BANCA D'ITALIA

EUROSISTEMA

The Governor's Concluding Remarks

Annual Report

Rome, 31 May 2022

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Ladies and Gentlemen,

The invasion of Ukraine by Russia at the end of February marks a dramatic watershed in recent history. It has triggered a grave humanitarian crisis, leading to the re-emergence of tensions between different parts of the world that seemed to have been permanently reduced, if not completely allayed, in the last thirty years. Our first thought today goes to the people of Ukraine, to those who have lost their lives, to those who have been forced to abandon their homes, and to those who have had their daily existence turned upside down.

The war has also abruptly worsened global economic growth prospects, at a time when the damage caused by the pandemic has not yet been completely repaired. Uncertainty has dramatically increased the world over, affecting the pillars supporting the international economic and financial framework in place since the Cold War, namely the peaceful coexistence between nations, market integration and multilateral cooperation.

The economic outlook and the impact of the war in Ukraine

The progressive worsening of geopolitical tensions has significantly accentuated the rise in energy prices associated with the recovery of economic activity after the public health crisis. Above all, this has been reflected in the price of gas in Europe which has risen on average to about €90 per megawatt-hour since last September, with peaks of around €200, compared with just over €10 per megawatt-hour in the months preceding the pandemic (Figure 1). The increase was much smaller in the United States, rising from almost $10 to around $20 per megawatt-hour.

Although Russia only accounts for 2 per cent of world trade, it is one of the main exporters of oil and gas, fertilizers, and, along with Ukraine itself, cereals. According to market quotations, the prices of these products are likely to remain very high in 2022, going down only slightly over the next two years. Higher food prices and supply difficulties risk hitting, above all,

the most vulnerable sections of the world population and those countries that most depend on food imports.

The conflict in Ukraine is slowing the world economy significantly and the recent measures adopted in China to counter new outbreaks of the virus are exacerbating this trend, rekindling the global value chain problems already seen in 2021. The International Monetary Fund estimates an increase in global GDP of 3.6 per cent for this year, almost 1 percentage point down on January's projections and about 1.5 points lower than those for October. Inflation, which in all economies largely reflects increases in commodity prices, is expected to remain high and then to fall in 2023. This scenario is based on relatively favourable hypotheses as regards prices and supplies of food and energy, hypotheses that are closely tied to how the conflict in Ukraine will develop and to the consequent sanctions against Russia. The risk of a more marked slowdown in the economy should not be overlooked, also because of the still uncertain development of the pandemic.

The cyclical outlook also deteriorated in the euro area, which is particularly exposed to the economic effects of the conflict. The most recent estimates suggest that GDP growth will be less than 3 per cent this year, well below what was forecast a few months ago; an increase already largely acquired thanks to the strong recovery in 2021, and that therefore implies only a modest expansion of the economy over the course of this year. There is a significant risk of a less favourable trend. As for the other economies that import energy products, the supply shock has serious repercussions on demand as well: the worsening of the terms of trade negatively affects the resources available to households and firms, curbing consumption and investment. In addition, the widespread decline in confidence and the fragility of international trade are contributing to the weakening of the outlook.

In April, consumer prices recorded an increase of 7.4 per cent compared with the same month last year, driven by the price rises for energy and, to a lesser extent, for food (Figure 2). Net of these components, inflation stood at 3.5 per cent, in turn influenced by the transmission of higher energy costs to the final prices of other goods and services. In the United States though, core inflation, at 6.2 per cent, is only 2 percentage points below overall inflation, mainly as a consequence of demand overheating.

The latest forecasts of the main international institutions and private analysts indicate that price growth in the euro area will remain high this year and then fall considerably in 2023, returning to levels consistent with the European Central Bank's definition of monetary stability, namely inflation at 2 per cent in the medium term (Figure 3). The expectations of market

operators, inferred from the quotations of financial assets index-linked to consumer prices, are in line with this profile.

The uncertainty of these forecasts is far greater than a year ago. In the last few months, the size and persistence of the price rises have been underestimated, including in central bank projections. Given the faster than expected recovery in global demand, the emergence of supply bottlenecks has driven up the prices of intermediate goods everywhere. However, in the euro area, the main factor has been the exceptional increase in energy prices that began at the end of the summer in relation to the geopolitical tensions. The worsening of these tensions, culminating in Russia's attack on Ukraine, is the main reason for the persistence and spread of the inflationary pressures we are witnessing today.

The worsening of the terms of trade and the loss of purchasing power will tend to hold down final demand, easing the pressure on prices. However, we should not overlook the risk of an increase in inflation expectations above the medium-term objective and the start of a wage-price spiral. At the moment, expectations are not very far from the 2 per cent objective and, unlike what has happened in the United States, wage growth in the euro area has been moderate so far, even if very high wage demands have been advanced in some countries (Figure 4). If these ended in one-off increases in wages, the risk of starting a vicious circle of inflation and wage growth would be reduced.

The economic outlook has therefore changed considerably in the last few months. Given that the risk of deflation, which had called for the introduction of unconventional monetary policy measures, has been averted, and the impact of the pandemic on final demand has faded, the negative key rates policy can now be left behind. A raise in these rates, which the ECB Governing Council might decide to start in the summer, should proceed by taking account of the uncertain evolution of the economic outlook. Financing conditions for households and firms, which are today exceptionally accommodative, will remain favourable; according to current market quotations, short-term interest rates in the euro area will stay negative in real terms for several years to come.

The Governing Council stands ready to adjust all its instruments to pursue its medium-term inflation aim. During the pandemic crisis, flexibility in the design and conduct of asset purchases was crucial to counter tensions on the financial markets; it remains a key element in our strategy in the event that malfunctions in the monetary transmission mechanism risk compromising the pursuit of price stability. To address rapidly evolving needs, particular attention will have to be paid to ensuring that the monetary policy normalization process takes place in an orderly manner and to preventing the

emergence of any market fragmentation that is not justified by the economic fundamentals.

The action of the Eurosystem is still intertwined with that of the fiscal authorities. The increase in commodity prices cannot be directly countered by monetary policy. What monetary policy can do is ensure price stability in the medium term, maintaining the anchoring of inflation expectations and countering pointless wage-price spirals. Temporary fiscal interventions, carefully calibrated to protect the soundness of the public finances, are able to limit rises in energy prices and to support the income of the households most in difficulty, in both cases reducing pressures to increase wages. This allows for a more gradual normalization of monetary policy, mitigating the risks of a recessive impact on the economy.

In Italy, the expansion of GDP in 2021, equal to 6.6 per cent, amply surpassed expectations, mainly reflecting strong investment and the recovery of exports. Although the energy deficit has doubled, the current account side of the balance of payments has remained broadly positive, thus helping to strengthen the positive net international investment position. The wide gap between nominal GDP growth and the average cost of the debt led to positive results for the public accounts. After the significant rise in 2020, the debt-to-GDP ratio fell by more than 4 percentage points to less than 151 per cent, while one year ago, when a much higher deficit had been forecast, an increase to about 160 per cent was expected.

Italy's economy, together with that of Germany, is among the worst hit by the increase in the price of gas, because of the high share of imports from Russia and the importance of the manufacturing industry, which makes intensive use of gas. In January, our forecasts indicated that GDP would return to pre-pandemic levels about half way through this year and that there would be a solid expansion of above 3 per cent on average in the two-year period 2022-23. The war has radically accentuated the uncertainty over these prospects. Production activity weakened in the first quarter, also affected by the resurgence of the virus, and it should strengthen moderately this quarter. In April, we calculated that the protraction of the conflict in Ukraine could mean about 2 percentage points less growth overall, for this year and the next. The most recent forecasts of the main international organizations are similar. However, more adverse developments cannot be ruled out. If the war should lead to an interruption in the supply of gas from Russia, GDP could decline on average over the two years.

Inflation reached 6.8 per cent in March, its highest point since the start of the 1990s; it fell by half a percentage point in April, thanks to the recent

measures on fuel, electricity and gas. Until now, there has been no sign of price pressures being transmitted to salaries, partly because of the characteristics of Italy's collective bargaining system, designed to limit the repercussions of increases in inflation due to energy shocks. Other factors include the still incomplete recovery in terms of the number of hours worked, the reduction of profit margins observed in 2021, and the government measures to reduce the impact of the energy crisis on household and business incomes.

The increase in imported commodity prices is an unavoidable tax for the country. Government action can redistribute the effects of inflation between households, factors of production, and present and future generations, but it cannot wipe out the overall impact. As regards households, interventions calibrated according to their general economic condition rather than individual incomes are more effective in countering the repercussions of inflation on inequality. Among other things, targeted measures enable the role of prices to be better preserved as an incentive to invest in renewable sources and to save energy.

Despite the deterioration of the economic outlook, the most recent assessments by the European Commission indicate that the debt-to-GDP ratio will continue to decline both this year and the next. In the last few weeks, we have nevertheless observed an increase in the yield spread between Italian government securities and the corresponding German Bund which, for ten-year bonds, has repeatedly gone above 200 basis points. This sudden increase does not reflect any abrupt changes in the underlying economic conditions: the net international investment position is robust, Italy's producers are successfully competing on the outlet markets, and the level of household and business indebtedness is low by international standards. The increase does, however, call attention to the structural fragility represented by the high level of public debt; it confirms the need to continue firmly on the path towards gradually strengthening the public accounts.

Although varying in severity across countries, the economic consequences of the war in Ukraine, like those of the pandemic, are affecting the whole of Europe. There was a common response to the pandemic, which included the Next Generation EU (NGEU) programme. The Commission has now proposed to expand it with the REPowerEU programme to put an end to dependence on fossil fuel imports from Russia. European initiatives could prevent unfavourable shocks from exacerbating the differences between national economies and financial market fragmentation risks, ensuring a fiscal policy stance that is more suited to conditions in the euro area. The main beneficiaries of the NGEU programme, of which our country is undoubtedly

one, are responsible for demonstrating, in a concrete way, what milestones a stronger and more cohesive Union can achieve.

There has been discussion for some time about the advisability of completing the institutional framework of the Economic and Monetary Union by endowing it with an adequate common budget. This would have a stabilizing effect and guarantee the supply of European public goods to be offset by own resources or debt issuance. This innovative approach could help resolve the asymmetry between the many different national fiscal policies and the single monetary policy, although this would require amending the Treaties, which is a long process with uncertain results.

Without involving Treaty changes, one possible – and less ambitious – solution could be to set up an instrument to be used as needed, avoiding having to create ad hoc programmes each time, as happened after the sovereign debt crisis and during the pandemic. In this way, confidence would be bolstered in Europe's capacity to intervene promptly when necessary. The new instrument could finance common projects of an exceptional nature or help with the macroeconomic stabilization of the European area in response to a shock of a certain size. Following the example of the NGEU programme, funds would be raised via the issuance of EU debt and then transferred to the member countries to be employed judiciously and for uses agreed at European level; the servicing of this debt would be guaranteed by adequate own revenues.

This innovation could accompany the ongoing reform of the Stability and Growth Pact. Today, there seems to be a consensus not only on the need to renew the Pact, but also on some of the desirable characteristics of the new system of rules. It should continue to guarantee the sustainability of public debt, while taking account of the differences in macroeconomic and structural conditions between the various countries. To ensure simplicity and transparency, the role of unobservable items, such as the structural deficit or potential GDP, should be limited as much as possible.

Starting with these points of agreement, which are also clearly present in the proposals for reform advanced by the governments of some euro-area countries, a framework of rules that is simpler and more flexible, but which preserves budgetary discipline, could be centred on medium-term programmes agreed with the European Commission and approved by the Council of the European Union. These programmes, based on realistic macroeconomic projections and subject to independent validation, should indicate debt objectives and time horizons for their achievement, specific to each country, going beyond the uniform criterion of reducing the debt-to-GDP ratio in line with the current rules; they should also set out a multi-year profile for net borrowing consistent with these objectives. Deviations from this profile that are not due to any unforeseen macroeconomic factors, would be

subject to corrective mechanisms similar to those currently contained in the excessive debt procedure. If the budget instrument I have alluded to were to be introduced, access to common resources could be bound to compliance with these programmes.

As we have argued on more than one occasion, there are also very sound reasons for adopting forms of common management for a part of the national debt issued in the past – for example, the component relating to the pandemic emergency – by means of a European fund that would buy a share of existing public sector securities, financing itself on the market. While I am well aware of the political difficulties that such an initiative would encounter, it must be underlined once again that it would make a significant contribution to strengthening the stability of the euro area as a whole and to creating a supranational public sector bond market of adequate depth and liquidity, with positive effects also for the completion of the banking union and the capital market union. The activity of this kind of European fund would be structured in such a way as to avoid the systematic transfer of resources from one country to another and to maintain the incentives to conduct fiscal policy responsibly.

The risks for the international scenario beyond the short term

The governance of globalization and international equilibria have been under consideration for some time now, driven by the serious shocks that have hit the world economy one after another in the last 15 years, by the distributional consequences of this process in various countries, as well as by the gradual changes in the relative demographic, economic and political importance of the advanced and emerging countries (Figure 5). The war in Ukraine risks diverting the course of this essential rethinking and leading us towards a world divided into blocs, with fewer movements not only of goods, services and financial capital but also of technologies, ideas and people.

With the end of the Cold War, over the last thirty years, the opening up of trade and technological progress have generated profound changes. Billions of people that had hitherto been excluded have had access to global markets, resulting in an unprecedented expansion. Today, world GDP is two and a half times what it was in 1990, per capita GDP has increased by 75 per cent and international trade has more than quadrupled (Figure 6). In some areas of the world, particularly in the emerging countries of Asia, the economic development and the improvement in living conditions have been extraordinary. Despite the increase in the world's population – from five to eight billion, more than 90 per cent of which in the emerging and developing economies – the number of people living in extreme poverty has

declined considerably, from almost two billion to below 700 million, with the exception of sub-Saharan Africa.

Efficiency gains, generated by exploiting economies of scale, differences in productivity and in the availability of production factors between countries and economic areas, have been increased by the organization along global value chains in which around half of international trade took place, prior to the pandemic. At the same time, capital flows have continued to support economic integration, ensuring a better allocation of resources and greater risk diversification.

This process has not been without uncertainties and difficulties. The way in which capital moves has changed, and the role of non-banking financial intermediation has grown considerably since the global financial crisis. While the riskiness of the banking component has been attenuated by a wide-ranging reform of the rules and by micro- and macro-prudential policies, the increasing diversification in sources of funding for the economy has been accompanied by episodes of marked volatility. The lengthening of value chains has accentuated firms' financing needs; for those operating in emerging economies and less developed countries, the large share of foreign currency debt has increased their vulnerability to external shocks. The reproduction on a global scale of just-in-time organizational planning models has heightened the fragility of production chains and the risks of an international propagation of local production difficulties.

Globalization has also leveraged the regulatory differences between countries, especially regarding the taxation of profits, environmental sustainability and protecting workers. Furthermore, despite the significant reduction in per capita income gaps between countries, the inequalities in wealth and income distribution have increased sharply within many economies, especially the advanced ones, giving rise to calls for greater social protection and undermining trust in the benefits of globalization and technological progress, in part because of the lack of adequate national policy responses. The repeated external shocks, as well as amplifying income volatility, have increased the uncertainty over individual economic prospects and contributed to generating widespread insecurity.

The pandemic, with the marked fall in international trade and the supply chain bottlenecks for some intermediate goods, and the Russian invasion of Ukraine, with its repercussions for energy and food supplies, could push towards a reorganization of international trade that favours the resilience of supply, especially in strategic sectors. In this situation, trade could be concentrated within areas comprising countries that are politically like-minded or united by regional economic agreements.

However, a division of the world into blocs would risk jeopardizing the mechanisms that have stimulated growth and reduced poverty at global level. A reshaping of the dense network of interdependencies among countries would be difficult to achieve without tensions or marked adjustments in the prices of goods, services, and financial and real assets, even if it were spread out over time. The allocation of global savings would inevitably be less efficient, and the funding of the public and private debt of individual countries would be more difficult. A fragmentation along borders drawn by political security considerations, albeit necessary ones, could have extremely negative consequences for smaller economies, especially emerging and low-income ones that do not benefit from participation in consolidated regional economic areas.

In a world divided into blocs, we would also and above all lose that wealth of mutual trust, however fragile and uncertain, that, as well as being indispensable for nations to co-exist peacefully, is an irreplaceable foundation for tackling the key challenges for future generations. Limiting global warming, fighting against extreme poverty and combating pandemics are formidable objectives that no country can face alone. The experience of Italy's G20 Presidency last year showed that, despite considerable and increasing difficulties, acting in concert can achieve important results, although it must be acknowledged that it is made more arduous by the altered political context.

A change of direction that aims to blend the benefits of globalization with policies framed to limit its negative consequences is indispensable. It must be based on an open discussion of the rules and governance of the global economy, which leads to a new international balance, taking account of the greater importance of emerging countries and the need to guarantee fundamental respect for the founding principles and values of peaceful coexistence among nations.

Otherwise, the most vulnerable and the poorest social groups and countries would pay the highest price of a disorderly 'deglobalization', although there would be no shortage of pressures on advanced economies, and on Europe in particular. More than half of the increase that is forecast for the world's population, of two billion over the next thirty years, will be in Africa: a steady and sustainable development in this continent's economies is crucial for reducing extreme poverty and guaranteeing a substantial improvement in the social and economic prospects for those living there, as well as for averting the emergence of migration flows that would be difficult to manage in terms of scale and size.

Difficulties, trends and challenges for the Italian economy

The restructuring that took place in the decade prior to the pandemic enabled Italian firms to face the crisis from a relatively sound financial position. A recovery in competitiveness has been underway for some time. The financial system, which has also become stronger, is capable of providing the production sector with adequate support. The renewed confidence in Italy's economic outlook had fostered a return to growth in investment and facilitated the recovery, which is now being impacted by the consequences of the war in Ukraine.

The progress made, though partial, indicates that the Italian economy can overcome the weaknesses that are slowing its development, in order to end the stagnation in productivity, counter the effect of demographic trends on labour supply and reduce the weight of public debt, which has risen considerably with the pandemic crisis (Figure 7). The National Recovery and Resilience Plan (NRRP) is a crucial tool for successfully tackling this challenge.

The Plan, which is on a significant financial scale, marks a sharp break with the past in drawing up economic policies. It sets out a comprehensive strategy for modernizing Italy, combining reform plans and public investment with private investment, thereby helping to bring about the digital transition and the ecological or 'green' one. It introduces profound innovations to how measures are implemented, by setting specific targets, also for programmes managed at local level, outlining the interventions needed to overcome the regulatory obstacles that could hold back their achievement and establishing milestones and targets, supported by an extensive monitoring system.

The NRRP does not cover all the interventions needed or Italy's financial commitment; it is flanked by other significant reforms to be implemented, such as that of the tax system, and resources allocated by the national budget to spending programmes with similar objectives. However, it does provide an opportunity to close the accumulated lags in tangible and intangible infrastructures in a short space of time, to boost R&D, to improve the education system and to step up investment in new technologies, which are all key factors for accelerating productivity and strengthening our economy's growth potential. To ensure its success, the design and implementation of the reforms will have to be capable of profoundly changing the landscape in which economic activity takes place; the Plan's innovative approach could become common practice for public interventions.

The fact of having drawn clear lines for industrial development based on green and digital technologies and on support for research and innovation could contribute to reinforcing and expanding the most dynamic segment

of the production system. There is no lack of entrepreneurial excellence; the productivity of medium-sized and large Italian firms and their ability to reach international markets are comparable to those of similarly sized French and German firms, but their share of employment and of value added is still insufficient. In Italy, firms with more than 250 employees, which on average have better managerial and organizational resources and a greater capacity for bearing the costs of innovation and adapting to the green transition, account for less than one quarter of persons employed, about half the figure for France and Germany (Figure 8).

The action aimed at improving the functioning of public services and the regulation of economic activity is an integral and in many ways essential part of the Plan. Regulatory interventions are expected in many areas, as are suitable resources to support the digitalization of government entities, enhance the skills of public sector employees and organize judicial offices more effectively. The measures implemented in previous years have enabled some progress to be made: digital access to government and local authority services has expanded considerably, and the number of pending court cases has fallen by one fourth since 2015. However, the complexity and instability of the rules, the unwieldy nature of administrative proceedings and the shortcomings in the functioning of the public administration and the justice system continue to be substantial. These are factors that are still limiting the willingness to invest in our country, and in the South in particular, undertaking large-scale business initiatives.

Drafting the legislative and regulatory measures included in the Plan requires considerable commitment in order to ensure compliance with the deadlines agreed upon with the European Commission. Of the interventions to be completed in the first half of this year, the enabling law for reforming the Public Procurement Code is particularly important. Over the next few months, the process for approving the law on competition will need to be completed, allowing the numerous associated acts to be implemented.

Progress has also been made with the tax system: the recent revisions of personal income taxation have corrected clear anomalies in the structure of marginal effective tax rates, and the fight against tax evasion has benefited from the introduction of regulatory and technological innovations, such as electronic invoicing. The inclusion of future interventions in a comprehensive reform, the need for which has been pointed out many times, would make it possible to design the system in a less distorted way, give it stability and make further inroads in fighting evasion. The sustainability of the public accounts will in any case have to be preserved, providing for full coverage of the measures adopted. Limiting ourselves to intervening on individual

aspects of taxation would fuel the process of regulatory stratification. The uncertainty stemming from frequent modifications – not always especially consistent from one to the next or over time, and with retroactive effects – and from the lack of continuity in the interpretative guidelines and in the case law is a severe barrier to economic activity.

Overcoming the factors that hinder productivity growth has become even more necessary given the demographic projections, which point to a downward trend in the labour force that can only partly be countered by an improvement in the migration balance and by an increase in labour market participation. Istat's most recent projections show that over the next 15 years, the population aged 15 to 64 will fall by 13 per cent (about five million people, half of whom in the South); the cohort of those aged between 24 and 70, useful to account for the projected increase in the years spent in education and work, will decrease by just under three million.

Over the last ten years, the lack of suitable work opportunities has driven almost one million Italians to move abroad, many of whom are highly educated; by contrast, there are increasingly fewer people, often with low skill levels, who transfer from abroad to Italy. Adequate policies for planning migration flows, training and integration are lacking. The labour market participation rate is among the lowest in Europe, especially in Southern Italy. The participation rate for women, equal to 55 per cent in Italy compared with an average of 68 per cent for Europe, is 18 percentage points lower than that for men (Figure 9). To narrow the gap, among other things, the obstacles that mothers face in re-entering the work force after having children must be removed. The NRRP funding for services for families is a first step in this direction.

Employment opportunities and the choice of whether to participate are closely connected with educational attainment, which should be raised quantitatively and qualitatively starting from secondary school, where there is still a high rate of abandonment and learning outcomes are unsatisfactory. Despite the progress made, there is still a big gap between the percentage of Italian university graduates and those of other European countries, even for the youngest population cohort: 28 per cent of those aged between 25 and 34 held university degrees in 2021, 13 percentage points below the European average. The interventions and the effective use of NRRP funds for schools' physical and digital infrastructures, for bolstering STEM programmes, and for improving the selection and training of teachers can all help to increase both the demand for and the supply of high-quality education. Those most in need of this are students from less advantaged geographical and family backgrounds and young immigrants, for all of whom education surveys continue to show severe difficulties, which worsened considerably during the

pandemic. It is increasingly necessary for these survey findings to be used in framing targeted and consistent corrective measures.

In order to achieve the hoped-for results, it is crucial for the structure of the Italian economy to open to change, by taking advantage of the programmes and reforms envisaged under the Plan to increase firms' propensity to expand and to invest in innovation and in enhancing human capital. This is particularly needed in the regions of the South, where more than one third of the population resides but that only produces just over one quarter of the national GDP, and where the average per capita GDP is 45 per cent lower than in the Centre and North. The ever-widening geographical gap in the development of the economy reflects, along with the widespread inadequacy of public action, the limited importance of and the lags in the private production sector in the South. This is partly explained by how entrenched organized crime is in this area, something which in turn imposes costs on firms and distorts the functioning of the market and of competition.

From now until 2030, according to the official assessments, in addition to the €80 billion envisaged under the Plan, the South can count on additional resources of around €120 billion from the European structural funds and the Development and Cohesion Fund. These are substantial allocations, the use of which should kick-start the southern economy, such as to contribute to increasing the productive potential of the entire country.

The high public debt exposes our economy to considerable risks, including those connected with market volatility. Looking ahead, consistently higher growth rates than in the past will be needed to significantly reduce the debt. There will also have to be adequate surpluses net of interest expense, in part to take account of the expected increase in the expenses connected with the ageing of the population. Against this backdrop, the use of debt to fund new public programmes – apart from what is necessary to address true emergency situations – must be avoided.

The main investment programmes are being launched and the NRRP reforms are still underway. The crisis triggered by the war in Ukraine does not call for a review of the Plan's strategies, and if anything has made accelerating the green transition more urgent. The difficulties associated with higher energy and commodity prices can be overcome with specific financial allocations, as is already happening.

This is not only a question of combating climate change as part of a common global strategy, but also of achieving greater energy security by reducing dependence on imported fossil fuels, increasing the diversification of supplies, raising energy efficiency and using more renewable resources.

These are the targets of the REPowerEU plan recently presented by the European Commission, which proposes that the Member States include new programmes in their NRRPs, to be funded mainly by common resources.

Eliminating administrative red tape for the building of photovoltaic and wind plants and developing the required infrastructure are key elements of the European strategy. In Italy, it is imperative to continue with the interventions to simplify the authorization procedures and to foster the development of systems for accumulating energy and of transmission networks. These measures will allow the southern regions to exploit their comparative advantage in the production of energy using renewable sources, with benefits in terms of attracting production investment, which will also be stimulated by incentives, reforms and the improvement in public services and infrastructure envisaged in the Plan. Success in promoting social and territorial cohesion and the digital and green transitions are essential to boosting trust in Italy's prospects for development and to combating the increased uncertainty caused by international tensions.

Finance and innovation

The financial system will need to provide an adequate flow of private funds that, alongside public funds, can support the investments needed for Italy to develop in a balanced and long-lasting way. Italian intermediaries are now in a position to provide expertise and resources to help tackle the challenges posed by digitalization and the green transition effectively. They have proved this by taking part in the collective effort undertaken by the national and European monetary and fiscal authorities to overcome the repercussions of a shock as far-reaching as that caused by the pandemic.

At the end of 2021, the ratio between the common equity tier 1 and risk-weighted assets (CET1 ratio) of Italian banks stood at 15.3 per cent, up by 1.3 percentage points compared with two years before. The ratio of non-performing loans to total loans was down, net of loan loss provisions, to 1.7 per cent, almost half of what it was at the end of 2019 (Figure 10). For significant institutions, both indicators are essentially in line with the average levels for the other intermediaries directly supervised by the ECB. The less significant institutions have made similar progress.

The non-performing loan rate, which remained low during the pandemic, has only been slightly affected by the gradual phasing out of the debt moratoriums: around two thirds of the firms that had benefited from them have already returned to paying debt servicing costs in full. The quality of loans backed by public guarantees shows no signs of worsening for now:

during the grace period that is still in force, almost all firms have continued to pay the interest component. The Bank's focus on a correct classification and valuation of loans continues to be supported by targeted analyses.

Although profitability has returned to pre-pandemic levels, it is still low, including by international standards. Last year, the return on equity, net of extraordinary components, of Italian significant institutions was 5.4 per cent, more than 1.5 percentage points lower than that of the other significant banks. The average profitability of Italian less significant institutions with traditional business models is 1 percentage point lower than that of the larger banks. The steps to increase efficiency levels and the commitment to reviewing their business models must therefore not fall short of the mark.

This situation, which is not negative on the whole, is exposed to new risks stemming from the conflict in Ukraine. Direct exposures to counterparties resident in Russia, Belarus and Ukraine, which are concentrated in the two largest groups, are low. However, the indirect effects of the conflict are more difficult to assess. The marked increases in energy prices are affecting firms' financial conditions. Banks' exposure to those operating in the sectors hit hardest by the price rises is not negligible, even though it should be noted that, on average, their default probability as reported by banks before the war was lower than for other sectors.

A protracted conflict and heightened frictions in global value chains could also lead to a more pronounced cyclical slowdown than is currently expected and to a subsequent worsening of the financial situation of households and firms, making it necessary to operate prudently when classifying loans, booking loan loss provisions and distributing earnings.

The deterioration of the cyclical situation could create serious problems for the banks more geared to typical credit intermediation, particularly for some small and medium-sized ones that are already finding it difficult to keep costs down and are struggling to benefit from economies of scale, to diversify their revenue sources and to raise the capital needed to invest in new technologies. The Bank of Italy's supervisory action remains focused on encouraging these intermediaries to adopt a corporate governance able to define and implement business plans that are credible and consistent with the challenges posed by the market situation; it is up to the management bodies to act without delay, including on the front of possible mergers, to minimize the risk that situations of difficulty turn into irreversible crises.

A process to strengthen the role of institutional investors in the allocation of private savings has long been underway in the Italian financial industry. More than one third of households' financial wealth is currently invested in

asset management products; the gap with the euro-area average has narrowed significantly over the last ten years (Figure 11).

A sizeable share of savings is managed by open-end funds, for a total amount of €1,300 billion, compared with €1,400 billion worth of bank deposits of households and firms. A small share of the resources managed by funds is invested in securities issued by Italian firms, to the tune of 5 per cent, compared with 34 per cent in France and 14 per cent in Germany. These differences for the most part reflect the structure of the Italian production sector, which has a relatively high number of small firms that make less recourse to capital markets to fund their business.

The expertise of specialized asset managers investing in innovative sectors and in turnarounds could play an important role in selecting and financing firms with greater potential for growth. The assets managed by alternative funds specialized in purchasing securities issued by small and medium-sized firms, typically less liquid, and in financing companies that need to be restructured more than tripled between 2015 and 2021 (from €9 billion to €30 billion). The growth was spurred by tax and legislative incentives. However, assets under management are still low compared with the euro-area average, which is 6 per cent of GDP, three times the figure for Italy.

The growth of non-bank finance must take place in stable conditions. The risks of financial investment cannot be wiped out but they must be better understood by investors and overseen prudently and carefully by the companies managing them. Even when they are small, asset management companies must adopt corporate governance structures and possess adequate expertise in order to act in the interest of their customers. The ongoing update of the regulatory framework and of monitoring tools is aimed at fostering an orderly and transparent evolution of this sector. The focus of the Financial Stability Board and of other forums for international cooperation, which was rekindled by Italy's G20 Presidency last year, remains high.

The pandemic crisis has created strong momentum for the digitalization of all segments of the financial industry. In credit intermediation, new technologies are now embedded in every step of the loan origination process. In retail payments, there has been an increase in consumer preference for using cards rather than cash for purchases at physical points of sale, especially if they have contactless technology (Figure 12).

For innovative products, processes and distribution channels to take hold, customer and personal data protection measures must be strengthened. In setting them up, the authorities benefit from dialogue with customers and market players. A significant rise in financial literacy is a necessary condition

to ensure that customers' ability to choose is improved and supervisory rules and actions are better able to protect consumers.

The use of distributed ledger technologies (DLT) can enhance efficiency in the supply of financial services and afford significant benefits to customers. The reduction in payment times and in the costs connected to the issuance and circulation of financial instruments is spurring a widening in the pool of investors and deepening the markets for assets that have not been considered very liquid so far. On this front, in Italy as in other European countries, pilot initiatives are being designed in connection with the forthcoming introduction of an EU regulation establishing a pilot regime for market infrastructures based on DLT.

These technologies are used for the issuance and trading of crypto-assets. The latter term, for which internationally agreed taxonomies are still lacking, refers to a highly heterogeneous set of instruments. An important distinction should be made between crypto-assets whose issuance is backed by real or financial assets (known as 'fully-backed stablecoins') and those for which there are no such underlying assets. The former, if adequately regulated and when issued by clearly identified entities, can maintain a relatively stable value over time and provide services to the economy. The latter – including algorithmic stablecoins, which have stabilization mechanisms based on automated rules that adjust supply based on changes in demand – have no intrinsic value, are highly volatile and, as a result, are exposed to significant risks of a run; they are mostly used for speculative purposes. Depending on their characteristics, crypto-assets can therefore have different levels of riskiness, something that regulation must take into account when laying down the rules governing them.

A step in the right direction is the European Commission's proposal for a regulation addressing these markets (Markets in Crypto-Assets Regulation, MiCAR), which sets out common rules for the issuance and offer of crypto-assets to the public as well as the requirements for the provision of related services, such as their purchase, custody and sale. Some issues, however, remain open, such as the possibility for customers to access crypto-asset markets without going through regulated entities. We are aware of additional risks – that are often not fully understood by customers – arising from the use of unhosted wallets, i.e. electronic wallets that enable the automated exchange of crypto-assets without the involvement of service providers, and from the possibility of obtaining financial services through smart contracts, i.e. software made available directly by unregulated entities (decentralized finance, or DeFi). An orderly development of these phenomena cannot happen without setting out standards and practices that can act as a benchmark not only for supervised intermediaries but also for all the other players involved. We are

stepping up the in-depth analyses necessary to enhance the transparency and the reliability of these new forms of financial intermediation, in order to share them with the other supervisory authorities.

Regardless of the differences among crypto-assets, we must be well aware that even DLT instruments issued by clearly identified entities are private sector liabilities and, as such, are characterized by the risk of insolvency. The only instrument in circulation that is free of this risk is cash issued by central banks. It is on the basis of this awareness that the Bank of Italy is involved in the work being carried out at Eurosystem level to consider the introduction of a digital euro. A digital currency issued by a central bank would represent an anchor for the public's trust in money, which would act as a complement to cash and the existing electronic means of payment as well as to the development of reliable private-sector digital instruments. For this to be possible, the digital euro will have to meet users' expectations in terms of ensuring personal data protection, security and ease of use, fostering innovation and accompanying the digital transformation of the economy. A decision on the possibility of issuing it will be taken in the coming years based on the outcome of the work currently underway.

Innovations such as electronic identification systems and advanced data analysis methods are helping the fight against money laundering and terrorist financing. They make it possible to verify the identity of customers remotely and to carry out in-depth checks on financial flows. At the same time, FinTech companies – which often experience a rapid expansion in their operations – sometimes struggle to implement anti-money laundering rules properly. Their difficulties are greater when they operate across several markets, for which the sectoral rules have not yet been fully harmonized. The utmost attention must be paid to these risk profiles. Going forward, setting rules that are directly applicable across the EU and the introduction of a common supervisory system would make it possible to overcome many of the current difficulties.

In an ever more digitalized and interconnected environment, and even more so when there are international tensions, cyber-risks become particularly significant, including those stemming from the use of third-party service providers, which can threaten the stability of both individual entities and the system as a whole. The need to guarantee the security of IT systems calls for adequate and careful organizational choices on the part of financial intermediaries' management and control bodies, as well as an overhaul not only of the supervisory toolkit but also of the regulatory framework. In Europe, a proposal for a regulation – the Digital Operational Resilience Act (DORA) – lays down harmonized rules and robust and uniform measures for

digital operational resilience in finance, including through the introduction of an oversight framework for critical ICT service providers.

In our dialogue with market players, we promote the development of technologies with the potential to yield the greatest benefits to the public. A regulatory sandbox was launched last year, upon the initiative of the Ministry of Economy and Finance and in cooperation with the relevant supervisory authorities, providing a dedicated environment for supervised intermediaries and specialized players in the banking, financial and insurance sectors to test technologically advanced products and services, also with a view to assessing their compatibility with current regulations. This initiative, which was well received by the market, is being carried out alongside the other activities underway at Milano Hub, the Bank of Italy's innovation centre. Following the first call for proposals on artificial intelligence, ten projects have been selected and are now in the development phase and benefiting from the support of the Hub, which provides technical expertise, answers queries about regulatory issues and provides support in organizing presentations and other events.

The supervisory rules and activities concerning financial intermediaries and the markets are helping to ensure that the financial system's support to the green transition is provided while limiting climate-related risks to individual entities and to overall stability. The supervisory authorities are guiding and encouraging financial intermediaries to accelerate their adoption of management and organizational instruments that are better suited to monitoring these risks, and to disclose accurate information to the market on the activities conducted. Central banks have been moving in that direction for quite some time as well. A few weeks ago, we published our first *Report on sustainable investments and climate-related risks*, which documents the Bank of Italy's methodologies and choices and the results achieved in the management of the portfolios it holds for purposes other than monetary policy.

In line with what was done by the ECB for significant institutions, we have recently published our supervisory expectations concerning the way in which the banking and financial institutions that we directly supervise will need to integrate climate and environmental-related risks into the control strategies and systems and the information they disclose to the markets. Moreover, both at EU and at Basel Committee level, the possibility of modifying prudential regulation to take account of these risks is being assessed. This is being done cautiously, out of an awarenes of the difficulty in measuring them.

In the asset management industry, the new regulation on sustainable finance disclosure entered into force last year. For funds marketed in Europe that wish to promote environmental and social initiatives or whose goal is

sustainable investment, reinforced transparency disclosure requirements are envisaged. The availability of comparable and reliable data is an essential condition for financial intermediaries to measure and manage risks, for the supervisory authorities to carry out their guidance and control tasks, and for investors to make informed decisions. Action is still needed to improve the European taxonomy for sustainable investment, whose implementation criteria were drawn up last year, and to carry out in-depth analyses of how to harmonize at global level the definitions adopted in the various jurisdictions.

It will be necessary to establish principles to verify developments in climate-related risks, set up accounting standards for disclosing information on carbon emissions and prepare recommendations on regulatory and supervisory approaches. Italy provided a decisive boost in this direction during its G20 Presidency. At the same time, to avoid what is known as greenwashing, it will be crucial to identify clearly the entities responsible for carrying out the checks and to establish auditing rules for the 'sustainability reports' that are similar to those in force for ordinary financial statements, as provided for in the proposal for a Corporate Sustainability Reporting Directive (CSRD). Furthermore, an accurate analytical framework will need to be developed to take into account the heightened uncertainty that characterizes both the models that quantify the impact of human activity on climate and those that aim to estimate the consequences of climate changes on social welfare.

* * *

Two years ago, during the most difficult phase of the pandemic, we wondered about its short-term social and economic consequences; there was extraordinarily high uncertainty and it seemed hard to foresee the equilibria and the new 'normal' that would emerge in the longer term. Last year, on recalling the exceptional breadth and efficacy of the measures implemented to counter the impact – and not only the economic one – of the public health crisis, we underlined how, in a deeply interconnected world, it could not be said that the risks of the pandemic had been overcome unless it were truly so for everyone. We reiterated the crucial role of international coordination.

On the economic front, the recovery in production exceeded the forecasts. In some countries, the measures for macroeconomic stabilization eventually created demand pressures that, given the supply constraints, caused a marked rise in inflation. In the second half of 2021, after years of excessive moderation, consumer prices returned to robust growth in Europe too, not because of excess demand but because of the higher prices of imported energy products.

Monetary policy cannot counter the increase in commodity prices, but it must aim to ensure price stability in the medium term. The economic

situation, which has changed profoundly in the space of a few months, makes it appropriate to move past the policy of negative key interest rates. Given the uncertainty of the economic outlook, the rates will have to be raised gradually; it will be easier if pressures for wage increases linked to the rise in inflation prove limited, in part thanks to the fiscal measures designed to curb the higher energy prices and support the income of the hardest hit households. The funding conditions for the economy will in any case remain broadly favourable.

Italy's high public debt reduces the margins available. Fiscal interventions must be clearly targeted and well calibrated to maximize their efficacy and to keep their costs down. The increase in recent weeks of the yield spread between Italian and German bonds confirms that the public debt is still a source of significant vulnerability; it reminds us, if ever we needed reminding, that we must not let our guard down, aiming in the medium term for a primary surplus and a stable increase in the economy's potential growth.

The positive interplay between monetary policy and fiscal policy over the last two years shows the importance of continuing to pursue the completion of the institutional framework of the Economic and Monetary Union, endowing it with a common budget instrument and simplifying the rules applied to national budgets. Through the NGEU programme and the suspension of the Stability and Growth Pact, Europe delivered a coordinated and adequate response to the pandemic shock. We can build on this turning point. As the main beneficiary of the programme, Italy has a responsibility to show that using European resources to support individual Member States can bring benefits to the European Union as a whole.

The NRRP has taken on features and proportions capable of achieving the goal of closing the serious gaps accumulated in Italy in education and research, in gender equality and in support for youth employment, and in the quality of infrastructures and public services. The prospect of a development strategy based on green and digital technologies and on support for innovation will be able to help strengthen and expand the most dynamic sectors of our production system, as well as the financial industry.

This will bring about profound changes, also to the way in which work is organized. One legacy of the pandemic is certainly the recognition of the possibilities opened up by digital technologies in terms of agile and other forms of remote work. Here at the Bank of Italy too, these new ways of working have taken hold, and are applied, where possible, with flexibility and sound judgment. They do not replace, but rather complement in-person work, which retains a central role in the direct transmission of knowledge, in the training of junior colleagues, and in building trust among staff. There

will be no change in the resolve with which we will continue to carry out our duties in the service of our country and as part of the Eurosystem.

In the NRRP, bridging the geographic divide has become a cross-cutting priority. The financial resources that will flow into the South of Italy are significant: we must all be aware that they will only bear the expected fruit if the State and its institutions continue to effectively counter criminal behaviour, intimidation, violence and collusion. The example set by Giovanni Falcone and Paolo Borsellino is always before us – judges and extraordinary figures embodying the State's renewed, if disputed, power. Those of us who were there thirty years ago remember the emotion and grief generated across the country by their sacrifice and that of Falcone's wife and of their security staff. The younger generations bear witness to this shared collective memory.

We now find ourselves dealing with a new crisis caused by Russia's invasion of Ukraine. The plight of the population of that country, which can only be mitigated by a swift end to the war, is compounded by serious consequences for prices and the supply of energy and food products. In the short term, the countries that will be hit hardest are European ones, which are more dependent on Russian gas, and the poorest ones, which are already struggling to secure the necessary supplies of agricultural commodities and fertilizers.

The conflict could have potentially very serious effects – albeit difficult to predict – on longer-term international equilibria, on market openness and on trade, not only of goods and capital, but also of information and knowledge. Europe, which has always aimed for a rules-based global order, would stand to lose more than others in a world dominated by division and conflict.

Since the end of the Cold War, economic globalization has generated indisputable benefits, with a sharp reduction in extreme poverty at world level, though with a marked increase in inequality in the distribution of income and wealth within many countries. Even before the Russian attack on Ukraine, discussions were underway on how to correct the most obvious shortcomings of globalization, while at the same time retaining the benefits achieved over the last thirty years. Global problems such as pandemics and greenhouse gas emissions can only call for global responses.

Writing after the adoption of the Bretton Woods Agreement, Luigi Einaudi stated: 'In the past, international cooperation has always benefited the poor more than the rich. Let it be so this time too. Yet it will only be so if we steadfastly desire it.' Even before that, in the midst of the Second World War, he had underlined how 'the nation states are becoming less and less influential in the face of growing economic interdependence on a planetary

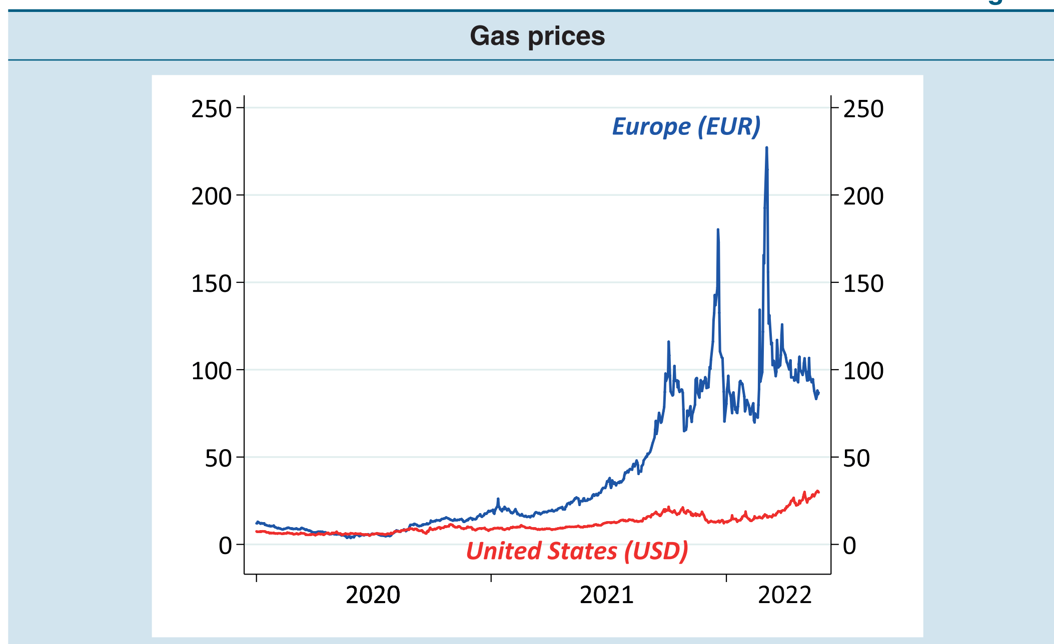
scale' and that open borders are builders of prosperity, because: 'international free trade means peace'.

It is hard to put it any better: international cooperation must not falter. The necessary reflections on the governance of globalization must not be overshadowed by the distrust and tensions engendered by the ongoing conflict. What must, instead, be nurtured with the utmost determination, by keeping the lines of dialogue open, is the hope that this war, which we unequivocally and categorically condemn, draws swiftly to a close.

FIGURES

Figure 1

Gas prices

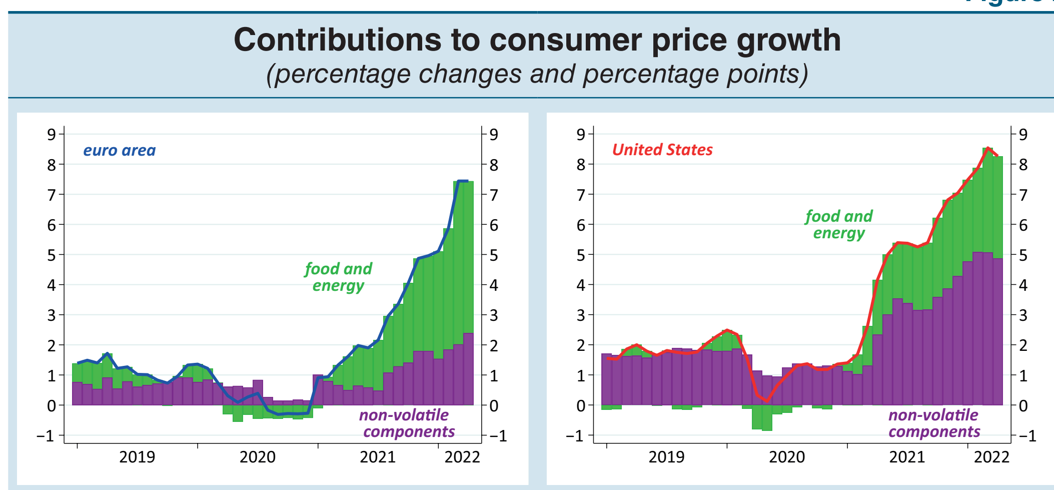


Source: Refinitiv.
Note: Title Transfer Facility (TTF) prices for European gas and Henry Hub for US gas.

Figure 2

Contributions to consumer price growth

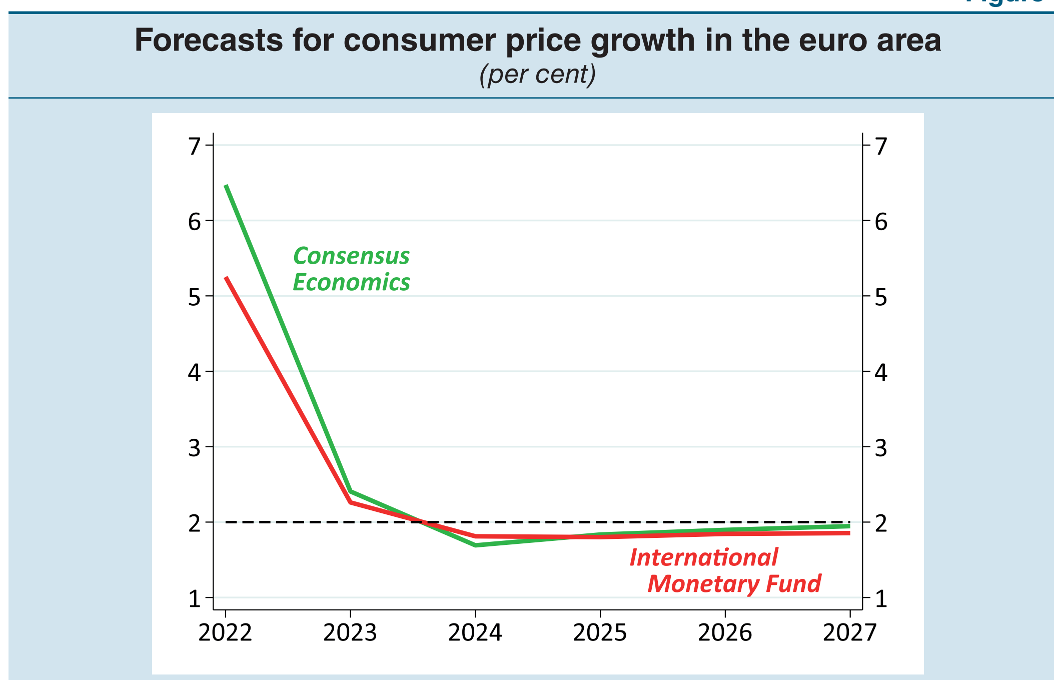
(percentage changes and percentage points)



Sources: Based on Eurostat and U.S. Bureau of Labor Statistics data.
Note: 12-month percentage changes.

Figure 3

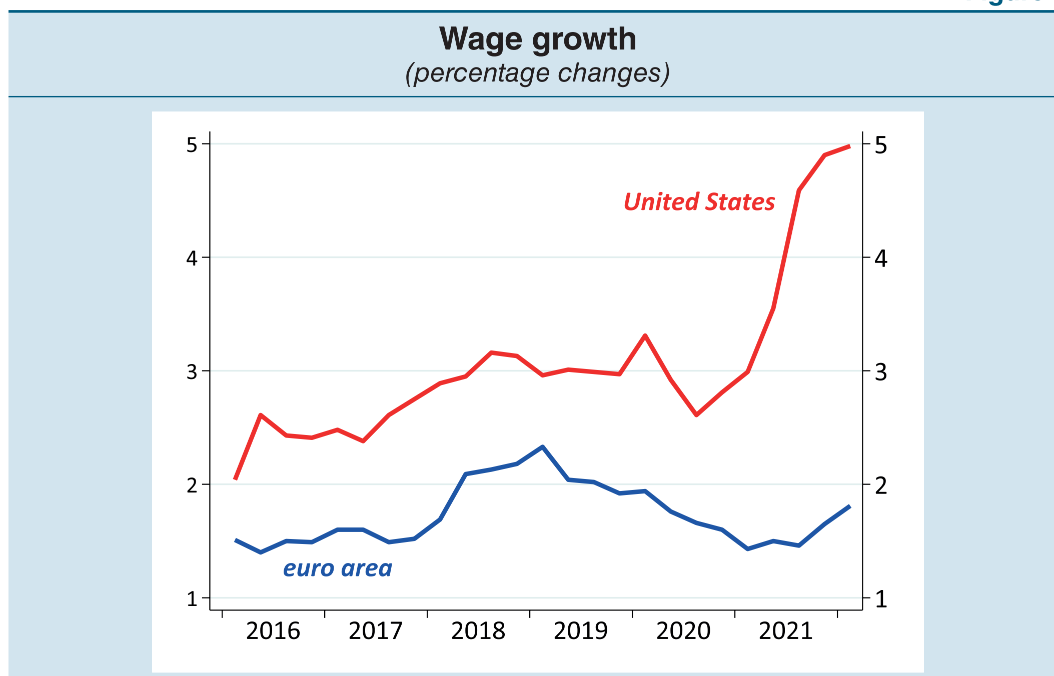
Forecasts for consumer price growth in the euro area
(per cent)



Sources: Consensus Economics and International Monetary Fund, April 2022.

Figure 4

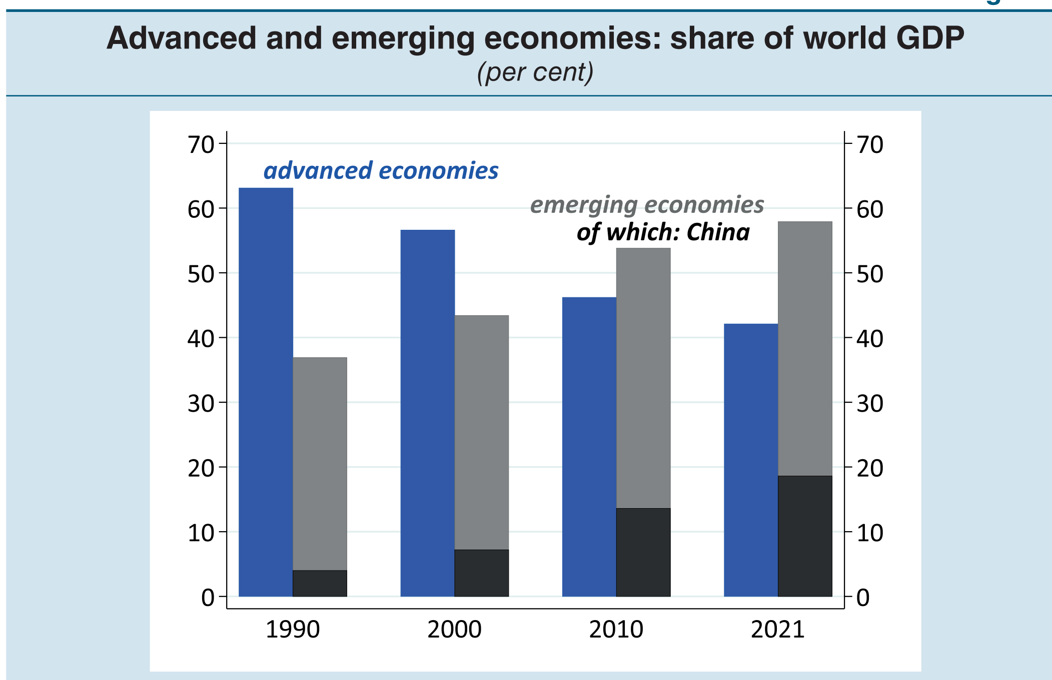
Wage growth
(percentage changes)



Sources: European Central Bank and U.S. Bureau of Labor Statistics.
Note: Annual percentage changes of quarterly data; negotiated wages net of one-off payments for the euro area, and the Employment Cost Index for the United States.

Figure 5

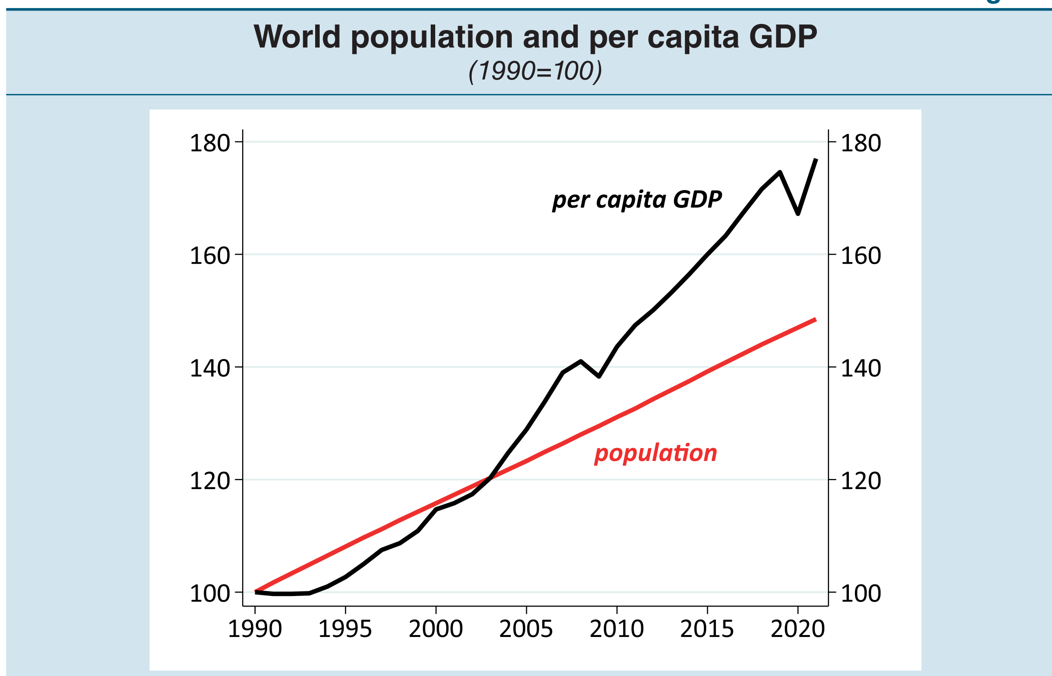
Advanced and emerging economies: share of world GDP
(per cent)



Source: Based on International Monetary Fund data.

Figure 6

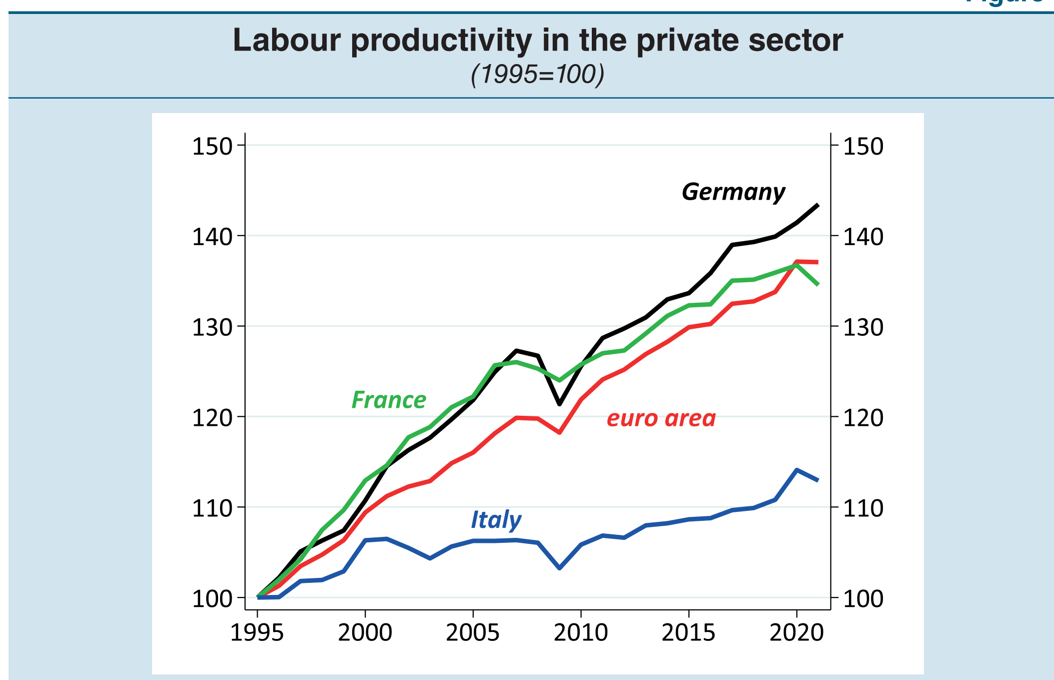
World population and per capita GDP
(1990=100)



Sources: Based on World Bank and Maddison Project data.

Figure 7

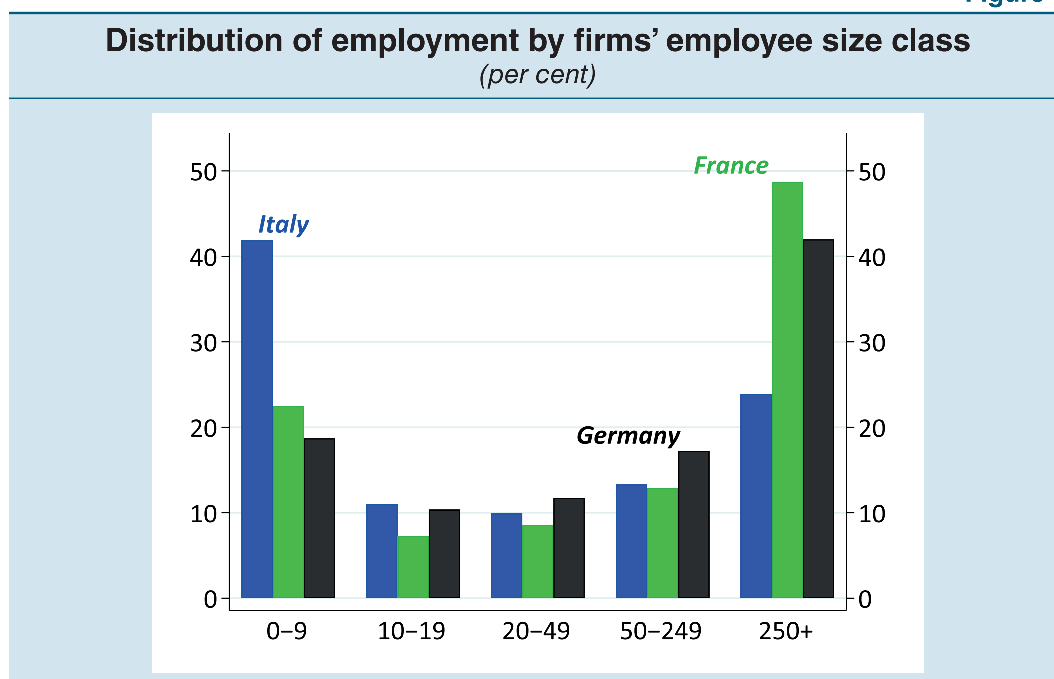
Labour productivity in the private sector
(1995=100)



Source: Based on Eurostat data.
Note: Value added per hour worked, in real terms.

Figure 8

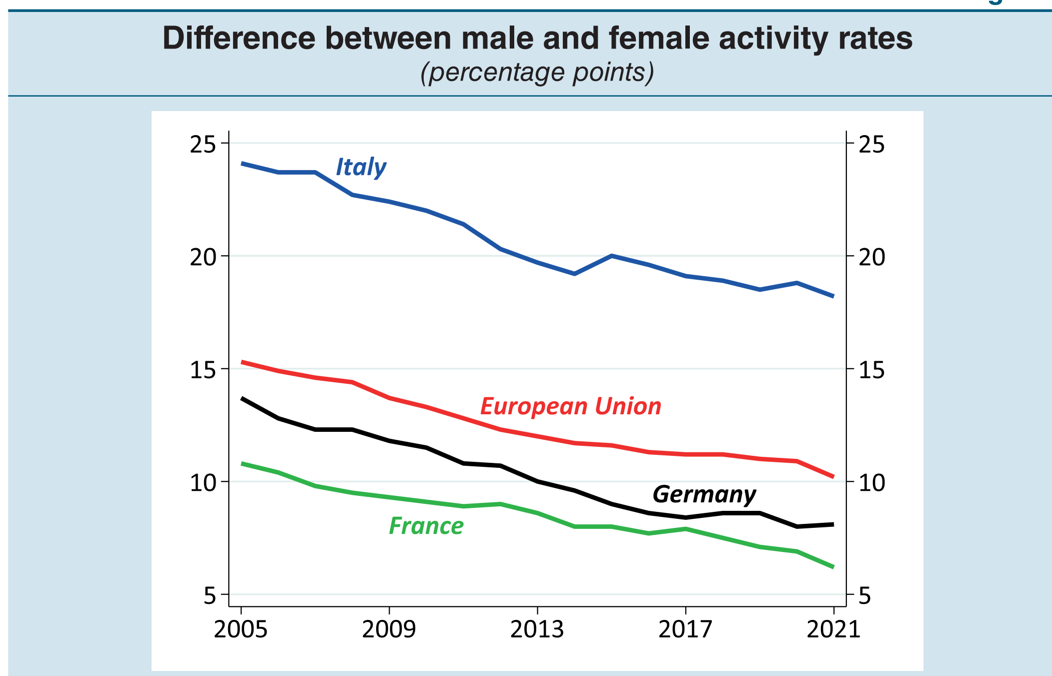
Distribution of employment by firms' employee size class
(per cent)



Source: Based on Eurostat data.
Note: Firms in the non-agricultural private sector, excluding financial firms and insurance companies.

Figure 9

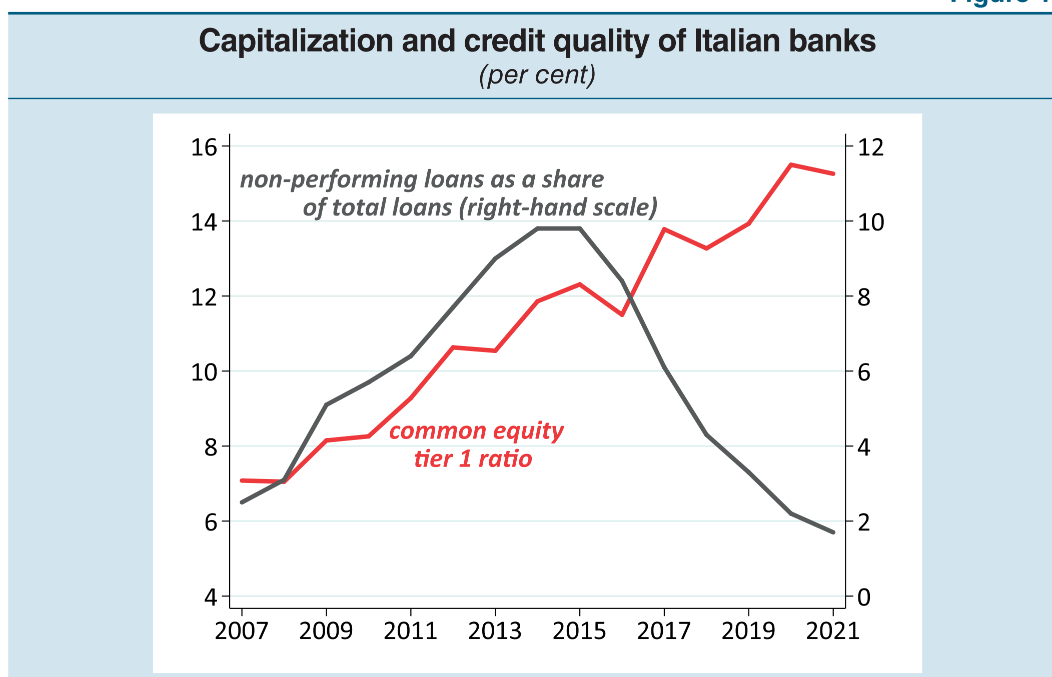
Difference between male and female activity rates
(percentage points)



Source: Based on Eurostat data.

Figure 10

Capitalization and credit quality of Italian banks
(per cent)

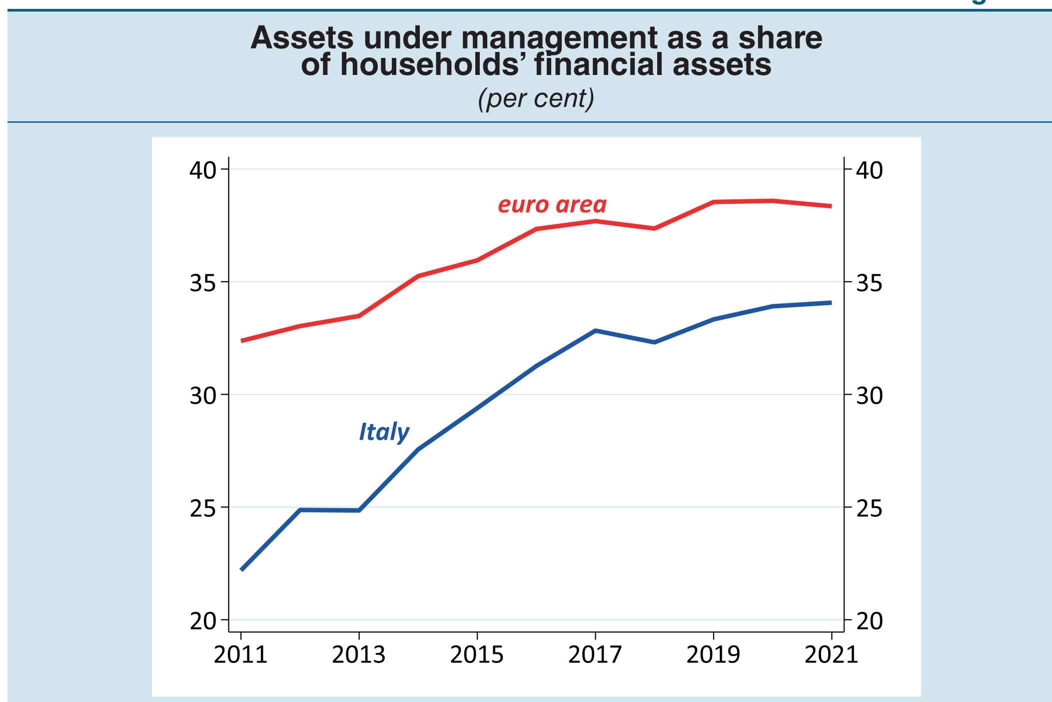


Source: Supervisory reports.
Note: Non-performing loans as a share of total loans (net of loan loss provisions); end-of-year data; the data for 2021 are provisional.

Figure 11

Assets under management as a share of households' financial assets

(per cent)

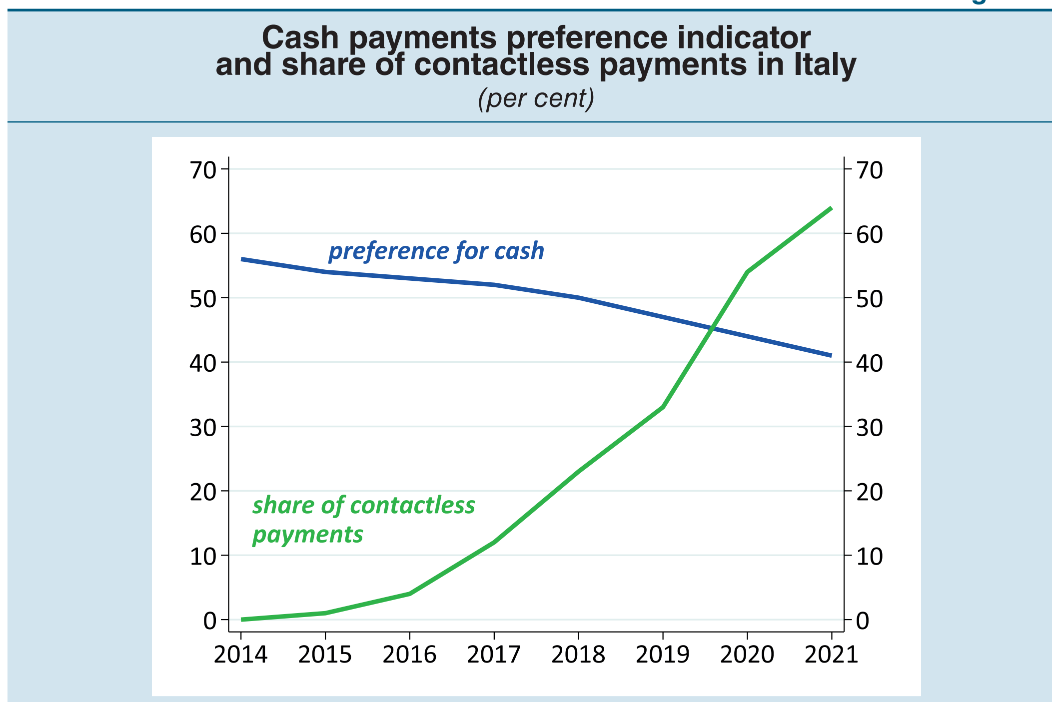


Sources: Bank of Italy and European Central Bank.

Figure 12

Cash payments preference indicator and share of contactless payments in Italy

(per cent)



Source: Bank of Italy.

Note: Based on a representative sample of cards in use; the indicator of preference for cash is the ratio of withdrawal amounts from ATMs to the sum of these withdrawals plus the value of card payments at Points of Sale (POS); the ratio of contactless payments to the total of payments made with cards is calculated based on the value of the transactions.

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