidated with those of investee companies insofar as the Bank is not among the entities referred to in Article 25 of Legislative Decree 127/1991.

TANGIBLE FIXED ASSETS

Depreciation begins in the quarter subsequent to that of acquisition both for buildings and for plant and equipment.

Buildings

– *are stated at cost, including improvement expenditure, plus revaluations effected pursuant to specific laws. The depreciation of "instrumental" buildings used in the Bank's institutional activities and those that are "objectively instrumental", in that they cannot be used for other purposes without radical restructuring, included among the investments of the provision for staff severance pay and pensions is on a straight line basis using the annual rate of 4 per cent established by the ECB. Land is not depreciated.*

Plant and equipment

– *are stated at cost, including improvement expenditure. They are depreciated on a straight line basis using the rates established by the ECB (plant, furniture and equipment, 10 per cent; computers and related hardware and basic software and motor vehicles, 25 per cent).*

INTANGIBLE FIXED ASSETS

Procedures, studies and designs under way and related advances are valued at purchase or directly allocable production cost. Procedures, studies and designs completed are valued at purchase or directly allocable production cost and amortized on the basis of allowances deemed congruent with the assets' remaining useful lives.

Software licences are stated at cost and amortized on a straight line basis over the life of the contract or, where no time limit is established or it is exceptionally long, over the estimated useful life of the software.

Costs incurred in constructing and enlarging communication networks and one-off contributions provided for in multi-year contracts are amortized on a straight line basis over the foreseeable life of the network in the first two cases and over the life of the contract in the third case.

Costs incurred in improving buildings owned by third parties and rented to the Bank are amortized on a straight line basis over the remaining life of the rental contract.

Costs of less than €10,000 are not capitalized, except for those incurred for software licences.

ACCRUALS AND DEFERRALS

Include accrued income and prepaid expenses and accrued expenses and income collected in advance. Interest accrued on foreign exchange assets and liabilities is recorded on a daily basis and included in the net foreign exchange position.

BANKNOTES IN CIRCULATION

The ECB and the euro-area NCBs, which together comprise the Eurosystem, issue the euro banknotes (ECB Decision No. 29 of 13 December 2010 on the issue of euro banknotes, in OJ, *L35 of 9 February 2011).*

The total value of euro banknotes in circulation is allocated within the Eurosystem on the last working day of each month on the basis of the criteria set out hereinafter.

The ECB is allocated 8 per cent of the total value of euro banknotes in circulation, while the remaining 92 per cent is allocated to the NCBs according to the weighting of each in the capital key of the ECB. The share of banknotes allocated to each NCB is disclosed under the balance sheet liability item Banknotes in circulation. *On the basis of the banknote allocation key the difference between the value of the banknotes allocated to each NCB and that of the banknotes it actually puts into circulation gives rise to remunerated intra-Eurosystem balances. From the year of the cash changeover of each member state that has adopted the euro and for the five subsequent years the intra-system balances arising from the allocation of euro banknotes will be adjusted in order to avoid significant changes in NCBs' relative income positions as compared with previous years. The adjustments are effected by taking into account the differences between the average value of banknotes in circulation of each NCB in the reference period established by law and the average value of banknotes that would have been allocated to them during that period under the ECB's capital key. The adjustments are reduced in annual steps for five years starting from the year of the cash changeover, after which income on banknotes is allocated fully in proportion to the NCBs' paid-up shares in the ECB's capital (ECB Decision No. 23 of 25 November 2010 on the allocation of monetary income of the national central banks of member states whose currency is the euro, in* OJ, *L35 of 9 February 2011). The adjustments recorded in 2010 arise from the entry into the Eurosystem of the central banks of Slovenia in 2007, Malta and Cyprus in 2008, and Slovakia in 2009; they will terminate at the end of 2012, 2013 and 2014 respectively.*

The interest income and expense on intra-Eurosystem balances is cleared through the accounts of the ECB and is disclosed under Net interest income.

The Governing Council of the ECB has decided that the seigniorage income of the ECB arising from the 8 per cent share of banknotes allocated to the ECB and the income deriving from the securities held in connection with the Securities Markets Programme (SMP) shall be recognized to the NCBs in full with reference to the financial year in which it accrued and distributed in January of the following year in the form of an interim distribution of profit (ECB Decision No. 24 of 25 November 2010, in OJ, *L6 of 11 January 2011). The interim distribution of ECB profit is recorded on an accrual basis in the year to which the income refers, by way of derogation from the cash basis applied in general to dividends and profits from participating interests. The Governing Council of the ECB may decide to reduce the amount of seigniorage income to be distributed in respect of expenses incurred in connection with the issue and handling of banknotes; in addition, the Council may decide to retain all or part of the ECB's income arising from SMP securities and, if necessary, all or part of the seigniorage income to the extent necessary to ensure that the amount of the distributed income does not exceed the ECB's net profit for that year. The Governing Council of the ECB may also decide to transfer all or part of the ECB's income arising from SMP securities and, if necessary, all or part of the seigniorage income to a provision for foreign exchange rate, interest rate, credit and gold price risks.*

INTRA-EUROSYSTEM ASSETS AND LIABILITIES

For each NCB the intra-Eurosystem balance arising from the allocation of euro banknotes is included under Net claims/liabilities related to the allocation of euro banknotes within the Eurosystem.

PROVISIONS FOR RISKS

In determining the provisions for risks, the riskiness of the various sectors of the Bank's operations is taken into account in an overall evaluation of adequacy.

In particular, the riskiness of the foreign exchange position and the securities portfolio is evaluated on a value-at-risk basis, with consideration also given to the size of the revaluation accounts.

The provision for general risks is also for risks in connection with the Bank's overall activity that cannot be determined individually or allocated objectively.

Transfers to and withdrawals from the provisions are decided by the 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 credit and counterparty risks deriving from monetary policy operations.

STAFF-RELATED PROVISIONS

– *transfers to the provision for severance pay and pensions of staff hired before 28 April 1993 are included in the annual accounts under Article 3 of the related Rules for an amount that comprises the severance pay accrued at the end of the year, the mathematical reserves for the disbursements to pensioners and those corresponding to the situation of staff having entitlement;*
– *the provision for staff costs includes the estimated amount of costs that had accrued but not been paid at year-end;*
– *transfers to the provision for early retirement incentives connected with the reorganization of the Bank's branch network are entered for the amounts determined on the basis of the expected costs;*
– *transfers to the provision for grants to BI pensioners and their surviving dependents are made in accordance with Article 24 of the Rules governing staff severance pay and pensions;*
– *transfers to the provision for severance pay of contract staff, who do not participate in pension funds or who pay only a part of the contributions for retirement benefits, are determined in accordance with Law 297/1982.*

For staff hired from 28 April 1993 onwards a defined-contribution supplementary pension fund has been created (for more details see below under Other assets and liabilities*).*

OTHER ASSETS AND LIABILITIES

Receivables are stated at their nominal value, except in the case of diminutions in value connected with particular situations concerning the counterparty.

Pursuant to Recommendation NP7/1999 of the Governing Council of the ECB, the costs incurred in the production of banknotes are not included in the valuation of stocks.

Deferred tax assets and liabilities are included in the financial statements on the basis of their presumable tax effect in future years. Deferred tax assets include those deriving from the application of Article 65.2 of Law 289/2002, as amended by Decree Law 203/2005, ratified by Law 248/2005.

The items Other assets *and* Other liabilities *include the investments and separate patrimony of the defined-contribution supplementary pension fund created for staff hired from 28 April 1993 onwards. The fund is invested in financial instruments, which are valued at year-end market prices. The resulting revaluation gains (losses) are treated as revenues (expenses) and, in the same way as for other operating revenues (expenses), added to (subtracted from) the fund's patrimony.*

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.

Forward purchases and sales of foreign currency

– *forward purchases and sales are recorded in the memorandum accounts at the trade date at the spot exchange rate of the transaction. The difference between the values at the spot and forward exchange rates is recorded, on a* pro rata temporis *basis, under interest in the profit and loss account.*

Foreign currency swaps

– *forward and spot purchases and sales are recorded in the memorandum accounts at the trade date at the spot exchange rate of the transaction. The difference between the values at the spot and forward exchange rates is recorded, on a* pro rata temporis *basis, under interest in the profit and loss account. The forward position is valued in conjunction with the corresponding spot position.*

At the time of the settlement of forward purchases and sales of foreign currency and foreign currency swaps, the entries in the memorandum accounts are transferred to the appropriate items of the balance sheet.

Interest rate futures denominated in foreign currency

– *are recorded in the memorandum accounts at the trade date at their notional value and translated at the end of the year at the exchange rate communicated by the ECB. Initial margins in cash are recorded in the balance sheet among foreign currency claims, those in securities are recorded in the memorandum accounts. Positive and negative daily variation margins are communicated by the clearer and taken to the profit and loss account, converted at the exchange rate of the day.*

Other cases with the amount entered in the memorandum accounts

– *securities denominated in euros held on deposit are stated at their nominal value; shares are stated on a quantity basis; those of other kinds at face value or at conventional value;*
– *collateral supplied by counterparties to take part in the collateralized interbank market are stated at nominal value;*
– *commitments in respect of foreign currency transactions are shown at the contractually agreed exchange rate. The entries are deleted at the time the commitments are settled;*
– *other foreign currency amounts are converted at the year-end exchange rates communicated by the ECB.*

Comments on the items of the balance sheet

The items *Gold and assets and liabilities denominated in foreign currency, Monetary policy operations* and *Securities portfolio* are aggregated according to their purposes or type. The other items are commented on following the layout of the balance sheet.

Gold and assets and liabilities denominated in foreign currency (Items 1, 2 and 3 on the asset side and Items 6, 7 and 8 on the liability side)

The increase in the value of gold (79 million ounces or 2,452 tons) was entirely due to the rise in the metal's price.

The increase in the amount of net assets denominated in foreign currency reflected the positive movements in exchange rates and, to a lesser extent, the growth in stocks.

Table 22.6

Gold and assets and liabilities denominated in foreign currency (thousands of euros)			
	31.12.2010	31.12.2009	Changes
Gold (Item 1)	**83,197,329**	**60,410,211**	**22,787,118**
Net assets denominated in foreign currency	**29,553,146**	**25,860,232**	**3,692,914**
Assets denominated in foreign currency	**37,788,520**	**33,440,598**	**4,347,922**
claims on the IMF (Sub-item 2.1)	*9,463,179*	*8,379,559*	*1,083,620*
bonds other than those held to maturity (Sub-items 2.2 and 3.1.1)	*23,969,871*	*22,013,055*	*1,956,816*
current accounts and deposits (Sub-items 2.3 and 3.1.3)	*3,828,856*	*2,737,428*	*1,091,428*
reverse operations (Sub-items 2.4 and 3.1.2)	*523,390*	*306,591*	*216,799*
other assets (Sub-item 2.5)	*3,224*	*3,965*	*-741*
Liabilities denominated in foreign currency	**8,235,374**	**7,580,366**	**655,008**
counterpart of SDRs allocated by the IMF (Item 8)	*7,609,876*	*7,158,755*	*451,121*
advances of general government departments (Sub-item 6.2)	*623,222*	*419,386*	*203,836*
current accounts and deposits (Sub-item 7.1)	*2,054*	*1,904*	*150*
other liabilities (Sub-item 7.2)	*222*	*321*	*-99*

Gold reserves are valued at the year-end market price in euros per fine ounce. This price was obtained by converting the dollar price of gold at the London fixing on 31 December 2010 using that day's exchange rate of the euro against the dollar. Compared with end-2009, gold appreciated by 37.7 per cent (from 766.347 to 1,055.418 euros per ounce).

Compared with the end of the previous year, the exchange rates of the main foreign currencies against the euro showed appreciations of the US dollar (from \$1.4406 to \$1.3362), the yen (from ¥133.16 to ¥108.65), the pound sterling (from £0.8881 to £0.86075), the Swiss franc (from CHF 1.4836 to CHF 1.2504) and the SDR (from 1.0886 to 1.1572 euros per SDR).

Compared with the end of 2009 there were unrealized gains at the end of the year that were entered in the corresponding revaluation accounts for gold (€22,787 million), for dollars (€1,216 million), for yen (€1,018 million), for SDRs (€114 million), for pounds sterling (€110 million) and for Swiss francs (€18 million). After the above-mentioned movements, the exchange rate revaluation accounts amounted at the end of 2010 to €67,631 million, of which €63,776 million was in respect of gold, €1,878 million the yen, €1,469 million the dollar, €339 million the pound sterling, €137 million the SDR and €32 million in respect of the Swiss franc (see Revaluation accounts*).*

Receivables from the IMF increased as a result of the appreciation of the SDR against the euro and of withdrawals by debtor countries, which led to an increase in Italy's net position vis-à-vis the Fund. The item was also boosted by the transactions carried out under the *Standing arrangement to buy and sell SDRs*, entered into by the Bank of Italy with the IMF on 13 April 2010 with the aim of supporting the market liquidity of SDRs by means of purchases/sales against euros with other members of the Fund.

The portfolio of securities denominated in foreign currency is made up of bonds, issued primarily by government bodies and international organizations. Of the total portfolio 63 per cent consisted of securities denominated in US dollars, 22 per cent of securities denominated in yen and 15 per cent of securities denominated in pounds sterling.

Table 22.7

Accounts with the International Monetary Fund
(thousands of euros)

	31.12.2010	31.12.2009	Changes
Assets			
Receivables from the IMF (Sub-item 2.1)	**9,463,179**	**8,379,559**	**1,083,620**
a) Reserve Tranche Position in the IMF	1,846,114	1,281,848	564,266
quota in the IMF	*8,169,745*	*7,603,802*	*565,943*
IMF holdings	*-6,323,631*	*-6,321,954*	*-1,677*
b) Participation in the PRGF	441,654	560,456	-118,802
c) Special Drawing Rights	7,175,411	6,537,255	638,156
Liabilities			
Counterpart of SDRs allocated by the IMF (Item 8)	**7,609,876**	**7,158,755**	**451,121**

The other foreign currency assets, denominated primarily in US dollars, consisted mainly of time deposits (€2,565 million), current accounts (€1,264 million), reverse operations (€523 million) and foreign banknotes (€3 million).

Among the liabilities denominated in foreign currency, primarily in dollars, the most important are the liabilities to general government (€623 million) in respect of advances received for the management of cross-border payments and collections.

Monetary policy operations (Items 5 and 7.1 on the asset side and Item 2 on the liability side)

The operations carried out by the Bank of Italy within the framework of the single monetary policy of the Eurosystem are shown in Table 22.8.

Table 22.8

Monetary policy operations
(thousands of euros)

	31.12.2009	31.12.2008	Changes
Lending to euro-area credit institutions (Item 5)			
5.1 Main refinancing operations	16,557,600	1,945,114	14,612,486
5.2 Longer-term refinancing operations	31,012,600	25,192,670	5,819,930
5.3 Fine-tuning reverse operations	65,000	–	65,000
5.4 Structural reverse operations	–	–	–
5.5 Marginal lending facility	–	–	–
5.6 Credits related to margin calls	–	18,280	-18,280
Total	**47,635,200**	**27,156,064**	**20,479,136**
Securities held for monetary policy purposes (Sub-item 7.1)	**18,078,656**	**5,014,842**	**13,063,814**
Liabilities to euro-area credit institutions (Item 2)			
2.1 Current accounts (covering the minimum reserve system)	20,225,850	26,282,721	-6,056,871
2.2 Deposit facility	2,514,566	8,030,403	-5,515,837
2.3 Fixed-term deposits	–	–	–
2.4 Fine-tuning reverse operations	–	–	–
2.5 Deposits related to margin calls	–	–	–
Total	**22,740,416**	**34,313,124**	**-11,572,708**

In 2010, the movements in monetary policy operations were again influenced by the unconventional measures adopted by the Eurosystem to counter the adverse effects of the financial crisis. In addition to the measures already adopted in 2009, in May 2010, in the light of the strains observed in some segments of the market for euro-area bonds, the Eurosystem launched a programme for the purchase of securities on the secondary market, the Securities Markets Programme, which was in addition to the programme of covered bond purchases completed in 2010.

The year-end value of the stock of *Main refinancing operations* increased while the average stock decreased from €6,248 million to €4,681 million. By contrast, both the year-end value and, albeit to a limited extent, the average stock of *Longer-term refinancing operations* increased (the latter from €24,041 million to €25,248 million). The average stock of *Fine-tuning reverse operations*, to which no recourse was made during 2009, amounted to €46 million. The *Marginal lending facility*, the end-2010 value of which was zero, recorded a small increase in the average stock (from €8 million to €10 million). As in 2009, no recourse was made in 2010 to *Structural reverse operations*.

Table 22.9

Movements in securities held for monetary policy purposes (Sub-item 7.1)
(thousands of euros)

	Bonds held to maturity		Total
	Covered bonds	Government securities (Securities Markets Programme)	
Opening balance	**5,014,842**	**–**	**5,014,842**
Increases	**5,107,385**	**8,017,445**	**13,124,830**
Purchases	5,107,385	7,968,483	13,075,868
Net premiums and discounts	–	48,962	48,962
Decreases	**-61,016**	**–**	**-61,016**
Net premiums and discounts	-61,016	–	-61,016
Closing balance	**10,061,211**	**8,017,445**	**18,078,656**

The *Securities held for monetary policy purposes* consisted of covered bonds and securities of some euro-area countries, acquired respectively under the programmes approved by the Governing Council of the ECB in resolutions adopted in May 2009 (Covered Bond Purchase Programme) and May 2010 (Securities Markets Programme). These securities are classified, in accordance with the decision of the Governing Council of the ECB, as securities held to maturity. The year-end checks made on these securities found no lasting reduction in value.

Under Article 32.4 of the ESCB Statute, the risks associated with refinancing operations and securities held under the Securities Markets Programme, should they materialize, may be allocated, in a decision adopted by the Governing Council of the ECB, among the Eurosystem NCBs in proportion to their shares of the ECB's capital. At the end of 2010, the Eurosystem's total refinancing operations amounted to €546,747 million, down from €749,906 million at the end of 2009. The securities purchased by the NCBs under the Securities Markets Programme amounted to €60,873 million.

On the liability side the deposits held by banks to fulfil their minimum reserve obligations decreased at year-end while the average stock rose slightly (from €25,321 million to €26,116 million). Banks' holdings in the *Deposit facility* decreased, both at year-end and in terms of average stock (from €2,522 million to €1,661 million). The average stock of *Fixed-term deposits* was virtually unchanged at €193 million. No recourse was made to *Fine-tuning reverse operations* in 2010.

Other claims on euro-area credit institutions (Item 6 on the asset side)

These claims increased by €2,595 million (from €359 million to €2,954 million); they consisted in large part of repos on securities denominated in euros (€2,762 million) and liquidity in connection with the management of cross-border euro payments and collections for general government (€170 million).

Securities portfolio (Items 7.2, 8 and 11.2 on the asset side)

In addition to the securities making up part of the foreign exchange reserves (€23,970 million), commented under *Gold and assets and liabilities denominated in foreign currency* and those held for monetary policy purposes (€18,079 million), commented under *Monetary policy operations*, the Bank's securities portfolio amounted to €119,148 million, of which €35,215 million comprised investments of reserves and provisions.

Table 22.10

Securities portfolio
(thousands of euros)

	31.12.2010	31.12.2009	Changes
A) SECURITIES DENOMINATED IN EUROS (Sub-item 7.2 and Item 8)			
1. Securities held to maturity	**76,893,166**	**59,199,004**	**17,694,162**
a) Government securities (Sub-item 7.2)	59,240,252	41,389,879	17,850,373
b) Other bonds (Sub-item 7.2)	44,518	49,289	-4,771
c) Government securities assigned to the Bank of Italy (Item 8)	17,608,396	17,759,836	-151,440
2. Securities other than those held to maturity	**7,040,769**	**4,254,541**	**2,786,228**
a) Government securities (Sub-item 7.2)	7,040,769	4,254,541	2,786,228
Total A	**83,933,935**	**63,453,545**	**20,480,390**
B) SECURITIES RELATED TO THE INVESTMENT OF RESERVES AND PROVISIONS (Sub-item 11.2)			
1. Securities held to maturity and other permanent investments	**27,790,517**	**27,415,221**	**375,296**
a) Government securities	27,483,324	27,073,352	409,972
b) Other bonds	142,500	177,176	-34,676
c) Shares and other equity	164,693	164,693	–
of subsidiary companies and entities	*107,949*	*107,949*	–
of other companies and entities	*2,196*	*2,196*	–
of other companies and entities denominated in foreign currency	*54,548*	*54,548*	–
2. Securities other than those held to maturity and other than other permanent investments	**7,424,114**	**7,467,506**	**-43,392**
a) Government securities	36,952	141,382	-104,430
b) Other bonds	–	29,295	-29,295
c) Shares and other equity	4,913,502	5,120,730	-207,228
of subsidiary companies and entities	*20,146*	*23,968*	*-3,822*
of other companies and entities	*4,893,356*	*5,096,762*	*-203,406*
d) ETFs and shares/units of UCITS	2,473,660	2,176,099	297,561
of which: denominated in foreign currency	*677,990*	*511,918*	*166,072*
Total B	**35,214,631**	**34,882,727**	**331,904**
Total (A+B)	**119,148,566**	**98,336,272**	**20,812,294**

In more detail:

A) securities denominated in euros consist exclusively of bonds issued in the euro area and are stated in:

– Sub-item 7.2 (*Securities of euro-area residents – other securities*). This item consists for 47 per cent of bonds issued by the Italian government and for 53 per cent of bonds issued mainly by other euro-area governments;

– Item 8 (*General government debt*). This item contains the Italian government securities assigned to the Bank following the bond conversion under Law 289/2002 and the termination of the 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 €101 million corresponded to the annual accrued amount of the difference between the purchase price and the redemption value (discount).

  The securities deriving from the termination of the mandatory management of stockpiling consist of non-interest-bearing BTPs; the reduction of €50 million was due to the annual amount redeemed.

Another €34 million of claims deriving from the termination of the management of mandatory stockpiling, also included in Item 8, have not been converted into securities because the relevant legislation made the issue of such securities subject to approval by the State Audit Office of the accounts of the transactions that gave rise to the claims. Following legislation on this matter, the Bank is waiting for the Ministry for the Economy and Finance to decide how the amount is to be paid.

B) securities related to investments of reserves and provisions (Sub-item 11.2 – *Financial assets related to the investment of reserves and provisions*), were denominated in euros and to a very small extent in foreign currency. At year-end, 79 per cent of the portfolio consisted of bonds and 21 per cent of shares, participating interests, ETFs and shares/units of UCITS. As regards the issuers of these securities, 67 per cent of the securities were Italian and the bulk of the remainder was issued by issuers in other euro-area countries. Most of the investments in shares consisted of listed securities. Most of the net purchases during 2010 consisted of government securities.

The Bank also invests in ETFs and shares/units of UCITS denominated in foreign currency. The resulting position is hedged against exchange rate risk by forward sales of the corresponding currencies.

The controlling interests refer to Società Italiana Di Iniziative Edilizie e Fondiarie S.p.A. (SIDIEF) and Bonifiche Ferraresi S.p.A. The participating interests held as permanent investments also include shares of the Bank for International Settlements, which are denominated in SDRs, valued at cost and translated at historic exchange rates. The Bank's interest is equal to 9.61 per cent of the BIS's capital.

The securities related to investments of reserves and provisions denominated in euros and held to maturity included securities whose book value (€38,941 million) was higher than the year-end valuation at market prices (€38,240 million). The securities in question – for which no lasting reduction in value was found relating to the position of the issuers – were stated at amortized cost in accordance with the accounting rules of the Eurosystem.

Intra-Eurosystem claims and liabilities (Item 9 on the asset side and Item 9 on the liability side)

Table 22.11

Positions with the ECB and the other euro-area NCBs
(thousands of euros)

	31.12.2010	31.12.2009	Changes
Assets			
9.1 Participating interest in the ECB	944,718	736,442	208,276
9.2 Claims arising from the transfer of foreign reserves to the ECB	7,198,857	7,198,857	–
9.4 Other claims within the Eurosystem (net)	3,699,017	55,275,886	-51,576,869
Total	**11,842,592**	**63,211,185**	**-51,368,593**
Liabilities			
9.2 Net liabilities related to the allocation of euro banknotes within the Eurosystem	7,092,747	10,358,203	-3,265,456
Total	**7,092,747**	**10,358,203**	**-3,265,456**

On the asset side:

– the *Participating interest in the ECB* increased by €208 million as a result of the payment by the Bank of the first of the three instalments of the increase in the ECB's capital that the Bank subscribed in 2010.

The Governing Council of the ECB decided to increase the ECB's subscribed capital by €5 billion from €5.76 billion to €10.76 billion. The decision was adopted in conformity with the Statute of the ESCB and Council Regulation (EC) 1009/2000 of 8 May 2000. The Governing Council also decided that the euro-area NCBs should pay the capital they had subscribed in three annual instalments of equal size. The first of the three instalments was paid on 29 December 2010, while the second instalment will be paid at the end of 2011 and the third at the end of 2012.

Pursuant to Article 28 of the Statute of the ESCB, the NCBs are the sole subscribers and holders of the capital of the ECB. Subscriptions depend on the shares, which are determined on the basis of the key for the subscription of the ECB's capital established in Article 29 of the Statute and adjusted every five years or when a new country joins the EU. The last periodic five-year adjustment was made on 1 January 2009; at the end of 2010 the Bank of Italy's share of the ECB's subscribed capital was 12.4966 per cent. Considering only the NCBs belonging to the Eurosystem, this share was equal to 17.9056 per cent, which was adjusted to 17.8598 per cent on 1 January 2011 when Estonia joined the euro area.

The Claims arising from the transfer of foreign reserves to the ECB *represent the interest-earning claim denominated in euros recorded at the start of the Third Stage of EMU against the transfer of gold, foreign securities and foreign currencies to the ECB in proportion to the Bank's share of the ECB's capital, as in the case of the other Eurosystem NCBs (see "Comments on the items of the profit and loss account"* – Net interest income*).*

– there was a decrease in *Other claims within the Eurosystem (net)*, which derive mainly from the operation of the TARGET2 system. The latter gave rise to a credit position that fell by €51,343 million (from €54,753 million to €3,410 million); the average position over the year also decreased, albeit to a lesser extent, falling from €59,065 million to €34,775 million.

As in 2009, the liabilities (Sub-item 9.2) refer exclusively to the allocation of euro banknotes within the Eurosystem (see "Legal basis, methods of preparation and layout of the annual accounts").

Other assets (Item 11 on the asset side)

This item consists mainly of securities (see *Securities portfolio*) and *Deferred tax assets*, primarily in connection with prior-year tax losses.

The year-end fair value of the buildings owned by the Bank was estimated to be €4,247 million for those used for its operations and €1,317 million for those related to investments of the severance pay and pension provision.

Deferred tax assets (Sub-item 11.6) decreased by €446 million as a consequence the offsetting of €342.5 million of the deferred taxes deriving from the carryforward of the remaining tax loss for 2002;

– the decrease of €104 million in the deferred tax assets in respect of the provision for Eurosystem monetary policy operations (see *Provisions* and *Provision for general risks*);

– the net increase of €1 million in the deferred tax assets deriving from other sources.

The amount of deferred taxes is calculated using the tax rates that are expected to be in force at the time the temporary differences that have generated them are reversed. The bulk of the deferred tax assets included in the balance sheet derive from the carryforward of the residual tax losses deriving from the bond conversion under Law 289/2002. 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 utilized with no time restriction to offset up to 50 per cent of the corporate income tax liability each year. The inclusion of deferred tax assets in the balance sheet is based on the reasonable expectation – considering the outlook for the Bank's income and the applicable tax law – of offsetting the full amount of the above-mentioned tax losses.

Sundry (Sub-item 11.7 on the asset side) includes the balance-sheet total of €174 million of the defined-contribution supplementary pension fund for staff hired since 28 April 1993, which is matched on the liability side by an equal amount entered in Sub-item 11.3 of *Other liabilities*. The other components of the sub-item are mainly payments on account of corporate income tax and Irap made in 2010. The decrease compared with 2009 was primarily due to the payment of tax credits (and accrued interest) by the Revenue Agency.

Banknotes in circulation (Item 1 on the liability side)

Banknotes in circulation, which represent the Bank of Italy's share (16.5 per cent) of the total Eurosystem note issue (see "Legal basis, methods of preparation and layout of the annual accounts"), increased by €5,484 million (from €132,840 million to €138,324 million). The banknotes actually in circulation, without taking account of the adjustments for their distribution within the Eurosystem, increased by €2,219 million (from €143,198 million to €145,417 million). The average stock of banknotes rose from €135,409 million to €139,318 million, an increase of 3 per cent, compared with 6 per cent for the euro area.

Liabilities to general government and other counterparties in euros (Item 4 on the liability side)

The item refers mainly to the deposits held by the Treasury with the Bank of Italy. The *Other liabilities* include other Treasury claims of €26 million (compared with €1,115 in 2009) and debtor positions with general government in respect of advances received for the management of cross-border euro payments and collections amounting to €121 million (compared with €133 million in 2009).

Although the year-end balance on the Treasury accounts with the Bank of Italy increased significantly, the average balance fell from €44,018 million in 2009 to €40,091 million in 2010. Whereas the year-end balance of the sinking fund for the redemption of government securities decreased, the average balance increased very significantly, rising from €28 million to €471 million.

Liability to non-euro-area residents denominated in euros (Item 5 on the liability side)

The sub-item *Other liabilities* amounted to €2,949 million (€312 million in 2009) and referred mainly to accounts held by customers that used the Eurosystem Reserve Management Services.

Other liabilities (Item 11 on the liability side)

The sub-item *Sundry* (11.3) includes €641 million for the lira banknotes not yet presented for conversion, excluding the two payments on account that the Bank of Italy has already made to the Treasury for the banknotes that will presumably not be presented within the legal time limit.

Provisions and Provision for general risks (Items 12 and 14 on the liability side)

The balances and movements in *Provisions* (Item 12) are shown in Tables 22.12 and 22.13.

Table 22.12

Movements in provisions (Sub-item 12.1)
(thousands of euros)

	Insurance cover	Tax provision (1)	Provision for Eurosystem monetary policy operations	Other provisions	Total
Opening balance	**309,874**	**423,472**	**721,080**	**–**	**1,454,426**
Increases	**–**	**479,069**	**–**	**4,015**	**483,084**
Allocations	–	478,900	–	4,015	482,915
Other increases	–	169	–	–	169
Decreases	**–**	**-422,505**	**-324,315**	**–**	**-746,820**
Withdrawals	–	-417,281	–	–	-417,281
Other decreases	–	-5,224	-324,315	–	-329,539
Closing balance	**309,874**	**480,036**	**396,765**	**4,015**	**1,190,690**

(1) Changes in the *Tax provisions* include the flat-rate withholding tax for the alignment of book and fiscal values. Other changes include the change in deferred tax liabilities for IRAP.

The reduction in *Provisions for specific risks* (Sub-item 12.1) was due mainly to the decrease of €324 million in the provision for Eurosystem monetary policy operations. In accordance with Article 32.4 of the ESCB Statute, all the Eurosystem NCBs created provisions against the counterparty risk associated with monetary policy operations in proportion to their subscribed capital key shares in the ECB in the year in which the events occur. The Governing Council of the ECB has revised the amount of the buffer created by the NCBs in 2008, reducing it to €2,207 million from €4,011 million at the end of 2009. The reduction is entered in the profit and loss accounts of the Eurosystem NCBs, apportioned in the same way as their allocations to the buffer. The amount pertaining to the Bank of Italy decreased from €721 million to €397 million (see "Comments on the items of the profit and loss account" – *Net result of the pooling of monetary income)*.

The change in the tax provision was due not only to the taxes for the year but also to the decrease of €5 million in connection with the settlement of tax disputes.

The provision for charges refers to the costs to be incurred for the restructuring of the Bank's buildings in L'Aquila damaged by the earthquake of 6 April 2009. The Bank has already received payments on account from insurance companies for this damage (see "Comments on the items of the profit and loss account" – *Extraordinary income and expense*).

Table 22.13

Movements in staff-related provisions (Sub-item 12.2)
(thousands of euros)

	For staff severance pay and pensions	For staff costs	For severance pay (1)	For grants to BI pensioners and their survivors	Total
Opening balance	**6,378,750**	**167,928**	**2,811**	**2,140**	**6,551,629**
Increases	**23,913**	**105,964**	**313**	**37**	**130,227**
Allocations	23,913	105,964	162	37	130,076
Other increases	–	–	151	–	151
Decreases	**-183**	**-104,499**	**-141**	**-21**	**-104,844**
Withdrawals	-183 (2)	-104,499	-137	-21	-104,840
Other decreases	–	–	-4	–	-4
Closing balance	**6,402,480**	**169,393**	**2,983**	**2,156**	**6,577,012**

(1) Includes severance pay of contract staff and of ordinary staff prior to joining the supplementary pension fund. – (2) Includes the transfer of severance pay of staff participating in the supplementary pension fund.

The increase in *Staff-related provisions* (Sub-item 12.2) was mainly due to the increase of €24 million in the severance pay and pension provision, which rose to €6,402 million at the end of 2010. Of this amount €5,328 million was for supplementary pensions and €1,074 million for severance pay. The provision for staff costs amounted to €169 million at the end of the year. Of this figure, €53 million was in respect of early retirement measures in connection with the reorganization of the Bank's branch network (see "Comments on the items of the profit and loss account" – *Extraordinary income and expense*).

The *Provision for general risks* (Item 14) rose from €7,796 million at the end of 2009 to €9,146 million at the end of 2010 following the allocation of €1,350 million approved by the General Council. The allocation for 2010 continues the replenishment of the provision following the withdrawals of previous years.

Revaluation accounts (Item 13 on the liability side)

These include the valuation at market prices of gold, foreign currency, securities and forward operations (see *Gold and assets and liabilities denominated in foreign currency* and *Securities portfolio*).

Table 22.14

Revaluation accounts (Item 13)
(thousands of euros)

	Opening balance	Withdrawals	Net revaluations	Closing balance
Exchange rate revaluations	**42,368,472**		**25,263,314**	**67,631,786**
of which: gold	*40,989,318*		*22,787,119*	*63,776,437*
net foreign currency assets	*1,379,154*		*2,475,982*	*3,855,136* (1)
financial assets related to the investment of reserves and provisions	*–*		*213*	*213* (1)
Price revaluations	**2,599,146**		**-24,758**	**2,574,388**
of which: foreign currency securities	*155,104*		*100,242*	*255,346*
securities denominated in euros	*58,078*		*-18,645*	*39,433*
financial assets related to the investment of reserves and provisions	*2,385,964*		*-106,355*	*2,279,609*
Revaluations at 1 January 1999	**8**	**-3**		**5**
Total	**44,967,626**	**-3**	**25,238,556**	**70,206,179**

(1) Includes net revaluations relating to forward operations.

Capital and reserves (Item 15 on the liability side)

As detailed below:

Table 22.15

Capital and reserves (Item 15)
(thousands of euros)

	31.12.2010	31.12.2009	Changes
15.1 Capital	**156**	**156**	**–**
15.2 Statutory reserves (Article 39)	**13,409,718**	**12,339,169**	**1,070,549**
Ordinary	6,578,109	6,076,391	501,718
Extraordinary	6,831,609	6,262,778	568,831
15.3 Other reserves	**7,739,511**	**7,739,511**	**–**
Revaluation reserve under Law 72/1983	694,502	694,502	–
Revaluation reserve under Law 408/1990	683,274	683,274	–
Revaluation reserve under Law 413/1991	16,943	16,943	–
Revaluation reserve under Law 342/2000	896,577	896,577	–
Revaluation reserve under Law 266/2005	1,521,240	1,521,240	–
Fund for the renewal of tangible fixed assets	1,805,044	1,805,044	–
Surplus from the merger of UIC (Law 231/2007)	2,121,931	2,121,931	–
Total	**21,149,385**	**20,078,836**	**1,070,549**

Table 22.16

Movements in ordinary and extraordinary reserves (Sub-item 15.2) *(thousands of euros)*					
	Balance at 31.12.2009	Allocation of 2009 profit under Art. 39 of the Statute	Distribution to shareholders under Art. 40 of the Statute (1)	Transfer of 2010 income under Art. 40 of the Statute	Balance at 31.12.2010
Ordinary	6,076,391	333,715	-29,299	197,302	6,578,109
Extraordinary	6,262,778	333,715	-30,115	265,231	6,831,609
Total	**12,339,169**	**667,430**	**-59,414**	**462,533**	**13,409,718**

(1) From the income earned in 2009.

Table 22.17

Shareholders in the Bank of Italy	At end-2010				At end-2009			
	Number	Shares (1)	%	Votes	Number	Shares (1)	%	Votes
With voting rights	58	299,934	100	539	58	299,934	100	539
S.p.A.s engaged in banking, including companies referred to in Article 1, Legislative Decree 356/1990	*51*	*253,434*	*84*	*418*	*51*	*253,434*	*84*	*418*
Social security institutes	*1*	*15,000*	*5*	*34*	*1*	*15,000*	*5*	*34*
Insurance companies	*6*	*31,500*	*11*	*87*	*6*	*31,500*	*11*	*87*
Without voting rights	6	66	..		6	66	..	
S.p.A.s engaged in banking, including companies referred to in Article 1, Legislative Decree 356/1990	*6*	*66*	*..*		*6*	*66*	*..*	
Total	**64**	**300,000**	**100**	**539**	**64**	**300,000**	**100**	**539**

(1) The nominal value of each share is €0.52.

Off-balance-sheet accounts

Forward sales of foreign currency refer to the commitment arising from operations to hedge the exchange risk on foreign currency investments in respect of reserves and provisions (see *Securities portfolio*).

Commitments to the IMF for loans granted relate to existing IMF initiatives with Italy for financing to be disbursed. The increase in this item over the year was due to the increase in the commitments entered into by the Bank of Italy in connection with the Poverty Reduction and Growth Facility.

The Bank participates in the automatic securities lending programmes managed by specialized intermediaries both for securities included among its foreign currency assets and, since 2010, for covered bonds. At the end of 2010, the Bank's lending under these programmes amounted to €302 million for foreign currency securities and €327 million for covered bonds.

Table 22.18

Off-balance-sheet accounts (thousands of euros)			
	31.12.2010	31.12.2009	Changes
Orders in progress	**375,949**	**23,713**	**352,236**
purchases	292,159	20,846	271,313
sales	83,790	2,867	80,923
Forward operations	**653,511**	**626,536**	**26,975**
forward sales of foreign currencies	653,511	556,536	96,975
forward purchases of foreign currencies	–	70,000	-70,000
Commitments	**1,950,185**	**1,141,835**	**808,350**
to the IMF for loans granted	1,950,088	1,141,815	808,273
other	97	20	77
Collateral received	**132,482,268**	**97,446,245**	**35,036,023**
for refinancing operations (1)	129,723,147	76,413,394	53,309,753
other	2,759,121	21,032,851	-18,273,730
Collateral granted	**23,464**	**29,863**	**-6,399**
Third-party securities and valuables on deposit with the Bank	**145,600,601**	**155,676,147**	**-10,075,546**
Memorandum accounts of the supplementary pension fund	**112,413**	**66,687**	**45,726**
Total	**281,198,391**	**255,011,026**	**26,187,365**

(1) Includes securities and bank loans used as collateral.

Comments on the items of the profit and loss account

The net profit for the year was €852 million, compared with €1,669 million in 2009.

Net interest income (Item 1)

Net interest income increased by €200 million, from €3,000 million to €3,200 million.

Table 22.19

Interest income (Sub-item 1.1) (1) (thousands of euros)			
	2010	2009	Changes
On assets denominated in euros	3,852,025	3,694,742	157,283
securities	*3,122,390*	*2,383,256*	*739,134*
lending operations	*303,033*	*452,178*	*-149,145*
intra-ESCB balances	*414,945*	*829,591*	*-414,646*
other	*11,657*	*29,717*	*-18,060*
On assets denominated in foreign currency	394,470	468,072	-73,602
receivables from the IMF	*27,494*	*17,105*	*10,389*
securities	*358,015*	*424,850*	*-66,835*
other assets denominated in foreign currency	*8,961*	*26,117*	*-17,156*
Total	**4,246,495**	**4,162,814**	**83,681**

(1) Interest earned on financial assets related to the investment of reserves and provisions is shown as a separate income item (see *Net income from financial assets related to the investment of reserves and provisions*).

Table 22.20

Interest expense (Sub-item 1.2) *(thousands of euros)*	2010	2009	Changes
On liabilities denominated in euros	1,024,260	1,133,409	-109,149
Treasury payments account	*685,148*	*660,084*	*25,064*
sinking fund for the redemption of government securities	*5,499*	*588*	*4,911*
current accounts (covering the minimum reserve system)	*264,252*	*324,217*	*-59,965*
intra-ESCB balances	*57,121*	*121,883*	*-64,762*
other	*12,240*	*26,637*	*-14,397*
On liabilities denominated in foreign currency	22,399	29,096	-6,697
counterpart of SDRs allocated by the IMF	*21,986*	*8,558*	*13,428*
other	*413*	*20,538*	*-20,125*
Total	**1,046,659**	**1,162,505**	**-115,846**

Net result of financial operations, write-downs and transfers to/from risk provisions (Item 2)

The result for 2010 comprised:

– net profit on foreign exchange trading (€89 million) deriving mostly from sales of assets denominated in dollars and Swiss francs;

– net profit on trading in securities denominated in euros (€21 million) deriving from sales of government securities;

– net profit on trading in securities denominated in foreign currency (€227 million) deriving primarily from sales of securities denominated in dollars;

– write-downs due to price changes on securities denominated in euros (€117 million) and foreign currency (€80 million), primarily denominated in dollars;

– the transfer of €1,350 million to the provision for general risks.

Table 22.21

Net income from financial assets related to the investment of reserves and provisions (Item 6) *(thousands of euros)*	2010	2009	Changes
Interest	951,700	892,752	58,948
statutory reserves	*306,512*	*299,233*	*7,279*
other reserves and provisions	*645,188*	*593,519*	*51,669*
Dividends	246,933	255,266	-8,333
statutory reserves	*158,664*	*145,236*	*13,428*
other reserves and provisions	*88,269*	*110,030*	*-21,761*
Profits/losses from trading and disposals	88,805	33,768	55,037
statutory reserves	*39,436*	*4,191*	*35,245*
other reserves and provisions	*49,369*	*29,577*	*19,792*
Write-downs	-74,292	-24,785	-49,507
statutory reserves	*-57,110*	*-15,608*	*-41,502*
other reserves and provisions	*-17,182*	*-9,177*	*-8,005*
Other components	24,460	21,384	3,076
statutory reserves	*15,031*	*12,113*	*2,918*
other reserves and provisions	*9,429*	*9,271*	*158*
Total	**1,237,606**	**1,178,385**	**59,221**

Net income from fees and commissions (Item 3)

The net result for the year decreased by €4 million (from €22 million to €18 million). *Fee and commission income* included the charges payable by the participants in TARGET2 (€6 million), fees for financial services on behalf of general government (€5 million), substitute protest declarations (€4 million), fees for Correspondent Central Banking Model services (€3 million) and those for the use of Central Credit Register information (€2 million). *Fee and commission expense* referred primarily to the centralized securities management service (€7 million).

Income from participating interests (Item 4)

The item *Income from participating interests* increased by €101 million, from €162 million to €263 million, and consisted exclusively of the Bank of Italy's share of the ECB profits earned in 2009 and distributed in 2010.

In 2010, the ECB's income deriving from the seigniorage on the 8 per cent share of banknotes allocated to it and from its holdings of securities purchased under the Securities Markets Programme was all kept by the ECB to strengthen the provision for foreign exchange rate, interest rate, credit and gold price risks (see "Legal basis, methods of preparation and layout of the annual accounts").

In March 2011, the Bank of Italy received a dividend of €31 million from the ECB profits earned in 2010.

Net result of the pooling of monetary income (Item 5)

The result for 2010 was €613 million, consisting of:

– the receipt of the Bank of Italy's share of the pooling of monetary income (€303 million, compared with €373 million in 2009);

– the effect, negative for €14 million, of the redetermination of the pooling of monetary income for prior years;

– the reduction of €324 million in the provision in respect of monetary policy operations (see "Comments on the items of the balance sheet" – *Provisions* and *Provision for general risks*).

The result for the pooling of monetary income in 2010 was the difference between the monetary income pooled, €1,570 million, and that redistributed, €1,873 million. The monetary income (to be pooled) of each NCB is determined by measuring the actual annual income that derives from the earmarkable assets held against its liability base.

The liability base of each NCB consists mainly of: banknotes in circulation; liabilities to euro-area credit institutions related to monetary policy operations denominated in euros; net intra-Eurosystem liabilities resulting from TARGET2 transactions; and net intra-Eurosystem liabilities related to the allocation of euro banknotes within the Eurosystem. Any interest paid on liabilities included within the liability base is deducted from the monetary income to be pooled.

The earmarkable assets of each NCB consist mainly of: lending to euro-area credit institutions related to monetary policy operations; securities held for monetary policy purposes; intra-Eurosystem claims equivalent to the transfer of reserve assets to the ECB; net intra-Eurosystem claims resulting from TARGET2 transactions; net intra-Eurosystem claims related to the allocation of euro banknotes within *the Eurosystem; and a limited amount of each NCB's gold holdings and gold receivables in proportion to each NCB's subscribed capital key. Gold is considered to generate no income. The securities held for monetary policy purposes under the Covered Bond Purchase Programme (Decision No. 16 of 2 July 2009 of the Governing Council of the ECB) are considered to bear interest at the last marginal rate applied to Eurosystem main refinancing operations. Where the value of an NCB's earmarkable assets exceeds or falls short of the value of its liability base, the difference is offset by applying the last marginal rate applied to Eurosystem main refinancing operations.*

The monetary income pooled by the Eurosystem is redistributed to each NCB according to its subscribed capital key.

Net income from financial assets related to the investment of reserves and provisions (Item 6)

The improvement in the result on this item was due both to the increase in interest on securities, as a consequence of the large average stock invested, and to the growth in trading income, which more than offset the write-downs on equity securities.

Other income (Item 8)

The item *Other income* includes the amount of the annual reimbursement (€22 million) by the participating central banks of the costs incurred in developing the TARGET2 platform in cooperation with the German and French central banks.

Transfer of investment income to statutory reserves (Item 9)

As provided for in Article 40 of the Statute, income earned on investments of the ordinary and extraordinary reserves is used to increase these reserves. The amount appropriated in 2010 increased from €445 million to €463 million owing to the increase in interest income, dividends and profit on trading, which more than offset the increase in write-downs on equity securities (for more details, see *Net income from financial assets related to the investment of reserves and provisions*).

Expenses and charges (Item 10)

This item is detailed in the table below.

The most significant development relating to the Sub-item *Transfers to provisions for accrued expense and staff severance pay and pensions* was the decrease in the annual transfer to *Staff severance pay and pensions* from €89 million to €24 million. The increase in the item *Pensions and severance payments* was primarily due to the increase in the number of persons leaving the Bank's employment.

Table 22.22

Sundry expenses and charges (Item 10) *(thousands of euros)*			
	2010	2009	Changes
Staff wages and salaries and related costs	693,266	715,508	-22,242
Other staff costs	72,077	82,574	-10,497
Transfers to provisions for accrued expenses and staff severance pay and pensions	107,506	174,605	-67,099
TQP	*23,913*	*88,769*	*-64,856*
accrued expenses not yet paid	*83,394*	*85,630*	*-2,236*
other	*199*	*206*	*-7*
Pensions and severance payments	394,022	333,241	60,781
Emoluments paid to head and branch office collegial bodies	3,667	3,812	-145
Administrative expenses	437,530	450,372	-12,842
Depreciation of tangible and intangible fixed assets	185,656	196,067	-10,411
Banknote production services	3,961	18,220	-14,259
Other expenses	23,294	30,532	-7,238
Total	**1,920,979**	**2,004,931**	**-83,952**

Staff costs (including those for contract workers), comprising wages and salaries (including overtime) and related costs, transfers to the provisions for accrued expenses not yet paid and other staff costs (including per diem expenses for missions and transfers), amounted to €830 million, down from €865 million in 2009. The average number of employees decreased by 403 from 7,629 in 2009 to 7,226 in 2010. The per capita expense for the wages and salaries and related costs of staff in service was respectively €95,900 and €114,900, considering all the components of cost referred to above (€93,800 and €113,400 in 2009). The number of full-time equivalent employees – taking account of overtime, part-time and unpaid absences – fell from 8,161 in 2009 to 7,667 in 2010. The corresponding per capita expense for the wages and salaries and related costs of these full-time equivalent employees was respectively €90,400 and €108,300 (€87,700 and €106,000 in 2009).

The *Emoluments paid to head and branch office collegial bodies* include:

– €401,115 paid to the members of the Governing Council;

– €134,334 paid to the members of the Board of Auditors;

– €2,077,015 paid to the members of the Governing Board.

The emoluments paid to the individual members of the Governing Board were as follows:

– €757,714 to the Governor;

– €593,303 to the Director General;

– €441,057 to each Deputy Director General.

For members of the Governing Board entitled to a pension payable by the Bank, at the time the emoluments referred to above are paid they are decreased by the amounts of such pensions, which are included under Sub-item 10.4 *Pensions and severance payments*.

Table 22.23

The Bank's staff

	Average number of persons in service		Percentage composition	
	2010	2009	2010	2009
Managerial	2,066	2,098	28.7	27.6
Non-executive	4,130	4,444	57.4	58.5
General service and security	512	572	7.1	7.5
Blue-collar	486	484	6.8	6.4
Total payroll workers	**7,194**	**7,598**	**100.0**	**100.0**
Contract workers	32	31		

Administrative expenses decreased overall by €13 million. Spending on raw materials and subsidiary materials for banknote production decreased by €8 million (from €38 million to €30 million), the cost of security services and banknote escort decreased by €5 million (from €80 million to €75 million), equipment rentals decreased by €3 million (from €22 million to €19 million) and the cost of utilities also decreased by €3 million (from €29 million to €26 million). By contrast, building maintenance costs increased by €12 million (from €63 million to €75 million), the cost of external software leasing and maintenance increased by €3 million (from €33 million to €36 million). The following costs were basically unchanged: participation in TARGET2 (€9 million), systems assistance (€30 million) and electronic transmission (€16 million).

Banknote production services, which comprise the costs for banknote production outside the Bank, amounted to €4 million in 2010 (€18 million in 2009).

Extraordinary income and expense (Item 12)

Extraordinary income and expense showed a negative balance of €34 million. The income included the insurance payments received for the earthquake damage to the Bank's buildings in L'Aquila (€10 million), the reduction in the part of the tax provision serving to protect against the risks associated with tax disputes (€5 million) and the payment by the Revenue Agency of interest on tax credits in respect of prior years (€3 million). The expense included the additional transfer to the provision for early retirement incentives in relation to both subsequent amendments to pension legislation and the completion of the reorganization of the Bank's branch network (€23 million), the recognition of claims by the municipality of Savona in relation to the disposal of the building formerly used by the Bank's branch office (€5 million) and the amount spent in 2010 on restructuring the Bank's buildings in L'Aquila (€5 million).

Taxes on income for the year and on productive activities (Item 13)

Taxes for the year amounted to €925 million and comprised both the current taxes due and the change in deferred tax assets and liabilities. Corporate income tax for the year, including deferred taxes, amounted to €774 million (€662 million in 2009).

Table 22.24

Taxes on income for the year (Item 13) *(thousands of euros)*		
	2010	2009
Taxes for the year (-)	-478,900	-412,300
Change in deferred tax assets (+/-)	-445,858	-392,870
Change in deferred tax liabilities (+/-)	103	102
Taxes on income for the year (-)	**-924,655**	**-805,068**

The regional tax on productive activities (Irap) rose from €143 million to €151 million.

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 2010 of €852,306,887:

	euros
– 20 per cent to the ordinary reserve	170,461,377
– an amount equal to 6 per cent of the share capital to shareholders	9,360
– 20 per cent to the extraordinary reserve	170,461,377
– an additional amount equal to 4 per cent of the share capital to shareholders	6,240
– the remaining amount to the State	511,368,533
Total	852,306,887

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 €61,695,000, equal to 0.50 per cent (as in the previous financial year) of the total reserves at 31 December 2009.

If these proposals are approved, the total dividend will be equal to €61,710,600, corresponding to €205,702 per share.

THE GOVERNOR

Mario Draghi

23. DOCUMENTATION ATTACHED TO THE ANNUAL ACCOUNTS

REPORT OF THE BOARD OF AUDITORS

ON THE 117th FINANCIAL YEAR OF THE BANK OF ITALY
AND THE ACCOUNTS FOR THE YEAR ENDED 31 DECEMBER 2010

To the shareholders,

We have examined the annual accounts of the Bank of Italy for the year ended 31 December 2010, 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.

We conducted our examination of the annual accounts in accordance with the principles of conduct for the board of auditors recommended by the Consiglio nazionale dei dottori commercialisti e degli esperti contabili. Procedures required by Article 19 of the Bank of Italy's Statute were also based on the same principles.

In our opinion the annual accounts of the Bank of Italy for the year ended 31 December 2010 have been prepared in accordance with the accounting standards and valuation methods indicated in the notes to the accounts. They comply with the law in force and with the harmonized accounting rules laid down by the Governing Council of the ECB and made applicable for the purposes of the annual accounts by Article 8 of Legislative Decree 43/1998.

The accounts were kept properly in conformity with the standards and rules laid down by the law in force. The individual items of the annual accounts, which were also audited by external auditors, were compared by us with the accounting records and found to conform with them.

The inclusion in the balance sheet of deferred tax assets, arising primarily from the carrying forward of the residual tax losses arising from the government bond conversion under Law 289/2002, is based on the reasonable expectation – considering the outlook for the Bank's income – of offsetting the full amount of the above-mentioned tax losses. In relation to the result for the year, deferred tax assets decreased by €446 million (from €6,020 million to €5,574 million).

The General Council approved the transfer of €1,350 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.

The accounts submitted for your approval show the following results:

Assets	€	332,960,570,509
Liabilities	€	310,958,878,623
Capital and reserves	€	21,149,384,999
Net profit for the year (as shown in the income statement)	€	852,306,887

The off-balance-sheet accounts, equal to €281,198,390,665, refer to commitments, forward transactions, guarantees granted and received, and third parties' deposits of securities and sundry valuables.

We have examined the management report accompanying the annual accounts and consider it to be consistent therewith.

Pursuant to Article 39 of the Statute, the General Council proposes the following allocation of the net profit:

– 20 per cent to the ordinary reserve	€	170,461,3773
– an amount equal to 6 per cent of the share capital to shareholders	€	9,360
– 20 per cent to the extraordinary reserve	€	170,461,377
– an additional amount equal to 4 per cent of the share capital to shareholders	€	6,240
– the remaining amount to the State	€	511,368,533
Total	€	852,306,887

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 €61,695,000, equal to 0.50 per cent of such reserves at 31 December 2009 and within the limits laid down in the above-mentioned article.

During the year ended 31 December 2010 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 2010 that have been submitted to you (the balance sheet, the profit and loss account and the notes to the accounts) and the proposed allocation of the net profit for the year and the additional allocation to capital pursuant to Article 40 of the Statute.

Rome, 29 April 2011

THE BOARD OF AUDITORS
Dario Velo (Chairman)
Giovanni Fiori
Elisabetta Gualandri
Gian Domenico Mosco
Sandro Sandri

LIST OF ABBREVIATIONS

ABI – *Associazione bancaria italiana*
Italian Banking Association

BI–COMP – *Banca d'Italia Compensazione*
Bank of Italy Clearing System

BI–REL – *Banca d'Italia Regolamento Lordo*
Bank of Italy real-time gross settlement system

BOTs – *Buoni ordinari del Tesoro*
Treasury bills

BTPs – *Buoni del Tesoro poliennali*
Treasury bonds

CCTs – *Certificati di credito del Tesoro*
Treasury credit certificates

CIPA – *Convenzione interbancaria per i problemi dell'automazione*
Interbank Convention on Automation

Confindustria – *Confederazione generale dell'industria italiana*
Confederation of Italian Industry

Consob – *Commissione nazionale per le società e la borsa*
Companies and Stock Exchange Commission

Covip – *Commissione di vigilanza sui fondi pensione*
Pension fund supervisory authority

CTOs – *Certificati del Tesoro con opzione*
Treasury option certificates

CTZs – *Certificati del Tesoro zero-coupon*
Zero-coupon Treasury certificates

EFPD – Economic and Financial Planning Document

FIU – Financial Intelligence Unit

FPR – Forecasting and Planning Report

HICP – Harmonized index of consumer prices

ICI – *Imposta comunale sugli immobili*
Municipal real estate tax

Iciap – *Imposta comunale per l'esercizio di imprese e di arti e professioni*
Municipal tax on businesses and the self-employed

Ilor – *Imposta locale sui redditi*
Local income tax

INAIL – *Istituto nazionale per l'assicurazione contro gli infortuni sul lavoro*
National Industrial Accidents Insurance Institute

INPS – *Istituto nazionale per la previdenza sociale*
National Social Security Institute

Irap – *Imposta regionale sulle attività produttive*
Regional tax on productive activities

Irpef	–	*Imposta sul reddito delle persone fisiche* Personal income tax
Ires	–	*Imposta sul reddito delle società* Corporate income tax
ISAE	–	*Istituto di studi e analisi economica* Institute for Economic Research and Analysis
Istat	–	*Istituto nazionale di statistica* National Institute of Statistics
Isvap	–	*Istituto per la vigilanza sulle assicurazioni private e di interesse collettivo* Supervisory authority for the insurance industry
MAC	–	*Mercato Alternativo del Capitale* Alternative Capital Market
MTS	–	*Mercato telematico dei titoli di Stato* Screen-based secondary market in government securities
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 2010

GOVERNING BOARD - DIRECTORATE

Mario DRAGHI	Governor - Member of the Governing Board
Fabrizio SACCOMANNI	Director general - Member of the Governing Board
Ignazio VISCO	Deputy director general - Member of the Governing Board
Giovanni CAROSIO	Deputy director general - Member of the Governing Board
Anna Maria TARANTOLA	Deputy director general - Member of the Governing Board

GENERAL COUNCIL

Paolo BLASI
Paolo DE FEO
Francesco PERONI
Lodovico PASSERIN D'ENTREVES
Paolo LATERZA
Rinaldo MARSANO
Cesare MIRABELLI
Giovanni MONTANARI
Ignazio MUSU
Gavino PIRRI
Stefano POSSATI
Giovanni FINAZZO
Giordano ZUCCHI

BOARD OF AUDITORS

Dario VELO - Chairman
Giovanni FIORI
Elisabetta GUALANDRI
Gian Domenico MOSCO
Sandro SANDRI

ALTERNATE AUDITORS

Lorenzo DE ANGELIS
Angelo RICCABONI

MANAGING DIRECTORS

Paolo PICCIALLI	secretary general
Franco PASSACANTANDO	responsible for central banking, markets and payment systems
Alberto Mario CONTESSA	responsible for service quality
Salvatore ROSSI	responsible for economics, research and international relations
Fabrizio RUDEL	responsible for property and purchasing
Carlo PISANTI	responsible for currency circulation
Olivia BRIZZI	responsible for the reorganization of the bank
Claudio CLEMENTE	accountant general
Stefano MIELI	responsible for banking and financial supervision
Sandro APPETITI	responsible for information technology resources and statistics

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Giovanni CASTALDI	responsible for the financial intelligent unit