The Governor’s Concluding Remarks

Annual Report
Rome, 31 May 2019
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2018 - 125th Financial Year

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Ladies and Gentlemen,

The Bank of Italy contributes to the definition of monetary policy in the euro area. It is the authority charged with safeguarding financial stability and supervising intermediaries. It manages payment settlement systems, monitors these systems and supervises the financial markets. It conducts economic, legal, and statistical research and provides services to the public. It is perhaps difficult to appreciate the sheer variety and breadth of everything the Bank does, given the many essential tasks it carries out in the public interest. In compliance with transparency requirements and legal obligations, the Bank provides an account of its work in the Report on Operations and Activities which, as is now customary, is published today together with the Annual Report. We are increasingly committed to promoting economic and financial knowledge and to communicating the results of our work.

The Bank’s key functions are highlighted in our balance sheet, which I already talked about on 29 March in an Address to the Ordinary General Meeting of Shareholders. This also illustrated the Bank’s capital reallocation, a process which began in 2014 with the reform of the ownership structure, leading to an expansion of the shareholder base. Finally, it presented the results of the financial year for 2018, which recorded a net profit of €6.2 billion, €5.7 billion of which were allocated to the State, in addition to taxes amounting to €1.2 billion.

Three of the five members of the Bank of Italy’s Governing Board completed their mandates this year. With the appointment of Fabio Panetta as Senior Deputy Governor, the confirmation of Luigi Federico Signorini as Deputy Governor and the designation of Alessandra Perrazzelli and Daniele Franco to the same role, the board has been fully replenished.

Salvatore Rossi and Valeria Sannucci have retired from the Governing Board. They both brought their talents and skills to several sensitive positions within the Bank. The conclusion of his term as Senior Deputy Governor of the Bank of Italy means that Salvatore has also come to the end of his mandate as President of IVASS, which greatly benefited over the years from his drive for innovation.
I am sure I speak for the Board of Directors in thanking them for their work in the service of our country. Let me add to the gratitude of the entire institution my own affectionate farewell to these two people I count as friends, with whom I have worked very closely over the course of my career and with whom I have shared the by no means light responsibility of managing the Bank during these undoubtedly difficult years.

I would like to welcome Alessandra Perrazzelli, who has agreed to put at the service of the general public her considerable experience and proven ability in senior professional positions in Italy and abroad. I would like to welcome back Daniele Franco, whose outstanding technical abilities, along with his steady and balanced judgment, will be of great use to us over the coming years.

The contribution of each and every member of the Governing Board is crucial in guiding the Bank’s operations. Yet nothing we do is or would be possible without the commitment and professionalism of all our staff: hired and promoted via rigorous, meritocratic procedures, immune to external pressures, and united by that spirit of genuine dedication to public service of which we are justly proud. Let me extend the heartfelt thanks of the Board of Directors, the Governing Board, and express my own personal gratitude to all the women and men working for the Bank.

**The international outlook and the Italian economy**

The system of supranational institutions and multilateral rules that has supported integration and global economic growth since the end of the Second World War has entered a very difficult phase. The trend towards trade openness, which had grown stronger in recent decades, has come to an end. The sharp deceleration in international trade observed in 2018 reflected tensions linked above all to the new protectionist strategy pursued by the United States (Figure 1).

A large share of intermediate goods is produced abroad, and by increasing the cost of production factors, protectionist measures ultimately rebound on domestic firms and magnify the effects of tariffs on consumers. The repercussions on production are not confined to those caused directly by trade barriers, but also stem from the deterioration of firms’ confidence, the downward revision of investment plans, and the greater volatility of international financial markets.

The International Monetary Fund predicts that global growth will fall to 3.3 per cent this year, the lowest figure since the contraction of 2009. The weaker conditions are widespread and affect areas accounting for over 70
per cent of the global economy. The projections point to a recovery starting in the second half of this year, boosted by expansionary economic policies in the main countries and by the ensuing improvement in financial market conditions. There are still significant risks, however, including geopolitical ones.

The slowdown is mainly affecting the economy of the euro area, which is more open to international trade than the United States or Japan. Reliance on foreign demand is particularly high in Germany, the most vulnerable country from this point of view, but also in France, Italy and Spain, countries that are all closely integrated into global value chains, including intra-European ones. The marked decline in business confidence is curbing investment (Figure 2), and in the second half of 2018 the downturn in the automobile industry contributed to the worsening of the macroeconomic situation.

The growth projections for the euro area have been steadily revised downwards. According to the main international institutions, GDP growth will be just over 1.0 per cent this year and around 1.5 per cent in 2020: the risk of this trend being less favourable is not negligible. The weakness of production has affected both actual inflation and that expected by the markets. At the same time, the ECB forecast a slower convergence in inflation towards the objective of a level below, but close to, 2 per cent.

Last March the ECB's Governing Council announced that monetary policy would remain expansionary for longer than had previously been indicated. It expects that rates will stay at the current low levels at least until the end of 2019 and, in any case, for as long it takes to achieve price stability. The Eurosystem will continue to fully reinvest the resources obtained from the redemptions of maturing securities held under the asset purchase programme for an extended period of time. From next September there will be a new series of targeted longer-term refinancing operations to maintain favourable conditions on the credit market and the orderly transmission of monetary policy. The Governing Council reiterated that it stands ready to adjust all the available instruments to guarantee convergence towards the inflation aim.

In the second half of 2018, GDP declined slightly in Italy. For the year as a whole, the rate of growth was 0.9 per cent, just under half that of 2017. Negative contributions came from the slowdown in output in Germany and greater uncertainty, which in turn was affected by the heightened tensions surrounding government securities. This led to a sharp downsizing of firms’ investment plans. Household spending also slowed, reflecting the deterioration of the economic outlook and sluggish employment rates since the summer.

Permanent employment contracts in the private sector turned upward again, boosted by the conversion of fixed-term contracts. These were affected
in the second half of the year by the limits introduced by the ‘Dignity Decree’ which, together with the worsening economic situation, are nevertheless reducing the probability of remaining employed at the end of a fixed-term contract.

In 2018, inflation stood at 1.2 per cent and the core component, net of food and energy products, remained below 1 per cent. The pace of growth in prices remained lower than in the euro area; the weakening of the economy weighed on labour costs and firms’ profit margins.

Even though GDP recorded a slight increase in the first quarter, there is widespread consensus regarding the forecasts for much lower growth this year than the already subdued growth of 2018. To return to higher investment rates and more robust spending on consumption, trade tensions must subside, global financial market conditions must remain favourable and above all, the confidence of firms and households must rise again.

According to official estimates, the introduction of a new basic income scheme (reddito di cittadinanza) and new pension measures, without taking account of the restrictive effects of covering the cost, would lead to an increase in GDP of about 0.6 percentage points over the three-year period 2019-21. This assessment appears reasonable if we assume that all the funds allocated are spent. By contrast, the assessment of the effects on employment, which is expected to be half a percentage point higher in 2021, displays ample margins of uncertainty.

The tensions in Italy’s government bond market are curbing growth prospects. The yield on ten-year government bonds is almost one percentage point higher than the levels recorded in April of last year. The spread with respect to the equivalent German bond has increased by 160 to around 280 basis points, while it has risen by 140 to 190 basis points with respect to Spanish bonds (Figure 3). The premiums on credit default swaps indicate that both credit risk and the risk of the debt being redenominated in a currency other than the euro continue to push the yields on Italian government bonds upwards; these risks are closely interlinked and in times of tension could rise sharply in market assessments.

The pass-through of the greater cost of public sector securities to that of bank loans to firms and households has been modest so far, thanks to the ample liquidity and the improved balance-sheet conditions of intermediaries. Nevertheless, signs of tension are beginning to emerge: surveys indicate that credit supply policies, though remaining relaxed overall, are gradually tightening, especially for small firms; this is due to both the deterioration in the macroeconomic outlook and to higher bank funding costs. It is estimated that, other things being equal, and discounting negative effects on firms’ and
households’ confidence, an increase of 100 basis points in the yields on public sector bonds would lead to a reduction of 0.7 per cent in GDP over three years.

As acknowledged in the Economic and Financial Document (DEF), the cyclical slowdown is increasing the budget deficit in the current year. The increase in the debt-to-GDP ratio could exceed that indicated in the government’s budget (almost half a percentage point), which assumes revenue from privatizations amounting to about €18 billion (one percentage point of GDP).

The structural difficulties of the Italian economy

Our country has a number of strengths it can draw on to support economic activity in unfavourable conditions. In this decade, goods exports have kept pace with foreign demand, interrupting the protracted decline in Italy’s share of the global market. The current account balance turned positive again in 2013 and for three years now the surplus has stood at around 2.5 per cent of GDP; the net international investment position is practically in balance. Italy’s ability to compete on the international markets has benefited from the reallocation of exports towards forms of production which are less exposed to the pressures of emerging economies and made by more efficient and larger firms.

At the end of last year, household debt was equal to 41 per cent of GDP, as against 61 per cent in the other euro-area countries as a whole; the value of savings, of which more than 60 per cent in real estate, was more than eight times that of income, compared with an estimated seven times for the rest of the area. Firms’ debt is also low: equal to 69 per cent of GDP, against 112 per cent in the other countries.

Overall, however, the economy has been struggling to pick up since the double-dip recession. GDP is still more than 4 percentage points below what it was in 2007, and 7 percentage points in per capita terms. Though it has regained the 2007 level of 59 per cent, the employment rate is 9 points below the euro-area average. The development gap has increased in the South of Italy, where more than 18 per cent of the labour force is unemployed, compared with 7 per cent in the Centre and North; the gap is 4 percentage points higher than it was in 2007.

The problem is not merely low aggregate demand. In the decade preceding the crisis, Italy also lagged behind the other euro-area countries by around one percentage point per year (Figure 4). Despite the measures enacted, our economy’s capacity to grow and to achieve high employment rates is
weighed down by the unsatisfactory quality of public services, inadequate infrastructure, low levels of competition and the distortions associated with widespread tax evasion and corruption, not to mention the obstacles posed by organized crime. The result is an economic climate that is little predisposed to business and its growth, to investment and to employment.

To confine ourselves to seeking temporary relief by raising the public deficit could prove less than effective, even counterproductive, if this led to a deterioration in financial conditions and in the confidence of households and firms. The risk of a ‘restrictive expansion’ must not be underestimated; the expansionary effects of a budget can be more than offset by the restrictive ones of higher financing costs for the State and the economy.

The high debt-to-GDP ratio continues to be a severe constraint; to lessen it, there must be no delay in defining a rigorous and credible strategy for its reduction in the medium term. Compared with the rest of the euro area, the cost of Italy’s public debt is higher and its economic growth lower. Aside from Greece, on average in the last four years Italy is the only other country to report a large and positive gap between these two variables; at 1 percentage point, this gap has in turn pushed up debt-to-GDP ratio by around 1.3 points per year. In the same period, GDP growth was 0.3 percentage points higher than the average cost of the debt in France, 1.0 points higher than that in Spain. When the gap between the cost of the debt and economic growth is positive, what is needed, if only to stabilize the debt, is a primary surplus (when revenues exceed expenditure net of interest expense). The larger the gap, the bigger the surplus required.

The increase of 1 percentage point recorded in the average yields at issue of Italian government securities in 2018 followed a decline of around 3 points between 2012 and 2017. The risk of this leading to a further widening of the gap between the cost of the debt and the GDP growth rate must be countered (Figure 5). Only careful budgetary control and solid prospects for a return to higher economic growth rates can boost confidence in the government bond market and bring yields down towards the levels prevailing in the rest of the euro area.

Ensuring that the budget can contribute to a lasting increase in GDP growth calls for incisive interventions in the composition of expenditure and revenue. Greater prominence should be given to programmes better able to stimulate economic activity, as opposed to subsidies and transfers. This must be accompanied by measures designed to limit the distortions introduced by taxation, especially in the labour market, and to step up the fight against tax evasion. Increases in public expenditure or lower revenues must, however, be part of a framework that guarantees financial sustainability and specifies objectives, priorities and sources of funding.
Public investment expenditure amounts to about 2 per cent of GDP, one third lower than it was at the start of this decade. The objective of recouping half of the lost ground in three years, with planned increases in spending in the order of 10 per cent per year, assumes a big improvement in the ability to move from identifying what needs to be done to actually getting it done. But it is not enough to simply spend more; resources must be utilized more effectively, by improving the procedures for selecting, assigning and executing the works. By international standards, Italy is behind both in terms of works completed and money spent.

A primary surplus of under 0.5 per cent, such as would be obtained in 2020 if the VAT increases under the safeguard clauses envisaged in current legislation were deactivated without any countermeasures, would be incompatible with a reduction in the debt-to-GDP ratio; it would have adverse effects on the risk premiums on public sector securities and, subsequently, on economic activity. Making the deactivation of the VAT clauses conditional on the identification of compensatory measures, as the Economic and Financial Document (DEF) does, reflects these concerns. All the possible options call for a careful and transparent evaluation of the potential effects on demand, economic activity and income distribution.

Looking ahead, what Italy needs is a broad-based tax reform. Since the early 1970s, new forms of taxation have been introduced and a complex set of concessions and exemptions progressively put in place, with no comprehensive plan and, not infrequently, with unclear guidance. Reforming only some concessions or restructuring just one tax means continuing this process of stratification. Instead, this must stop, and a stable framework erected that gives certainty to producers and consumers, investors and savers, with measures that reward workers and are pro-business. Account must also be taken of how the various components of the taxation system interact: indirect taxation with forms of low-income support; direct taxation with detractions and deductions; income support with employment incentives; interactions between the various exceptions to the general taxation regime envisaged for each taxable base; and between these components and the fight against tax evasion, taking full advantage of all the available technologies.

Italy is a country with a rapidly ageing and shrinking population. While these trends are common to many EU countries, they are more evident here. The medium scenario projection published by Eurostat shows that in the next 25 years, the share of the population aged at least 65 will reach 28 per cent in the European Union as a whole and 33 per cent in Italy; the financial pressures on pensions and long-term care will increase as a result. The population aged between 20 and 64 will fall by 6 million in our country,
notwithstanding a hypothetical net influx from abroad of 4 million persons in this age group (Figure 6). The reduction in production capacity linked to demographic trends must be countered with sharp increases in the labour market participation rate and in productivity.

The participation rate is still 8 percentage points below the European average, despite having risen in the last 20 years, from 61 to 66 per cent. As in the other countries, the main contribution has come from older workers, linked to changes made to the pension system. The female participation rate has also risen, from 47 to 56 per cent. The increase has nonetheless been less marked than that recorded in the rest of the EU and the male participation rate is still 19 points higher than that of women, one of the largest gaps in Europe. This suggests that there is much potential for increasing labour force participation and highlights the need to act decisively to identify and introduce measures, services and incentives designed to raise the female participation rate.

Immigration can help to boost Italy's production capacity, but the difficulties encountered in attracting high-skilled workers and in integrating and training those who come from abroad. Since the early 1990s, the number of immigrants arriving in Italy has surpassed that of emigrants every year. After falling slightly during the sovereign debt crisis, net immigration has continued to rise, reaching almost 190,000 people in 2018 or 0.3 per cent of the population. The share of foreigners who hold degrees, equal to almost 13 per cent, is less than half the EU average. Productivity and entrepreneurial skills are also being adversely affected by the gradual increase in the number of young people and university graduates leaving Italy every year, reflecting structural lags in the economy. In the space of ten years, youth emigration increased fivefold to reach 0.5 per cent in 2017, while at 0.4 per cent, graduate emigration more than doubled.

Italy has been slow to respond to the technological revolution (Figure 7) and economic growth has been badly hit as a result. The sectors comprising the digital economy today contribute 5 per cent of total value added, against 8 per cent in Germany and 6.6 per cent on average in the European Union. Since the outbreak of the sovereign debt crisis, the relative weight of these sectors has declined in Italy, going against the trend in terms of the European average. But we must invest in advanced and green technologies for the very sustainability of economic and social development, and to preserve environmental balance.

The gap with respect to the rest of the EU concerns almost all sectors where firms can adopt innovative technologies; in the automation of
production processes it is very apparent in countries that have the kind of sectoral specialization Italy has, such as Germany. The development of new generation telecommunications networks remains limited. The role of central government in promoting the introduction of new technologies is similarly modest; the European Commission’s Digital Economy and Society Index (DESI) ranks Italy 19th for digital public services.

One of the factors that has slowed the advent of the digital economy has been Italy’s fragmented production structure, mainly comprising small firms, whose ownership and management arrangements often overlap, and which are little inclined to accept external injections of capital, technology and expertise. In 2017, fewer than one fifth of firms with between 20 and 49 workers had adopted at least one advanced technology (such as robotics and artificial intelligence); this share rises to one third among medium-sized firms and is more than half for those with 250 or more workers. The more complex the technologies considered, the wider the gap between small and large firms.

The fragmentation of the productive sector has had a negative effect on firms’ capacity to innovate: expenditure on research and development in the private sector amounted to 0.8 per cent of GDP in 2017, less than half the average in OECD countries. It is low in the public sector too (0.5 against 0.7 per cent). At just below 1 per cent of GDP, the share of resources devoted to the university system is roughly one third below the OECD average.

In recent years, incentives have been introduced to support investment, research and development, and innovative start-ups. These measures have proved effective overall. Some of these incentives were confirmed in the latest budget law or in last April’s ‘Growth Decree’, recalibrated mostly in favour of small and medium-sized firms. To be effective, industrial policy requires a stable legislative framework that facilitates change in the economy as a whole.

Low investment in innovation has been accompanied by the comparatively poor acquisition of knowledge and skills by Italian students and adults; these delays feed into one another, in a vicious cycle that must be reversed. Investments in training that accompany individuals throughout their working lives are also necessary to prevent the risk that the adoption of new technologies, with the attendant drop in demand for the workers most affected by the advent of automation and digitalization, will magnify inequalities of income and opportunity, and reduce employment.

Italy’s difficulties are amplified in the South and Islands, harder hit by the double-dip recession than the rest of the country. First and foremost, the business climate in the South needs to improve, especially in relation to guaranteeing legality. The technological gap to be bridged is even wider: the
share of value added ascribable to the digital economy, at close to 2.5 per cent, is more than 3 points below that of the Centre and North. The skills gap must be narrowed, public policies made more effective, and the quality of local government and infrastructures improved: 70 per cent of ‘unfinished works’ are located in these regions, of which only 30 per cent are public works.

Roughly one third of Italy’s population lives in the South of Italy, which generates almost one quarter of the country’s GDP. The southern regions are becoming poorer still now, owing to the emigration of their youngest and most highly-educated people, mostly to the Centre and North of Italy. In the last ten years, net migration has been barely positive overall, but there has been a large net outflow of young university graduates. It is a trend that has immediate social costs and impacts negatively on the prospects for growth.

Over the years there have been numerous attempts to deal with the economic difficulties of the South, with very different interventions whose results, on the whole, have been disappointing. Support measures can contribute to growth in the regions that lag behind; they must not, however, distort the incentives for firms and workers by hindering the optimal use of resources. To improve the economic conditions in the South and Islands and to raise growth potential requires long-term action, fully exploiting the opportunities afforded by European and national funds. It is necessary to intervene in the factors underlying the delays in the South; attempts to compensate for them with monetary transfers cannot be the only solution. The effects on the southern economy of public investment in schools and infrastructure could be highly significant.

**Banks, finance and supervision**

Even though banks’ balance sheets continued to strengthen in 2018, the effects of the crisis have not yet been fully reabsorbed and are delaying their response to the profound changes in the industry’s market structure, customers’ habits, financial regulations and technology. As in the rest of the euro area, profitability, though recovering, remains low and the incidence of operating costs is still high; these trends are reflected in banks’ share prices. Some medium-sized banks are still experiencing difficulties, which are being dealt with by the Italian and European supervisory authorities and by the government. Solutions are being actively sought to relaunch banks and to protect those involved.

The outlook for banks is still closely linked to the performance of the economy and to the perception of country risk, which affect asset quality and the costs they incur in raising funds on the markets. For the entire
banking system, capital ratios, which in mid-2018 were affected by tensions on government bonds, are recovering; at the end of 2018 the CET1 ratio of banks directly supervised by the ECB stood at 12.7 per cent of risk-weighted assets, against an average of 14.3 per cent for significant euro-area banks. Adverse cyclical developments would inevitably affect balance sheets again, so the need remains for continued decisive action to reduce costs and improve profitability.

In Europe the use of digital channels in banking intermediation is in constant growth. Over the last decade, the share of customers using the Internet to access their current accounts has almost doubled (Figure 8) and the number of branches has been reduced by about one quarter. The spread of more complex technologies (FinTech) is rapidly transforming the structure of the financial industry. The management and analysis of big data, the use of artificial intelligence and machine learning, and the potential offered by distributed ledger technologies are changing the services provided; they are also opening the sector to new competitors – including, but not only, the Big Techs – that are able to swiftly exploit the advantages of operating in the digital economy and trade. Market estimates indicate that investment in financial innovation, mainly attributable to large technological firms and start-ups, has increased sixfold at global level in the last five years; in 2018 it exceeded $100 billion, one third of which in Europe, but it is still modest in Italy.

Italy’s banks are providing more and more traditional services online, in order to increase organizational and operational efficiencies. Almost all banks now permit payments to be made using mobile devices, often for small amounts; over half of them place savings products through digital channels; though on the increase, the number of banks offering loans through portals is still modest (Figure 9). Nevertheless, the delay in responding to the challenges posed by the use of more complex technologies risks the gradual erosion of market shares. According to our surveys, half of the banks have yet to launch or even plan to launch trials in this field, for instance in the use of new instruments for assessing creditworthiness. A relatively limited amount of resources are allocated to these projects and are concentrated among the larger banks.

Using technology to provide customized services with greater value added can generate tangible benefits in terms of reducing costs, broadening consumer choice and increasing profitability. The smaller banks, for whom investment at individual level is too costly, can enter joint initiatives for the outsourcing of services designed to promote their products. The spread of new technologies, however, also carries new risks, especially regarding cyber
security and customer data protection; IT projects require particular care and advance planning.

The Bank of Italy is also experimenting with the use of new technologies in its supervisory activity. Recourse to artificial intelligence is not confined to seeking improvements in forecasting economic and financial variables; it is also useful for analysing the level of investors’ trust in banks and it boosts the effectiveness of anti-money laundering activities. The Bank has long been in contact with market operators offering innovative solutions: since 2017 we have had an innovation hub, ‘FinTech Channel’, on our website. This direct interface with operators in a digital environment makes it possible, by means of advance knowledge of new projects, to assess their compliance with legislation, identify potential problems and consider changes to the rules and procedures applied at national level.

The importance of preventing and controlling cyber risks is bound to grow in an increasingly digitalized and interconnected system in which outsourcing is on the rise. The computer emergency readiness team for the financial sector (CERTFin), presided over by the Bank of Italy and the Italian Banking Association, whose members also comprise other sectoral authorities and most financial and technological operators, facilitates the exchange of information during cyber attacks, supports operators in the event of security breaches and helps to improve the effectiveness of firewalls. We play an active part in international cooperation initiatives – especially in the Financial Stability Board, the Bank for International Settlements and the G7 – to define common standards and lines of action to limit cyber risks at national and global level.

Bank credit quality continues to improve (Figure 10). Thanks in part to the improved economic situation in recent years, the new non-performing loan rate has fallen below the levels observed before the global financial crisis; in the first quarter of this year it was equal to 1.3 per cent. The stock of non-performing loans declined considerably, especially as a result of some major sales, totalling €26 billion in 2016, €42 billion in 2017 and €55 billion in 2018. Driven by pressure from the supervisory authorities, the increase in sales also benefited from banks’ progress in providing detailed information on the characteristics of exposures and from the greater number of NPL recovery specialists. The coverage ratio reached 52.7 per cent at the end of 2018, 6 percentage points higher than the average figure for the main euro-area banks. Net of write-downs, the ratio of NPLs to total loans fell to 4.3 per cent for the banking system as a whole, down from 9.8 per cent at the end of 2015; according to the plans
required of all banks by supervisors, it is expected to reach around 3 per cent at the end of 2021.

Due to the reduction in bad loans achieved in recent years, more than half of banks’ net NPLs now consists of exposures to firms in temporary difficulty (unlikely-to-pay). It is important to do as much as possible to enable these loans to be reclassified as performing; as happens in other countries, recourse to specialized investors, such as turnaround funds, can provide resources and knowledge to help firms in difficulty, possibly with the banks themselves. The contribution that the reform of corporate crises can make to effective business restructuring processes will have to be evaluated.

In 2018 profitability showed signs of improvement, mainly following the reduction in loan loss provisions and lower operating costs. Nevertheless, the cost-to-income ratio is still high (66 per cent) and the return on equity (5.7 per cent) remains lower than that which investors would require to subscribe newly-issued shares. This gap, which is also affected by the higher country risk, hinders both market access and efforts to strengthen the capital bases of Italian banks.

The amount of bank bonds maturing by the end of next year exceeds €70 billion. At a time when yields at issue are high by international standards, raising funds on the market is a major challenge for the bigger banks too: the new crisis management rules require the establishment of an ample reserve of liabilities, capable of absorbing losses and replenishing capital. The need to roll over and increase wholesale funding will tend to reduce net interest income. Market access remains difficult for smaller banks; creating institutional demand for their bonds could bring significant benefits.

With the establishment of two cooperative banking groups this year, the reform launched in 2016 to strengthen the overall solidity of this category, while preserving its mutualistic nature, has been enacted. The new groups must combine the benefits of the individual banks’ proximity to and knowledge of local firms with an effective exploitation of cost synergies, in order to increase profitability and the capacity to turn to the market when necessary; maximum effort is vital on these fronts.

For the popolari banks classified as less significant for supervisory purposes, last year the cost-to-income ratio was higher than the system-wide average, return on equity was lower, and the stock of NPLs was still high. These banks are in urgent need of close forms of cooperation or mergers that allow them to compete on the market. Such actions are necessary to preserve the capacity to use resources collected locally to finance, with foresight, economic development, especially in southern Italy, where the limited size
of banks and the greater riskiness of the business environment affect overall supply conditions.

Adequate consumer protection is vital in promoting confidence in the financial system and in individual banks. The latter, in line with the provisions introduced by MiFID II on investment services and with the rules on banks’ product governance, need to orient their behaviour towards the goal of ensuring effective fairness, while taking account of customers’ characteristics and needs. The Bank of Italy is strongly committed to overseeing bank products; it also collaborates with Consob, which is responsible for investment services. In recent years, our interventions on individual banks have been supplemented by thematic action in areas such as the organization of complaints offices, the charging of some fees, unilateral contract changes made by credit institutions, and salary-backed loans. The forms of individual protection offered by the Banking and Financial Ombudsman have been reinforced and there will soon be an ombudsman for insurance disputes too.

Over the last few years, the insufficient attention paid by a number of intermediaries to compliance with anti-money laundering rules has become apparent in Europe. The ensuing risks are high and often go beyond national borders. At EU level there is an ongoing debate as to how to strengthen and harmonize the necessary regulatory and supervisory requirements. At a time when the threats of money laundering and the financing of terrorism are particularly significant at international level, efforts to prevent supervised intermediaries from being infiltrated by criminal activities must be a strategic goal for senior management. In Italy supervisory action is unceasing; a specific agreement with the Financial Intelligence Unit encourages cooperation, the identification of risk factors, and coordinated interventions for monitoring and applying sanctions to intermediaries. In the event of suspected criminal offences, the information provided to the judicial authorities is of the utmost importance, and the Bank responds swiftly to any requests they make.

The role of markets and non-bank intermediaries in allocating resources is increasing in Europe and at global level. This trend may bring benefits to countries such as Italy, where banking intermediation plays a predominant part. A diversified financial system supports economic growth and mitigates the effects of adverse shocks on production. Deep and liquid capital markets are needed to encourage investment, especially in innovative and long-term projects; specialized operators that facilitate the supply of equity and assist firms in the various stages of their development are also required. In order to prevent disorderly and opaque developments from creating risks to overall
stability, the authorities must remain especially vigilant, in the FSB and in the other fora for international cooperation.

Between 2014 and 2018, some 116 non-financial corporations obtained listings on the stock exchange in Italy, against 39 in the previous five years, and over 500 companies placed bonds for the first time. The share of household savings entrusted to institutional investors has increased by 14 percentage points over the last decade, to 31 per cent. These developments have been favoured by tax incentives. Recourse to equity has been encouraged as have bond issues by non-listed companies; other incentives have supported investment in venture capital funds and in the securities issued by innovative firms. The introduction in 2016 of individual savings plans (piani individuali di risparmio or PIRs) has favoured household investment in Italian companies’ securities.

However, there is still a large gap compared with countries where capital markets are more developed. In France and in the United Kingdom, the ratio of market capitalization of non-financial companies to GDP is more than three times that of Italy and the ratio of bonds to firms’ total financial debt is almost double. Promoting the development of non-banking finance must continue, by assessing the effectiveness of the initiatives already introduced, streamlining interventions and favouring regulatory stability. Frequent changes – as in the case of the repeated revisions of incentives for capitalizing firms and of the reform of the PIRs included in the last budget law – could heighten uncertainty, with negative effects on the allocation of savings and on firms’ financing choices.

While for the largest firms, which can stand up to the scrutiny of external investors and sustain the costs of access to capital markets, non-banking finance is sure to become a key point of reference, for most businesses, banks will remain the first port of call for external resources. Healthy firms must be able to count on the support of banks and markets, regardless of their size. Management policies for loans to micro-enterprises and small firms need to select and measure risks carefully; they could benefit from technological innovation, something which is in the interest of both the firms that find it hard to access credit and of banks themselves.

**Italy and Europe**

Italy is deeply integrated in the European economy (Figure 11). Some 60 per cent of our imports come from other EU countries, which in turn receive 56 per cent of our exports. In the last 20 years, partly as a result of the Union’s enlargement, exports to EU countries as a share of GDP have increased by
almost 5 percentage points, to 18 per cent. Two thirds of direct foreign and portfolio investment in Italy are from EU countries, which are themselves the recipients of 60 per cent of comparable Italian investments.

Italy was one of the main beneficiaries of EU transfers for a long time. In the 1980s, annual average net funds amounted to 0.4 per cent of GDP. Partly owing to the accession of new member states, the country’s position then gradually changed. Since the early 2000s, Italy has been a net contributor to the EU budget; since 2014, net outward transfers have amounted to just under 0.2 per cent of GDP per year. France and Germany contribute more (0.3 and 0.4 per cent of GDP respectively). In gross terms, the resources allocated to support disadvantaged regions in our country for the period 2014–20 amount to €34 billion or to an annual average of 0.3 per cent of GDP. Their efficient utilization must be a priority as is determination in overcoming past obstacles.

Europe’s institutions promote research and innovation through programmes that channel resources towards shared objectives, facilitate cooperation among member countries’ institutions, and increase opportunities for private-public sector collaboration. Universities, research centres and high-tech firms are important contributors to the EU’s innovation programmes and derive tangible benefits from the opportunities for exchanging information and ideas. If Italy’s research system were larger and better organized, greater resources could be obtained from such programmes.

Inflation, which was close to 20 per cent in the early 1980s and still as high as 5 per cent in the first half of the 1990s, reached 2 per cent in the two years prior to the adoption of the euro and stayed around that level until a few years ago; the more recent risk of deflation has been averted thanks to the monetary policy measures in place since 2014 (Figure 12). The single currency has stabilized the reduction in the occult tax that curbed households’ purchasing power and forced the country into making repeated devaluations with temporary benefits for some firms but costs for the wider community. Thanks to the reduction in inflation and exchange rate risk, as well as to the possibility of accessing a bigger financial market, the yields on government securities and those on loans to firms and households came down in the lead-up to the euro.

Neither the European Union nor the euro are responsible for Italy’s sluggish growth over the last twenty years; almost all the other member states have performed better than we have. What today are sometimes perceived as the costs of belonging to the euro area are, in reality, the result of Italy’s tardy response to technological change and to global markets opening up. The specialization of production in mature sectors has exposed the economy
to competition on prices from emerging countries. Hesitating to reduce imbalances in the public accounts has curtailed the scope for policies on macroeconomic stabilization and for achieving sustainable growth. It is up to us to become aware of the problems and to address them, including with the help of European instruments. Others have done precisely this and done it well.

Although the single currency was a vital step on the path to European integration, economic and monetary union remains an unfinished construction. Europe’s architects knew this, and wanted and anticipated greater progress in the future. Even before the introduction of the euro, the unusual status of a Stateless currency had been underlined, as had the institutional solitude of the ECB and the problems posed by the imperfect mobility of capital and labour. Trust was placed in the push that integration would give to the economic convergence of the member states and in a strategy of progressive reforms, to be enacted when the political conditions were right.

The risks inherent in this process materialized with unanticipated violence during the sovereign debt crisis. The inadequacy of the euro area’s economic governance was laid bare: the rules of the Treaties failed to guide national policies appropriately and to ensure the necessary coordination; the lack of shared instruments for managing national economic crises has made them longer and deeper, and has raised the risk of episodes of contagion.

The proposals for reform drawn up after the peak of the crisis envisaged the gradual strengthening of integration, first in the financial arena and then for public finances. Yet only partial progress has been made so far. The banking union is incomplete and not without flaws, the bases for the capital union are still being laid, and fiscal union has been postponed to an unspecified future date.

Efforts to reduce national risks before agreeing to share them – and even then not all risks – end by increasing them and heightening the feelings of precariousness that surround the euro. Risk reduction and sharing must go hand in hand and mutually reinforce one another; the pooling of risks increases sustainability for all. The idea that what is instead needed is to proceed by degrees reflects political and economic concerns linked to residual differences between member states. It is the result of the mutual distrust that developed during the crisis, fuelled by doubts about the ability and desire of countries to tackle problems with the necessary determination and their willingness to draw up rules and policies in the common interest. Standing at the crossroads of the reform process, the euro area’s economic growth is being held back and the area itself continues to be exposed to financial risks.
Italy has a duty to help Europe exit this impasse and can play a constructive role in identifying the necessary steps for completing economic and monetary union. The more successfully it removes the structural obstacles to a return to a stable growth path, and embarks on a credible reduction plan for its public debt, the more authoritative its voice in Europe will be.

What Europe needs are integrated markets in finance, labour, goods and services, with common rules and procedures. It needs coordinated economic policies, built on sharing medium-term strategies and objectives. It needs instruments that enable it to swiftly tackle difficult situations, with decision-making processes that are not encumbered by drawn-out negotiations and uncertain outcomes.

Banking union must be accompanied by rules and arrangements for the effective and orderly management of banking crises, so that they are not themselves sources of instability. It is especially important to ensure that a disorderly liquidation is not the only option available for the crises of small and medium-sized intermediaries which, like most European banks, are not subject to resolution, as this would create serious risks for the continuity of financial services, for savers, and for stability as a whole. The new possibilities opened up by the recent pronouncement of the General Court of the European Union on preventive interventions by mandatory deposit guarantee funds should be explored further. At European level, the rules on State aid to safeguard competition must take account of the need to guarantee financial stability and, in any event, must be applied with due proportionality relative to the size of the intermediaries concerned.

The widespread concern over high public debts is justified, but the idea that a review of the prudential treatment of sovereign exposures is indispensable to break the sovereign-bank nexus fails to consider that this is primarily sustained through channels other than direct exposures. The main channel is the real economy; a sharp rise in the perceived risk of one State’s debt can quickly trigger a recessive spiral, kindling social tensions with unpredictable results. The blow to the banking system would be severe, irrespective of its capitalization and direct exposure.

Nor is there any evidence that the benefits associated with a reform of the prudential treatment of sovereign exposures outweigh the costs, or that the associated reduction in risk could be achieved by simply shifting the public debt securities from banks to other holders. Only a combination of prudent budgetary policies and credible, growth-oriented structural reforms can simultaneously drive a sustained increase in lending and a reduction in public sector securities on banks’ balance sheets.
The Euro Summit held last December reached an agreement on strengthening the European Stability Mechanism’s role in managing and preventing crises in euro-area member states. The conditions that countries must respect to access the ESM’s precautionary funding instruments were specified and cooperation procedures agreed between the ESM and the Commission for monitoring the public accounts of the member states.

To reduce uncertainty as to how and when a sovereign debt can be restructured, the Summit also decided to introduce ‘single limb’ collective action clauses (CACs) in euro-area government bonds by 2022 and that, if requested by the member state, the ESM could facilitate the dialogue between that state and private investors. This uncertainty, however, only contributes to a small extent to the cost of a possible insolvency crisis. Given the close economic and financial ties between the euro-area countries, the effects of a crisis of this kind would be serious and unpredictable not only for the country directly involved, but also for the others.

Europe should seek ways to support the efforts that must be made by member states to reduce their debt. Rigorous and prudent budgetary policies are indispensable, but the lowering of the debt-to-GDP ratio is a necessarily long process, which could be disrupted by events outside the control of individual governments; this is why some form of supranational insurance is needed, for example through the creation of a European debt redemption fund financed by dedicated resources of the participating countries.

The heated debate on NPLs and sovereign exposures tends to overlook other significant risks to which banks are exposed. One example is the high stock of illiquid and opaque assets on the balance sheets of some major European intermediaries, which the Single Supervisory Mechanism recently addressed in a series of initiatives to define the necessary interventions. The tendency to have an asymmetric vision of the importance of these risks was confirmed in the decisions of the Euro Summit in December: the possibility of the financial support provided by the ESM to the Single Resolution Fund being made operative before 2024 is conditional on progress being achieved in risk reduction measured solely in relation to NPL volumes and on building up buffers of liabilities to be used in a crisis.

The smooth functioning of a currency area requires a single capital market that facilitates access to financing for businesses. In addition, an integrated market helps to absorb local macroeconomic shocks, increases the robustness of the economic system, and strengthens financial stability. Its complementarity with the fiscal union and monetary policy is evident in this regard.
A fiscal union, which can take different forms but must promote macroeconomic stabilization before all else, would reconcile the full exercise of this function with balancing public accounts in each country. While it is difficult to conceive of any immediate adoption of discretionary instruments, it is instead possible to plan for common automatic stabilizers, for example mechanisms that would fund part of the expenditure on unemployment during downturns. Designed in such a way as to avoid systematic cross-country transfers, these instruments would help to make the European employment market more fluid and the benefits of economic and monetary union more tangible.

Monetary policy was the sole line of defence during the sovereign debt crisis and against the risks of deflation that emerged in the years thereafter. The ECB’s Governing Council demonstrated its readiness to use all of the instruments available to it and, if necessary, to introduce new ones to pursue the objective of price stability. It was successful, but its actions could have been even more effective had they been accompanied by other economic policies.

The introduction of safe assets in the euro area is the common denominator necessary for the completion of the three unions – banking, capital markets and fiscal – that must flank monetary union. By partly replacing national government bonds, a European debt instrument could help to diversify the sovereign exposures of financial institutions; it could reduce the risk of flights to safety by investors in times of market tension triggering massive capital outflows from the countries in difficulty, instead enabling the financial market to play an effective role as shock absorber; and it could be an instrument for funding shared automatic stabilizers. It is possible to design mechanisms that enable a safe asset to be introduced with the necessary safeguards against the risk of opportunistic behaviour. But aside from the rules, the essential requirement for the viability of this solution lies in a renewed and convinced commitment by all to the European project and a willingness to pursue common solutions for common problems.

* * *

The euro was introduced twenty years ago. It was by no means a given that Italy would be part of the single currency at the outset, but our country was resolute in its pursuit of the economic and financial objectives required to achieve that goal. Expectations were high; taking this brave step towards ever greater union between European countries sealed the commitment to continuing along the path of development built on the rubble of the Second
World War; there was little, though some, perception of just how much needed to be done to complete the economic and monetary union or of how great a responsibility was being entrusted to the European Central Bank in the absence of a political governance of the economy.

Italy has not responded to other challenges with the same determination. It has been slow to react to the changes imposed by technological progress and by the opening up of global markets, remaining more exposed than other countries to competition from the emerging countries. It has yet to complete the restructuring of the public accounts begun in the 1990s, which involved shoulder ing the risks connected with its heavy reliance on the financial markets to fund the government debt.

Tensions that have also been felt in the other advanced economies have been exacerbated by this dual weakness in Italy. A country where productivity was already sluggish has had to bear the consequences of a global financial crisis that began on another continent and of a sovereign debt crisis which it had done nothing to trigger. The economic and social suffering has been aggravated by the real and perceived difficulties encountered in managing growing migration flows.

The euro area had neither the governance nor the tools to deal with crises of this magnitude. In its pursuit of medium-term price stability, the single monetary policy can mitigate common cyclical difficulties, but it cannot intervene in favour of individual countries nor can it solve structural problems, whether they affect just one country or the euro area as a whole. Yet holding Europe responsible for our troubles is a mistake; there is nothing to be gained by it and it diverts attention from the real issues.

Italy is still struggling to recover from the double-dip recession as it is paying the price of not being – in terms of public service quality and respect for the rules – a business-friendly environment. It suffers from a serious technological lag, the result of a production structure that is fragmented and counts a high proportion of firms that find it difficult to grow and innovate. It is weighed down by the distortions caused by tax evasion and by the public debt, which makes funding more expensive for households, firms and banks, as well as for the country itself. A state of constant uncertainty squeezes firms’ investment and household consumption. Labour suffers, and social hardship increases.

The performance of the economy and country risk in turn affect the conditions of banks. The progress on credit quality, profitability, and banks’ assets observed in the last few years in many cases reflect the significant efforts made, supported by the Bank’s supervisory activities and helped by the improved economic situation and relaxed financial conditions that prevailed.
up until the spring of 2018. The possibility that macroeconomic risks could again hit a financial sector that has yet to reorganize is a source of vulnerability of which we must be aware. Sustaining growth and easing tensions on the financial markets remain crucial to guaranteeing that this vital component of the economic system is fully functional.

If we look beyond the short-term horizon we cannot ignore the risk, implicit in demographic trends, of a sharp deterioration in Italy’s production capacity, and the prospect of strong pressures on public finances. From here until 2030, without the contribution of immigration, the population aged between 20 and 64 is expected to fall by 3.5 million, and by a further 7 million in the subsequent fifteen years. Today, for every 100 people in this age group, 38 are at least 65 years old; in twenty-five years’ time, this share will have risen to 76. Italy’s inability to attract highly-skilled labour from abroad and, indeed, the concrete risk of losing our best and most dynamic workers, makes this outlook even more worrying.

A more careful calibration of the budget towards measures to support work and production activities, a rigorous and credible strategy to reduce the burden of the public debt, and broader structural reforms, designed to eliminate bureaucratic and administrative obstacles to competition and investment in physical and human capital, can all help to restore higher growth rates and confidence in the government bond market. This process can be facilitated by effective action to combat evasion as part of a broader tax reform.

Everything possible must be done to raise labour market participation rates, by prolonging working lives in line with the increase in life expectancy, and by removing the obstacles facing female workers; the country’s development requires that the South of Italy, where one third of the population resides, be revitalized. It is the job of economic policy to define the legislative framework, by providing adequate incentives and by removing the brakes on production, but it is up to firms to seize the opportunities offered by the market and technology, to be ready to grow, including by opening up to external capital and expertise; it is for students and workers to help effect change by seeking new and more varied skills. The financial intermediaries must prove able, in their own interest, to support this process by demonstrating prudence but also wisdom. This calls for a concerted effort, with no exceptions, and politics must show the way.

Italy’s membership of the European Union is vital to return to a path of stable growth: this is where we can respond to the global challenges posed by the integration of markets, technology, geopolitical changes, and migration flows. The institutional development of Europe has accompanied the economic
development of all the member countries: it has opened up a bigger market
for firms and consumers, made more funds available to support disadvantaged
areas, facilitated cooperation on strategic questions, and guaranteed a stable
monetary framework. Without Europe we would have been worse off, but if
we were to antagonize Europe we would become so.

We must work responsibly, constructively, and without prejudice to
complete the Union, to help reinforce its institutions, and for the wellbeing
of all. There must be no ambiguity about the responsibilities to be shared,
the objectives to be pursued or the instruments to be used, all the while in
the knowledge that, including for those who save, invest and produce, ‘words
are deeds’ and ‘in the dark, words weigh double’. The farsightedness shown
by those who laid the foundations of the European project must once again
guide our actions today. This is an essential condition for guaranteeing a
future of peace and prosperity for the generations to come.
FIGURES
Figure 1

World trade growth

Source: OECD.

Figure 2

Business confidence of industrial firms
(indices: 2000=100)

Source: Based on European Commission data.
**Figure 3**

**Sovereign spreads**  
(*yield spread vs. German government securities; basis points*)

Source: Based on Bloomberg data.

**Figure 4**

**GDP growth**  
(*the dashed lines indicate the average growth for the period*)

Sources: Based on Istat and Eurostat data. The euro-area aggregate is based on a fixed country composition (EA-19).
Figure 5
Average cost of the public debt and nominal GDP growth in Italy: forecasts
(per cent; average 2019-20)


Figure 6
Population in the 20-64 age group: projections
(indices: 2018=100)

Source: Based on Eurostat data.
Figure 7

Degree of digitalization
(DESI; percentage deviations from the European average)

Source: European Commission.
Note: The Digital Economy and Society Index (DESI) is a composite indicator that measures the digital performance of the European Union and of its member states.

Figure 8

Use of online banking

Source: Eurostat.
Note: Share of the population aged 25-64 years that uses the Internet to access their current accounts.
Supply of banking services offered through digital channels in Italy

Source: Regional bank lending survey (RBLS).
Note: Share of banks offering their services through digital channels. Unweighted frequencies. For lending to households and firms, the share refers to banks that provide online estimates of what loans would cost.

Credit quality of Italian banks
(billions of euros)

Source: Supervisory reports (consolidated for banking groups and individual for stand-alone banks).
Note: The stocks are calculated gross and net of loan loss provisions. Bad debts are a subset of total non-performing loans (NPLs).
Figure 11

Exports and foreign direct and portfolio investment in Italy
(destination/origin; percentage composition)

Sources: Based on Bank of Italy, Istat and IMF data.

Figure 12

Inflation

Source: OECD.