FESSUD

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# FESSUD

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# The Italian Financial System

Costanza Consolandi, Giampaolo Gabbi,
Massimo Matthias, Pietro Vozzella

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# The Italian Financial System

Costanza Consolandi, Giampaolo Gabbi, Massimo Matthias, Pietro Vozzella

**Affiliations of authors:** Università degli Studi di Siena (www.unisi.it)

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**Contact details:** Giampaolo Gabbi, Department of Business and Law, Università degli Studi di Siena, P.zza S. Francesco 7, 53100 Siena, Italy
e-mail: giampaolo.gabbi@unisi.it

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## Preface

This report on the Italian financial system is one of 15 studies of national financial systems undertaken as part of the research project Financialisation, Economy, Society and Sustainable Development (FESSUD) financed by the European Commission under the Seventh Framework Programme. The report main goal is to review the existing research and organize the most recent available data on the Italian financial system within in a framework that is broadly compatible with the studies undertaken in the other participating countries. The results of the study were first presented at the annual conference of the FESSUD project held in Berlin in October 2012, and were revised in August 2013.

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## 5. Impact of financial globalisation on national financial systems

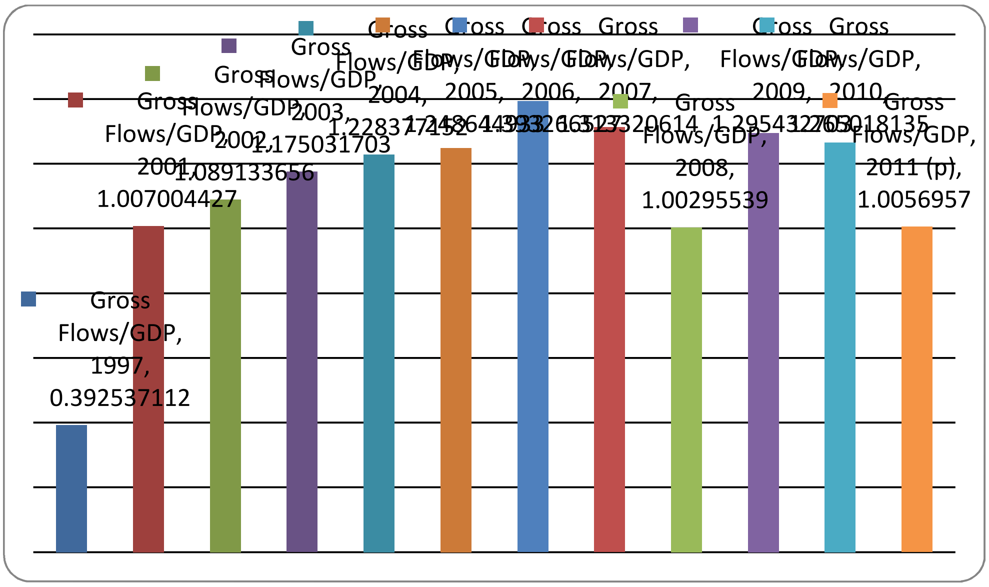
Costanza Consolandi

There have been an extensive literature on the measurement of the effects of the liberalization process (and subsequent market integration and globalization) on financial variables within national financial markets.

Focusing on national equity markets, financial globalization should affect the expected return of equity, through a decrease of the cost of capital, volatility and correlations with industrialized countries and contagion and market liquidity.

As can be seen in Figure 5.1, the volume of foreign investment in stocks and bonds on GDP increased noticeably from 1997 through 2010, with a growth rate of more than 200%. This indicator can be used as a proxy for market openness, as it capture one of the outcomes of financial globalization.

**Figure 5.1: Cross Border security transactions on GDP**




Source: World Bank, IMF

In Italy, the impact of financial globalization on the cost of equity capital has been driven mainly by economic and monetary integration in Europe, which has have both a direct and an indirect effect on the cost of equity capital.

The direct effect is straightforward and consists in a reduction in real risk free rates. In fact, as a precondition to EMU entry, inflation and interest rates converged among EU countries towards the typically low levels of Germany, which used to be considered as the benchmark country. As shown in Figure 4.3 of the previous paragraph, this convergence also resulted in lower real rates, implying that the opportunity cost of investing in equity decreased, reducing the cost of equity capital. Other things remaining equal, this effect on the cost of equity capital in Italy can be approximated by the difference in real short term interest rates from the German rates prior to 1995, when it became apparent to market players that European Monetary Union may materialize with high probability.

However, most importantly, economic and monetary convergence, and subsequent financial integration, has also an indirect effect on the cost of equity capital which consists in a decrease of the equity risk premium, the second component of the cost of equity capital. This effect is due to the gradual abolition of barriers to intra-EU investments and the launch of the common currency, the latter eliminating currency risk in intra-EU transactions.

As a result of both decreasing barriers and the launch of the common currency, risk sharing among EU investors increased, reducing the required equity risk premium and, hence, lowering the cost of equity capital.

Nevertheless, a recent work by Cappiello et al. (2008) point out the relevance of the time component: using an International Capital Asset Pricing Model (ICAPM) and introducing also an inter temporal risk premium in their analysis, they show how in the period after summer 2007, in correspondence with the US subprime crisis, it contributed in increasing the total premium.

As argued by Stulz (1999), another relevant issue for the analysis of the impact of globalization on the cost of capital, is the decreasing of the home bias, as its reduction has an impact on the cost of equity. Thus, the decreasing of the home bias helps to improve a firm's value since the cost of equity is reversely related to the latter, consistently with the optimal global risk-sharing hypothesis and the market segmentation hypothesis.

To measure the degree of home bias, we follow Chen and Yuang (2011) and use Coordinated Portfolio Investment Survey (CPIS) data during 2001 to 2010 provided by the International Monetary Fund (IMF). We use the share of Italy's market capitalization in the world market as a benchmark and the Italian stock market capitalization is used as the market capitalization.

Formally, the measure of home bias can be defined as follows:

$$\text{Home Bias} = w - w^*,$$

Where w represent the proportion of domestic asset on domestic market capitalization, whilst w* is the weight of domestic market capitalization on world market capitalization.

As shown in Table 5.1, the level of home bias for the Italian equity market noticeably decreased from the beginning of the century, thus confirming the increasing openness and integration of Italian financial system.

## Table 5.1 The evolution of the home bias in Italy

| | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 (p) |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Total Foreign Assets | 239,472 | 247,460 | 331,012 | 380,176 | 416,446 | 534,875 | 576,442 | 305,252 | 384,077 | 454,320 | 409,394 |
| Total Foreign Liabilities | 119,639 | 112,017 | 157,160 | 215,048 | 248,745 | 351,856 | 358,856 | 178,467 | 245,295 | 202,931 | 161,764 |
| Domestic Market Capitalization | 527,396 | 480,630 | 614,841 | 789,563 | 798,167 | 1,026,640 | 1,072,692 | 520,855 | 317,317 | 318,140 | 431,471 |
| Domestic Equity Portfolio | 647,229 | 616,072 | 788,693 | 954,690 | 965,867 | 1,209,658 | 1,290,278 | 647,640 | 456,099 | 569,529 | 679,100 |
| World Market Capitalization | 27,906,268 | 23,509,266 | 32,036,192 | 38,151,366 | 43,319,352 | 53,375,286 | 64,575,373 | 34,900,893 | 47,379,869 | 54,511,412 | 45,082,821 |
| Domestic Market Capitalization/World Market Capitalization (%) | 0.02 | 0.02 | 0.02 | 0.02 | 0.02 | 0.02 | 0.02 | 0.01 | 0.01 | 0.01 | 0.01 |
| Foreign security holding/Domestic equity portfolio | 0.37 | 0.40 | 0.42 | 0.40 | 0.43 | 0.44 | 0.45 | 0.47 | 0.84 | 0.80 | 0.60 |
| Domestic securities holding/Domestic equity portfolio | 0.63 | 0.60 | 0.58 | 0.60 | 0.57 | 0.56 | 0.55 | 0.53 | 0.16 | 0.20 | 0.40 |
| Home Bias | 0.61 | 0.58 | 0.56 | 0.58 | 0.55 | 0.54 | 0.54 | 0.51 | 0.15 | 0.20 | 0.39 |

Source: World Bank, IMF

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## THE ABSTRACT OF THE PROJECT IS:

The research programme will integrate diverse levels, methods and disciplinary traditions with the aim of developing a comprehensive policy agenda for changing the role of the financial system to help achieve a future which is sustainable in environmental, social and economic terms. The programme involves an integrated and balanced consortium involving partners from 14 countries that has unsurpassed experience of deploying diverse perspectives both within economics and across disciplines inclusive of economics. The programme is distinctively pluralistic, and aims to forge alliances across the social sciences, so as to understand how finance can better serve economic, social and environmental needs. The central issues addressed are the ways in which the growth and performance of economies in the last 30 years have been dependent on the characteristics of the processes of financialisation; how has financialisation impacted on the achievement of specific economic, social, and environmental objectives?; the nature of the relationship between financialisation and the sustainability of the financial system, economic development and the environment?; the lessons to be drawn from the crisis about the nature and impacts of financialisation? ; what are the requisites of a financial system able to support a process of sustainable development, broadly conceived?'

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## THE PARTNERS IN THE CONSORTIUM ARE:

| Participant Number | Participant organisation name | Country |
|---|---|---|
| 1 (Coordinator) | University of Leeds | UK |
| 2 | University of Siena | Italy |
| 3 | School of Oriental and African Studies | UK |
| 4 | Fondation Nationale des Sciences Politiques | France |
| 5 | Pour la Solidarite, Brussels | Belgium |
| 6 | Poznan University of Economics | Poland |
| 7 | Tallin University of Technology | Estonia |
| 8 | Berlin School of Economics and Law | Germany |
| 9 | Centre for Social Studies, University of Coimbra | Portugal |
| 10 | University of Pannonia, Veszprem | Hungary |
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