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Speech by the Governor of the Bank of Italy
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Global growth strengthened considerably last year although uncertainties remain linked to future US trade policies and possible upward shifts in risk premiums in the financial markets. Monetary policy in the euro area has staved off deflation but inflation is still far from the levels consistent with monetary stability.

Economic activity in Italy appears less dependent on the expansionary stance of monetary and fiscal policies. The consolidation of the recovery requires us to proceed with the economic reform effort. Prudent budgetary policies will help make markets more confident in the reduction of the public debt-to-GDP ratio.

Lending to households and firms is expanding and loan quality is improving, partly thanks to the successful handling of the most critical situations in the banking sector. The reduction in non-performing loans must continue, exploiting the favourable economic conditions. Competitive pressures and a challenging regulatory environment have made it urgent for banks to continue to limit costs and to fully recoup profitability, including through additional mergers. These needs are especially pressing in the mutual banking sector, where the 2016 reform must be implemented *in toto*.

Notwithstanding the progress made since the outbreak of the crisis, the institutional arrangements of the European Union and of the euro area remain a work in progress. Diminished trust among member states has led to a sterile conflict between calls for risk reduction versus those for risk sharing. These proposals are instead complementary. Only by acknowledging this can solutions be found from which all countries can benefit.

Recent economic developments

The economic expansion is increasingly broad based at global level. According to the estimates of the main international institutions, in 2017 world output returned to growth at a rate of more than 3.5 per cent; this year it is expected to rise by almost 4 per cent. The favourable outlook remains vulnerable to the repercussions of possible trade restrictions and to a potentially abrupt increase in risk aversion in the markets.

Domestic demand in the euro area is being sustained by rising employment and very accommodative financing conditions. Exports are continuing to improve, driven by the uptick in foreign demand. According to the Eurosystem's forecasts, this year output will expand by 2.3 per cent, a similar pace to that recorded in 2017. Inflation remains low, however, reaching 1.3 per cent in January; core inflation also continues to be weak, partly because of the effects of wage moderation in many economies.

Monetary policy is working. The strong cyclical momentum and ongoing reduction of economic slack have strengthened confidence among the members of the ECB's Governing Council that inflation will gradually converge towards the inflation aim of a rate below, but close to, 2 per cent in the medium term. This is why we recalibrated our monetary policy interventions last October, while maintaining the highly expansionary conditions intended to ensure a lasting return to price stability. We have extended the duration of the APP until September of this year, trimming our monthly purchases to €30 billion. The Eurosystem will reinvest the principal payments from maturing securities purchased under the APP for an extended period of time after the end of its net asset purchases, and will continue to provide abundant liquidity to the banking system until at least the end of 2019. The Council expects to keep interest rates at their present levels well past the horizon of the net asset purchases.

Inflation, after falling slightly at the start of this year owing to the base effect associated with the temporary increase in energy commodity prices in 2017, is expected to rise gradually to levels consistent with the target in the second half of 2020. The risk of deflation has been averted but it is proving difficult to push up inflation expectations.

Exchange rate volatility poses one of the main risks to the inflation outlook, also given the high sensitivity of forex markets to the announcements of monetary and government authorities. The euro exchange rate is not among our objectives *per se* but it can have significant repercussions on the transmission of monetary policy; disorderly developments, especially if triggered by factors unrelated to the macroeconomic fundamentals, can make it harder to achieve price stability.

The decisions of the ECB's Governing Council will continue to be shaped by economic data and by the inflation outlook. We will be patient in pursuing the inflation objective and perseverant on the monetary stance adopted.

In Italy GDP rose sharply in 2017. According to initial estimates, it rose from 0.9 per cent in 2016 to 1.5 per cent last year. Employment continued to expand (0.8 per cent in 2017),

while the unemployment rate fell to 10.8 per cent in December, its lowest level since August 2012; hours worked per employee also increased moderately from the low recorded in the first quarter of 2015, and grew by 0.5 per cent in the first nine months of 2017.

The expansion of productive activity is being driven by the global cyclical upswing and expansionary economic policies, but it is also benefiting from the reforms undertaken in recent years. Progress made in the labour, capital and services markets has begun to bear fruit; it has enabled Italy to benefit from the global and European recovery and has meant that the consolidation of growth is no longer supported by cyclical factors alone.

Investment has increased since the summer. The effects of monetary policy, which has kept financing costs very low, have been flanked by those of tax incentives for the purchase of capital goods and digital technologies. Although uncertainty about whether these incentives will be maintained in 2018 may have prompted businesses to bring forward some of their investment to 2017, the outlook remains favourable: our surveys indicate a further expansion in capital accumulation for 2018, supported primarily by demand expectations.

The vitality of Italian companies is evident in the sharp increase in innovative start-ups entered in the companies register (currently over 8,000, a more than fourfold increase from 2014), the healthy performance of exports, which are estimated to have risen by more than 5 per cent last year, and the current account surplus on the balance of payments, which in 2017 rose to almost 3 per cent of GDP. Positive developments in the external account are helping to improve our country's net debtor position, which in the space of just over three years has gone from 25 per cent to less than 8 per cent of GDP, its lowest level since 2002.

This year GDP is expected to grow at a rate of about 1.5 per cent and should remain above 1 per cent in the next two years as well. The virtuous circle of supply and demand is gaining momentum: the rise in households' disposable income and the decline in firms' spare capacity mean that the improved outlook is increasingly translating into higher consumption and investment.

This scenario assumes that financial conditions will remain accommodative. When the improvement in GDP and inflation in the euro area reaches a level that justifies raising interest rates, our economy will not suffer provided that domestic economic policies have been able to consolidate the current recovery, leaving investors in no doubt as to the Government's commitment to following a prudent fiscal policy without straying from the reforms undertaken in the last few years. This path must be pursued with determination in

order to improve public services, increase competition in the private sector and stimulate greater investment in human capital.

At the current projected rate of growth, the low level of household debt and the significant decrease in firms' indebtedness make increases in the cost of borrowing, even considerable ones, sustainable. Banks and insurance companies in turn face little exposure to the effects of a rate hike. Public debt is still too high in relation to GDP but its average residual maturity of more than seven years ensures that the rate increase will pass through to the average cost of debt very gradually.

Aside from the primary surplus, developments in the debt-to-GDP ratio will depend on the differential between the average cost of debt and nominal GDP growth; therefore, the lower the sovereign spreads on Italian government securities and the more our economy is in line with that of the rest of the eurozone, the lower will be the impact of a rate increase. We should not be concerned about the normalization of monetary policy, but rather with the credibility and effectiveness of the reforms and the process of reducing the debt-to-GDP ratio.

Banks

Lending to the private sector in Italy is expanding again. Loans to households remain brisk while those to firms are gaining pace in the manufacturing segment and expanding slightly again in services; the decline in lending to the construction sector is still pronounced, but is abating. Credit supply conditions are favourable overall; demand by firms has been limited by the ample availability of internal funds and greater recourse to non-bank financing.

The ratio of new non-performing loans to total outstanding loans has fallen to below pre-crisis levels; in the third quarter of last year it came to 1.7 per cent (1.2 per cent for households, 2.6 for firms). For two years now, the stock of NPLs has been falling, with an acceleration owing to major sales of bad loans completed last year. The total stock of NPLs, net of loan loss provisions, has fallen from a peak of €200 billion in 2015 to €140 billion (equal to 7.8 per cent of total loans), with bad loans alone decreasing from €86 billion to €60 billion (3.5 per cent).

The economic environment is helping banks continue to strengthen their balance sheets and reduce their NPLs, actions which, since 2012, have been the focus of our recommendations and supervisory interventions. There is still ample room to improve the efficiency of the bad loan management and recovery process, specifically by making information on the status of the

recovery proceedings more readily available. The banks that are most effective in doing this obtain recovery rates that are much higher than the industry average. More pro-active management can also lead to a large portion of unlikely-to-pay loans (which make up about half of all net NPLs) being classified as performing again.

In the coming weeks the European Commission and the Single Supervisory Mechanism will finalize their proposals for writing down non-performing loans over time (calendar provisioning). In its proposal the Commission suggests introducing minimum, or Pillar 1, requirements that all EU banks will have to meet. That put forward by the Single Supervisory Mechanism, instead, sets supervisors' expectations for the NPL coverage ratio under a Pillar 2 approach. A reduction in NPLs is necessary to lower banks' risks and funding costs. This should be pursued through measures that take into account the starting conditions, are sustainable, and do not have potentially destabilizing procyclical effects. They should also ensure a level playing field to banks operating in different environments, especially in terms of a swift and efficient civil justice system, something Italy still needs to improve on.

The European Commission will also submit a proposal to establish national asset management companies, which may or may not be publicly sponsored, and which would specialize in the management of NPLs. These companies would be able to achieve economies of scale in their debt recovery activities and enjoy greater bargaining power when selling NPLs in the market, including through securitization. To attain these objectives, adequate incentives must be put in place to encourage banks' voluntary participation in the asset transfer scheme under conditions that do not make it excessively rigid and in reality impracticable.

A new EU-wide stress test was launched a couple of days ago with the publication of the methodology and the macroeconomic scenarios that will be used in the exercise. The results will be released in early November. The test will cover 48 banks, of which 33 euro-area significant banking groups, four of them Italian. At the same time, the Single Supervisory Mechanism will carry out an analogous exercise on the other significant banks, taking into account their smaller size and lower degree of complexity.

Compared with the ones utilized in previous exercises, the methodology for this year's stress test incorporates the new IFRS 9 accounting principle. The move to the new standard, in force since the beginning of this year, will help to enhance transparency and prudence in banks' valuation of loans. This is a good opportunity to increase write-downs and spur the development of a market in non-performing assets. At the same time, the incorporation of the new standard makes the methodology used for the stress test more complex; this will have to be taken into

account when interpreting and assessing the results of this year's exercise, also with respect to previous years. As in 2016, no pass-fail threshold has been set. Supervisors will use the results to carry out their supervisory review and evaluation process.

While still low, the profitability of Italy's leading banks improved in the first nine months of last year. Return on equity was 4.4 per cent, compared with 1.4 per cent in the same period of 2016. According to banks' expectations, profitability over the coming years should be sustained by a reduction in loan loss provisions, an increase in asset management fees, and a decrease in operating expenses.

But an in-depth review of banks' business models is inevitable in Italy, as it is throughout the EU. Some important factors that could dampen profitability must not be underestimated. Regulatory changes as well as any additional write-downs made in connection with the sale of NPLs could affect loan-loss provisioning. Competition in the asset management market is bound to grow, as is the scale of operations necessary to be profitable. The costs for banks, which are burdened by persistently high staff expenses, will be affected by investments in new digital technologies, which have been limited so far but can no longer be delayed. Moreover, the entry into force of new EU rules on the required loss-absorbing capacity in a crisis and on the provision of investment and payment services is expected to push up wholesale funding costs, competition for certain services, compliance costs and those related to ensuring that customers are fully protected.

Banks must therefore take action on several fronts to recover profitability and competitiveness. This means cutting expenses further, merging or entering into consortiums to exploit cost and revenue synergies, and investing in order to respond effectively to the challenges and opportunities brought about by the development of the Fintech sector. Increasing transparency towards customers must be viewed not as a legal or regulatory requirement but rather as essential to becoming more competitive. The provision of new products and services must ensure that customers fully understand the information essential for accurately assessing the potential risks and returns.

The recent agreement on the completion of Basel III reforms, which will start to be applied in 2022 and enter into full effect in 2027, marks the culmination of the responses to the shortcomings in the regulatory framework that were highlighted by the global financial crisis. Without raising the overall capital requirements significantly, it contributes to reducing regulatory uncertainty in the banking system. An important objective of the agreement is to limit excessive variability in banks' risk-weighted assets, as this can impede comparability of capital

ratios and undermine investors' trust in the calculation methods used by banks to compute capital requirements.

While mutual banks' (*banche di credito cooperativo*, BCCs) solvency ratios continue to be higher than the system average, the gap has been narrowing given the squeeze on profits and the impossibility of raising equity on the market. The measures taken to cope with the serious deterioration in loan quality have proved less effective than those adopted by other banks. The BCCs are now facing an NPL ratio that is more than 2 percentage points above the average and substantially lower coverage ratios. The implementation of the reform of the sector, and the creation of cooperative banking groups, must be swiftly carried out if the BCCs are to overcome the disadvantages of their small size and continue to support the local economy while upholding the values of cooperation and mutual benefit.

The groundwork for the establishment of cooperative banking groups must be laid more rapidly, with the affiliated institutions fully supporting their future parent companies. Business plans should be tailored to ensure that the objectives of the reform are achieved forthwith; these include openness to the capital market, robust corporate governance and internal audit arrangements, allocative and operational efficiency, and a reduction in NPLs. Any delay or resistance to change would eventually endanger the success of the reform.

Banca d'Italia is examining the application by Cassa Centrale Raiffeisen to set up a local banking group, and discussions are currently under way with Iccrea and Cassa Centrale Banca on their applications to establish the two significant groups that will be placed under European supervision. Before this happens, both will undergo a comprehensive assessment of their balance sheets. The parent banks must draw up suitable capital strengthening plans to be put into effect as and when necessary.

Europe

The tools and reforms introduced in recent years in unfavourable economic conditions have enhanced the euro area's ability to withstand macroeconomic and financial shocks. The European Stability Mechanism has been launched to provide financial assistance for EU countries in difficulty, budget rules have been tightened, the ECB has introduced outright monetary transactions, and the Single Supervisory Mechanism and Single Resolution Mechanism, the first two pillars of banking union, have been set up. This progress would have been unthinkable only a few years ago: in a short space of time we have overcome formidable political, legal, economic and organizational difficulties.

Today the European reform process is still struggling to make headway. Although the debate is ongoing and the key problems have been identified, there is a deadlock between those who would prioritize action to reduce macroeconomic and financial risks in the individual member states and those who are calling for the rapid adoption of common safeguards against the consequences of such risks, given the absence or paucity of national tools.

This deceptive dichotomy, however, rooted in misunderstandings and scant mutual trust, has come to condition the drafting of European rules for managing bank crises and to impede the completion of banking union. The result is a system without a safety net, one that lacks the new European financial backstops for the Single Resolution Fund and the deposit insurance scheme, while the national tools and procedures used by many countries for the management of bank crises, even in recent years, are now out of bounds. In a context such as this, stricter rules and common supervisory and resolution mechanisms cannot prevent the outbreak of crises – even just of liquidity – nor can they adequately limit the consequences. This needs to be acknowledged and the necessary adjustments devised. The experience of recent years has demonstrated how important it is to leave an opening that will allow situations with the potential to disrupt financial stability to be successfully managed.

Risk reduction and risk sharing are complementary first and foremost in relation to public finance. A high debt-to-GDP ratio is a source of vulnerability: it discourages investment and impedes growth; it exposes countries to a loss of market confidence and financial contagion. Budget flexibility is essential in a cyclical downturn, but further progress, i.e. strong lasting growth of output, is impossible with a large deficit. Italy cannot delay setting in motion a steady and tangible reduction in the debt-to-GDP ratio. The reduction of the time needed to achieve this requires budgetary discipline above all else. Structural reforms to increase the economy's growth potential are essential.

We should bear in mind, however, that in the absence of adequate safeguards, a country's recovery efforts can be rapidly thwarted by negative shocks. To avoid this happening, risk-sharing measures could be considered in order to reduce the sensitivity of national budgets to macroeconomic conditions, thereby avoiding the rapid accumulation of debt during adverse economic cycles and the adoption of procyclical policies in an attempt to limit it.

This lower sensitivity can be achieved by shifting some important automatic stabilizers to the European level and handing over responsibility for adopting the necessary discretionary measures, for example with programmes for large infrastructure projects, for managing immigration or for common defence. It is technically possible to introduce this 'common

budget’ without it becoming, as some countries fear, a source of permanent transfers towards more structurally indebted countries. This would help greatly in reducing the asymmetry of a situation in which there is a single monetary policy but a fragmented fiscal policy.

Measures geared to repurchasing outstanding securities can help to reduce the public debt-to-GDP ratio more rapidly. National initiatives of this kind, funded by privatization programmes for example, can encounter both operational and quantitative constraints. A faster reduction of public debts in euro-area countries than that guaranteed by prudent budget policies could be achieved by issuing European debt securities to remove a portion of those issued by member states from the market, with clearly defined procedures and without transferring resources from one country to another, giving form to a fiscal union to be accompanied by binding rules and powers of control and intervention. As I have recalled on other occasions, various concrete proposals have been made in this direction. The new common debt instrument could serve as the kind of safe asset typically found in advanced countries with a national currency; the reduction of member states’ national debts would eliminate potential sources of financial instability; the greater scrutiny of public accounts that would accompany this measure would shelter the euro area from the risk of new increases in public debt at the national level.

Some of the proposals put forward in the European debate seem to rely on the possibility of proceeding sequentially, putting risk reduction before risk sharing. These proposals identify the main source of vulnerability in the euro area as the ‘doom loop’ between banks and sovereign debtors and suggest breaking it by discouraging banks from investing in government securities and by setting up orderly procedures to restructure public debts deemed unsustainable. This is a simplified vision of the origins and management of financial crises, which in any case does not pay sufficient attention to the risks that could ensue from rapid and broad movements of capital within the market for European government securities.

This question should be dealt with pragmatically. Changes in the prudential treatment of government securities held by financial intermediaries (such as risk-weighting or introducing quantitative limits), particularly if badly designed or wrongly calibrated, risk being counterproductive. Especially at times of system-wide tensions, they can end up by generating the very crises they were supposed to prevent, triggering episodes of financial contagion or fuelling speculation. In any case the link between banks and sovereign debtors is not limited to financial relationships but is channelled, above all, through the effects that both sides exercise on economic activity. It is unrealistic to think that the restructuring of a large public debt, however orderly, could

be achieved without serious consequences for the national economy and for the European economy as a whole.

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The difficulty of straddling the paths of risk reduction and risk sharing is evident. There are sizeable obstacles to overcome, both in reaching a consensus and in the practical implementation of reforms destined to profoundly change our European identity.

It is often claimed that the time is not yet ripe for political union. Yet with foresight, we can take important steps in this direction. Italy is called on to make an authoritative contribution to the current European debate. The more steadfast and credible its commitment to improving Italy's growth potential and ensuring financial stability, the stronger its position will be.

Banca d'Italia's supervisory work, including in the realm of the Single Supervisory Mechanism, will continue to push the banks to make the most of the opportunities offered by the current economic climate and to proceed decisively with strengthening their balance sheets, reducing NPL stocks, and increasing profitability. This is necessitated by the spread of new technology, growing competition on the financial markets, and increasingly prudent rules.

To strengthen growth in the medium term, further steps must be taken towards structural reforms, improving public services, and rationalizing and stabilizing the tax laws. This is not a question of European rules, this is about the balanced development of our economy, its inherent strength. An increase in the public deficit is no substitute for reform and could prove counterproductive, since the problem of the national debt cannot be sidestepped. Even without the constraints of the Stability and Growth Pact, the need remains for us to make responsible choices.

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