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Keynote address by
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Ladies and gentlemen,

Thank you for inviting me to this important conference. Trade is key to prosperity and finance is key to the development of trade. The role that monetary policy and financial regulation play in ensuring a stable and efficient financial environment is therefore, I believe, of interest to this audience. Without any pretence of generality, in my speech I shall take up a selection of policy and regulatory issues confronting the global economic and financial environment at the moment and discuss briefly the policy response and agenda.

Inflation

Low inflation remains a challenge, in the euro area and beyond. We in the Eurosystem take this risk very seriously.

The adverse effects of a long period of low inflation are well known. When the economy is at the lower bound of nominal interest rates, the room for conventional monetary policy shrinks. Since debt contracts are fixed in nominal terms, a fall in inflation increases the ex-post real debt burden for borrowers; with long-dated debt this effect may persist for years. With very low inflation even otherwise favourable supply shocks, like the effects of increased supply on fuel prices, may not be an unmixed blessing. Research at the Bank of Italy has shown that, when the zero lower bound is binding, even a negative cost-push shock may generate a negative and protracted decline in output.[1]

A protracted period of low inflation and a string of negative inflation surprises increase the risk of de-anchoring of long-run inflation expectations. A symptom of this risk is the tendency of long-term inflation expectations to move together with short-term expectations. Some of the studies we have conducted at the Bank of Italy show that this risk is material, but also that it can be countered:[2] the correlation of long- and short-term expectations in the euro area has increased, but the announcements of monetary policy measures have had a perceptible impact in weakening this correlation.

The aim of the decisions taken by the Governing Council of the ECB is to counter the risk of persistent downward pressures in prices. Our assessment is that the effects of the Asset Purchase Programme (APP) on financial markets and on the real economy, in the euro area and in Italy, have been significant and largely consistent with our initial estimates.

Between November 2014 and the beginning of January 2016, the yields on ten-year government securities decreased by about 40 basis points in the euro area, and by about 90 basis points in Italy; the adjustment of portfolios towards assets in other currencies led to a depreciation of the euro of 13 per cent against the dollar and 6 per cent in nominal effective terms. Credit supply conditions also improved: the cost of new loans to firms has declined by 70 basis points since mid-2014 in the euro area (120 basis points in this country). This is pretty much in line with what we initially expected.[3]

Estimates made at the beginning of last year indicated that the APP would have a significant effect on GDP and on inflation in the euro area; for Italy, we estimated a cumulative effect on GDP of 1.4 percentage points over two years and an increase in inflation of 0.5 percentage points per year. In the past 12 months, the expansion of world trade has fallen short

[1] Neri and Notarpietro, 2014.
[2] Cecchetti, Natoli and Sigalotti, 2015. Natoli and Sigalotti, 2016.
[3] Cova and Ferrero, 2015.

of what was expected; the negative contribution of commodity prices to inflation is now much greater than initially assumed. Nonetheless, GDP has so far grown in line with expectations and projections for 2016 have remained virtually unchanged, thanks to the on-going shift towards a more domestic driven recovery; headline inflation was in line with the projections until the autumn, although it decreased significantly in December and January. The more favourable financing conditions and the depreciation of the euro associated with the ECB's unconventional measures have largely offset the effects of a less benign external environment on economic activity. But the risk that they may again start to affect long-term inflation expectations must be countered.

Despite the positive effects of the programme, the current inflation outlook is not yet in line with the objective of monetary policy. This reflects global headwinds, which have been – and still are – much stronger than was expected when the programme was launched.

The persistent weakness in inflation suggests that continued action is still needed on the monetary side. The Governing Council of the ECB will review and possibly reconsider its monetary policy stance at the next meeting in early March.[4] As President Draghi re-affirmed, we do not give up pursuing our mandate.

Banks

Banks' stocks have had a rough start to 2016. As of yesterday, in the US, the euro area and Italy, banks' stock prices have fallen by about 19, 24 and 29 per cent, respectively, year-to-date, and by 20, 30 and 28 per cent year-on-year.

Increased uncertainty in the global economy has surely contributed to a revision in expectations of banking profits. Furthermore, a factor in the eyes of the markets may be the effect of regulation and especially of capital requirements as the closing round of the Basel III standards approaches.

Basel III has indeed increased capital requirements in quantity and quality. This was necessary in the wake of the financial crisis, which exposed weaknesses in the previous international framework, especially a treatment of trading-book risks that was too lenient and a definition of capital that was too lax. Regulators have succeeded in strengthening the capital basis of banks. Capital ratios, besides being a multiple of what they used to be years ago, are also defined in a much more robust way. While this may have had a negative impact on return on equity in the short-to-medium run, it has increased the resilience of the banking system and should ensure a more sustainable level of profitability, net of risks, in the longer term.

Many changes, however, have already been implemented and, one assumes, have also been amply digested by the markets. The concern today is that a number of final pieces still missing to complete the Basel III standards (such as finalising the leverage ratio, constraining internal models and completing the review of the OpRisk and Trading Book frameworks) will end by significantly increasing banks' capital requirement again.

On this I need to be clear: I do not think that a further significant increase is justified; neither is it envisaged. While individual increases may be appropriate for outliers, the overall result of this final round of rule-making should be broadly neutral. This is not just my personal view: the Basel group of Governors and Heads of Supervision said as much in their January statement. As a member of the Basel Committee and of various Financial Stability Board

[4] Draghi, 2016.

structures, I am committed to work towards ensuring that this aim is duly pursued at the technical level.

In Europe certain further factors need to be considered.

With 2016 the European Banking Recovery and Resolution Directive (BRRD) has come into full force. Investors know that they may be called upon to take losses in the event of a bank's distress, with public support a more remote possibility. The shift of the burden of bank crises from public to private capital was a conscious political decision at the European level; that this would reflect on the market valuation of banks' capital and debt was to be expected. However, there are elements that have increased market uncertainty and sensitivity and that need to be taken into account when, as already foreseen, the BRRD is revised in the light of experience, as Governor Visco recently said. It is especially important that the European concept of 'bail-in-able' instruments is brought as fully as possible into line with international standards (reference here is to the TLAC concept), ensuring legal certainty, awareness of investors and a clear procedure in the event of resolution.

Furthermore, there seem to be lingering market concerns in Europe about legacy assets. Opaque financial assets are one issue that needs to be tackled. In this speech I intend to concentrate on non-performing loans (NPL).

The global financial crisis and the ensuing recession caused a deterioration in bank credit portfolios. According to a recent analysis by the IMF[5]), NPLs in the European Union countries more than doubled between 2009 and 2014. The increase in NPLs is therefore by no means unique to Italy: however, as their level as a proportion of loans is especially high in this country, let me confront the issue head on.

There are two reasons for the high NPL/loans ratio in Italy. The first is structural: procedures for recovering a credit in the case of default or distress of a borrower are typically lengthy in this country, which means that, all else being equal, NPLs stay on a bank's balance sheet for longer and therefore their ratio to outstanding loans at any given moment is higher[6].

The second reason is that in Italy the length and severity of the recession was unique among major European countries, with a fall in GDP of almost 10 per cent, and in industrial production of almost a quarter, from peak to trough (2008 to 2014). This took a toll on banks. Banks in Italy mostly have a traditional business model and tend to stick to the core business of commercial banking. The Italian banking system therefore shouldered the first phase of the financial crisis fairly well, owing to its negligible exposure to toxic assets. But this also meant that it was affected by the deterioration in the economic situation: provisions for credit losses absorbed on average more than 95 per cent of operating profits over 2012-2014.

That said, let me say clearly that concerns are vastly overrated. While they depressed bank profitability for a few years, hefty provisions (spurred by supervisory action, first by the Bank of Italy alone, then by the Single Supervisory Mechanism) meant that the coverage ratio of NPLs in Italian banks grew from 39 to 45 per cent between 2012 and 2015. Within the broader category of NPLs, provisions for 'sofferenze' (loans to debtors in full distress) reach 60 per cent of gross amounts. Moreover, around two thirds of NPLs are collateralised. Increases in capital

[5] IMF, 2015b.

[6] Our estimates suggest that a reduction of two years in credit recovery times could substantially decrease, by up to one half in steady state, the ratio of bad debt to total loans. This suggests that government action to reduce the length of judicial procedures is a key ingredient for a reduction of the stock.

ratios have also been substantial. Provisioning levels for NPLs are currently in line with the European average and no new requests for higher provision levels or capital are foreseen, as President Draghi recently clarified.

As the economic landscape gradually improves, the flow of new NPLs has trended down over the past two years. The rate of new non-performing loans stood at 3.6 per cent in the third quarter of 2015, more than two percentage points below the peak reached at the end of 2013. Our models forecast a further steady reduction in 2016.

Running down the existing stock of NPLs will, of course, take time. Let me mention, however, a series of developments in this respect. Last year the Italian bankruptcy law was amended, with several provisions intended to facilitate out-of-court restructuring agreements and shorten court proceedings for forced sales of collateral. Additional measures have recently been announced by the Government. As a result, the length of bankruptcy procedures is expected to diminish appreciably. This will reduce the time NPLs stay on banks' balance sheets and at the same time is expected to improve the secondary market for bad loans. The tax treatment of loan losses, which used to be extremely unfavourable for Italian banks, has also been brought broadly into line with practices elsewhere. Finally, a recent agreement between the Ministry of Economy and Finance and the European Commission will introduce a government guarantee scheme for senior tranches of securitised bad loans, which is also expected to support the secondary market.

Macro-prudential policy

I shall now move away from Italy, back to more general issues, and talk briefly about macro-prudential policies, a set of tools which in the past few years has started to complement two long-established ones (monetary policy and prudential supervision) in the overall pursuit of financial stability. The macro-prudential policy set sits on the intersection of the other two sets. Europe, as you will know, now has a rather developed set of rules and institutions to apply macro-prudential measures; other jurisdictions have been experimenting with them to various degrees.

Much has been written about macro-prudential policy, but as it is still, comparatively speaking, in its infancy, much is yet to be learned about its working and potential. This is not the occasion for a comprehensive treatment of such a large subject. I would like to offer just two points for reflection.

First, the relation between macro-prudential and monetary policies should be well understood. Macro-prudential policy is not meant to undo what monetary policy does; in this respect, it is useful that monetary authorities have a significant responsibility in the decision-making process for macro-prudential measures in many jurisdictions. More specifically, if monetary policy is enacted with a view to fostering bank lending generally, it would make little sense to use macro-prudential tools to restrict bank lending generally as well. On the other hand, carefully targeted macro-prudential measures do have a role to play in tackling any undesired side-effects of monetary policy in specific sectors or markets: think, for example, of a real estate market bubble in any particular country of the euro area. We have had many examples of measures enacted to that effect in Europe recently. They should be seen as complementary to monetary policy, not undermining it.

Second, macro-prudential measures should not be seen in isolation and it is important to think jointly about micro- and macro-prudential regulation. The line between the two regimes is thin: on the one hand, because they rely on a largely overlapping set of policy tools; on the other, because when micro-prudential policies are implemented simultaneously on the entire banking system (as with the introduction of new prudential standards), this has macro implications that should not be overlooked. Consequently, I think that we should develop an ability to understand and measure what I term the 'overall prudential stance', that is to say, the combined effect of all prudential measures, and to do so in a way that is comparable to the way we understand and measure the monetary or fiscal stance. Today, we have no such measure, either in the euro area or globally. Understanding the way prudential action works at the macro level is more challenging than in the case of monetary or fiscal action because (i) the micro and macro policy frameworks are different, with separate governance structures; (ii) each comprises a large set of policy tools; (iii) these tools can vary across countries; and (iv) we still know too little, as I said, about transmission mechanisms. But constructing a holistic measure of the prudential stance, difficult as it may be, is an important research and policy programme.

Non-banks

Stricter regulation of banks is one factor behind the increase in non-bank financing, especially market-based funding, that we have seen in the past few years. A more diversified set of financial channels is welcome, especially in Europe where the composition of firm financing appears to be too heavily tilted towards bank financing. The increase in non-bank financing, however, poses a whole range of regulatory questions that I cannot cover extensively here. Let me point to a couple of issues, specifically concerning asset management companies, which I think deserve attention at the present juncture.

Market-based funding sits at a crossroads between market and prudential regulation, often done by separate regulators with different mandates, and I think that the importance of the latter has increased. Asset managers now operate with larger portfolios, but in a context of thinner market liquidity. The main concern is the potential interaction between reach for yield, possible undervaluation of credit and liquidity risks and a decline in secondary market liquidity. Under stressed conditions, this may result in rapid asset re-pricing in certain markets such as corporate bond markets. These potential liquidity strains may be increased by the recent growth in assets under management in open-ended mutual funds that invest in less liquid assets while offering on-demand liquidity to their unit-holders.

The risk of fire sales triggered by massive redemption requests to open-ended funds which invest in illiquid, long-term securities, while remote, should not, therefore, be overlooked. This would call for policies to limit the funds' structural liquidity and maturity transformation, such as some alignment of redemption rules with the asset classes the fund is allowed to invest in (Italy has some such regulations in place). Authorities should also consider whether and how to incorporate investment funds into system-wide stress testing exercises, to form a view on how funds' selling impacts the market and how this in turn feeds back into funds' asset price declines and further redemptions. Finally, data gaps (concerning e.g. investment funds' leverage, liquidity and maturity transformation) should be addressed; in awareness of this, the Bank of Italy is contributing to the Data Gap Initiative launched by the G20 Finance Ministers and Central Bank Governors in October 2009 and expanded in 2015.

Capital flows in Emerging Market Economies

The final point I would like to touch on concerns the risk of capital flow reversals in Emerging Market Economies (EMEs), a risk that is frequently mentioned in the flagship reports of the international financial institutions and deserves attention. Two main developments have, in my view, contributed to the evolution of this risk in the last decade.

First, global factors have assumed an increasing role as driver of capital flows towards EMEs. It is now largely accepted that major capital flow episodes (surges, sudden stops, flights, retrenchments) can be associated with the evolution of global factors (i.e. global risk aversion, global interest rates, global growth).[7] Recently, the IMF[8] has provided a thorough analysis of the mechanisms driving the strong increase in the corporate debt of non-financial firms across major EMEs. One of the points emphasised by the IMF's analysis – based on micro data – is that firm and country specific characteristics appear to have become less and less relevant, compared with global factors, in explaining leverage growth, issuance and spreads in emerging markets.

Second, the composition of capital flows towards EMEs has changed. While, up to a few years ago, cross-border banking flows were the main driver of the increase in capital flows towards EMEs, more recently portfolio flows have grown in importance. Low yields in advanced economies (AEs) have spurred an extensive search for yield. An increasing fraction of global capital has been allocated to governments and corporations in EMEs, with large inflows into cyclical sectors like mining and energy. At the same time banks have been retrenching from some activities and risks, not least because of the new post-crisis regulation. Although bank loans still account for the largest share of EME debt, the share of bonds has nearly doubled over the last decade, and increased issuance has been largely absorbed by investment funds held by individuals and institutions domiciled in the AEs.

These two developments have increased the potential exposure of EMEs to extreme capital flow episodes and altered the effectiveness of the policy tools which can be used to limit the inherent risks.

One issue is extending some elements of the prudential framework to the non-banking sector, something I have just mentioned.

Another issue concerns the effectiveness of the global financial safety net (GFSN). Key components of the GFSN are each country's own FX reserves, Regional Financing Arrangements resources and IMF resources. Regional Financing Arrangements have grown in importance in recent years (the European ESM and the BRICS' Contingent Reserve Arrangement are two examples). Also, the financial crisis has highlighted the importance of central bank swap arrangements – including the conversion of temporary bilateral liquidity swap arrangements into standing arrangements.

Achieving consensus on the required size and the most useful role for each component is a clear priority at the G20 level and one of the main aims of the Chinese presidency.

Regarding the size, i.e. the amount of resources needed to confront a sudden stop crisis, the evidence seems to show that overall existing effective resources in the GFSN would be sufficient in most plausible scenarios, provided all components can be effectively put to use; in the case of a systemic sudden stop scenario, the IMF's resources would be called upon to play a key role.[9] The last point has implications for the discussion of the Fund's resources that is to take

[7] Forbes and Warnock, 2012. Rey (2013) highlights the co-movements of different classes of capital flows with global factors.

[8] IMF, 2015a.

[9] Denbee, Jung and Paternò (2016).

place in the coming months, specifically concerning extending the 2012 bilateral loans and raising the overall IMF quotas in the context of the XV General Review of Quotas.

Of course, the existence of a carefully designed and properly sized GFSN does not reduce the role that macro-prudential policy needs to play in limiting the risk and the consequences of extreme capital flow episodes in EMEs.

Ladies and gentlemen,

Trade is one of the hallmarks of civilisation. In the semi-brutish state of *bellum omnium contra omnes*, the war of all against all that certain old philosophers assumed to have existed before the emergence of civilised polities, trade would have been next to impossible. Trade flourishes on physical security, legal certainty, honesty, and peace.

It also needs technology, another feature of human civilisation, and not just for the physical delivery of goods and services, as this audience knows perfectly. From barter to specie, to fiat money and letters of credit, to the more complex arrangements of today's trade finance, the progress in credit and payments technology has multiplied the potential prosperity gains from trade.

Financial technology, however, like all technology, carries risks as well as the ability to increase productivity. Global financial regulation has to adapt to the evolution of finance.

I have taken this opportunity to review some current issues in financial policy and regulation. Much progress has been made in making the international financial system more resilient. The effort will not stop. Risks evolve and alertness to new risks is essential. The international regulatory and monetary policy community is, and must remain, fully aware of this need.

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