# ACRI Association of Italian Savings Banks

## **2019 World Savings Day**

Address by the Governor of the Bank of Italy Ignazio Visco

#### The economic outlook

The trade tensions, the slowdown in China and the persistent uncertainty concerning the United Kingdom's withdrawal from the European Union have continued to affect the global economy. International trade, which has been declining since last autumn, seems to have contracted in the second quarter as well; for the year as a whole, it is expected to increase but at a rate of less than 1 per cent, the lowest since 2009.

In recent weeks, the International Monetary Fund revised downwards its growth forecast for 2019 and 2020 for nearly every country. Going forward, global demand may benefit from the stimulus measures implemented in the major economies, but the risks remain significant and are aggravated by the high level of public and private sector indebtedness in many countries.

In the euro area, the sharp drop in industrial activity, especially in Germany, has thus far been partially offset by the performance of the service sector. However, this sector has also started to show signs of weakness. Among the main economies, GDP decreased in Germany while it continued to grow in France and Spain in the second quarter. If the contraction in the German economy persists, it will inevitably spread to other countries.

In Italy, economic activity seems to have remained substantially unchanged during the summer, after having grown just slightly in the second quarter. The manufacturing sector has suffered heavily from the close production and trade ties with Germany, as well as from the negative effects stemming from the global context; the sector's weakness seems to have been offset by a slight expansion in services and construction.

In the surveys carried out by the Bank of Italy between September and October, firms expressed less unfavourable opinions on the economic situation and on the trend in demand for their own products in comparison with the opinions expressed at the start of the year. The higher planned investment likely also reflects

the reintroduction of tax incentives in April; instead, firms that sell in Germany further downsized their expenditure plans.

Despite the contraction in world trade, exports continued to grow in the second quarter; Italy's current account surplus has helped to further reduce its net foreign debtor position, which is now close to balance. The new tariffs applicable to the European Union, announced by the United States administration, will affect a limited share of Italian exports to the US but the indirect effects could be significant.

Thanks to the decline in uncertainty surrounding Italy's economic policy stance, lessened tensions with the European institutions and greater monetary accommodation, yields on Italian government securities have declined significantly, falling to historically low levels; yields on ten-year bonds now stand at around 1 per cent. The spread with the corresponding German bonds has narrowed, falling from the peak of almost 290 basis points recorded at the end of May to approximately 130 basis points this week (Figure 1). However, it remains higher than the spread of other euro-area countries such as Spain and Portugal. For Italy, the reduction in the spread was in part due to the fall in the debt redenomination risk premium, which came to almost 30 basis points, nearing the level recorded at the start of 2018.

Accommodative financial conditions attenuate the contractionary effects that stem from the global situation; for our economy, this is an opportunity that should not be missed. Looking forward, the average debt burden is expected to remain on a downward path, reducing the effort needed to reach a primary surplus that is capable of ensuring balanced public accounts. The decline in interest rates on government securities has already significantly lowered the cost of wholesale bank funding and of corporate bond issues. Interest rates on bank loans to firms and households also fell slightly, though they ran the risk of increasing significantly had tensions not abated on the government securities market over the course of the year.

The fiscal stance tries to strike a difficult balance between ensuring sustainable public finances and supporting the economy. To counter the cyclical slowdown effectively, the choice of measures must be based on their effect on aggregate demand; in addition, guaranteeing the attainment of the balances envisioned is essential to avoid a decline in private sector confidence. In order to reduce the debt-to-GDP ratio decisively and durably, we must improve the growth outlook through concrete initiatives that improve the environment in which economic activity takes place. Removing uncertainty on the current and future situation of

the public finances is essential to protecting savings, which can only be amassed and increased if the economy grows at sufficiently high rates along a stable and sustainable path.

### Monetary policy and savings

Inflation in the euro area remains at levels that are still too low, and these low levels are pushing down short-term inflation expectations. The risk of a de-anchoring of medium- to long-term expectations has emerged as they have moved further away from the price stability aim (Figure 2). The inflation expectations at the five-year horizon of the participants in the ECB's Survey of Professional Forecasters have decreased by about 0.2 percentage points since the start of the year, to 1.6 per cent. Those implied by the prices of inflation-linked financial assets, which also incorporate a risk premium, fell by 0.4 percentage points over the five-year, five years forward horizon, to 1.2 per cent.

Low inflation and the ongoing economic slowdown must be countered decisively, lest they translate into a further, progressive reduction in inflation expectations or into a re-emergence of the threat of deflation. The ECB Governing Council took timely, appropriate and proportionate action to respond to the cyclical downturn and the worsening inflation outlook by adopting a very broad set of expansionary measures. It decided to restart, effective tomorrow, net asset purchases at a monthly pace of €20 billion (they had reached €80 billion per month between April 2016 and March 2017); to reduce by 10 basis points, to -0.5 per cent, the interest rates on banks' deposits with the Eurosystem; and to lower the cost and extend the maturity of targeted longer-term refinancing operations.

There was unanimous agreement within the Council on the need for action, and broad consensus on the package of measures as a whole, although there were differing views on the individual measures. While the effects of some of them are uncertain, there is no reason to doubt their overall effectiveness. The monetary policy stance will therefore remain resolutely expansionary for as a long as necessary to support aggregate demand and, through this, ensure price stability.

Our analyses suggest that the ECB's asset purchase programme is likely the most effective tool under the current conditions. The effects of the purchases are transmitted through various channels: they have a direct impact on the yields of

the securities being purchased; they help to improve credit supply conditions; and they strengthen the monetary stimulus to the entire economy through wealth and portfolio-rebalancing effects.

The consequences of a reduction in the key interest rates to even more negative levels – the true 'non-standard' instrument among those that have been introduced thus far, given that open market operations have always been in the toolbox of central banks – should be assessed more carefully. The evidence suggests that reductions in the key interest rates have so far had significant expansionary effects. Going forward, however, the risks of undesirable side effects may grow the longer the key interest rates remain at negative levels and, especially, the lower they fall.

There is the possibility that banks' balance sheets will be penalized by a reduction in net interest income, with repercussions on their ability to grant loans, especially to households and small firms, and on the transmission of monetary policy. To counter this risk, we have accompanied the latest reduction in interest rates with the decision to remunerate part of banks' excess liquidity holdings with the Eurosystem at zero per cent as opposed to a negative rate. In addition, banks' balance sheets benefit from the very favourable conditions (including negative interest rates) applied to loans granted by the Eurosystem.

It has been argued that, as the whole term structure of interest rates remains at very low if not negative levels, there could be an incentive for households, firms and investors to take on excessive risks, fuelling possible misalignments between the prices of financial and real assets and their fundamental economic value. There are currently no signs of a generalized widening in euro-area imbalances. The indicators continue to suggest that the weak phase of the economy is not transitory and they do not signal imminent financial risks. The Governing Council is constantly monitoring these developments.

In the years following the global financial crisis, Italian households were cautious in their selection of portfolio investments. The share of deposits in their total financial assets has continued to grow, reaching almost 30 per cent in June, also as a consequence of the reduction in the yields on other financial instruments (Figure 3). In addition, households have significantly reduced their direct investments in bonds, especially government and bank bonds, bringing them to 3.3 and 1.5 per cent of their total investments, down by 3 and 6 percentage

points respectively compared with 2007. Purchases of asset management products increased (especially those of insurance products): their share in total financial assets surpassed 31 per cent in June, some 11 percentage points higher than in 2007. Overall, portfolio diversification has increased.

Within this context, the activities geared at protecting savers, in which the Bank of Italy, Consob and IVASS each play a part, are especially important. We carry out our role on various fronts. On the one hand, we have strengthened our supervision of bank products, most recently through measures on the handling of complaints, on product oversight and governance, and on the rights of payment service users. On the other hand, we are continuing to expand upon our financial education initiatives for young people and adults, including in relation to the effects of digital technology on payment instruments: we are completing the update of the informational material for students; we will soon launch a new financial education website; and we are working very closely with the national financial education committee.

The main way to protect savers is through growth. This objective is currently being pursued by maintaining very accommodative monetary conditions. In the long run, the return on savings necessarily depends on the economic outlook. The unsatisfactory level of market yields is the consequence of the insufficient level of investment with respect to the supply of savings; more generally, it is the result of the weakness in demand caused by negative long-term trends, such as demographic trends, and by cyclical trends, such as the recent sharp increase in uncertainty. If the latter is not tempered, it could further increase the propensity to save for precautionary purposes, leading to a downward spiral in economic activity that would lower, rather than increase, aggregate savings, as convincingly maintained by Ragnar Frisch and John Maynard Keynes during the Great Depression. Policies designed to stabilize the economy, which extend beyond monetary policies, serve to combat this risk by stimulating investment and consumption.

There would be less need to maintain our monetary policy measures for an extended period of time – thereby also mitigating the risk of negative side effects – if, in those countries where the public finances permit, fiscal policies were to contribute incisively to strengthening aggregate demand and if Europe's focus were placed on reforming the structure and functioning of the economy so as to increase the growth potential, about which monetary policy can do little.

#### **Banks**

In Italy the upturn in economic activity recorded in recent years, even if rather modest, helped to improve the quality of banks' assets, an improvement that has continued in recent months despite the stall in growth. In the first half of this year, the ratio of NPLs net of loan loss provisions to total outstanding loans fell from 4.3 to 4.0 per cent for the banking system as a whole; it was 9.8 per cent at the end of 2015. According to the reduction plans submitted by both significant and less significant banks, this ratio should decrease further, to around 3 per cent by the end of 2021 (Figure 4).

Going forward, however, NPLs dynamics could be affected by a protraction of the current phase of cyclical weakness. Efforts to strengthen balance sheets must therefore continue in an orderly but resolute fashion, especially by smaller banks, whose NPL ratios are higher and coverage ratios lower than those of the significant banking groups.

The improvement in the quality of banks' assets was facilitated by the development of the market for NPLs: in the three years 2016-18, NPL disposals amounted to more than €120 billion, gross of provisions; so far this year they came to around €20 billion. This was due not just to the fact that banks can access the state guarantee scheme (GACS) for securitized bad loans, which was renewed in March of this year, but was also spurred by the early results of the reforms undertaken to reduce the length of credit recovery proceedings, which deters investors and affects disposal prices. The expected time needed to sell foreclosed property decreased from more than three years to around two years. The expected length of time needed to complete all preparatory procedures also declined, albeit by only three months, to just over two years. There is still room for further reductions, which can be accomplished in part by following the best organizational practices promoted by the High Council for the Judiciary, whose effects can already be seen in some areas of the country.

Progress can also be achieved by turning more frequently to corporate restructuring and turnaround specialists (e.g. turnaround funds). This could lead to some 'unlikely-to-pay' loans returning to performing status, benefiting both banks' balance sheets and the economy.

The credit recovery sector has grown significantly in recent years. This development has contributed to the reduction in NPLs in banks' balance sheets, but it is not free of problems. Inefficient recovery performance can erode value,

reintroduce risks to banks' balance sheets and, in extreme cases, have repercussions on the guarantee provided by the State through the GACS. The Bank of Italy remains highly vigilant in supervising the intermediaries for which it is responsible.

Banks' profitability was helped by low funding costs and the drop in loan loss provisions; excluding extraordinary items, in the first six months of 2019 the return on equity was about 7 per cent on an annual basis. Net interest income remains under pressure, also due to increased competition in the market for loans to high-quality customers. Banks, especially small ones, must continue to diversify their sources of revenue and to contain their costs; less significant banks have reduced their operating expenses by just under 1 per cent in the first half of this year, compared with a drop of almost 4 per cent for the significant banking groups.

Better profitability is critical for banks, and not just Italian ones, to enable them to meet the challenges posed by competitive pressures, by prudential regulation, by the new European crisis management framework, and by technological innovation in the financial sector. This is essential for small and medium-sized banks which are still suffering from the effects of the deep and protracted economic recession, especially in the South of Italy. Among other things, these banks face greater difficulties in accessing the market for debt and equity capital.

The heterogeneity of financial intermediaries in terms of firm size, business models and corporate form can play an important role in the proper functioning of the system. However, it must be compatible with the safety and soundness of banks, which is essential for them to remain in the market. From this standpoint, achieving various forms of integration could help significantly by unlocking the benefits associated with a larger operating scale, a wider range of products, and the adoption of innovative technologies.

With the launch this year of two new cooperative banking groups (Iccrea and Cassa Centrale Banca), this sector can continue to support local economies from a much sounder position. As a result of the reform, the structure of the Italian banking system has undergone extensive change, moving towards less fragmentation. As of last June, the 12 significant groups (which include both cooperative banking groups) held almost 80 per cent of the system's total assets.

Many of the about 90 less significant banks, with the exception of the Raiffeisen banks for which an institutional protection scheme is to be established, operate on a

very small scale, which also impacts their ability to adapt their business models to technological change: more than half of them report assets of less than €1.5 billion and over one third of less than €1 billion. Effective integration must be pursued in this sector as well, especially among the smaller *popolari* banks, which suffer from the typical governance problems that stem from the cooperative banking model. For these *popolari* banks, the measures and projects we have been suggesting for some time for their strengthening need to be implemented quickly.

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To make the fullest possible use of the expansionary potential of the monetary policy measures adopted by the ECB Governing Council, the other policies also have to move in the same direction. Fiscal policies that support economic activity in the euro area can deliver a faster return to price stability. To ensure sustained higher growth, reforms are needed to remove any obstacles to development, foster innovation and help modernize the productive system. Acting in isolation, monetary policy can do nothing but continue along the path of 'non-standard' measures. This increases the risk of adverse side effects, which, in turn, need to be kept under control using instruments of an increasingly administrative nature.

European economic and monetary union is still incomplete. As the President of the ECB recalled last Monday, 'we need a euro area fiscal capacity of adequate size and design: large enough to stabilize the monetary union'. In the current circumstances, the difficulties arising from the absence of this fiscal capacity are manifest. Such difficulties are not confined to the impossibility of using fiscal policy to support aggregate demand, but also include the resulting obstacles to the conduct of monetary policy and transmission of the related stimulus measures: the euro area feels the consequences of the lack of a common safe financial asset that plays the same role as the sovereign debt securities of other major economies.

Yet, Member States could coordinate their policies as they did at the height of the global financial crisis. We should not now rule out this possibility and we should assess in good time, for the purposes of prevention, the scale of the risk of a return to an emergency scenario. Boosting the European economy's capacity for growth also requires us to focus our efforts on the areas that are the most important today, such as new digital technologies and the protection of the environment. This can be done by drawing up a common public investment programme that is also aimed at improving and redeveloping major infrastructure – energy, transport, and

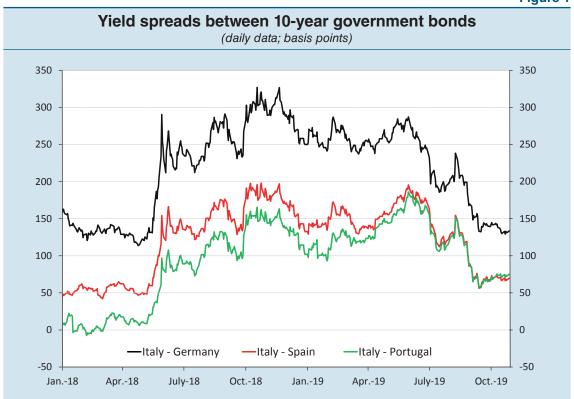
urban services – to enhance service quality, reduce their environmental impact and unleash private investment which, in the absence of any clear strategic direction, today struggles to materialize. This type of programme could help to launch R&D projects and would thus have long-term effects on the EU's productivity and growth potential.

In the climate of mistrust that has emerged in recent years, also following the damage caused by the financial and sovereign debt crises, there is less inclination to consider coordinating national fiscal policies. While waiting for the realization to take hold that action is needed at European level, Italy must make the most of the favourable financial conditions to outline clearly the necessary process of change and initiate it decisively. This process will involve the economy's productive sectors, the government sector, and the definition of and compliance with the rules. It will require a committed effort to develop the parts of the country that are lagging behind and harness the available resources, especially in terms of human capital. Changing the composition of the government budget to set aside more resources for tangible and intangible investments can stimulate economic activity beyond the short term.

However, collective action is required to raise the growth potential: economic policy must create an adequate framework, providing incentives and removing any brakes on productive activities; firms and banks must be prepared to invest in order to seize the opportunities offered by the market and by technology; and everyone must contribute to this change by looking to acquire new and better skills. Making the best use of savings, achieving sustainable economic and social development, protecting the environment and creating jobs all depend on the success of this undertaking.

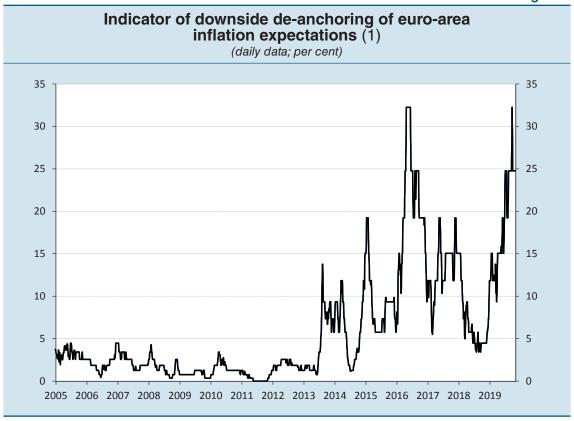


Figure 1



Source: Bank of Italy, based on Bloomberg data.

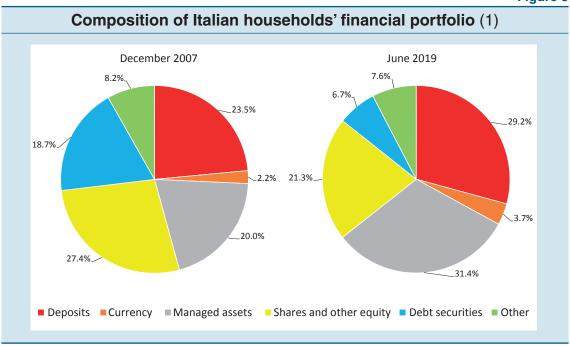
Figure 2



Source: Bank of Italy, Economic Bulletin, 4, 2019 (October 2019).

(1) An increase signals an intensification of the link between sharp drops in short-term and in long-term inflation expectations.

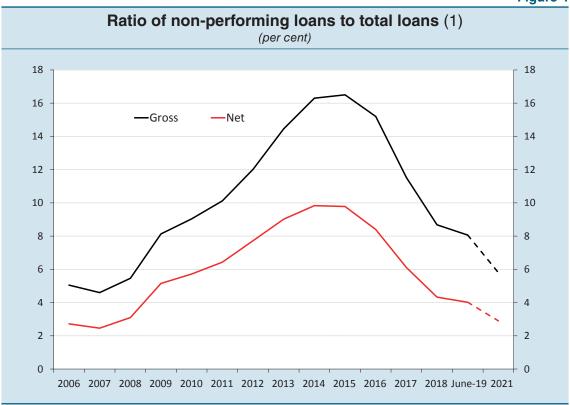
Figure 3



Source: Bank of Italy.

(1) 'Managed assets' comprise investment funds, life insurance reserves and pension funds (other than severance pay); 'other' comprises trade and other payables, derivatives and stock options, severance pay, and any other insurance components not included under managed assets.

Figure 4



Source: Bank of Italy.

(1) The 'gross' ratio measures non-performing exposures (bad loans, unlikely-to-pay loans and past-due/ overdrawn exposures) in relation to total loans gross of loan loss provisions; the 'net' ratio excludes loan loss provisions. The ratios for 2021 are estimates based on the NPL reduction plans that banks agreed with the supervisory authorities.