

European Parliament

Committee on Economic and Monetary Affairs

**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**

Brussels, Tuesday, 11 April 2017

Introductory Statement

Mr Chairman, Honourable Members,

I would like to thank you for inviting me here today and offering me the opportunity to clarify my views on matters relating to my institutional duties. I will start by focussing on the role that monetary policy plays in the euro area at this juncture, as well as on its limitations. I will then discuss the situation of Italian banks against the background of Italy's economic recovery.

Over the last few years the euro area has experienced a challenging environment indeed. Downward risks to price stability increased sharply after mid-2014. There was a material risk of expectations de-anchoring. The activation of 'debt-deflation mechanisms' would have had very serious effects on the economy in a situation of high levels of public and private debt.

I believe we at the ECB Governing Council adopted the right set of monetary policy measures to counter these risks. Official interest rates were progressively cut; those on the deposit facility for banks were reduced to negative levels, possibly the most 'non-conventional' element of our monetary policy. We supplied base money in very substantial amounts through the asset purchase programme. Finally, we offered banks rewarding refinancing conditions for providing more credit to the economy.

The impact of the overall package has been considerable and is still unfolding. Without it, inflation would have been negative in 2015 and in 2016; GDP growth would have been lower too. According to ECB estimates, which we share, monetary policy will raise GDP by more than 1.5 percentage points over the period 2017-19. We expect the effect to be somewhat stronger for Italy, at around 2 percentage points. The measures have also significantly lessened financial fragmentation in the euro area, favouring a more homogenous transmission of the monetary impulse and, in turn, an improvement in financing conditions for firms and households.

Although deflation risks have virtually disappeared, inflation remains subdued in the euro area as a whole. The positive dynamics of headline inflation over recent months largely reflects its most volatile components, such as energy and unprocessed food prices. Net of these items, core inflation remains very low, below 1 per cent. It is forecast to return only gradually to values consistent with price stability, as economic slack is progressively absorbed.

For this reason it is of the utmost importance, for the euro area as a whole, that we maintain the very favourable financing conditions needed to secure a durable, self-sustained and broadly-

based convergence of inflation rates towards our price stability objective. The asset purchase programme, which is set to continue at least until the end of next December, the low level of our policy rates, and the forward guidance constitute a package of mutually consistent elements. A reassessment of this package is not warranted at this stage. Before altering any component of our stance, we need to be confident that a convincing and self-sustained improvement in inflation and economic activity is taking place.

To date, we have not seen any sign that this accommodative stance of monetary policy is causing generalised imbalances in the area. The impact of monetary policy measures on bank profitability has in general been contained. Should any threat to financial stability materialise, macro-prudential measures should be used to limit the build-up of systemic risks and to smooth the financial cycle in particular sectors or geographical areas.

While monetary policy has been successful in warding off a deflation trap and no negative side effects have emerged so far, when it comes to achieving a durable recovery monetary policy cannot be left to itself. Aggregate demand must be supported by fiscal policy, whenever and wherever possible. At the same time, potential growth must be reinforced by adopting appropriate reforms to foster technological progress and strengthen human capital.

The very magnitude and diffuse nature of the challenges and changes we face – new technologies, global trade, demography, migration – demand a truly common strategy that goes beyond emergency response. It is a fallacy that we can direct the course of the economy and finance, patently global phenomena, from within the limited confines of individual European countries, but a common strategy is lacking.

As the crisis unfolded in recent years, measures to deal with the emergency were progressively flanked by reform of the governance of the European Union and especially of the euro area. These reforms, which began with intervention on public finance rules and macroeconomic surveillance, have marked further steps in economic integration: the European Stability Mechanism and the banking union are the most prominent examples. However, we seem to have lost momentum along the way.

Today, banking union – whose first pillar, the Single Supervisory Mechanism, has been put together in an extremely short time and at a difficult moment – remains incomplete. The capital markets union is an excellent project, but it is still at a very preliminary stage. In spite of the efforts of many, including members of the European Parliament, moving ahead towards fiscal union appears somewhat difficult. The legacy of the crisis has aroused fears and prejudices once thought

long buried. Distrust leads to disaccord; in the exasperated pursuit of mutual reassurance, looking only to short-term gain, the necessary steps are hard to take. Moving forward based on a series of compromises is becoming more difficult. I am convinced that true European integration can only be achieved through the carefully considered development of democratic institutions appointed to manage shared sovereignty.

The sovereign debt crisis was also a crisis of trust: interest rate spreads on sovereign bonds increased sharply amidst fears of a euro break-up and redenomination risk. The latter accounted for about two thirds of the increase in the interest rate differential between Italian and German sovereign bonds at the height of the sovereign crisis in 2011.

We may now say that Italy is coming out of the worst economic crisis of its history as a nation. From 2008 to 2013, as a result of a double-dip recession, GDP fell by almost 10 percentage points, industrial production by about a quarter, investment by 30 per cent, and consumption by 8 per cent.

Fiscal consolidation, even if pro-cyclical, was necessary to regain the trust of markets and to convince our partners of the country's resolve to address its imbalances. The primary budget balance had returned to surplus by 2011 and net borrowing was brought back below the threshold of 3 per cent of GDP in 2012. Keeping primary current expenditure in check played an important role: since 2010 it has recorded modest growth in nominal terms (around 1 per cent) compared with more than 4 per cent in the previous ten years.

As tensions in the sovereign market spread to banks, the latter's ability to access international funding was impaired and a credit crunch ensued, which added to the contractionary impulse coming from the much-needed fiscal consolidation. This was not offset by an acceleration in foreign demand, either from the rest of the euro area or from other countries. The aggregate fiscal stance of the euro area was also contractionary. Only monetary policy responded by fighting financial fragmentation and avoiding the looming financial meltdown.

Eventually, an economic crisis of these proportions could not leave Italian banks unaffected. Until 2012, the deterioration of bank loans appeared gradual and overall manageable. Still in 2013, the International Monetary Fund acknowledged the proven ability of the Italian banking system to contain the effects of the crisis and ensure adequate capitalisation by resorting to the market.

Subsequently, as the level of economic activity remained low longer than forecast by most national and international institutions and analysts, widespread company failures and job losses fuelled a further rise in non-performing loans. We estimate that without the double-dip recession, the gross stock of bad loans to non-financial firms would be about two thirds lower.

Nevertheless, at the origin of a number of banking difficulties we also find managerial decisions undermined by misconduct and incautious allocation of credit. It was a potentially devastating combination of factors. Yet, all things considered, the damage to the banking system was centred on few, clearly identified, banks. They have been, and still are, the object of intense supervisory monitoring and intervention.

Many risks have been eliminated or attenuated. European institutions continue to play a fundamental role in solving critical cases. The stock of NPLs is slowly but steadily declining, and the economic recovery will accelerate this trend, partly thanks to legislative and organisational changes to speed up credit recovery procedures.

The large volume of Italian NPLs requires careful management; the real magnitude of the problem, however, needs to be clarified through careful scrutiny of the specific conditions of each bank.

Last December bad loans and other NPLs on the balance sheets of Italian banks amounted to €173 billion net of write-downs, that is 9.4 per cent of total loans. Including write-downs, NPLs came to €349 billion, a figure which refers to the face value of the exposures and accordingly does not represent their actual weight in banks' balance sheets. Out of €173 billion of NPLs, €2 billion pertained to situations in which regular repayments may resume, especially if the recovery gains momentum. Net bad loans, i.e. exposures to insolvent debtors, amounted to €1 billion or 4.4 per cent of loans.

The majority of these bad loans are held by banks whose financial position does not require to sell them immediately. A good NPL management policy combines improving internal workout, choosing adequate governance and incentive structures, addressing problems relating to poor statistical information, and deciding whether to sell NPLs or externalise servicing to a specialised operator.

Of the total of €1 billion of net bad loans, only about €20 billion are with banks, significant and less significant, that are currently experiencing difficulties. The average book value of these assets is around 40 per cent of their face value. This is about twice the low prices currently offered by a few market specialists. Based on these prices, the additional provisions that such banks may need to book could be estimated at about €10 billion. This amount of additional provisioning is far

below the €20 billion fund set up by the Italian Government at the end of last year to support troubled banks. Moreover, it should not be forgotten that any public support would be accompanied by some burden sharing.

The NPL legacy comes from the past. Another and even more serious challenge for all European banks lies in the present and the future and has to do with technology and the shape of the market. Current trends are compressing profitability. It is time for a change in the business model of many banks. The extension of branch networks, the provision of services, and the use of technology must be reviewed in a bold and innovative spirit. This is essential for Italian banks if they want to compete effectively and maintain their stability.

The prospects for the Italian economy have been improving gradually but steadily in the last three years; the moderate recovery is a testimony to the effectiveness of the policies put in place, but also to the need for further intervention. The production of goods and services continues to increase in the current quarter, although the pace of recovery is slow and lags behind that of other large countries in the euro area. Domestic demand is benefiting from favourable monetary and financial conditions, as well as from a mildly expansionary fiscal policy. Labour market conditions have improved. Business confidence is increasing. Bank lending has continued to expand in recent months, even though it remains heterogeneous across firms.

Our latest forecasts suggest a further moderate strengthening of GDP growth. As in the euro area as a whole, the outlook, however, is clouded by risks, and tilted to the downside mostly by global geopolitical factors. Economic policy uncertainty – as measured by the most popular indicators – is at very high levels nationally, in the euro area, and outside Europe. Italy has been on a path of reform for a number of years now. Change is beginning to pay off. The effort to modernise the country must go on.