

Fabio Panetta: Overview of economic and financial developments in Italy

Address by Mr Fabio Panetta, Governor of the Bank of Italy, at the ordinary general meeting of shareholders, Rome, 28 March 2024.

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Ladies and Gentlemen,

The global economy remains weak. Sluggish international trade and the uncertainty raised by geopolitical tensions are weighing on economic activity.

The restrictive monetary policy of the European Central Bank (ECB) is dampening demand and is contributing, together with falling energy prices, to a fast decline in inflation. Risks to price stability have subsided and the conditions for starting monetary easing are taking shape.

As I will explain shortly, the implementation of monetary policy aimed at price stability is reflected in the Bank of Italy's 2023 Annual Accounts, which are submitted to you for approval today, and will continue to affect profitability in the near future.

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I would like to take this opportunity to thank my predecessor Ignazio Visco once again for his service to the Bank of Italy, as we did at the symposium held recently to express our appreciation and to celebrate his two mandates at the helm of the Bank.

I would also like to extend my warmest wishes to Piero Cipollone, former Deputy Governor of the Bank of Italy, who was appointed to the ECB's Executive Board last November. He has been replaced on the Bank of Italy's Governing Board by Chiara Scotti, former Senior Vice President and Director of Research at the Federal Reserve Bank of Dallas.

Monetary policy and its impact on the Bank's Annual Accounts

The Eurosystem central banks have purchased a large amount of securities in recent years in order to ensure that inflation returns to 2 per cent over the medium term.

With the rise in inflation, the ECB Governing Council began to tighten its monetary policy in July 2022. It stepped up these efforts in the first nine months of 2023, raising its key interest rates by 200 basis points overall, to 4.5 per cent on the main refinancing operations, 4.75 per cent on the marginal lending facility, and 4 per cent on the deposit facility. The Governing Council has kept the policy rates unchanged since last October.

The reinvestment of securities held for monetary policy purposes under the asset purchase programme (APP) was discontinued in July 2023. Maturing securities under the pandemic emergency purchase programme (PEPP) will instead continue to be fully reinvested through the first half of 2024. The ECB Governing Council intends to reduce

reinvestments by €7.5 billion per month over the second half of the year, before discontinuing them from the end of 2024. Over the next few months, reinvestments will continue to be made with the flexibility required to counter risks to the monetary policy transmission mechanism.

The amount of funding granted to euro-area banks through Eurosystem refinancing operations continued to fall significantly, from €1,324 billion at the end of 2022 to €410 billion at the end of 2023. The decline was mainly due to the repayments of maturing third-series targeted longer-term refinancing operations (TLTRO III), combined with voluntary early repayments driven by the change in funding conditions, which have been less favourable to banks since November 2022.

The balance sheet

At the end of 2023, the Bank of Italy's balance sheet assets stood at €1,253 billion, down by €223 billion from 2022. The balance sheet reduction is set to continue in the current year as a result of maturing TLTRO III operations and of the ECB Governing Council's decisions to discontinue the reinvestment of maturing securities.

On the asset side, just as for the other national central banks of the Eurosystem, the decline was mainly due to refinancing operations, down from €356 billion to €150 billion. Securities held for monetary policy purposes also declined, though to a lesser extent: at the end of 2023, they amounted to €657 billion (€39 billion less than in the previous financial year), with Italian government bonds accounting for around €600 billion.

On the liability side, there was a decline both in deposits held by banks, which fell by €57 billion, and above all in the Bank's negative TARGET balance, down from €684 billion to €521 billion. The sizeable reduction in the latter was largely due to net purchases of Italian securities – mostly public sector securities – by foreign investors, and to an expansion in Italian banks' net funding on international markets. These liquidity inflows were partly offset by Italian residents' investment in foreign securities. The disbursement of the third and fourth tranches of Recovery and Resilience Facility funds to the Italian State through the TARGET system contributed to the decrease in the Bank's negative balance. The negative TARGET balance continued to edge down in the first months of 2024, to around €500 billion on average in March.

Main drivers of the 2023 net profit and future prospects

The Eurosystem's monetary policy is designed and implemented to fulfil the statutory mandate of price stability, even if this leads to a temporary worsening in central banks' profit and loss accounts.

Last year, we anticipated that the Bank of Italy would post a sizeable gross loss for 2023, before the release of the general risk provision, largely due to the sharp contraction in net interest income. This has also occurred at the other Eurosystem central banks, some of which recorded a gross loss as early as 2022. The rise in the ECB policy rates led to an increase in the cost of balance sheet liabilities, mainly bank deposits, with no corresponding increase in the yield on monetary policy assets. These assets are actually less sensitive to changes in interest rates, as they consist mainly of fixed-rate securities with medium to long-term maturities.

Confirming what had been anticipated last year, the financial result for 2023 before tax and before the release of the general risk provision was €-7.1 billion, against €5.9 billion in 2022. In addition to the €11.4 billion deterioration in net interest income, the reduction in the financial result was explained by the net result of pooling of monetary income, down by €3.5 billion, which was also attributable to the impact of monetary tightening over the last two years.

The Bank of Italy is able to absorb these losses thanks to its past capital strengthening policies, based on the principle of prudence. The financial buffers built up over the years to weather the potential materialization of risks are more than sufficient to cover both the loss for 2023 and that estimated for 2024. Based on current monetary policy decisions and the expectations regarding interest rate developments, we expect 2025 to mark a return to profit.

As a result, €5.6 billion is released from the general risk provision in the 2023 Annual Accounts. Along with the positive contribution of €2.3 billion from the carryforward of the tax loss – which will enable us to pay lower taxes in the future – releasing this amount means that the Bank can close the year with a net profit of €0.8 billion.

We believe that the level of risk coverage remains adequate from a medium-term perspective. In 2023, the risks did, indeed, decrease and they will decrease further in the future as a result of the reduction in the size of the balance sheet.

The Bank of Italy – an institution constantly evolving to serve the public

When I took office, in a message addressed to the Bank's staff, I called on them to be open to change and innovation, while never losing sight of the values that have underpinned the authority and prestige of the Bank over time. A combination of continuity and innovation must drive organizational planning, working methods and operating procedures. We must seize the opportunities offered by digitalization.

We need to carry on with and complete the rationalization of the Bank's offices and processes, keeping the organizational structure aligned with changes in institutional activities and the quest for greater efficiency. We must take special care to use financial resources wisely, to control costs and to maintain a strong balance sheet.

I would like to mention two examples that illustrate these principles. To be able to contribute effectively to the Eurosystem's digital euro project – an innovative, secure means of payment, freely available to everyone – we are in the process of adopting an organizational model that brings together all the expertise needed to carry out the required activities in an agile and flexible way.

Furthermore, leveraging the experience we have gained with the hybrid work model – which means less need for office space – we have drawn up a plan for reallocating space that will deliver significant savings on building costs.

We must then respond to the expectations formed in recent years concerning the size and the activities of the branch network. The Bank's widespread presence throughout

Italy is an asset that reflects its historical origins and that strengthens its bonds with civil society, but we must bear in mind that many of the functions traditionally performed locally have been superseded.

We are currently evaluating a project to ensure the continued provision of the Bank's services across the country through greater integration with the central offices, making adjustments that do not significantly alter the branch network. The activities that benefit from being conducted locally will be maintained and strengthened further: from relations with local communities to consumer protection, from anti-money laundering to economic analysis and financial education. The local availability of currency circulation services will not be affected.

This project and other issues regarding the modernization of our management systems and the improvement of working conditions will certainly form part of future discussions with the trade unions. These talks, when characterized by open, good-faith and constructive debate, are a fundamental prerequisite for the smooth functioning of the Bank.

Proposal for the allocation of the net profit

Dear shareholders,

Pursuant to Article 38 of the Statute, acting on a proposal of the Governing Board and after hearing the opinion of the Board of Auditors, I present for your approval the Board of Directors' proposal for the allocation of the net profit. Under the current dividend policy, the amount paid to the shareholders is kept within a range of €340 million to €380 million, provided that the net profit is sufficient and without prejudice to the Bank's capital adequacy. Amounts outside this range are possible, should the Bank's profitability undergo large shifts, such as occurred in 2023 with the recognition of a gross loss and the consequent need to draw on the general risk provision.

Accordingly, from the net profit of €815 million, we propose allocating €200 million as a dividend to the shareholders, €140 million less than that allocated last year. The profit for the State amounts to €615 million, down by €1,061 million.

The amount of €140 million is released from the special item for stabilizing dividends to supplement the current dividend allocated to the shareholders. The shareholders will therefore receive a total of €340 million this year too. The remaining balance of the special item – equal to €140 million – would continue to be available should it be necessary to supplement the dividend amount in the future.

The total amount effectively allocated to the shareholders over the last five years would therefore be €1,544 million. The total allocated to the State over the same period in the form of profits would amount to €21,629 million, in addition to the current taxes for IRES and IRAP purposes of €4,005 million.