Ignazio Visco: The recovery and the risks – an Italian central banker view

Speech by Mr Ignazio Visco, Governor of the Bank of Italy, at the 20th ASSIOM FOREX (the Financial Markets Association of Italy) Congress, Rome, 8 February 2014.

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The recovery and the risks

Since last summer the continued strengthening of economic activity in the advanced economies, particularly the United States, has been accompanied by an improvement in financial conditions and a decline in the risk premiums on government bonds in the euro area. In Italy, net capital inflows have continued, and the Bank of Italy's debit balance in TARGET2 has diminished by a third compared with the high point recorded in the summer of 2012.

The easing of tensions in the euro area reflects the progress made in European Union governance, the resolute steering of monetary policy towards the maintenance of accommodative conditions, and the correction of national imbalances, with significant progress being made in the countries hardest hit by the crisis.

Nevertheless, the risks remain high. Tensions on the international markets, which had arisen after the Federal Reserve's initial announcement of the gradual tapering of security purchases, have returned in recent weeks, exacerbated by signs of economic slowdown in China. This has affected the emerging economies, especially those with structural problems and short-term financing difficulties.

The euro-area economy has begun to grow again, but slowly and with marked differences between countries. In Italy, industrial production, which had declined in every quarter since the summer of 2011, grew by about 1 per cent in the last quarter of 2013. Since last summer, sales and orders of industrial firms have been increasing moderately and the qualitative indicators have improved steadily, pointing to a continued expansion of output in manufacturing and a move back towards growth in services as well. GDP is estimated to have increased by several tenths of a percentage point in the fourth quarter of 2013, after ceasing to fall in the third. Our latest baseline scenario put GDP growth at about three quarters of a percentage point in 2014.

The recovery in sales in industry is driven by exports, which in recent years have grown in line with our outlet markets, after a lengthy period of decline in Italy's market shares.

Domestic demand, by contrast, is still struggling. Household consumption has been affected by the persistent weakness of the labour market and insufficient growth of income, as well as by the desire to bring saving back to higher levels after the decline of recent years. Given the good performance of export orders, investment should return to growth this year, but as a percentage of GDP it will remain at the lowest levels of the last twenty years. If capital formation is to show a stronger increase, the uncertainty regarding the prospects for the medium term must diminish and the credit supply tensions and the financial imbalances affecting our firms must be overcome.

The recovery has not spread to all sectors of the economy, nor to all parts of the country; the improvement has mostly involved larger, more export-oriented firms located in the Centre and North. What sets the firms that continue to expand sales and jobs apart from those that are struggling to stay in the market is their ability to innovate products and processes, to compete successfully on domestic and international markets and to penetrate the most dynamic of these.

The competitiveness of manufacturing firms, measured on the basis of producer prices, improved by about 4 per cent between 2007 and 2013. Unit labour costs increased more than in the other main countries of the area, mainly because of the dynamics of productivity,

but this was offset by a reduction in profit margins. The gain in competitiveness in trade with non-euro-area countries due to the depreciation of the euro between 2007 and 2012 has been practically wiped out in the last year.

Several contrasting factors affect the performance of exchange rates. An appreciation of the euro is favoured both by the rising surplus in the euro area's current account and by the inflow of capital associated with the attenuation of the sovereign debt crisis. An impetus to depreciation, however, particularly against the dollar, derives from the cyclical improvement and the start of monetary tapering in the United States.

In any case, the gains in competitiveness that might possibly result from changes in the exchange rate will be transient in the absence of a recovery in productivity. In the last three years, it is estimated that total factor productivity in Italy has only just recouped the loss due to the contraction of 2009, whereas in France it has grown by 1.5 per cent and in Germany by about 5 per cent. Investment per worker fell by almost 9 per cent in Italy, compared with an increase of 2 per cent in France and 8 per cent in Germany.

Over the past few months the first signs of a stabilization in employment and an increase in hours worked have emerged. But the unemployment rate now nears 13 per cent, twice as high as before the crisis and the highest on record since this statistical series began to be collected in the 1950s. Given the extensive use of wage supplementation, and also considering the longer-term changes produced by technological innovation, employment runs the risk of recovering only slowly, and with a lag behind the upturn in activity. As in other countries, the protracted slump in economic activity has weighed most heavily on the young: the employment rate for young people aged between 15 and 24 years, not counting students, has fallen to 43 per cent from 61 per cent in 2007; for the 25–34 age group it has fallen from 74 to 66 per cent.

Overall, the recovery still appears to be weak and uncertain. Every effort must be made, at national and European level, to increase demand by fostering, in a shared vision of clearer prospects for the future, the creation of new job opportunities, business investment, and innovation geared to achieving productivity gains to transfer to incomes.

The political and social difficulties besetting this course are accompanied by the presence of some risks that need special consideration. Besides the evolving international situation, these relate to price dynamics, conditions on the sovereign debt market and access to credit.

Price dynamics

In recent months, inflation in the euro area and in Italy has regularly fallen by more than expected; since October, the twelve-month rise in consumer prices has stood below 1 per cent.

Eurosystem projections suggest that consumer price inflation, both this year and next, will remain well below the level considered consistent with the European Central Bank's definition of price stability, namely inflation below but close to 2 per cent over a medium-term horizon. Our forecasts paint a similar picture for the evolution of consumer prices in Italy.

The deceleration of prices reflects not only the downward trend in the energy component, but also the cyclical weakness of the economy. The exceptional decline in economic activity provoked by the crisis may have heightened the sensitivity of inflation to cyclical conditions, in particular for goods other than food and energy.

We are not in a situation of a generalized price reduction, of deflation. But even a prolonged period of price changes below the level compatible with monetary stability is undesirable. It hinders the correction of macroeconomic imbalances through the adjustment of relative prices. It can reduce consumers' spending capacity and adversely affect the cost of capital for investment. Above all, the risk – limited at present – that long-term inflation expectations may become detached from price stability must not be underestimated. This is a nonlinear process, capable of materializing suddenly.

For this reason, the ECB's Governing Council has reaffirmed its intention to maintain an accommodative monetary policy stance for as long as necessary and has firmly reiterated that policy rates will remain at present or lower levels for an extended period. In line with its mandate, the Council will use all the tools needed to keep actual and expected inflation in line with the definition of price stability in the medium term.

Sovereign debt

The narrowing of the spread between ten-year BTPs and German Bunds to about 200 basis points, the level recorded in July 2011, reflects the abatement of the risk of a euro-area break up and strengthening market confidence.

Upward pressures on global interest rates stemming from the consolidation of the recovery or from international turbulence cannot, however, be ruled out; only a return, including in Italy, to sustained growth can offset such pressures, by favouring a further reduction of the component of sovereign bond yield differentials due to different trends in the fundamentals.

Hard-won confidence must not be undermined by the resurgence of fears about the determination of Italy, and of all the countries of the euro area, to continue on the path of reform and responsibility. Failure to do so would hinder the improvement of the conditions of access to credit, with inevitable repercussions on the cost of capital and investment by firms.

The path ahead is a narrow one, and in taking it due consideration must certainly be accorded to the needs of those who are suffering the most as a result of the long crisis and the major changes accompanying the opening of markets and the rapid emergence of new technologies, changes for which most of the necessary structural adjustment is still incomplete.

Observance of budgetary constraints does not only stem from formal obligations; it is what guarantees full access to the financial markets for the Treasury. In 2013, the public sector borrowing requirement amounted to around €80 billion. Including the rollover of maturing debt, the Treasury's annual recourse to the markets is on the order of €400 billion.

Net foreign purchases of Italian government securities, in particular by institutional investors, began to show signs of recovery in mid-2012, and continued through 2013. But the confidence of foreign investors, at times summarily dismissed as "speculators", can be very quickly undermined by any sign of deterioration in a sovereign borrower's creditworthiness. Between summer 2011 and spring 2012, the share of Italian government bonds in foreign hands (not counting the Eurosystem's purchases through the Securities Markets Programme) fell by 16 percentage points to 31 per cent.

Before the crisis, Italy had postponed the reduction of its structural deficit and failed to grow enough to ensure a rapid reduction of the debt-to-GDP ratio. The acceleration of the adjustment came at the most difficult moment; it has had inevitable procyclical effects, but it served the need to avoid the worst. It could not keep the debt ratio, in these years of crisis, from rising.

What the European rules require is the reduction of this ratio, not of the absolute amount of the debt. In order to achieve this, even given moderate growth, it is sufficient not to deviate from the objective of structural budget balance. The credibility that Italy has regained with its efforts and its awareness that there is no alternative to proceeding along the road of reform is producing savings on interest payments, making it easier to contain the budget deficit.

This credibility can allow the country to exploit the margins of flexibility envisaged by the European rules to finance public investment, and enable it to uphold, with authority, the completion of the European construction, with a view among other things to a fiscal union that makes it possible to use common resources to step up infrastructural investment and facilitate the implementation of reforms.

Access to credit

The decline in lending to Italian firms has continued, with a contraction of more than 9 per cent over the last two years after an expansion of nearly 14 per cent between the end of 2007 and the autumn of 2011. Against the background of an economic outlook still clouded by uncertainty, credit demand remains weak, but the supply-side tensions are obstinate as well.

The responses of Italian banks to last quarter's bank lending survey confirm the attenuation of credit restrictions; however, a large percentage of firms, especially small businesses, still report finding it difficult to obtain credit. The gap between the cost of new loans to firms in Italy and the euro-area average has narrowed – to under 80 basis points in December, from nearly 100 at the end of 2012 – but it remains wide.

Banks' liquidity has improved in the last year. Recourse to Eurosystem refinancing fell to €224 billion at the end of January 2014, €50 billion less than a year earlier. Italian banks, led by the largest ones, have repaid €64 billion of the €255 billion they obtained in the two three-year refinancing operations of December 2011 and February 2012. Improvement in the conditions on the wholesale funding market could facilitate early repayment of the remaining amounts.

The tensions affecting credit supply stem above all from the increasing incidence of non-performing loans in banks' balance sheets and from their worsening perception of borrowers' creditworthiness.

New bad debts have ceased to rise in proportion to outstanding loans since the third quarter of 2013, and in our estimates should remain virtually stable in the coming quarters. However, reflecting the long recession, the ratio of total bad debts to total loans reached 9.1 per cent in December, almost 7 percentage points higher than at the end of 2008. For loans to firms, the ratio rose from 3 to 13 per cent.

The requisite provisions for the deterioration in loan quality dent banks' profitability; in the first nine months of 2013 they absorbed three quarters of operating profit. The return on equity was particularly low.

In Italy, the private market in impaired assets is underdeveloped. Some recent transactions signal interest on the part of specialized investors in managing these assets. The actions under way at a number of banks to rationalize the management of non-performing loans by creating dedicated structures able to enhance the efficiency of the procedures and the transparency of these assets go in the right direction. More ambitious interventions, whose compatibility with European rules must be pondered, are not to be ruled out. They could, at moderate cost, release resources to be used for financing the economy.

The revaluation of the Bank of Italy's share capital has adjusted values that were unchanged for decades. The excess concentrations of holdings will be eliminated. The ensuing increase in the highest quality capital of the shareholding banks, though it cannot be considered in the assessment of asset quality being conducted in the euro area, will help to sustain the supply of credit.

As the economic recovery gathers strength and the riskiness of loans gradually diminishes, the banking system will be able to offer greater support to the economy, helping in turn to stimulate growth. A contribution to this can come from targeted measures, some of them already decided, such as the refinancing of the Guarantee Fund for SMEs and changes to the tax rules on loan loss provisions in banks' balance sheets.

The Bank of Italy's supervisory action and the banking union

Thanks in part to the action of the Bank of Italy and in spite of the sharp deterioration in loan quality, between September 2012 and September 2013 the non-performing loan coverage ratio rose from 38.3 to 39.9 per cent on average for Italian banking groups. The ratio of core

tier 1 capital to risk-weighted assets rose from 10.0 to 10.6 per cent. Coverage and capital ratios must continue to increase; this preserves investors' confidence in the banks and lowers the cost of funding, thus helping to ensure an adequate flow of credit to economic activity. During the crisis, lending has been more buoyant at the better-capitalized banks.

The Bank of Italy is scrutinizing the weaknesses in the structure and working of banks' boards of directors; the aim is to remove factors that can hinder banks' capital strengthening and to foster better business management. The proposals put forward in last December's public consultation document are designed to improve banks' governance by limiting the number of directors and increasing the possibility for shareholders to make their views known. The Bank will take account of the comments that emerged during the public consultation when it issues the final provisions. Correct organizational arrangements are essential for efficiency and stability. The growth in the number of banks in difficulty was mainly due to the recession, but weak governance systems also played a role, as did episodes of outright malfeasance.

During the crisis the vicious spiral between the state of the banks and that of their respective sovereign issuers had a perverse effect on intermediaries' creditworthiness and their ability to raise funds in the market. Banking Union can make a decisive contribution to breaking this link. The first step is the launch of the single supervisory mechanism.

The comprehensive assessment of the leading euro-area banks' balance sheets □ to be carried out by the ECB and the national authorities □will contribute to the single supervisory mechanism's launch, at the end of this year, on a solid and credible basis. This will make clear and comparable information available on the state of European banks' health.

The exercise will be carried out transparently and rigorously, with uncertainty about the way it is performed reduced to the minimum. The assessment will cover all the asset items and the related risk profiles. In examining the quality of exposures, uniform criteria will be used, in line with Italian practices, which are acknowledged to be among the most scrupulous.

The first phase of the examination of the quality of banks' assets, devoted to the selection of riskier portfolios, is drawing to a close. In the second phase, which will get under way in the coming weeks, a large number of credit files will be analyzed and the adequacy of the value adjustments in banks' accounts will be assessed.

In the last few days the European Banking Authority and the ECB have announced the main features of the stress test. The exercise will refer to the three years 2014–16. The threshold value of the capital ratio that banks must comply with at the end of the period is 8 per cent in the baseline scenario and 5.5 per cent in the adverse one. The definition of capital, which will take due account of the choices made by national authorities, in line with the provisions of the transitional regime, will be that in force at the end of 2016.

The corrective measures that intermediaries will be asked to take will be related to the nature of the capital weaknesses revealed by the stress test. If they emerge in the baseline scenario, banks will be asked to implement the necessary measures rapidly; if, instead, they only appear in the adverse scenario, the time frame will be determined appropriately as part of a recapitalization plan agreed with the supervisory authorities.

In recent months I have already drawn attention to the need for a rapid definition of public backstop mechanisms, capable of reassuring the markets about the authorities' determination to tackle and overcome any weaknesses that should emerge from the assessment exercise. The design of the Banking Union must be completed with the introduction of the single resolution mechanism for failed banks. The negotiations under way between the Council, the Commission and the European Parliament on the agreement reached by the Council at the end of last year must move forward and be concluded rapidly, so as to allow the responsibilities of supervision to be aligned with those of the management and resolution of crises as soon as possible. The decision-making process must be speeded up and made more effective. The long transitional period envisaged before the resolution

fund becomes fully effective must be shortened, so as to make the overall mechanism entirely credible.

In order to return to rapid, sustained economic growth it is not enough to eliminate the factors of risk that I have recalled – to counter excessive disinflation, ensure the credibility of fiscal consolidation and stimulate renewed lending. Italy has still not risen properly to the challenges of technological innovation and the globalization of markets. Mere financial support to troubled sectors is no solution. Competitiveness can be recovered only through a wide- ranging, consistent reform strategy involving the public sector, firms and the financial system.

The commitment to creating a more business-friendly institutional and legal environment has to be strengthened, with further simplification of rules and regulations, improvement in the quality of essential public services, and continuing action to combat illegal behaviour.

Especially in today's circumstances – marked by profound transformation – an easing of the fiscal burden on productive factors, together with selective spending cuts to reduce waste and measures to make government more efficient, can be decisive to the ability of the system to undertake the necessary changes. Income support, retraining and job placement programmes for workers driven out of traditional forms of production are needed to protect those who will be disadvantaged in the short term.

There is no lack of firms capable of taking up the challenge, growing large enough to compete in global markets, increasing the technological and innovative content of their products. A better balance in sources of finance, reducing dependency on bank loans and increasing the importance of equity capital, would help in providing enterprises with adequate resources. New forms of intermediation can facilitate the financing of firms by institutional investors. In other countries, banks' ability to stimulate and sustain innovation on the part of firms – including by offering high-value-added financial services – is one of the key drivers of economic growth.

In Italy as elsewhere, the financial system must regain public trust, which has been sapped by the excesses, occurring mostly in other countries, that led to a global crisis with enormous costs. It must demonstrate its ability to perform its function to the full. The negative perceptions of the conduct of banking and finance must not be allowed to trigger disproportionate reactions. Public hostility must be overcome through decisive improvements to governance and through sound and prudent intermediation, ensuring that finance is not denied to those who deserve it and share the risk and that the financial system continues to support real economic activity. We are fully conscious of the difficulties that lie ahead. We are working to help remove them in the firm belief that sound finance remains essential to eliminate the liquidity constraints that cramp economic activity and prevent the fruitful exploitation of ideas and to promote growth by fostering innovation.