Remarks by Luigi Federico Signorini at the presentation of the Bank of Italy’s report on economic developments in Lombardy

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Italy has emerged from the longest and deepest recession in peacetime memory. Slow and hesitant at first, the recovery is gradually strengthening, and for two years now the trend has been clearly positive. Of course, the road ahead is still long and fraught with uncertainty. Notwithstanding its recent growth, Italy's GDP remains seven percentage points below the level of early 2008. Spain's is about to reach that level, while France and Germany have already outstripped it by five and eight points respectively. Nor should the risks on the horizon be underestimated. And yet, even taking account of the lost ground that will be difficult to make up, recent economic developments have been undoubtedly favourable.

In the first three months of this year Italy's GDP grew by 0.4 per cent, exceeding the expectations of the leading forecasters.

Exports have continued to expand. In the last few years the growth in Italian export sales has outpaced that in demand from outlet markets. This was not the case between 1999 and 2009, when Italian firms struggled to keep up with competition from emerging economies and even from the other developed countries. The improved export capacity of Italian firms has been especially important as it has supported GDP growth in the most testing times of the crisis. Since 2010 Italy's market shares have stabilized. Since 2013 there has been a surplus on the current account of the balance of payments. Italy's net foreign debtor position has diminished rapidly in recent years, from 25 per cent of GDP in 2013 to 15 per cent at the end of last year.

The investment-to-GDP ratio had shed five percentage points since 2007, when in 2014 it hit a postwar low of 17 per cent. The fall in investment was one of the most conspicuous signs of the crisis: the poor economic outlook discouraged it and its collapse in turn lowered GDP and productivity, making the outlook even worse and triggering a vicious circle. Years of low investment led to fixed capital not being renewed, lowering production capacity and contributing to weak GDP growth on the supply side too.

However, little by little since 2014 investment has recovered, though the trends by sector and type vary greatly. Purchases of capital goods – machinery, equipment and transport equipment – have risen by almost 11 per cent in the last three years: as a share of GDP they are back near pre-crisis levels. By contrast, spending on construction has lagged behind for longer. Between 2008 and 2014 it contracted uninterruptedly, weighing heavily on the overall investment-to-GDP ratio, which to date has hardly risen at all. Yet even this sector has shown some signs of a revival starting last year. The signs are clearer in the residential sector, which has long benefited from tax incentives for the renovation of existing buildings, while the non-residential construction sector is still struggling to pick up and public investment has been on a trend decline since 2010.

Why has investment returned to growth, at least in machinery and equipment? The Bank of Italy's econometric model can give us some quantitative answers. According to our estimates,[1] almost half of the growth recorded is attributable to the improvement in the credit market: the strongly expansionary monetary policy stance has recently led to a reduction in the cost of capital and fostered more relaxed supply conditions. Yet the gradual improvement in demand and increased confidence on the part of firms have also contributed by one third; if the favourable economic situation continues, then this factor's contribution should increase.

Lastly, government policies to encourage spending on capital goods have also made a significant contribution, which we estimate at around one fifth of the total. As is well known, various tax incentive schemes for

[1] See the box 'The trend in investment and the cyclical recovery' in the Bank of Italy's *Annual Report for 2015*, 2016.

investment have been set up and implemented in recent years, especially in favour of advanced technology. The results of the Bank of Italy's annual business survey (to which, as always, the Bank's regional research network has made a vital contribution) show that in 2016 tax benefits for investment provided considerable support, and will do so to an even greater extent in 2017. We estimate that these benefits are going to boost investment by 3.5 percentage points overall in the period 2016-18. The fact that they are of limited duration is also important: part of their short-term effect is that firms bring forward their spending plans.

Our surveys show that in 2016 investment was higher for small and medium-sized manufacturers, which had been particularly hard hit by the recession. They also indicate that investment will expand further this year: the share of manufacturing firms that plan to increase investment in 2017 was much higher than the share of those planning to reduce it. The slowdown recorded in the early months of the year is therefore expected to be temporary.

Household spending also continues to rise. The recovery has been driven until now by the durable goods sector, which had contracted more than the others in the early stages of the crisis, but in recent years has fared comparatively better owing to the highly accommodative financial conditions. Loans to households in the form of home purchase mortgages and consumer loans have increased considerably. The latest available data show that the increase in household spending is now extending to services.

Real estate wealth, which accounts for over 60 per cent of net Italian household wealth, has turned upward again thanks to the initial signs of a recovery in prices. Confidence indicators remain high. Yet the main driver of consumption is the improvement in income levels and prospects. Last year households' disposable income increased in real terms by 1.6 per cent, double the figure for 2015; it continued to grow, though at a slightly slower rate, in the first three months of this year too.

The consequent improvement in households' economic conditions is partly due to net job creation. Employment has been increasing since the second half of 2014, though with some fluctuations in the monthly data. The growth is wholly attributable to payroll employment, which has now exceeded pre-crisis levels, while the number of self-employed workers has continued to fall.

The recovery in employment has been greater than the mechanical effect of the increase in GDP. This may be partially ascribable to the results of various measures introduced over the last few years, such as those on social security contribution relief, and the reform process that began with the Fornero Law (Law 92/2012) and continued with the approval in 2015 of the legislative decrees of the Jobs Act. According to our estimates,[2] these measures have especially benefited payroll employment and permanent contracts.

This is an overview of the recent changes in the main macroeconomic variables. But what is the current situation and what is the short-term outlook? For the quarter just ended, our estimates suggest overall GDP growth more or less in line with that of the previous quarter. The latest quantitative and qualitative indicators all point to a fresh increase in economic activity in services and to a return to growth in manufacturing, which in recent months had stalled a little.

[2] Sestito, P., and Viviano, E. (2016) 'Hiring incentives and/or firing cost reduction?', Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), 325.

Forecasts beyond the short term are always uncertain. However, our central projections continue to be moderately favourable. On 9 June we published the Bank of Italy's macroeconomic projections prepared as part of the Eurosystem staff macroeconomic projections: these suggest that GDP will rise by 1.0 per cent this year, before accelerating to 1.2 per cent in the subsequent two years. The projections will be updated as usual in the Economic Bulletin to be published on 14 July, incorporating the new data which will become available in the meantime. Just the revised GDP estimates for the last quarter of 2016 and the first quarter of 2017, released by Istat after the closure of our projections exercise, raises the outlook for the growth achieved so far in the current year by about 0.3 percentage points.

Growth in global demand is expected to continue and leading international forecasters are actually predicting that it will strengthen this year and the next. Nothing can ever be taken for granted in these matters; there is continuing uncertainty about the future stance of US trade policy and the consequent possibility of a global shift towards protectionism, which would curb demand and might cause tensions at international level. However, for the time being at least, the economic forecasts are positive.

As we heard during the presentation of the report on economic developments in Lombardy, these positive trends are being confirmed at regional level. In the last 15 years Lombardy has almost always boasted higher GDP growth than that for Italy as a whole, though it has lagged behind − as the report points out – comparable European regions in terms of economic development and productive structures, both as regards per capita income and firms' innovation capacity. Indicators of industrial activity and of firms' investment plans in 2017 are encouraging and could foreshadow

Lombardy’s gradual convergence towards the more advanced areas of the EU.

Growth is also starting to take hold in the southern regions. The data collected by our branches from local economic operators also provide positive indications, though these are less widespread than in the Centre-North. For the labour market too, after widening at the height of the recession, since 2014 the gap between the Centre-North and the South has narrowed.

Those who have been listening up to now might have received the impression that the picture is almost uniformly optimistic, perhaps in contrast with the often bleak overtones that continue to mark the current debate on the state of Italy’s economy. So, in the interest of balance, I wish to reiterate the two essential provisos I made at the outset. First, growth is moderate and we are still nowhere near bridging the chasm in our living standards opened by the crisis that hit the Italian economy between 2008 and 2012, which was − and it bears repeating − the deepest and longest ever experienced in Italy in peacetime memory, and much deeper than that suffered by the other major European countries. Second, several elements of uncertainty weigh on the medium-term outlook; some of these are exogenous, while others are more within our control. By way of conclusion, I would now like to share with you some brief thoughts on the first point and some slightly longer observations on the second, particularly on the need to accomplish what lies within our power − which is a lot.

Let me first say that even before the crisis the Italian economy was growing more slowly, not only than the emerging economies but also than the other major advanced countries. And while the recession appears to have swept away the old debate about Italy’s ‘decline’, its intensity, so much greater in Italy than elsewhere, was probably due at least in part to the same structural problems that for years had been holding the country back. We must now tackle them. These are recurring themes among attentive observers and ones which the Bank of Italy and the ECB never fail to underscore: the need for structural reforms in the labour market and in the market for goods and services; greater efficiency in the justice system and in general government; simpler legal and taxation systems. Despite the crisis, or perhaps precisely because of its harsh impetus, Italy has embarked on a far-reaching programme of structural reform. Much has been done, more than that for which we sometimes get credit. Significant results have been achieved, for example in the areas of labour and pension reform. But much remains undone. We must not stop, much less go back, because our future growth depends on this.

My second point turns on the relationship between cyclical movements and economic policy priorities, especially those of fiscal policy. It is about the choices that can shelter our country from the uncertainties of the global economy versus those that on the contrary could exacerbate them.

With all these provisos the improvement in the economy is real; so what should we do with this 'cyclical dividend'? The answer that the Governor of the Bank of Italy gave a few weeks ago in his concluding remarks is clear. We must exploit the available leeway to develop a gradual and credible plan to lower our debt-to-GDP ratio, a fundamental source of fragility for our economy.

The ratio has been high for more than 30 years. In the mid-1990s, with the prospect of joining the euro, the reduction got under way (about 12 percentage points in five years, between 1995 and 2000); at that time Italy succeeded in generating significant primary surpluses over an extended period, a necessary step for gradually reducing the debt-to-GDP ratio.

Unfortunately, the crisis has led to another, sharp increase, connected with the exceptional contraction in economy activity and very low inflation. The high debt ratio did not allow the government to use fiscal policy to support aggregate demand during the double-dip recession. In fact, market concerns about the sustainability of Italy’s accounts made corrective measures necessary at the height of the sovereign debt crisis.

In those days, Italy’s vulnerability to the vagaries of the economic cycle and to every murmur from the markets was palpable; there was a tangible risk of triggering a spiral of recession and debt. I believe the lesson we can draw from this is clear: in other words, the importance of getting our public finances in order, to the greatest possible extent, during favourable phases in the macroeconomic cycle.

In recent years it has been wise to mediate between the competing needs of public finance and those of the economy: pursuing budgetary consolidation too eagerly while hoping to trigger a recovery could have had deleterious procyclical effects. A balanced approach has been made possible, among other things, by the flexibility allowed in implementing EU rules on public finances, in connection with the adverse cyclical conditions, structural reforms and some exceptional events.

Also owing to the continuation of the crisis, the goal of achieving a structurally balanced budget in 2015 indicated in the 2013 Update of the Economic and Financial Document (EFD) was postponed several times. The latest EFD sets the objective of a substantially balanced budget for 2019 but, as we know, there is still some uncertainty about the measures needed to accomplish this.

It is now time to dispel this uncertainty. Economic conditions have improved, the cyclical recovery is turning out to be stronger than expected, interest rates are low, and international developments have become more favourable. And it is during such favourable phases that the conditions for courageous decisions are created. As our Governor has said, ‘there must be no repeat of past errors: the failure to reduce the ratio of debt to GDP sufficiently in good economic times forced us to make procyclical adjustments during the crisis’.

Progress can be made in this sense as and when the cyclical upturn is reflected in the public finances. But let’s not delude ourselves that we have a *tesoretto* (treasure hoard) to spend, as we sometimes hear people say; let’s not forget the debt mountain in whose shadow we live and which we must attempt to reduce, for our own sake and for the sake of future generations.

The cost of servicing the debt weighs heavily on Italy’s public finances. Between 1999 and 2016 average annual interest expenses came to around 5 per cent of GDP. Italy must necessarily rely on high taxation levels or curb its primary expenditure in response. As happened between 2011 and 2012, worsening market sentiment about the soundness of Italy’s public finances could push these costs up further. In any event, the uncertainty this entails holds back private economic activity in Italy. But the launch of a credible plan would reassure the markets and would in some way be self-sustaining. For a country with such a high debt, we should remember that the spread game could trigger a virtuous circle just as much as a vicious one, depending on whether or not we succeed in coming up with serious and credible plans for lowering it.

Even though the Great Recession is behind us and we hope to never see anything of that kind again, one day or another the economic cycle will start to worsen again. This is inevitable, and it has always been so. Today the markets are relaxed, monetary policy is exceptionally expansionary and interest rates are exceptionally low. These conditions cannot last forever. What we can do today is work to make our country stronger, more resilient and more capable of reacting to adverse economic cycles and to changes in market sentiment. We must continue down the path of structural reform and do what we can to start to lower the debt. In a nutshell, we must not miss this opportunity.