BANCA D'ITALIA
EUROSISTEMA

The Annual Report at a Glance

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2016

THE ANNUAL REPORT AT A GLANCE

The World Economy and the Euro Area

[1] **In 2016 the global economy grew by 3.1 per cent, a lower rate than expected; the outlook improved in the early months of 2017.** Expansion in the emerging and developing countries was moderate. Despite their solid pace of growth, the United States and the United Kingdom only made a modest contribution to global growth, partially compensated by the expansion in Japan and the euro area.

The implications of the UK's 23 June vote in favour of Brexit are as yet uncertain. The short-term outlook for growth has not worsened so far, in part thanks to the strongly expansionary policies introduced by the UK authorities, but the medium- and long-term effects will depend on the highly complex negotiations with the EU on the exit conditions.

Global inflation rose slightly, thanks to the recovery in the prices of energy products, but the core component has remained weak. The Federal Reserve continued to raise interest rates, foreshadowing a slightly faster normalization of monetary policy than expected; the dollar gained strength. New expansionary measures were adopted in Japan and the United Kingdom.

Financial conditions improved overall, but the decrease in volatility on financial markets went hand in hand with a marked increase in uncertainty about economic policies. Yields rose on long-term bonds of the main advanced countries following the US election; stock markets reached new highs. The outflow of capital from emerging countries came to a halt.

BOXES:

The economic implications of Brexit

Productivity growth and allocative efficiency in the main emerging countries

[2] **In 2016 growth in world trade was again modest, but recovered at the end of the year.** It was affected by the general weakness in investment. The upturn recorded in the fourth quarter is expected to continue this year.

The glut in the oil market in 2015-16 has gradually been absorbed, favouring a rise in prices from the minimum levels recorded at the beginning of 2016. The cut in production announced in November by the OPEC cartel was a contributory factor; the resulting recovery in prices was limited by the reactivation of supply from producers of unconventional crude oil in the United States.

The downward trend in the prices of non-energy commodities broke off, thanks to the recovery in international demand and to China's expansionary fiscal policy, which boosted investment in infrastructure and construction.

Balance of payments disequilibria persisted across countries. In the emerging economies the balances of the countries most dependent on oil exports continued to worsen; among the countries structurally in surplus, China's balance diminished, while those of Japan and the euro area improved. China's foreign exchange reserves again decreased sharply as a result of repeated intervention by the authorities to counter expectations of a depreciation of the renminbi. The fall came to a halt at the end of last year, partly owing to the introduction of new controls on capital outflows.

BOX:

Concerns about trade openness and exposure to the effects of globalization

[3] **The economic recovery in the euro area strengthened,** buoyed by the increase in investment and consumption, but held back by slack foreign trade. In 2016 GDP grew by 1.8 per cent; the recovery continued in the first quarter of 2017.

Consumer price inflation was almost nil on average in 2016, a long way below the level consistent with the ECB's definition of price stability. It rose gradually in the second half of the year to just over l per cent in December and then to 1.7 per cent in the first quarter of 2017. The increase reflected above all the recovery in oil prices; inflation excluding food and energy products remained low, at just below 1 per cent.

The euro area's fiscal policy stance was essentially neutral in 2016 and is likely to remain so this year. The Commission and the European Council continue to debate the role of discretionary fiscal policy in achieving macroeconomic stabilization in the euro area.

Little progress has been made following the circulation of the Five Presidents' Report, intended to strengthen the institutional framework of the monetary union. The process of completing banking union has come to a standstill owing to differences of opinion: some countries consider a greater sharing of macroeconomic risks necessary while others believe that the first step should be to contain such risks, including through recourse to new prudential measures. To coincide with the sixtieth anniversary of the signing of the Treaty of Rome, the Commission published a white paper setting out some alternative scenarios for the future of the EU.

BOXES:

The pass-through of oil prices to inflation expectations in the euro area

Fiscal policy in the euro area during the crisis years

Public investment in the euro area: forms of funding and effects on the economy

[4] **The expansionary measures adopted by the ECB Governing Council considerably reduced the risk of deflation** at a time of stable but moderate growth in economic activity, prolonged weakness in inflationary pressures and a high degree of uncertainty about global economic growth. Monetary policy is still aimed at ensuring a gradual return of inflation to levels in line with the definition of price stability.

The Governing Council strengthened monetary stimulus on two occasions. In March 2016, given the growing concerns about world growth and high volatility in financial markets, the Council lowered official rates, increased the scale and composition of the asset purchase programme and introduced a second series of targeted longer-term refinancing operations. At the December meeting it extended the duration of the asset purchase programme until at least the end of 2017.

Core inflation remained very weak, however, with no sign of a stable increase. To consolidate the medium-term recovery of inflation the Council confirmed the need to keep the stance of monetary policy strongly expansionary and reiterated that it expects official rates to remain at or below current levels for a long time, well beyond the time frame for net asset purchases.

BOXES:

The determinants of low interest rates

The monetary policy implications of low interest rates

The Italian Economy

[5] **The Italian economy continued to grow in 2016**, at a rate of 0.9 per cent, mainly thanks to strong monetary policy stimulus, mildly expansionary fiscal policy, and persistently low oil prices.

The expansion in economic activity affected all the main geographical areas and continued in the first quarter of 2017. However, GDP is still 7 percentage points below pre-crisis levels, with a larger gap for the South. Economic activity remains far short of its potential.

The contribution to GDP growth of domestic demand, net of inventories, was higher than in 2015. Household consumption, though slowing, supported economic activity for the third consecutive year while investment spending strengthened. General government consumption returned to growth after five years of decline, while public investment contracted further. The contribution of trade to GDP growth, negative in 2015, was substantially nil owing to the slowdown in imports.

BOXES:

The determinants of economic activity in 2016 according to the Bank of Italy's model

Italy's output gap

Southern Italy's economy after the recession

[6] **The recovery in production spread more evenly across the various sectors of the economy:** economic activity continued to pick up in industry and accelerated slightly in the service sector; the long recessionary phase in construction came to a halt.

Spending on fixed investment strengthened, especially for capital goods, and for the first time since 2007 the improvement extended to the construction sector. The recovery in investment was fostered by expansionary monetary and financial conditions, new fiscal incentives introduced by the Government, and stronger business confidence. However, the indicators measuring the uncertainty surrounding Italian and European economic policies remain high.

Corporate profitability grew. The drop in interest rates was a factor in lowering firms' financial vulnerability indicators and reducing borrowing requirements. The ratio of self-financing to investment reached its highest level in more than fifteen years.

Credit supply conditions have improved, but business lending is struggling to expand, largely on account of the modest demand for financing. Credit trends continue to vary greatly across different types of firms.

BOXES:

The trend in investment and the cyclical recovery

Credit allocation and firms' characteristics

[7] **The growth in households' disposable income gained momentum, mostly thanks to the ongoing recovery in employment.** The inequality indices, which had fallen slightly between 2014 and 2015, remained unchanged but many people are still in financial difficulty; the absolute poverty index continued to be high.

Consumption expanded further, supported by the improved outlook for income and favourable credit conditions. Household confidence indices fell in 2016, although remaining high. Households' propensity to save stabilized significantly below the average for the past ten years.

Household wealth increased, reflecting the greater flow of savings. While the value of financial assets stabilized, that of real assets increased. In the housing market, the number of sales rose and prices showed signs of picking up.

Households increased their deposits and their investments in asset management products; the latter facilitated greater portfolio diversification, including through investment in foreign securities. Households stepped up their borrowing, prompted by the favourable lending conditions, the improved housing market outlook, and the recovery in disposable income.

BOXES:

Inequality during recessions

The survey on adults' financial literacy

[8] **The growth in employment that began in the second half of 2014 continued and spread**. The increase in labour demand also extended to the categories worst hit by the recent long recession: the young, the less-educated, and workers in southern Italy. In the private sector the number of payroll employees returned to pre-crisis levels, benefiting from the social security contribution relief for permanent hirings. The number of open-ended positions continued to rise. In the first few months of 2017, overall employment dynamics remained positive, largely thanks to fixed-term positions.

There are still ample margins of unused labour capacity. The number of hours worked per employee remains about 5 percentage points lower than before the crisis. The unemployment rate has fallen by just 0.2 points to 11.7 per cent, thanks in part to a significant increase in the labour supply, but it is still nearly twice as high as in 2007.

The growth in labour supply reflects increasingly high average education levels and female workforce participation, a trend already under way before the crisis. Other factors are the recent pension reforms and the sizeable reduction in the number of discouraged job seekers. However, the employment rate is still more than 8 points below that of the euro area.

Hourly contractual wages decreased further following the slowdown in consumer prices and in inflation expectations under way since the end of 2013. Some important labour agreements that were renewed in 2016 have significantly changed the contractual arrangements of previous years.

BOXES:

The lengthening of working life and the labour market

Current trends in labour relations

[9] **Average inflation was slightly negative in 2016.** Deflationary pressures from abroad compounded the weakness in domestic inflation. The latter was partly due to slack wage growth caused by still high unemployment and by low inflation expectations that were slowly incorporated into new labour contracts.

Although core inflation remains weak, price dynamics have increased since the autumn and, in the first few months of 2017, reached their highest levels in four years, mostly owing to the rise in crude oil prices.

Italian firms' price competitiveness has improved over the past few years. In 2016 it was stable vis-à-vis euro-area partners but decreased slightly against other countries as a result of the euro's appreciation at the start of the year.

BOXES:

*Inflation expectations of Italian firms according the Bank of Italy-*Il Sole 24 Ore *survey*

Competitiveness indicators in the euro area: prices, costs and margins

[10] **The current account surplus increased to 2.6 per cent of GDP** following an improvement in net investment income and a contraction in the energy deficit. The structural current account, i.e. adjusted for the effects of the unfavourable business cycle on imports, is also expected to maintain a strong surplus, thanks to the sound performance of exports and the drop in energy prices.

Goods exports kept pace with demand from outlet markets and Italy's share of world trade held stable. Imports continued to gain momentum, though less rapidly than in 2015.

The Bank of Italy's negative balance in the TARGET2 settlement system widened, reflecting, as in other countries, the redistribution through various channels of the excess liquidity injected by the Eurosystem. Italian investors continued to rebalance their portfolios towards foreign securities, mainly investment fund units; resident banks cut back their funding on the international interbank market; and foreign investors reduced their stock of Italian securities, especially medium- and long-term bonds.

Italy's external liabilities diminished significantly, falling to 14.9 per cent in 2016. Almost two thirds of the reduction in Italy's net foreign debtor position, which was down by 10.4 percentage points of GDP from the peak recorded at the end of 2013, is due to the current account surplus.

BOXES:

The improvement in Italy's goods exports since 2010

The trend in the balance on net investment income since 1999

The trend in the Bank of Italy's balance in TARGET2

[11] **General government net borrowing fell from 2.7 to 2.4 per cent in 2016,** the combined result of a reduction in interest expense and an increase in the primary surplus. The debt-to-GDP ratio rose from 132.1 to 132.6 per cent; however, excluding the change in the Treasury's balance with the Bank of Italy it was virtually stable. The primary aim of fiscal policy was to not hinder the strengthening economic recovery while keeping within the margins of flexibility allowed by European rules. The fiscal stance is expected to remain expansionary in 2017 as well.

The Government outlined its public finance programmes for 2018-2020 in the April 2017 Economic and Financial Document. Net borrowing is projected to fall from 2.1 per cent of the 2017 expected output to 1.2 per cent next year, essentially achieving nominal and structural balance in 2019. The debt-to-GDP ratio should begin to fall this year, if only slightly, and continue to narrow more rapidly in the following three years. The large contraction in the deficit programmed for 2018 should mainly come from activating the safeguard clauses that had previously been postponed and which the Government proposes to replace with measures to be set out in detail in the budget law.

BOXES:

General government commercial debts

Applying the BIMic microsimulation model to the changes in pensioners' fourteenth month payment

[12] **To foster growth, the production system must be freed of the obstacles to its development**, including the over-regulation of some markets and inefficiencies in the civil justice system and public administration.

The first annual bill on competition is still before Parliament. It has been envisaged by Italian legislation since 2009 as an instrument to guarantee continuity to liberalization measures and was first presented two years ago.

Several measures have been introduced in the last two years to regulate bankruptcy and mortgage foreclosure with some initial positive outcomes. Business crisis management tools have remained largely ineffective though, partly because of the inefficiency of the court system.

In the civil justice system the measures introduced in recent years have helped to keep the number of new cases down and reduce the backlog of pending proceedings, but they have had little impact as yet on the actual working of the system. Marked differences in productivity between the various courts persist, with a generally lower output in the South owing, among other things, to lingering organizational deficiencies.

The reform programme to improve the quality of government action went ahead. The regulations on public contracts were revised and the reform of general government was accomplished, although its success could be undermined by the lack of measures relating to senior public officials.

BOXES:

Limiting red tape for start-ups

Arrangement with creditors according to microdata on proceedings

Court productivity and the length of proceedings

Composition of employment in the general government sector and corruption indices

The economic effects of the spread of organized crime in the Centre and North of Italy

[13] **The economic recovery and the expansionary monetary conditions had a positive effect on credit quality for Italian banks.** The high proportion of NPLs is the legacy of the long and deep recession that caused a surge in the number of ailing firms and is partly due to the lengthiness of credit recovery procedures. In 2016 the flow of new NPLs in relation to total loans was reduced to pre-crisis levels, while the stock of NPLs, net of write-downs, decreased by €24 billion; their share in total lending to customers fell from 10.8 to 9.4 per cent.

Lending to the private non-financial sector returned to growth, though at a very slow pace. Loans to households and large firms increased, while those to small firms continued to diminish.

Banks' funding rose slightly. The increase in Eurosystem refinancing and in customers' deposits offset the decline in funding through bond issues.

The operating profit of the banking industry reflected a decline in revenues and the rise in outlays associated with restructuring plans. The decision of some banks to substantially raise the level of coverage of their NPLs led to large write-downs and overall negative net profits. Taking into account the capital increase finalized by UniCredit Group in the first quarter of this year, capital adequacy remained broadly unchanged.

The reorganization of Italy's banking system is proceeding. A reform of mutual banks was launched in 2016 to strengthen the sector's capital adequacy. Eight of the ten cooperative banks affected by the 2015 reform completed their transformation into joint stock companies.

At the end of 2016 the Government passed a number of measures to support the banks. Banca Monte dei Paschi di Siena, Banca Popolare di Vicenza and Veneto Banca took advantage of the new state guarantee to issue bonds and applied for precautionary recapitalization with public funds.

The first half of this year saw the completion of the sale to Unione di Banche Italiane (UBI Banca) of three of the four bridge banks set up following the resolution in November 2015 of four banks under special administration. A contract was also signed for the sale of the remaining bridge bank to BPER Banca.

BOXES:

The banking resolution regulatory regime in the European Union and the United States

Bad loan recovery rates

The profitability of the main Italian and European banks

Public shareholdings in SSM supervised banks

[14] **Italy's financial markets experienced bouts of volatility in 2016**, mainly as a result of growing uncertainty about the economic policy outlook at European and global level. However, tensions were kept within limits by the highly expansionary monetary policy in the euro area and by positive expectations associated with the strengthening economic recovery. Concerns for the soundness of the banking sector emerged at various times during the year but eased at the beginning of 2017 with the successful completion of some recapitalizations and the launch of other operations.

The yield spreads between Italian and German government securities widened, although on the whole interest rates continue to be low. Lending conditions for Italian firms on bond markets improved further thanks to the sharp drop in yields and credit risk premiums. A driver was the Eurosystem's decision to extend its asset purchases to bonds issued by corporations other than banks. Non-financial corporations raised more capital on equity markets than last year, but slightly less on bond markets.

Shares prices fell on the Italian stock exchange in 2016 before broadly picking up in the early months of 2017. Last year the general stock market index lost 8 per cent and the banking sector index dropped by more than one third. Between January and May this year, the general index more than recouped the previous year's losses and bank share prices also rose significantly.

BOXES:

Holders of Italian public sector securities

Long-term yields and term premiums

Recent developments in Italy's sovereign spread

The impact of Eurosystem purchases of private sector bonds

[15] **The weak performance of productivity is the main factor holding back long-term economic growth in Italy.** Productivity growth has been slow since the mid-nineties, both in historical terms and compared with the other main euro-area countries. This has been due above all to the very modest growth in total factor productivity and in more recent years to the decline in capital intensity.

There have been large discrepancies in performance across industries and firms, however. Productivity began to increase again in manufacturing in the early 2000s but has continued to stagnate in private non-financial services. The gap between Italian firms and their main European partners can be entirely traced back to small businesses.

There are signs, which have become clearer since 2011, that the restructuring of the production process is under way, with resources reallocated to the best firms. Market selection became an increasingly important driver during the recession: mortality increased among less efficient firms and new firms emerged that were generally more productive and better able to increase employment and productivity in their first years of life.

A determined reform effort to boost some of the many factors underlying an economy's efficiency has been under way since 2011. The labour market measures have reduced the gap between fixed-term and permanent employees, increased the incentives to build up human capital, encouraged a transfer of resources to more efficient firms, reduced business costs, and increased the support available in case of job loss.

Other areas are still in need of reform. The obstacles to setting up new businesses, the complexity of crisis management procedures, the length of judicial proceedings, and the tax and regulatory obstacles that discourage business growth all have major implications for allocative efficiency and for business demographics. The removal of these impediments would create a more favourable environment for business and increase the propensity to invest in order to improve efficiency and expand business.

BOXES:

The long-term trend in total factor productivity in Italy and other industrialized countries

The assessment of the macroeconomic effects of the reforms