

ABI and Confindustria

**ITALIAN COMPANIES AND BANKS  
IN THE NEW GLOBAL CHALLENGES**

Introductory speech by Salvatore Rossi  
Senior Deputy Governor of the Bank of Italy and  
President of the Institute for the Supervision of Insurance

Embassy of Italy in Washington, D.C.

April 21, 2017

I would like to thank the organizers of this conference on the Italian economy for inviting me to open the discussion. My thanks also go to Ambassador Varricchio for hosting us in such a beautiful venue, and for his kind words of welcome.

Today's conference centres around three words – companies, banks and global challenges – which, in my view, are the key elements for understanding the dismal growth performance of our economy since the late nineties, its exceptional difficulties during the double recession, its recent recovery, and its prospects for the future.

In my remarks I will start by mentioning one important challenge that the whole advanced world is facing, and which affects our economy too: policy uncertainty. I will then focus on the Italian economy, looking at it from a longer perspective. Finally, I will touch on the Italian banks.

### *Policy uncertainty as the main global challenge*

We see encouraging signs in the global economy, which we are discussing in depth during the meetings here in Washington. But we also see a sharp increase in policy uncertainty, especially in the advanced world. This is a matter for great concern. Policy uncertainty does not mean uncertainty about future political events in this or that country, relating to the emergence of populist movements, but something much more specific: which economic policies will be adopted in our countries in the immediate future, even by traditional political forces? The usual, historical distinction between left and right, labour and capital, is no longer the infallible guide it used to be.

Policy uncertainty dampens not only domestic economic activity, but also international trade. Financial markets have so far reacted unemotionally to events such as Brexit or the presidential election in the US, but the kind of uncertainty I am

talking about may acquire longer-term dimensions than the macro outlook that markets traditionally consider.

If the international openness achieved by our countries diminishes in the future, dire consequences will ensue for small open economies like Italy. If global trade and global value chains shrink, so will productivity. Inward-oriented policies are not the right reaction to political discontent. Protectionism is the wrong response to collateral damage of free trade, the exclusion of many from its benefits. Nostalgia for the past does not eliminate inequality; rather, it aggravates it.

### *Italian companies*

But let me turn to Italy. Between 2008 and 2013 the Italian economy suffered the worst slump of its history: GDP went down by 9 percentage points, slightly more than household spending, while investment fell by 30 points, industrial production by almost 25 and employment by 4. The double-dip recession was far more severe in Italy than in the rest of the euro area.

Since then the Italian economy has gradually recovered, mostly thanks to domestic demand, especially consumption and, more recently, capital spending, but also with a significant contribution from exports. Potential output has been slowly improving too. Three years into the recovery, business investment in Italy is now approaching the average of the ten years preceding the global financial crisis.

We expect this positive trend to continue over the current and the next two years, partly thanks to the support of external demand. The latest surveys run by the Bank of Italy on a large sample of companies indicate that the recovery of investment plans is now on a firmer footing, and that the lack of productive capital is being reabsorbed, with the exception of construction spending, which remains extremely low.

The common monetary policy designed by the European Central Bank has provided an important stimulus to every component of aggregate demand. But fiscal incentives have also played a role, while respecting the European rules on public finance.

However, we need a longer perspective than a purely cyclical one. The large swings since 2008 followed a decade of very slow growth, when the debate centred on the question of whether Italy was in a sort of unstoppable decline. From 1999 to 2007, GDP grew on average by 1.5 per cent per year, where the positive contributions of population and employment growth were accompanied by a disappointing performance on the part of total factor productivity (+0.1 per year on average), which instead recorded significant increases in France (0.6) and Germany (0.9).

Such a prolonged sluggishness of productivity reflects structural factors. The interpretation we proposed at the Bank fifteen years ago<sup>1</sup> – nowadays shared by many experts – is that since the mid-nineties Italian companies have been hit by a double world revolution: a shift in the dominant technology (ICTs) that triggered a re-organization of production on a global scale, and globalization.

The Italian economy was harder hit by these shocks because of its structural features: most of its companies are small in size and never grow, a characteristic that goes hand in hand with a lower propensity to innovate and worse-than-average management skills and practices. The predominance of small and medium enterprises (SMEs), which was an asset in the past because of their supposed flexibility, is nowadays a liability.

---

<sup>1</sup> Cfr. Rossi (2003), *La nuova economia: i fatti dietro il mito* (ed.), Il Mulino, Bologna.

Let me give you some figures. According to Istat, the national statistical institute, in Italy the private non-financial sector consists of 4.3 million units. Some 30 per cent of total value added is produced by independent workers and very small firms (less than 10 employees), another 30 per cent by large firms (more than 250 employees) and the rest (40 per cent) by SMEs. In Germany and France the number and economic importance of SMEs are also large, but less so than in Italy.

The share of firms with an established research and development activity is less than 20 per cent among the smallest companies and above 50 per cent among the largest. Italy is the European country with the largest share of firms in which the whole management – not only the CEO – is in the hands of the family owning the firm. Family management is less modern and embeds lower incentives for technological and organizational innovation.

When an Italian SME has the opportunity to grow a lot – and many of them do, even in these difficult years – often it does not. Why? For many reasons. Some have to do with the traditional practices and psychological traits of our entrepreneurs. Others, probably the most important ones, relate to the overall economic context, such as red-tape, high taxes, and inadequate human capital. Clearly, internal and external weaknesses are interconnected. It has been empirically proved, on one hand, that small firm size is associated with the excessive duration of judicial proceedings and with the combination of high taxes and low tax compliance, and on the other that the limited supply of human capital interacts perversely with the weak demand for skills by small firms in low-technology sectors.<sup>2</sup>

---

<sup>2</sup> Cfr. Visco (2014), *Investire in conoscenza. Crescita economica e competenze per il XXI secolo*, Bologna, Il Mulino.

Still, Italy is populated by companies, mostly of medium size, that are highly innovative and competitive on international markets. They have driven the Italian economy's recovery from the crisis, especially through their export performance.<sup>3</sup>

How can we reconcile micro optimism and macro worries? Three magic numbers can solve the puzzle: 25-50-25.<sup>4</sup> We have a quarter of excellent and healthy firms and, at the other tail of the distribution, another quarter with little potential and a high risk of exiting the market. In the middle, there are companies that could become key players but whose growth is currently hampered by the internal and external factors I mentioned before.

So, the question becomes: is Italy capable of changing these magic numbers into, say, 50-40-10?

The answer lies in the capabilities of the economy and in public policies. The existence of the first has been borne out on many occasions by history and by the literature.<sup>5</sup> The second depends on the people, civil servants and politicians generating together the right policies. We are talking mainly of structural policies: economic development is a long-term issue, barely related to the economic cycle and to macroeconomic stabilization policies.

In fact, important structural policies have been put in place in Italy in recent years: for example, the pension reform and the labour market reform (the Jobs Act). However, there is still much to be done if our economy is to become modern and innovative. What I personally have in mind are the legal and education systems, which I believe to be at the heart of all reform.

---

<sup>3</sup> Cfr. Banca d'Italia (2015), *Annual Report for 2014*, Chapters 5 and 6, pp.43-59.

<sup>4</sup> Cfr. Istat (2017), *Rapporto sulla competitività dei settori produttivi*, Chapter 3, pp. 58-63.

<sup>5</sup> Cfr. Giunta and Rossi (2017), *Che cosa sa fare l'Italia: la nostra economia dopo la grande crisi*, Laterza, Roma-Bari.

Of course, the interest of private investors, both domestic and foreign, can encourage the right policies, in a virtuous circle.

### *Italian banks*

Let me now move on to the situation of Italian banks, which is linked to that of non-financial firms in many ways. The financial structure of Italy is unusual: the leverage of non-financial firms is on average 45 per cent, against 41 in the euro area and 28 in the US, with a ratio of bank debt to total financial debt of more than 60 per cent, against less than 40 in the euro area and 33 in the US. Thus, we have companies that are both more indebted and more dependent on banks.

Is the importance of banks in our real economy an obstacle to the recovery, now that they are burdened with non-performing loans (NPLs)?

I would say no, for two reasons.<sup>6</sup>

First, bank credit to the non-financial sector is expanding, though at a moderate pace. True, lending to households drives the trend, while corporate lending remains modest and varies considerably across firms of different size, but the cost of credit is on average stable at historically low levels.

Bank credit fell in the recession years essentially because of the lack of demand. The 25 per cent of good companies I mentioned before do not need much bank credit as they are large enough to have access to the financial markets or to use internal financial resources. The 50 per cent of problematic companies are striving to weather the storm, so their demand for long-term credit has fallen

---

<sup>6</sup> Visco (2017), 'Exchange of views with the Governor of the Bank of Italy Ignazio Visco on the economic and financial situation of Italy and prospects for economic governance in the European Union', European Parliament, Committee on Economic and Monetary Affairs, Brussels, 11 April 2017.

considerably in past years. Only the 25 per cent of really troubled firms are desperately seeking survival credit, but they probably do not have a good enough credit scoring to get it. A recent Bank of Italy study found no evidence that the NPL stock is significantly impairing the credit allocation mechanism in Italy.<sup>7</sup>

The second reason is that the NPL stock, most of which originated with the terrible recession of 2009-2013, is finally being trimmed back by the recovery, though with the usual time lag.

But how serious does the problem continue to be? At the end of last year NPLs in Italian banks' balance sheets amounted to around 170 billion euros net of write-downs, around 9 per cent of total loans. The equivalent figure for the euro area was much lower, around 3 per cent. But Italian banks have much fewer level2/level3 assets, which are no less problematic than NPLs.

I refer here to net NPLs, not gross, because that is the indicator of the actual risk run by the banks. The gross figure is an indicator mostly of the state of the economy, rather than of banks. In fact, Italian banks' NPL coverage ratios are higher than the European average: the book value of NPLs (net of write-downs) is now about half the face value.

We must also bear in mind that NPLs are a very heterogeneous category, ranging from truly bad loans – loans to failed firms or insolvent households – to those granted to perfectly solvent borrowers who may just be in breach of overdraft ceilings.

Net bad loans account for less than half of total net NPLs at Italian banks. They are largely backed by real-estate collateral, whose market value is uncertain,

---

<sup>7</sup> Accornero et al. (2017), 'Non-performing loans and the supply of bank credit: evidence from Italy', Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), 374, available at [https://www.bancaditalia.it/pubblicazioni/gef/2017-0374/QEF\\_374.pdf](https://www.bancaditalia.it/pubblicazioni/gef/2017-0374/QEF_374.pdf)

however: even if we accept the valuation made by the banks and validated by the asset quality review conducted in 2014 by the Single Supervisory Mechanism, the value depends on how easily and quickly one can seize and dispose of the property.

That is why an NPL market is struggling to develop and banks prefer to keep most of their NPLs and work them out internally. Forcing all banks to liquidate NPLs immediately may not be the best option. Most NPLs are held by banks whose financial position is such that they do not need to sell them quickly.

Some banks, however, are not well equipped to work out NPLs internally. It is very important to eliminate all the inefficiencies in judicial and extra-judicial procedures. Substantive reforms have been undertaken in the last two years. Additional improvements should be sought.

The Italian banking system has two interrelated problems: a sometimes cumbersome corporate governance, preventing swift and orderly access to capital markets if need be, and the legacy of the recession, which, together with serious episodes of mismanagement, has hit a few medium and small banks hard.

The first problem was recently addressed by a couple of important legislative reforms regarding cooperative banks (Popolari and BCCs, small mutual banks). The second was tackled with the decision of the Government, subject to the approval of the European Commission, to offer public guarantees on newly-issued bank liabilities and to undertake a precautionary public recapitalization of a number of banks (currently three have applied), a tool provided for by the BRRD, the European directive on bank recovery and resolution; 20 billion euros have been budgeted for this purpose.

Of course, the significant amount of loan loss provisions has weighed on banks' gross operating profits. But low profitability is a long-term problem for our banks going forward, because of the evolution of technology and of the market.

Indeed, it is a problem for all European banks, but for the Italian banks it is particularly acute.

Cutting costs and changing business model are the strategic targets of Italian banks. How they can be achieved remains the responsibility of banks' boards and managers. What we do know is that banks' stability and competitiveness depend on reaching those goals. Mergers and acquisitions, especially among small and medium-sized banks, may be of help.

\*\*\*

The world is changing rapidly, and technology is making low value added retail activities less and less relevant and profitable. Italian companies need to rely less on bank credit and more on banks' market services and on non-bank intermediaries. Transforming our financial structure is one way to put the Italian economy back on track towards sustained and lasting development.