BANCA D'ITALIA
EUROSISTEMA

Consiglio per le Relazioni fra Italia e Stati Uniti
9 June 2012, Venice

Keynote speech by Ignazio Visco
Governor - Banca d'Italia

Economic and policy interconnections in the current crisis

1. **The current crisis is a clear demonstration that in an increasingly interconnected global economy even local events can easily take on systemic, international importance.** The crisis in the euro area originated in the financial debacle of 2007-2008, which was triggered by financial imbalances, regulatory failures and excessive risk-taking, mainly in the United States. Financial globalization has brought substantial benefits, such as more efficient intermediation of savings and risk-pooling, but it has also made the global system more vulnerable.

The sovereign debt strains in the euro area reflect the impact of the financial crisis on some countries' banking systems and public finances as well as pre-existing vulnerabilities, which for Italy consisted in slow growth and high public debt. Tensions were fuelled not only by the deteriorating outlook for the global economy but also by the worsening of Greece's financial situation and the fears of contagion triggered by the announcement of the private sector involvement in the reduction of the country's public debt.

2. **If the euro area were viewed as a single country, it would appear as a sound and balanced economy.** The external accounts are in balance. The public sector deficit and debt this year are forecast to be just over 3 and 90 percent of GDP, respectively. Households' gross financial wealth is three times their annual disposable income, while their debt is equal to that income; aggregate corporate financial debt is equal to one year's output. Italy's figures are not far from the European average, and as regards the financial position of households and firms they are better. The external current account deficit is around 3 percent of GDP. The public debt is 120 percent of GDP but should begin to decline in 2013. In the absence of a European political union, the vulnerabilities of individual countries are magnified. Without the design and implementation of appropriate governance arrangements, monetary union is difficult to sustain.

3. **Due to euro area's openness and financial interconnections, the crisis can have world-wide repercussions.** The area is more open than other advanced economies. Its trade with the rest of the world has increased noticeably, owing in particular to growing exchanges with new EU member states and the emerging economies. In 2011, euro-area exports and imports accounted for 49 percent of GDP, up from 32 percent in 1999; the corresponding figure for both the US and Japan is 29 percent. The area's financial assets and liabilities vis-à-vis the rest of the world amounted to 184 and 196 percent of GDP, respectively, up from 92 and 99 percent in 1999. In the US the corresponding figures in 2010 were 140 and 157 percent.

Italy is very open to foreign trade. Trade with countries outside the euro area is worth about 34 percent of Italian GDP and 6 percent of euro-area GDP. Including exchanges with the rest of the euro area, Italy's openness is even more pronounced, the total value of foreign trade equalling 59 percent of GDP. The share of manufacturing exports in GDP is high compared to other advanced countries. In 2009 about 90,000 manufacturing firms – a fifth of all Italian manufacturers – sold part of their output abroad. Many are able to reach distant, difficult markets like China: this is the case for 8,600 Italian industrial firms, against 6,300 German firms and 4,200 French firms. In 2011,

Italy's foreign financial assets and liabilities amounted to 119 and 140 percent of GDP, respectively, up from 92 and 97 percent in 1999.

4. **The crisis risks leading to re-nationalization of financial portfolios.** The perceived risks are amplified by the uncertainty over the resolution of events that are in many respects unprecedented. The key is careful and timely analysis of each national economy and of the actors within them. The opportunities offered by financial diversification in a global environment are potentially intact. Ongoing reform efforts in the euro-area countries aim at preserving their attractiveness for financial diversification.

°°°

5. **The crisis has highlighted the weaknesses of EU and especially euro-area governance.** First, the Stability and Growth Pact failed to provide sufficient incentives to correct fiscal imbalances. Second, budgetary discipline alone could not avert the financial tensions generated by macroeconomic imbalances. Third, the EU lacked a mechanism for managing systemic crises.

EMU governance hinged on fiscal rules and a no-bail-out clause. The rules were deemed necessary because "the constraints imposed by market forces might either be too slow and weak or too sudden and disruptive" (Delors Committee, 1989). Economic convergence was expected to follow almost automatically from competitive pressures. But the fiscal rules were not fully enforced, macroeconomic imbalances mounted and markets behaved as expected: in spite of the no-bail-out clause, for years sovereign risks were underestimated; then they were overestimated.

The crisis also made clear the close linkage between sovereign risk and bank risk. Before the crisis there was substantial convergence of interbank interest rates in the euro area and a significant reduction in the home bias of investors' portfolios. Greater financial integration favoured uniform monetary policy transmission across the area. The crisis changed things dramatically. In the countries most severely affected by the sovereign debt crisis interbank rates increased to very high levels and wholesale bank funding became extremely difficult.

Italian banks' net fundraising from non-residents, on foreign interbank markets and by way of bond issues, shrank by more than €100 billion in the last five months of 2011. The huge volume of bank bonds maturing in 2012 and the difficulties that banks were encountering in accessing capital markets prompted fears that they might be forced to dump assets, triggering a potentially systemic negative spiral between declining asset prices, tighter lending standards and deteriorating economic conditions, which would jeopardize financial and price stability. Indeed, in the final part of 2011 the Eurosystem Bank Lending Survey signalled a sizeable tightening of lending conditions. There was the concrete risk of a ruinous credit crunch.

6. **Policymakers responded in three ways**: reform of European economic governance; ambitious programmes of fiscal consolidation and structural reform in member countries; and decisive actions by the Eurosystem to stabilize financial markets and preserve the monetary policy transmission mechanism.

7. **First, the reform of the treaties and of the Stability and Growth Pact reflects recognition of the shortcomings of European governance.** The first step was the creation of financial support mechanisms (the European Financial Stability Facility and the European Stability Mechanism), which permit the mobilization of substantial resources. The so-called "six-pack" and the "fiscal compact" reinforced the fiscal rules and strengthened enforcement mechanisms. Multilateral

surveillance was extended to macroeconomic imbalances.

The effort, though significant, is not complete. The fiscal compact awaits national ratifications. Proposals to further strengthen multilateral surveillance are still being discussed by the EU Commission, the Council and the Parliament. Financial assistance to states in difficulty must be made operationally effective. It must be possible to intervene promptly in the securities markets and directly in favour of banks, with flexible procedures that do not penalize countries that respect the rules of the Union. The progress of troubled countries in financial restructuring and structural reform must be accompanied by the undertaking of the European authorities to orient the markets' assessments.

At the same time, it is necessary to resist the re-nationalization of financial systems. Measures taken from a purely national standpoint could severely hamper the working of the euro area. We need to speed up the transition to a uniform system of financial sector rules and oversight. This should be accompanied by common guarantee and insurance mechanisms that can reassure savers and investors and prevent flights of capital. Rapid progress in setting up a European fund for the resolution of banking crises would help to dispel uncertainty.

8. **Second, consolidation measures were implemented in a number of euro-area countries to restore the markets' confidence in fiscal sustainability.** To varying degree these interventions were accompanied by structural reforms to increase potential growth and avert a downward spiral of deeper recession and deteriorating public finances. In the case of Italy, action on the public budget has been rapid and decisive. Structural reform has met with more resistance, but some important results have nevertheless been achieved.

Current forecasts put Italy's budget deficit for 2012 below the 3 percent ceiling; next year the budget should be near structural balance and the public debt-to-GDP ratio should begin to fall, thanks in part to the completion of the pension reform. There is a large and growing primary surplus; current expenditure net of interest payments has been falling in real terms for two years now. However, the recent fiscal consolidation consisted chiefly of tax increases. This burden can be sustained only temporarily. A stronger and more incisive fight against tax evasion and the implementation of spending cuts are the indispensable premises for the necessary reduction of tax rates. If expenditure savings are targeted to removing inefficiencies and if they are equitable, they will not hamper growth but should stimulate it.

On the structural front, in Italy more has been done since the summer of 2011 than during the previous decade. Work has begun on a vast scale with reforms to remedy the structural deficiencies that are holding the Italian economy back. Measures have been adopted in such crucial areas as competition and regulation, business environment, civil justice and infrastructure development. The reform of labour market regulation and the social safety net now in course of approval by Parliament aims at attenuating labour market dualism by altering the relative economic advantage of temporary over permanent contracts for firms; it also broadens the social safety net by widening unemployment insurance coverage.

Competition-enhancing measures have been introduced in a good number of sectors. Some entail significant changes in the regulatory environment, whereas others have significantly less potential efficacy. Procedures for business start-ups have been streamlined, authorizations and ex-ante controls reduced. The administrative burdens placed on firms by environmental, labour, public procurement and privacy regulations have been reduced. As to the civil justice system, a geographical reorganization of the courts is under way to achieve economies of scale, while

incentives for productivity have been introduced. Specialized courts have been instituted for some kinds of dispute involving firms. To promote infrastructure, administrative procedures have been simplified and measures taken to attract private investment.

The actual impact of all these structural measures on the Italian economy will depend greatly on their full and effective implementation. It will take time for the effects to materialize. Systematic ex-post quantitative economic impact assessments are essential if the purposes of the reforms are to be realized.

10. **The process of removing the obstacles to economic activity must be continued and strengthened.** Undue restrictions to market competition have to be eliminated. The public sector requires sweeping modernization based on the evaluation of single units' performance, reorganization, and further streamlining of regulations and administrative procedures. The fight against corruption and crime must be at the top of the agenda, also to minimize the costs that these two factors impose on the economy as they certainly form a significant obstacle to the efficient allocation of resources.

Together with the fragmented nature of Italian industry, uncertainty over the enforcement of contracts (due to the slowness of civil justice), corruption and public sector inefficiency are taking a toll on foreign direct investment in Italy. In the last ten years FDI inflows (1.1 percent of GDP) have been much lower than those to France (2.5 percent) or to the euro-area countries as a group (2.3 percent). Reforms to make Italy's economic environment more favourable to both domestic and foreign investment are needed to ensure the utilization of untapped human resources, especially young people and women, and to realize the growth potential of our southern regions.

11. **Third, the Governing Council of the ECB reacted promptly with bold measures to counter the instability that emerged in the last part of 2011.** The Council lowered official rates twice (to 1.0 percent), lengthened the duration of its full-allotment fixed-rate longer-term refinancing operations to three years, halved the compulsory reserve coefficient and expanded the range of assets eligible as collateral in refinancing operations.

The two three-year LTROs carried out in December and February resulted in a net injection of liquidity of some €500 billion, which compensated for the shortfall in banks' wholesale fundraising, averting the risk of a severe credit restriction and restoring more uniform monetary policy transmission. The abundant supply of liquidity and the greater availability of collateral strengthened investors' confidence in banks' ability to meet their funding needs, and market indicators improved. In Italy 112 banks participated in the operations, receiving a total of €140 billion on a net basis. Italian banks now have the resources to accommodate a recovery in the demand for credit, but the effects on actual credit growth will emerge only gradually, reflecting the usual lags. Much will depend on the evolution of economic conditions, which will affect credit demand and banks' assessment of borrowers' creditworthiness.

◦ ◦ ◦

12. **The European and global economic outlook and financial market conditions are daunting.** Uncertainty is very great. With the political deadlock in Greece and severe difficulties in the Spanish banking sector, tensions have re-emerged and sovereign spreads widened once again. The signs of faltering growth have intensified outside Europe as well, both in the advanced and the emerging economies. A new global economic slowdown would pose additional risks to already fragile financial systems and threaten the sustainability of public debts, in Europe and elsewhere.

13. **At this juncture, support from monetary policy, both conventional and unconvential, remains essential.** This week the Governing Council of the ECB confirmed its determination to provide all the necessary liquidity to the banking system and to preserve the functioning of the monetary policy transmission mechanism. In particular, our refinancing operations will continue to be conducted as fixed rate tender procedures with full allotment for as long as necessary, and in any case at least through the rest of this year.

At the same time it is crucial to observe that the Eurosystem's non-standard measures are temporary; they constitute a bridge that has yet to be crossed. A complete exit from the crisis will be achieved only if all actors properly shoulder their responsibilities.

14. **The commitments of the G20 to boost growth must be pursued consistently.** In the emerging economies, where there still is some fiscal and monetary leeway, policies should be geared to preventing an excessive slowdown. For the United States, it is essential to avoid the risk of a sharp fiscal tightening, such as would be produced in 2013 by the legislated automatic spending cuts and the expiry of earlier tax reductions.

In Europe, the reform process must be reinforced at supranational and national level, in order to foster growth and correct both public and private structural imbalances. In particular, the reform of economic governance must be accelerated, in order to break the linkage between sovereign risk and bank risk. This will require courageous moves towards fiscal and financial union. Amendments to national constitutions may be necessary to shift some elements of sovereignty to the supranational level. The common resources made available by any such form of union should be complemented by cogent rules and powers of control and intervention.

For Italy, the emergency is not over. Structural reforms, if seen within a consistent and comprehensive strategic framework, can provide the basis for a surge in confidence in our potential for sustained economic growth. Preserving and sustaining fiscal responsibility is essential, even if at the cost of some short-run difficulties.