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Speech by the Governor of the Bank of Italy
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The economic situation and the outlook

The ongoing pandemic and the uncertainty over the public health, social and economic situation continue to affect consumption and investment decisions, with significant repercussions for the production system, employment and income. The marketing authorization of the first vaccines, granted at the end of 2020, gives hope that the health emergency can be countered effectively over the course of this year.

However, the risks for the coming months still appear very substantial. The main one is that the containment of COVID-19 may prove to be more difficult than expected. Moreover, it is not clear whether the changes that the pandemic has caused in consumer habits, in the organization of society and of production, and in the way people work will persist.

The G20's cooperative response has made it possible to limit the economic impact of the health emergency. Italy, which has taken over the G20 presidency for this year, will have the opportunity to work towards reaffirming a multilateral approach. Global economic activity will be supported by the latest expansionary measures adopted by some advanced countries and by China's robust recovery, which is also being facilitated by sizeable public investment. These factors, together with the agreement reached by the European Union and the United Kingdom last December, led the International Monetary Fund to revise its growth projections for the world economy for 2021 slightly upwards, to 5.5 per cent, after the contraction of 3.5 per cent recorded in 2020.

In Italy, the marked increase in production activity in the third quarter of 2020 demonstrated that the economy retains the capacity to bounce back. However, the second wave of infection, the resulting restrictions put in place to contain its spread, and heightened uncertainty led, as in other EU countries, to a new drop in GDP in the fourth quarter, equal to 2 per cent on the third quarter and to 6.6 per cent compared with the year-earlier period. The experience gained so far has made it possible to limit its impact on the economy, in part thanks to more targeted containment measures and an improvement in the response capacity of the health system.

After the strong but partial recovery in the number of hours worked in the summer months, employment is now being affected by the sudden worsening of the economic situation. Since the beginning of 2020, the pandemic has had a significant impact on income and inequality. Among those affected were above all self-employed workers and payroll employees with fixed-term contracts, especially young people and women, who account for a higher share of employment in the sectors most exposed to the crisis. The policies implemented to alleviate its economic effects – such as wage supplementation schemes, the lengthening of the duration of unemployment benefits and the income support measures for self-employed workers and households in difficulty – have been effective overall, mitigating the shortcomings of the welfare system, due above all to the excessive fragmentation of the instruments available.

The surveys conducted by the Bank of Italy at the end of November suggest that consumption expenditure is being held back by fears of infection, besides the precautionary motive based on economic and financial considerations. The share of households that expect to spend less than their annual income in the next twelve months has increased; a non-negligible share (about 20 per cent) of the households anticipating a decrease in their income also reported that they expect to save. Over the course of the month, about 80 per cent of households spent less on tourism and restaurant services compared with November 2019, and reduced the frequency of purchases in clothing stores; two thirds decreased their spending on personal care services. The contraction for this set of consumption items was greatest in the regions hit hardest by the spread of the epidemic. These indications confirm the importance of a far-reaching and lasting strengthening of the healthcare system and suggest that a fully successful vaccination campaign will be crucial to a stable recovery.

The worsening of the health emergency was also reflected in firms' assessments of investment conditions, which started to deteriorate again, albeit slightly, in late 2020, especially in some segments of the service sector marked by the presence of a high number of small and micro firms with a limited ability to deal with shocks.

Our projections point to a recovery in production starting in the spring, although this central scenario hinges crucially upon the progressive attenuation of the epidemic over the course of the coming months. In addition to this, a robust recovery of the economy will require the reactivation of significant plans for investment; in this respect, a key role will be played by the benefits stemming from a rapid and full implementation of the measures still being drawn up as part of the Next Generation EU programme. However, it is likely that consumption will

pick up slowly, especially in services, owing to the gradual manner in which the uncertainty that drove the propensity to save will be reabsorbed.

In the current circumstances, measures providing economic and financial relief to households and firms remain indispensable. The urgent need to address today's problems must, however, be accompanied by reflections on how to conduct the inevitable progressive reduction of support measures in the future. The necessity of guaranteeing protection for workers and preventing healthy firms from exiting the market must be reconciled with the need not to hinder the automatic reallocation of resources towards the firms and sectors with the best growth potential. This process is indispensable to foster the efficiency gains that are fundamental to economic growth.

As uncertainty about the economic outlook diminishes, the use of support instruments can gradually be made more selective. Access to broad-spectrum instruments that are significantly more generous than ordinary ones can be revised to make them conditional on firms' ability to retain their workers and, at the same time, the general freeze on terminations can be eased. It will be possible to return progressively to firms' sharing the costs of these instruments. When calibrating these measures, it will be important to consider the particular conditions of the various sectors of the economy.

Measures to support firms' liquidity will have to be gradually readjusted to prevent a credit squeeze as the economy begins to pick up again. These measures must not, however, compromise the timely emergence of bad quality loans on banks' balance sheets, nor should they facilitate the prolonged survival of firms that, independently of the pandemic crisis, would not be able to remain on the market. Firms' capital strengthening must continue, by means of effective and easy-to-use tools.

The contribution of fiscal policy has been crucial to containing the economic fall-out from the public health emergency. However, we cannot cultivate the illusion that the public debt can increase indefinitely. In relation to GDP, it has already risen to levels only previously seen in the wake of the First World War. Fiscal policies must have the clear medium-term objective of guiding the debt ratio back to a downward slope.

This goal is within our reach: the low interest rates observed in recent years have reduced the average cost of the debt to historical lows and its residual maturity is a protection against temporary external shocks, but the crucial question

remains that of economic growth. Once the pandemic is behind us, achieving stable and sufficiently high growth rates, in line with those in the years prior to the global financial crisis, will allow us to reduce the weight of the debt with budget adjustments that are not excessively onerous. To relaunch the economy, the public spending plans for the green and digital transition must be accompanied by reforms to make Italy more business-friendly: private investment, company growth, and greater innovative capability within the industrial system also depend, to a high degree, on a significant improvement in the services provided by general government.

Given the unfavourable demographic outlook, productivity growth must be accompanied by a significant increase in activity rates. On the one hand, it will be necessary to accommodate the current trends by extending working lives and, on the other, we must facilitate participation in the labour market for those segments of the population, especially women and young people, that today remain on the margins of productive activity, above all in the South of Italy. In this regard too, we can only reiterate the importance of removing the lags in the levels of education and learning that exist today.

The year that has just ended was characterized by very erratic movements in the financial markets: in the early months of 2020, the yield spread between Italian and German ten-year government bonds repeatedly went above 250 basis points. The consistent approach of the economic policies adopted at national and EU levels led to a reduction of tensions and a sustained decline of market interest rates. A decisive part was played by the resolute and swift action of monetary policy – with new purchase programmes whose flexibility allowed incisive and vigorous action in jurisdictions where the financial tensions caused by the spread of the pandemic had been greatest – and the decision to establish the Next Generation EU programme for the joint funding of individual countries' investment and development plans by means of issuing European debt securities.

The yields on Italian ten-year government bonds have gradually fallen to very low levels and the yield spread with the German Bund has, in the last few days, fallen below 100 basis points, reaching its lowest level since the beginning of 2016. The set of measures adopted to support liquidity has also made it possible to preserve favourable conditions for accessing bank credit on the part of households and firms and to reduce the cost of bond and equity funding.

Faced with the effects of the public health emergency, which are expected to last longer than predicted last autumn, at its January meeting, the ECB Governing

Council reconfirmed that its very accommodative monetary policy stance and its continued presence on the market are still essential in order to support the economy and prices in the euro area, also by bolstering confidence and reducing uncertainty. The Council also confirmed that any tightening of financial conditions that is not consistent with containing the impact of the pandemic on price stability will be countered resolutely.

Banks

Thanks also to the economic support measures adopted by the Government, Italian banks have kept credit supply standards relaxed in response to firms' rising demand for funds. The growth in lending to non-financial corporations remained robust in the fourth quarter, still driven by the ample recourse to public guarantees. The average cost of new loans remains at very low levels.

The financial aid measures, the supervisory authorities' guidelines on the use of the flexibility built into the rules for classifying loans, and the expansionary monetary policy stance have all contributed to keeping the non-performing loan rate low. The disposal of NPLs continued, equalling almost €30 billion in 2020, surpassing initial projections. This development was supported by legislation that has enabled banks to convert a portion of their deferred tax assets into tax credits when such assets are sold.

Because of the ongoing restrictions on economic activity, rendered necessary to contain the risk of infection, the Government has extended the moratoriums introduced in March 2020 until next June. This measure, also taking account of the clarifications recently published by the European Banking Authority, will make it possible to continue to contribute generously to satisfying firms' liquidity needs. It is nonetheless essential that moratoriums continue to be a tool to help debtors make it through temporary difficulties, and are not used to conceal clear and irreversible crises. Never before have banks been called upon to perform their role with such skill, acting swiftly to improve the outlook for firms facing temporary distress and to set aside adequate provisions for expected losses, in line with the new accounting standards.

Since the start of the year, the new European rules with which credit institutions and non-bank financial intermediaries must comply have further refined the definition of default for prudential purposes. As we have explained, the 'new' definition of default does not entail any substantial changes in reports to the Central Credit Register. Instead, it affects the way in which financial intermediaries have

to classify their customers' positions to calculate their capital requirements. As the experience of the four Italian banks that chose to switch to the new system as early as 2019 has shown, the new framework seems to have had a limited impact on the stock of non-performing loans. To reduce the impact to a minimum, we have asked intermediaries to launch a suitable informational campaign on the new rules and to engage one-on-one with their customers more frequently. The goal is to prevent any defaults not connected to any actual situations of distress and to handle such situations effectively.

The latest data available show that, at the end of September 2020, the NPL ratio had fallen to 2.7 per cent net of loan loss provisions (5.5 per cent gross of provisions). The downward trend is likely to be interrupted owing to the impact of the current crisis, which, however, is making itself felt more slowly and less intensely than in the past, thanks to firms being in a stronger position when the crisis first hit and to the support measures mentioned earlier. The heightened uncertainty about changes in the macroeconomic outlook calls for a great deal of caution in interpreting the estimates put forth by a number of parties on the possible increase in NPLs. Although it is expected to rise, the non-performing loan rate should nonetheless stay well below the peaks reached during the euro-area sovereign debt crisis.

In the medium term, the deterioration in banks' balance sheets will depend on how quickly our economy is able to exit from this current difficult phase. The build-up of bad debt until 2015 was the result of two severe recessions that occurred in rapid succession. Serious deficiencies in the procedures used by intermediaries to manage NPLs have also had an impact, although important steps forward have been taken in the last five years, in part thanks to the development of the secondary market. While some slight progress has been made, considerable improvement is still needed in the legal and judicial system's ability to handle the caseload of business insolvencies swiftly and efficiently: to do this, the persistently large gap with other European countries must be closed. It is important that we monitor the actual impact of the reforms that, with the new Corporate Crisis and Insolvency Code, will take effect in the second half of this year.

The prudential rules and supervisory expectations based on a calendar provisioning approach seek to ensure that NPLs do not accumulate in banks' balance sheets without adequate write-downs. In many countries, including ours, the high levels of NPLs – despite the prompting, the targeted inspections and the prudential interventions by the supervisory authorities – were among the main causes of banking crises in the last few years. The effect of this approach on banks'

balance sheets may not prove trivial over the short term, but it is manageable overall. In any case, its impact on intermediaries' income statements is temporary and will basically disappear over the course of the credit recovery cycle.

The capital strengthening of Italian banks continued in 2020. The ratio between common equity tier 1 and risk-weighted assets (CET1 ratio) rose by about 1.2 percentage points, to 15.1 per cent. The capitalization of the profits from the 2019 financial year that were not distributed, in accordance with the recommendations of the European Systemic Risk Board, were a significant contributory factor. These recommendations sought to improve intermediaries' capacity to absorb losses and to guarantee an adequate flow of credit to the economy.

Last December, both the ECB and the Bank of Italy reiterated the need for extreme caution in dividend distribution policies on 2020 earnings. These profits were in part fuelled by considerable government support for firms and households, which also helped to soften the impact of the crisis on credit institutions' balance sheets. The recommendation is temporary in nature; in these very unusual times, it is necessary to maintain a sufficient degree of capitalization of profits.

Banks' profitability has indeed been significantly affected by the pandemic. Despite essentially stable operating profits, in the first nine months of 2020, the annualized return on equity fell to 2.4 per cent, about two thirds lower than in the same period of 2019. Unusual, one-off events that affected the balance sheets of some large intermediaries contributed to the aggregate decline in profits. In particular, in expectation of a deterioration in asset quality in the future, banks have considerably increased the loan loss provisions for performing loans for which the probability of default has risen.

Over the next few months, banks will be called on to manage effectively and with determination the effects of the crisis on credit quality, enhancing the instruments at their disposal to stave off an excessive build-up of non-performing loans and, looking forward, the pro-cyclical effects on credit supply. The European Commission's recent communication points to initiatives that could be useful to strengthen the secondary market for NPLs, but it falls short regarding the possibility of establishing asset management companies with public support, a tool that, as we have long stressed, is extremely useful, especially during economic downturns.

Small and medium-sized banks could feel the effects of the pandemic crisis to the extent that they have greater exposure to firms that do business in the most impacted sectors. This problem is layered on top of the 'structural' ones tied to

there being fewer opportunities to exploit economies of scale and to diversify, and to the restrictions on accessing capital markets. Given these considerations, which we too have recalled repeatedly, the development of a harmonized banking crisis management framework at European level is necessary and urgent, in order to foster the orderly exit of these intermediaries from the market.

It remains crucial that banks be headed by individuals whose professionalism and integrity are beyond reproach. The recent measures issued by the Government finally implement the relevant European legislation; they strengthen, in line with international standards, the requirements and eligibility criteria for bank officials; and they constitute an important step forward in defending the stability of the system and the interests of investors, be they small shareholders or bondholders of credit institutions. The action taken by the supervisory authorities to ensure sound and prudent management must of necessity be complemented by the conduct and competence of bank executives: it is they, first and foremost, who must guarantee the proper functioning of internal controls, an adequate monitoring of risks, and a medium and long-term strategic vision apt for facing the challenges posed by the difficult economic phase. The new legislation represents an opportunity, starting with the upcoming shareholders' meetings convened to make new appointments, to renew and enhance banks' managerial human capital, not just for the largest banks.

The markets and the G20 Finance Track

The banking sector is helping to sustain the economy in this phase of the public health emergency; it will need to continue providing its support during the recovery as well, with a complementary role to that of public sector and monetary policy interventions. However, the banks' role will not only be to lend to firms, but also to help them access alternative funding sources, especially for risk capital. Action is needed to increase trust in the possibility of using savings profitably, so that they can be invested in instruments that allow the firms with the best prospects to be funded.

The underdevelopment of Italy's equity market compared with those of the other main economies stems from the small average size of firms and from their historically low propensity to seek a listing. In recent years, however, there has been an increase in firms' initial public offerings, especially for small and medium-sized companies and those that are more high-tech. The dynamism of firms, the incentives introduced by the legislator and the simplified listing procedures

adopted by the market are all contributory factors. Once the effects of the crisis have faded, both firms that now need to strengthen their financial structure and those that plan to raise capital on the market to begin new activities will be able to take advantage of this trend to grasp in full the opportunities that the economic recovery will offer them.

The diversification of firms' funding sources and the expansion of investment opportunities for savers are favoured by the process for integrating the European Union's financial markets, which must continue. The more intermediaries and market infrastructures are able to increase the efficiency of their organizations and to adopt strategic guidelines open to innovation, the greater the benefits for Italy's financial marketplace. The Borsa Italiana group, to which Italy's market infrastructures belong, is on the eve of an important operation to transfer its entire shareholding from the London Stock Exchange Group to the Euronext Group, a pan-European federated infrastructure. This operation is currently being examined by the Italian and European authorities. Italian market operating and post-trading companies, in part due to their importance in the group's capital and financial structure, will be able to provide significant strategic input for the new ownership set-up and to seize the opportunities that may come from the wider range of services provided and a greater presence on European financial markets.

In 2021, the merger between SIA and Nexi will come to fruition; these two operators play a central role in the national payments industry. At a time when Europe is strongly committed to creating open, secure and sustainable digital finance, a new Italian hub has emerged that can make a significant contribution at European level to the soundness and innovation of payment infrastructures. An open and competitive context is crucial so that efficiency gains for financial operators translate into lower costs for the end-users.

As part of the G20 Finance Track, which brings together Finance Ministers and central bank Governors, Italy's presidency will promote analyses to evaluate, in light of the crisis caused by the pandemic, the adequacy of the financial regulation reforms introduced since 2008 and problems in the field of non-banking intermediation too, in order to identify any corrective measures that might be necessary.

Among the other priorities is that of ensuring the timely implementation of the Roadmap on Enhancing Cross-Border Payments, agreed upon last year to make the cross-border payment system more efficient, with a view to alleviating its fragmentation and to providing cheaper and faster services, especially for

remittances. The debate will also continue on private and public digital currencies that might appear on the global scene.

The digitalization of finance must be suitably governed, as it provides considerable opportunities but also brings new risks, such as that of excluding the most vulnerable. This includes the initiatives designed to ensure protection for customers and for their data. For retail payments, especially for remote card transactions, strong customer authentication solutions have been adopted to give further support to the development of e-commerce. It is important for the new provisions to be correctly and rapidly implemented by online financial operators and retailers. The work of a dedicated G20 platform (Global Partnership for Financial Inclusion) will also focus on the theme of financial inclusion and aims to capture the existing gaps, also by refining the tools for measuring them, and to find the most appropriate solutions to remedy them.

There will also be a significant focus on the issue of environmental sustainability. Finance must necessarily be an active part of strategies to counter climate change, acting rapidly, decisively and with farsightedness while at the same time incorporating the risks it brings in its evaluations. Best practices in terms of environmental sustainability, social commitment and corporate management have positive effects on firms' economic and financial equilibrium, on risk management and, ultimately, on the well-being of all citizens.

Investors' growing interest is leading to a marked expansion in sustainable finance and thus expanding the availability of capital for funding the transition towards a low-carbon economy. This trend has to be supported by better corporate information; firms that lag behind in increasing their transparency will find it difficult to attract capital. Correctly identifying and quantifying the exposure of their assets to climate risks is also essential for managing them more accurately and effectively.

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The pandemic, with its terrible toll, is not yet behind us, and much uncertainty remains about the course it will take. Considerable efforts are still required to tackle the health emergency and support the hardest hit businesses, workers and households. Our economy has demonstrated its capacity to recover. Italy must now find the cohesion it needs to return to the path of development, exploiting the opportunity provided by the EU's pandemic response and addressing the structural

problems that hold it back in the formation of a common strategy, one that has at its centre the challenges of environmental sustainability and the digital transition.

The components of the National Recovery and Resilience Plan, together with a broader recalibration of national policies, must aim to increase growth potential, defining the projects and their management in such a way as to permit their rapid realization, within the tight deadlines set out in the European programme and in accordance with the detailed operational guidelines of the European Commission. This is no small challenge for the public administration. As much as it is vital for modernizing the production sector, if it is not accompanied by reforms that tackle the problems hindering development and private investment, the Plan's implementation risks being insufficient to guarantee a lasting increase in the pace of growth. It is not just a matter of formally adhering to the recommendations of the European Commission, but rather of dealing concretely with problems that have been debated for years. The combination of the boost to potential GDP growth, made possible by a careful and targeted use of Next Generation EU funds, and the prolonged expansionary effects of monetary policy, offers Italy the opportunity to aggressively tackle its high debt-to-GDP ratio as well.

Thanks to its relatively high residual maturity, the cost of the debt will remain low for a prolonged period of time, even after market and official rates have started to rise again. In these circumstances, if, as we have shown we can, the country succeeds in returning to a path of steady growth, the debt-to-GDP ratio could fall rapidly from the high point reached owing to the crisis. Renewed confidence in the quality of policies and in the economic outlook could enable a further narrowing of the yield spread between Italian and German ten-year bonds, which is still close to double that of Spain and Portugal. As the economy improves, an appropriate strategy to gradually rebalance the public accounts could strengthen these confidence effects and further accelerate the reduction in the debt-to-GDP ratio.

The present difficulties must not prevent us from looking to the future. Certainly, there are risks in the near term. Yet by cultivating a longer-term vision, it is possible to do better than the trend projections suggest. Mindful, decisive and effective answers are required for today's very serious problems, greatly exacerbated by the pandemic but also reflecting existing structural gaps. Closing these gaps will require a collective commitment, on the part of all firms operating in our economy, including those in the financial industry represented here, but also by the institutions on which economic policy action depends. Extraordinary relief measures have been the necessary response for dealing with the most acute phases

of the crisis. Once the emergency is over, the measures designed to alleviate the difficulties of those hardest hit must constitute a bridge towards the realization of the reforms and investment that will enable the country to return to the path of growth from which it has strayed for too long.

