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Speech by the Governor of the Bank of Italy
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The positive signs emerging from the global economy are still accompanied by marked uncertainty. While growth has accelerated in the United States, it remains weak in Japan and is slowing in China and in other emerging economies; in Russia it is contracting rapidly. The slump in oil prices may bolster economic activity in the advanced countries but it is also the result of weak demand; it must be prevented from entrenching expectations of deflation. Financial conditions are favourable, but market volatility is on the rise.

Economic developments in the euro area and Italy

The euro area is struggling to re-establish satisfactory rates of growth and unemployment is still very high. While consumption has picked up somewhat, domestic demand has been held down by investment, which contracted in the second and third quarters of 2014. The difficulties are widespread: average area-wide GDP growth is no higher than the modest rate recorded for the group of countries directly hit by the sovereign debt crisis.

After a long series of unexpected drops in consumer price inflation, in December the twelve-month variation was negative in eleven countries and, for the first time since October 2009, in the euro area as a whole. Nowhere did inflation top 1 per cent. Preliminary estimates indicate that in January consumer prices fell by 0.6 per cent, and by 0.4 per cent in Italy; this does not just reflect the drop in energy prices, as even without this component inflation has reached an unprecedented low of under 0.5 per cent in the euro area. Medium- and long-term inflation expectations have been affected and this downward shift must be countered with firmness. In the first week of February the expectations implied by five-year inflation swaps were still 0.7 per cent and those for the five to ten year horizon were 1.6 per cent.

Italy is among the countries that are struggling hardest to make a start on the road to recovery. GDP has been declining almost without a break for three years and is expected to show no increase in the last quarter of 2014, mainly owing to the further contraction in investment, which is more than a quarter below the level of 2007.

The latest data point to some encouraging developments for both the euro area and Italy. The Bank of Italy's €-coin indicator, which tracks underlying trends for the euro-area economy, rose in December and January after falling steadily from May to November 2014. In December the unemployment rate fell marginally in the euro area (by 0.1 percentage points to 11.4 per cent) and slightly more (by 0.4 points to 12.9 per cent) in Italy, where the number of persons in employment rose by over 90,000 in the month. Household and business confidence has been picking up since the beginning of the year. These developments have likely been affected by the drop in oil prices and the changes in interest and exchange rates caused by expectations of expansionary monetary policy measures.

A revival of capital expenditure is essential in order to consolidate growth. In many countries, especially Italy, the uncertain economic outlook has led firms to take a 'wait and see' approach. In the December surveys conducted by the Bank of Italy almost half of the firms still expected their expenditure on investment to remain virtually unchanged in 2015. Signs of a possible resumption have emerged only in some branches of manufacturing.

A suitable policy mix must contribute to reversing the trend in investment and strengthening consumption. The new monetary policy measures are designed to defuse the risk of a negative spiral of deflation and economic stagnation. Budget policies in the euro-area countries, which have been persistently restrictive, can now be better adapted to cyclical conditions. For

demand stimulus to generate lasting growth, measures must be taken to reform the economy's capacity to respond to structural changes.

Monetary policy

On 22 January the ECB Governing Council announced a programme of purchases of bonds issued by euro-area public authorities and European institutions to supplement the existing ones for covered bonds and asset-backed securities. It is a far-reaching measure, broader than markets expected, to be rolled out immediately, and open ended.

The Eurosystem will buy €60 billion worth of bonds a month from March this year until September 2016, for a total of €1,140 billion. The programme will in any event continue to run until a lasting change is achieved, with the trend of inflation returning close to 2 per cent. Intervention by the national central banks (NCBs) will be proportionate to their shares in the ECB's capital; the Bank of Italy's purchases of Italian government securities could be in the region of €130 billion.

The Council viewed the expanded asset purchase programme as a legitimate tool of monetary policy and voted by a large majority to deploy it immediately. Equal sharing of the attached risks would have been more consistent with the singleness of monetary policy. The decision to let the balance sheets of the single NCBs carry the risk of losses on government bond purchases reflects a concern within the Governing Council that in the present institutional framework such a monetary policy measure might lead to transfers of resources between countries without the approval of the competent bodies. In any case, the more successful the programme proves to be in curtailing the macroeconomic risks faced by the euro-area countries, the more it will also reduce the risks to the NCBs' balance sheets.

Asset purchases can transmit effects to the economy through a variety of channels. They exert downward pressure on medium- to long-term interest rates, directly for the assets included in the programme, and indirectly for all the others through portfolio reallocations. They encourage bank credit by making it relatively more profitable than buying government securities and by reducing the cost of funding. They sustain inflation expectations and confidence. They help to ensure that changes in the exchange rate are consistent with cyclical developments: although the euro exchange rate is not a monetary policy objective, any variations linked to the monetary conditions in the different currency areas are an important component of the transmission mechanism. The effects on financial asset prices and, looking ahead, on real asset prices can stimulate consumption.

The risk that the programme could lead to excessive price increases for real and financial assets, such as to threaten financial stability, is limited in the current climate. There are no indications that any widespread imbalances are forming in the euro area at the moment: credit is still languishing, assets do not appear to be generally overpriced; overall the propensity to take risks is still low. Should tensions emerge in local market segments, they would be countered by the national authorities with targeted macroprudential measures (such as those already introduced in some countries) without altering the expansionary stance of monetary policy.

The purchase of government securities does not make the introduction of reforms to increase the growth potential of the euro-area countries any less necessary or likely. Indeed, it can foster them by improving the macroeconomic outlook and reducing its uncertainty.

The effects of the programme have already been seen in part on the financial and currency markets. Lower interest rates and the depreciation of the

exchange rate could bring euro-area inflation to levels more consistent with the definition of price stability towards the end of 2016. By acting on demand, they will also help to raise GDP. For Italy, we consider that the effect on GDP could exceed 1 percentage point in 2015-16, other things being equal. About half of this effect was already factored into the forecasts published in the *Economic Bulletin* of 16 January, which took account of the trends observed following the communication of November's Governing Council on the start of the preliminary technical work for the programme. The further variations in the interest and exchange rates deriving from the new measures could lead to higher GDP growth, currently estimated at more than 0.5 per cent this year and more than 1.5 per cent in 2016.

These effects could be joined by those connected to the other transmission channels, which are more difficult to quantify but also potentially important. The forecasts remain, however, subject to a high degree of uncertainty, mostly connected with developments in geopolitical conditions and their impact on world trade, the price of oil and the exchange rates themselves.

Other policies

Monetary stimulus is not in itself enough to strengthen the signs of the recovery. Without parallel budgetary action the effects on demand may be limited; they will fade in the medium term if there is no structural intervention on the economy's growth potential, using instruments capable of increasing both productivity and employment, creating new income and new demand.

The overall stance of fiscal policies in the euro-area countries was still restrictive in 2013, basically neutral in 2014, and is expected to remain the same in 2015 despite the unfavourable economic climate. When the crisis was at its height, the budgetary adjustments introduced in a number of countries bolstered

confidence among the member states and reassured the markets. Thanks to these corrections, as well as to the strengthening of Europe's governance and the start of structural reforms, today there is scope for measures to support demand. Political and financial tensions can still affect market stability in the area, but the risks of contagion are fewer than in the recent past.

The investment plan announced by the President of the European Commission at the end of last year marks the first attempt to organize a coordinated response at European level. The plan can be implemented rapidly, overcoming any difficulties in establishing new institutions and procedures and using all the sources of funding available.

The Commission's recent communication on flexibility in applying budgetary rules is another important signal, mainly with regard to the calibration of policies based on the output gap and the treatment of national contributions to the European investment fund. The Commission has explained that the latter will not affect the evaluation of countries' structural budget position nor – within certain limits – decisions relating to the excessive deficit procedure.

The Italian Government, while confirming its commitment to continue to adjust the public finances, has adapted the pace to the economic outlook. The structural reform programme undertaken in recent years must proceed, in particular as regards implementing decisions already taken.

All in all, the measures introduced so far go in the right direction. Lastly – in the wake of the 2012 reform to reduce the dualism in Italy's labour market – the first two implementing decrees of the Jobs Act have extended the protection provided by unemployment benefits and reduced the costs of procedures to terminate employment contracts and the uncertainty over their final outcome. The enabling law establishes that they shall be accompanied by an appropriate revision of active labour market policies.

Improving the efficiency of the public administration will increase the competitiveness of Italy's productive system, which is a prerequisite for the effectiveness of all the other reforms. Measures have recently been adopted to promote public employee mobility. A draft enabling law for broader reform, centred on increased transparency and simplification, is being discussed in Parliament. The success of the reform will depend on how the good principles underpinning the law are implemented in practice.

By international standards Italy's stock of human capital is limited and inadequate for an advanced country. By developing the right skills and capabilities through better education and training, the country could find its way back to a higher growth path. Corruption and the infiltration of the economy and society by organized crime remain unacceptably widespread. Guaranteeing observance of the law, partly through more effective administration of justice, enables the productive economy to function properly, encourages entrepreneurship, and attracts human and financial resources to the country.

Credit and banks

Improvements in credit market conditions fostered by the new monetary policy measures must accompany a revival of investment. Although the trend in business lending is improving it is still negative, above all owing to weak demand but also because of residual supply-side strains.

Banks' caution in lending is mainly due to the high default risk generated by the protracted recession. In 2014 the flow of new bad debts decreased steadily from the peaks of mid-2013 but it remains nonetheless high; according to the latest figures, in the third quarter the annual bad debt rate was around 2.5 per cent for total lending and 4.0 per cent for loans to firms. The new monetary policy measures, which reduce macroeconomic risk, should also have beneficial effects on credit risk.

At the end of September bad debts accounted for 10.6 per cent of the total customer loans of the leading banking groups while total non-performing loans amounted to 18.3 per cent. The still high proportion of the latter is partly due to the absence of a secondary market for these assets in Italy, as well as to the slow process of credit recovery. To date, transfers of these assets have been possible in just a few cases and at very low prices, incorporating not only normal management costs and the risks of the underlying assets, but also the uncertain economic outlook for the country.

Banks must liquidate their non-performing loans in order to raise funds to finance the real economy. Direct state intervention – within a framework whereby, in accordance with European rules on competition, banks participate fully in the costs of the operation and public support is suitably remunerated – could be used not to remedy excessive risk taking by single banks, but to respond to the deterioration in loan quality caused by the severity and length of the recession and to the need to ensure an adequate flow of financing to the economy. Appropriate tax relief or state guarantees on assets backed by bad debts would smooth the way for the creation of a private market in non-performing loans.

With the conclusion of the comprehensive assessment of the balance sheets of the largest euro-area banks, regular supervisory activity under the single supervisory mechanism has commenced. All the significant banks supervised directly by the ECB, with the assistance of the national authorities, have been notified of capital adequacy targets based on an analysis of their respective risk profiles. This practice, which is specifically envisaged under the rules of the second pillar of the Basel capital accord, is similar to the one that the Bank of Italy followed before the single supervisory mechanism and that it continues to use for the institutions it supervises directly. The banks for which

the assessment identified capital shortfalls have been assigned targets that are largely in line with the plans they presented following the exercise.

In recent years the need to observe more stringent capital adequacy requirements has affected the banks' propensity to lend during a cyclical downturn. Additional requirements for capital increases must be carefully calibrated so as not to undermine the signs of economic recovery. More generally, in the new context of Banking Union, a clear and stable supervisory review process in the spirit of Basel rules will make it easier for banks to draw up long-term plans, improve market transparency, and limit the potential pro-cyclical effects.

In the coming months single supervision will also focus on the sustainability of banks' business models. Lighter cost structures and business models that can adapt promptly to new technology will help banks cope with change more effectively. Italy's banks have made progress in recent years, but there is still room for improvement. A review of production and distribution processes will lead to efficiency gains and cost savings. Profit levels could be raised through greater diversification of revenues, which could include helping firms to access markets directly. There is scope for mergers and acquisitions designed to rationalize corporate structures and modernize production and distribution processes.

Appropriate corporate governance structures capable of increasing firms' resilience and competitiveness remain essential. The Government recently announced a reform of Italy's cooperative banks that responds to needs identified long ago – by us, by the International Monetary Fund and by the European Commission – and now made more pressing by the transition to single banking supervision.

The reform would require the biggest cooperative banks to approve their transformation into joint stock companies, an ownership structure that gives them increased access to capital markets. Broader participation by shareholders in general meetings would reduce the risk of power becoming concentrated in the hands of organized minority shareholder groups. There would be a greater incentive to monitor the conduct of management. The cooperative bank model could still be used by small and medium-sized intermediaries, thereby preserving the cooperative spirit of those local communities to which it is well-suited. For these intermediaries too, the reform aims to strengthen several aspects of governance and to increase the incentives to invest in their capital.

In the mutual banking sector capital strengthening requirements can be hindered by these banks' special legal form. Weaknesses stem from their at times extremely small scale, with implications for costs and innovation, and from excessive concentration of credit risks. Greater consolidation, favouring the creation of groups, can improve operational efficiency and recourse to the market for aligning capital to risks. These objectives can be achieved without sacrificing the mutualistic traits typical of the cooperative model.

The launch of the single supervisory mechanism was accompanied by that of the single mechanism for resolving bank crises. European legislation in this area has already been drawn up. Italy is behind in the transposition of the Bank Recovery and Resolution Directive (BRRD). The deadline for its adoption was the end of 2014, but Parliament has yet to approve the enabling law and establish the national resolution authority.

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The monetary policy measures taken during the crisis, including the latest ones, the progress made in European economic governance, and the efforts of

national governments have reduced the uncertainty that in recent years has weighed so heavily on economic activity in the euro area. This progress must not be put at risk but rather reinforced by laying the institutional foundations needed to shelter the stability of monetary union once and for all from turbulence originating at local level and to guarantee lasting prospects for growth.

To strengthen monetary union permanently further steps must be taken towards political union, but the road ahead will be neither short nor smooth. In the immediate future, mechanisms can be identified to fill the gaps of an incomplete Union by bringing to a satisfactory conclusion the reforms already launched and exploiting fully the instruments to hand.

Banking Union can be, as originally intended, an important factor of stability for the euro area so long as we succeed in striking the right balance between the need to safeguard the stability of banks and that of enabling them to support the economy. Exploiting fully the flexibility allowed under the fiscal rules to finance reforms to correct structural weaknesses should help to prevent crises rather than merely controlling and managing their consequences. Over the longer term, a number of other areas for common action may also be identified, with a gradual, circumscribed pooling of financial resources.

In our country efforts to make the economic environment more business friendly must be pursued unstintingly. Any lasting recovery of investment requires savings to flow to firms not just through a fresh expansion of bank credit but also via increased direct access to capital markets, not confined to the largest firms. The most innovative sectors and those best able to create new jobs stand to benefit as a result.

