Financial Year 123



# The Governor's Concluding Remarks

Annual Report 2016 - 123<sup>rd</sup> Financial Year

#### Ladies and Gentlemen,

Carlo Azeglio Ciampi, President Emeritus of the Italian Republic and Governor Emeritus of the Bank of Italy, passed away on 16 September.

He joined the Bank in 1946, serving as Governor from 1979 to 1993. Immediately following his appointment he had to address the gravest banking crisis of the post-war period, with the Bank of Italy still shaken by the dramatic events that had seen its top management unjustly accused.

During his governorship, he achieved full autonomy of the central bank and created the conditions for bringing high inflation under control; he initiated the construction of a modern payments system, based on the technological infrastructure essential for a large market economy; he began the reform of the Bank's supervisory activities with a radical revision of the rules and the banking market.

Ciampi left a lasting imprint on the Bank's management, introducing into its institutional culture a working method based on teamwork and an ability to combine different skills. This method was a hallmark of his work in all the positions of high office that he held after leaving the Bank.

With his death, Italy has lost a great statesman, a firm believer in the founding values of democracy and in a united Europe, which he considered fundamental to guarantee peace, freedom, equality and prosperity. We are left with the principles that inspired his way of working: a sense of duty, respect for others and awareness of one's own responsibility. These values help us to understand what is meant by the phrase 'serving the general interest', Carlo Azeglio Ciampi's lodestar throughout his life.

In the last six years the monetary policy response to the financial crisis, the sovereign debt crisis and the risks of deflation have had a profound impact on the size and structure of the Bank of Italy's balance sheet. Assets increased by more than  $\in$ 440 billion to  $\in$ 774 billion. The portfolio of securities held for monetary policy purposes rose from  $\in$ 18 billion to  $\in$ 245 billion. Lending to banks grew by  $\in$ 157 billion.

As I recalled on 31 March in my report to the Ordinary Meeting of Shareholders, in which I also dealt with the capital reallocation process, the expansion of the balance sheet has not only increased profitability but also heightened risks; these have been addressed by the introduction of capital safeguards. The 2016 financial year closed with a net profit of €2.7 billion; after allocations to the ordinary reserve and dividends paid to the shareholders, €2.2 billion were allocated to the State, in addition to the €1.3 billion paid in taxes.

The institutional innovations in supervision and the resolution of banking crises have altered the responsibilities of the Bank of Italy, increasing its tasks. Our remit in the area of safeguarding financial stability has been expanded, while the Bank has strengthened its longstanding role in Europe as provider of high-tech payment, market and statistical services. Before the end of this year private operators will have completed their adhesion to the European securities settlement platform TARGET2-Securities, a complex infrastructure whose entry into full operation makes a crucial contribution to the process of integrating Europe's financial markets.

We give an account of last year's numerous organizational changes in the Bank of Italy's Report on Operations and Activities, which is published today together with the Annual Report.

At a time of profound technological innovation, these changes have contributed to a reduction in operating expenses, which have come down by 15 per cent in real terms since 2009. During this period the Bank's staff diminished by 870 to around 6,900. Today secondments to other European and international organizations number more than 150 and have increased sharply since the launch of the Single Supervisory Mechanism.

The Bank of Italy holds fast to its principles, mindful of the responsibilities entrusted to it by society and careful to use the resources at its disposal efficiently. My own personal appreciation, that of the Governing Board and the Board of Directors, goes to the women and men who work here: their personal and professional qualities, and dedication to the common good enable the Bank to look with confidence to the changes that the future will inevitably bring.

# The economic situation and monetary policy

The world economy is growing at a rate of more than 3 per cent, supported by expansionary policies in the main economic areas; the rise in investment is providing renewed vigour to world trade (Figure 1). Optimism prevails in the financial markets despite the uncertainty connected with the future stance of economic policies in the United States, the United Kingdom's exit from the European Union, the high level of debt in various parts of the world, and persistent geopolitical tensions.

In the euro area growth is strengthening, led by consumption and investment in capital goods. In 2017, GDP is expected to grow by almost 2 per cent in the euro area, around twice the rate for Italy. Consumer price inflation, which had been practically nil since the end of 2014, has picked up in the last six months, sustained mainly by the rising prices of energy and food products. According to the European Central Bank's March projections, consumer price inflation in the area will be 1.7 per cent for the year as a whole, but scarcely 1.1 per cent net of the most volatile components (Figure 2). The corresponding figures for Italy are just under 1.5 and 1 per cent.

Economic activity and inflation are benefiting from the strongly expansionary stance of monetary policy; fiscal policies are on the whole neutral. The measures we have adopted in the Governing Council of the European Central Bank since mid-2014 have succeeded in averting the risk of a deflationary spiral which, given the high level of debt, both public and private, would have had severe depressive effects on the economy of the entire area. Since March 2016, when the asset purchase programme was expanded, the probability of deflation implied by option prices – which had exceeded 30 per cent at the beginning of 2015 – has gradually diminished and is now almost nil. The downward trend in medium- and long-term inflation expectations has come to a halt.

The objective of price stability in the euro area – a rate of inflation below, but close, to 2 per cent sustainable over the medium term – has yet to be achieved. Core inflation remains constrained by unemployment in many euro-area economies and by sluggish wage growth, even in the countries with better labour market conditions. The normalization of inflation expectations still has to be consolidated. Credit demand remains weak.

A highly accommodative monetary policy is needed to achieve the full convergence of inflation to the ECB's objective. A change in the monetary policy stance, to be implemented with the requisite graduality, will serve as confirmation that demand growth and price stability can be self-sustaining in the medium term.

Long-term interest rates are very low; besides monetary conditions, this reflects the depth and exceptional length of the recession. Owing to the still high level of debt, it will take more time than in past cyclical recoveries to regain suitable levels of investment demand and, therefore, profitability. Structural factors, such as the slowdown in productivity growth and the effects of demographic trends, are playing a role in keeping yields down.

Monetary policy alone cannot guarantee a return to strong and steady growth. The structural problems affecting the national economies must be

tackled by expediting the necessary reforms. Where public debt is especially high, deficit and debt reduction must be pursued decisively, with a budget composition that is more conducive to growth; where debt is lower, it is possible to support internal demand, especially through investment in infrastructure in order to avoid an overly large net external position which could provide an argument for protectionist policies.

Italy's economy, though still weak, has been expanding for two years. The cyclical improvement is spreading to most industrial sectors; positive signals have also recently emerged in services and construction, mainly in residential housing, which is benefiting from tax incentives for the renovation of existing homes and from low interest rates. Activity in non-residential building is struggling to gain traction, owing to sluggish public investment.

The improved performance of Italian exports, which has kept pace with the increase in world trade, continues to be coupled with a moderate increase in household expenditure, driven by the favourable outlook for income, and more recently, a recovery in private investment. The greatest increase has been in purchases of capital goods, which have a direct impact on the economy's potential output; this type of investment grew almost 5 per cent last year but is still 14 per cent below the 2007 peak.

Italy's southern regions have also posted growth. Positive indications, though less widespread with respect to the Centre-North, are nonetheless discernible from the data collected by our branches from local economic operators. The gap with the rest of the country remains wide, with a difference of more than 40 per cent in GDP per capita. The balanced development of Italy's economy necessarily depends on removing the obstacles, not only of an economic nature, that impede the recovery of Italy's South.

Overall, there are still ample margins of slack and firms' demand for labour is insufficient. This is reflected in the performance of prices while wage growth remains very subdued. Consumer price inflation was slightly negative on average in 2016. Core inflation decreased to 0.5 per cent, but we expect it to increase gradually.

At the current rate of growth, GDP would return to its 2007 level in the first half of the 2020s. Apart from cyclical factors, Italy's economic development is hampered by rigidities in the business environment, the slow growth of productivity, and an insufficient employment rate. Decisions to invest can be encouraged by continuing the reform effort to favour business activity. The positive signals that have emerged must be consolidated. A growing number of firms consider the tax incentives introduced for the purchase of capital goods

to be significant; this year they have been expanded to include investment in advanced digital technology.

#### The years of crisis

Ten years marked by a double-dip recession – first, the global financial crisis, then, the sovereign debt crisis – and the risk of a deflationary spiral have weighed heavily on the euro-area economy. Euro-area GDP fell by 4.5 per cent during the first crisis and, after recouping 3.5 percentage points, by over 1 per cent during the second, with sharply varying trends from country to country. It was not until 2015 that the economy regained 2008 levels (Figure 3).

Some countries were especially hard hit. The Italian economy suffered the worst years it had ever experienced in peacetime (Figure 4). The effects of the double-dip recession proved to be worse than those of the Great Depression. From 2007 to 2013 GDP fell by 9 per cent; industrial production declined by almost a quarter, investment by 30 per cent, consumption by 8 per cent. Today Italy's GDP is still more than 7 per cent below what it was in early 2008; in the rest of the euro area it is 5 per cent above that level.

The problems were exacerbated by the vulnerabilities of EU institutions and macroeconomic and financial imbalances whose importance had long been underestimated in a number of countries. Following Economic and Monetary Union, integration had progressed slowly on the assumption that common rules and market forces would make up for the lack of a unified government policy approach.

Nevertheless, the reaction to the global financial crisis was coordinated and incisive. As early as the end of 2008 the major central banks were providing ample liquidity and cutting official interest rates in concert, an unprecedented development; they eventually reduced them even further, to historic lows. At the same time, the European Council approved a macroeconomic support plan. Almost all the countries adopted expansionary fiscal policies; many took measures to stabilize the banking and financial system. In April 2009 the members of the G20 agreed on further actions.

Unlike other countries, Italy suffered from the slowness with which it had undertaken the modernization necessary to cope with the challenges of globalization, technological change and monetary union. Structural weaknesses amplified the repercussions of the crisis and further delayed recovery. Between 2007 and 2009 GDP fell by 6.5 per cent, recouping more than 2 percentage points over the next two years. In 2011 industrial production was still 15 percentage points below its pre-crisis level, while Germany's industrial output

had in large part recovered; the volume of German goods exports had already regained 2007 levels, while Italian exports were still 5 per cent below them.

During that phase, in many countries the financial support provided by governments to banks was considerable; at the end of 2011 the impact of State aid on public debt amounted to 48 per cent of GDP in Ireland, 11 per cent in Germany, and 7 per cent in the Netherlands and Belgium. In Italy, it came to 0.2 per cent of GDP, reflecting the limited exposure of our banks to the structured finance products that had triggered the financial crisis.

The response to the sovereign debt crisis in the euro area that began in 2010, after the true state of Greece's public accounts came to light, was not so rapid or adequate. The incompleteness of the European construction, with its lack of institutions for managing member state financial crises, contributed to this delay.

Concerns about the resilience of the economies that were affected by imbalances in banking systems, balances of payments and public accounts, triggered market turmoil. Borrowing conditions became prohibitive for Ireland and Portugal which, as Greece had already done, requested financial assistance programmes in autumn of 2010 and spring of 2011. Tensions then spread to Italy and Spain, with the dramatic widening of the differentials between their government bond yields and those of Germany. The problems in the government securities market extended to the banks, whose credit ratings were equated to those of their sovereign; the consequent tightening of the credit supply contributed to the start of a new recessionary phase; fears mounted for the break-up of the single currency.

To defend the sustainability of the public debt, fiscal policies took on a restrictive stance in the countries that had agreed to assistance and in those that feared loss of access to financial markets; an analogous policy was adopted in other countries as well, including Germany. The lack of a common budget precluded supranational action to counteract the strong procyclical impulse of national policies.

At that time macroeconomic conditions in Italy were deteriorating much more rapidly than indicated by our projections and those of the leading international organizations. In January 2012 we forecast a 1.5 per cent drop in GDP (0.4 per cent under a less unfavourable scenario) for 2012 and 2013; in the summer this forecast was revised to 2.2 per cent; in the end, the decline amounted to 4.5 per cent. This result was due in part to the deceleration in international trade and the collapse in confidence in euro-area prospects, which amplified the effects of credit tightening and the budgetary adjustment.

In the final months of 2011, monetary policy took on a clear expansionary tone, reinforcing the measures to counter the serious liquidity shortfalls in the banking system and the consequent fragmentation of financial markets. But the need for intervention to safeguard the single currency struggled for recognition in an environment in which tensions were blamed largely on the deterioration in national outlooks for growth and public finances and not also on a systemic risk, such as the potential break-up of the monetary union.

After overcoming the differences of opinion on this issue, in the summer of 2012 the ECB Governing Council authorized the purchase of the government securities of countries in difficulty. The announcement sparked an immediate improvement in financial market conditions and fostered a resurgence of capital inflows to the countries affected by the crisis.

Monetary measures, European institutional reforms, the credibility gained thanks to the corrective measures of national governments, and the agreements on financial assistance to the Spanish banking system and on the renewal of aid to Greece, all helped to ease financial tensions, bringing interest rate spreads back to regular levels and setting in motion the normalization of economic conditions within the euro area.

A contributing factor in this result was the decision to implement the project for Banking Union: the complexity of the reform and the commitment to carrying it out within a very short time frame, at least as regards the Single Supervisory Mechanism, were signals of the strong determination to continue on the path to integration. I have often remarked on the difficulties stemming from the incompleteness of the new framework and the lack of consideration of the risks associated with implementing the new legislation on banking crisis resolution.

# Two sources of weakness

The consequences of the double-dip recession for Italy are most clearly observed in the behaviour of two variables, radically different in nature and dimension, which owing to their rate of growth and current level are frequently cited as Italy's main problems: namely, the public debt and the loans defined as 'non-performing' held by banks. These are sources of weakness that limit the room for manoeuvre of the State and of financial intermediaries; both make the Italian economy vulnerable to market turmoil and can amplify the effects of cyclical fluctuations.

In order to assess these sources properly and identify the best strategies to manage their impact, we must first recognize their close connection with the problems of the economy as a whole. On both fronts we must continue to act, with resolve and clarity of purpose, to preserve and reinforce the trust of those who deposit their savings and invest in Italy and its banks.

#### The public debt

The ratio of debt to GDP has been at high levels for over thirty years now. Notwithstanding the reduction that began in the mid-1990s, at the outbreak of the crisis it was still close to 100 per cent. Since 2008 it has risen rapidly, to the point of exceeding 130 per cent (Figure 5). Not counting the Treasury's liquid assets, last year the ratio basically stabilized. Following the most turbulent phase of the sovereign debt crisis, fiscal policy has accompanied the expansionary monetary policy stance, mediating between the necessity of holding debt in check and that of supporting the recovery.

Since 2008 the increase in the ratio of debt to GDP has essentially been attributable to the poor performance of the latter. Had real output grown at even the low average rate recorded in the years between the launch of Economic and Monetary Union and the onset of the financial crisis, and had the rise in the deflator been consistent with the ECB's inflation aim, the larger denominator alone would have determined a debt-to-GDP ratio today comparable to what it was in 2007. Without the crisis, higher growth would also have enabled deficits to be brought down and avoided the need to provide financial support to other countries; the ratio would have been even lower as a result.

Long-term projections such as those made periodically by the European Commission indicate no significant risks to the sustainability of Italy's public debt. This is thanks to the reforms that have assured the financial equilibrium of the pension system, wiping out almost one third of the implicit pension liabilities accrued up to the early 1990s and enabling it to withstand adverse demographic or macroeconomic shocks.

Italy's high public debt is nevertheless a source of vulnerability and acts as a brake on the economy. It makes it more costly to fund productive investment by the private sector; it induces greater recourse to distortionary tax systems, with adverse effects on the capacity to produce income, save and invest; it stokes uncertainty, another way in which it discourages investment; and it leaves less room for macroeconomic stabilization policies. The high debt also exposes the country to a loss of market confidence and phenomena of contagion. The exceptional and abrupt widening of the spread between Italian and German government bonds at the height of the crisis was proof of this; the increase recorded in the last eight months is another such reminder. Every year market placements of debt securities issued by the Italian State amount to around €400 billion.

An appreciable and lasting decline in the debt-to-GDP ratio must commence without delay. There must be no repeat of past errors: the failure to reduce the ratio of debt to GDP sufficiently in good economic times forced us to make procyclical adjustments during the crisis.

In this current phase of – moderate – recovery, durable consolidation can be pursued through prudent budgetary policies, designed not only to lower the deficit but also to review the composition of expenditure and revenue. Economic growth can be strengthened and the reduction of the debt ratio facilitated by giving greater scope to public investment, rethinking the structure of government transfers, tax subsidies and exemptions, rebalancing the tax burdens on the various sources of income and redoubling efforts to combat tax evasion.

With annual growth of around 1 per cent, inflation at 2 per cent, and with the average interest rate on the debt gradually regaining pre-crisis levels, a primary surplus (net of interest payments) of 4 per cent of GDP, which is basically consistent with the Government's policy scenario, would bring the debt-to-GDP ratio below 100 per cent in around ten years. With higher growth, achievable as part of a package of incisive reforms, a recovery in investment, and a different composition of the public budget, this could happen even faster.

Italy has already shown it can deliver and maintain a large primary surplus: between 1995 and 2000 this averaged almost 5 per cent of GDP. Other countries have done even better and for longer periods of time; between 1995 and 2007 the primary surplus averaged more than 6.5 per cent of GDP in Canada and about 5 per cent in Belgium, Denmark and Finland. That is no small achievement, but it is not beyond our reach. According to the Government's plans, to meet the objectives outlined in the Economic and Financial Document and avoid next year's scheduled VAT hike will require the definition of corrective measures in the order of 1.5 percentage points of output in the three years 2018-20.

A constant, protracted effort to keep the public accounts under control is indispensable to a lasting reduction in the ratio of debt to GDP against a backdrop of a return to stable growth. This would have positive effects on confidence, economic activity, and interest expenses. While not the only answer, given the constraints on public real estate assets and their heterogeneity, and the characteristics of the State's portfolio of shareholdings, privatizations could help to speed up the reduction of the debt.

# Non-performing loans

The repercussions of the crisis could not but affect banks' balance sheets. Between 2007 and 2015 the ratio of bad loans to total loans i.e. exposures to insolvent debtors, more than tripled, reaching a level that was still below the peak recorded in the mid-1990s (Figure 6). In several cases, banks' difficulties were exacerbated by fraudulent conduct and imprudent lending policies.

At the end of 2016 Italian banks' non-performing loans, recorded in balance sheets net of write-downs, came to €173 billion or 9.4 per cent of total loans. The €350 billion figure often cited in the press refers to the nominal value of the exposures and does not take account of the losses already entered in balance sheets and is therefore not indicative of banks' actual credit risk.

Of the €173 billion in net non-performing loans, €81 billion or 4.4 per cent of total loans were classified as bad loans, against which the banks hold real collateral and personal guarantees of over €90 billion and almost €40 billion respectively. The remaining €92 billion are other non-performing exposures, whose nominal value has already been written down by roughly a third. For some of these, a return to regular payments is certainly possible, though to what degree will depend on the timing and strength of the recovery; active management of the positions on the part of the banks is indispensable if the share that become bad loans is to be reduced significantly.

Three quarters of net bad loans are held by banks whose financial conditions do not require their immediate disposal on the market. Those held by intermediaries experiencing difficulties, which could find themselves obliged to offload them rapidly, amount to around €20 billion. As we have documented, bad loans are recorded in banks' balance sheets at values consistent with the recovery rates actually observed in the last ten years. If they were sold at the very low prices offered by the few large specialist debt collection agencies active in the market today, which pursue very high returns, the amount of additional write-downs would be in the order of €10 billion.

At the end of 2011 net bad loans held by Italy's banks made up 2.9 per cent of total loans. A 'system-wide' intervention on non-performing loans, involving substantial public funds along the lines of what occurred in other countries, appeared neither justified nor feasible. The increase in bad loans was not concentrated in any specific sector of the economy; the macroeconomic predictions made in the course of 2012 were much more favourable than the results actually achieved. As the sovereign debt market strains grew more acute, government intervention on non-performing loans appeared incompatible with the state of the public finances.

In the years immediately following the picture changed rapidly. The recession proved much longer and deeper than originally forecast; the attendant rise in business failure rates and unemployment fuelled the growth of net bad loans, which in 2015 reached 4.8 per cent of total loans. The abatement of the tensions on sovereign debt markets, which began in mid-2012, gathered

momentum in 2013, and at that point made desirable the establishment of a publicly supported company to manage banks' non-performing assets, a possibility which we actively supported. Its fruition was, however, impeded by the position on State aid adopted by the European Commission in mid-2013.

In part following the proposals drawn up by European institutions, in recent months the idea has been mooted again. We remain convinced of its potential usefulness, provided that the asset sale prices are not excessively detached from their real economic value, banks' participation in the scheme is voluntary, and the restructuring plans of the participating banks are properly defined ex ante. Whether or not there is a real determination to proceed down this path must be clarified without delay: uncertainty slows the conclusion of the transactions under way and discourages those that could be completed in the coming months.

In 2016 the flow of non-performing loans declined, as did the ratio of non-performing loans and that of bad loans to total lending. The ongoing recovery supports this trend. The sales currently scheduled by the major groups could raise the reduction in the net bad loan ratio significantly.

The large stock and low market prices of non-performing exposures reflect Italy's excessive time to recovery, which is far longer than in the other main European countries. At the end of 2015 recovery times averaged almost eight years for bankruptcies and over four years for property foreclosures. Legislative measures taken in recent years go in the right direction but must be strengthened to ensure a sufficient shortening of recovery times. It would be especially useful to increase the degree of specialization in the handling of insolvency cases, providing for the centralization of the more complex proceedings, including by reviewing the territorial jurisdiction of Italy's courts.

For their part, the banks must make the best possible use of the instruments already available in the form of out-of-court agreements with firms on debt restructuring and the transfer of real estate pledged as collateral. As recent analyses by the Bank of Italy have shown, incentives for the disposal of non-performing loans would derive from the removal of the regulatory disincentives that impede the sale of large amounts of these assets by banks that use advanced internal models for calculating capital requirements.

Sufficient and timely information makes the management of non-performing assets less costly, increasing their value; harmonization at European level would facilitate cross-data analysis, with positive effects on the prices and speed of the transactions. The new reporting on bad loans that we introduced last year is a step in this direction, inducing banks to manage these exposures more actively and effectively.

Supervisors are mindful of the need to refrain from imposing blanket sales of non-performing loans, which de facto lead to a transfer of resources

from Italy's banks to a handful of specialized investors. However, as indicated by the recent guidelines issued at European level and drawn up with the active contribution of the Bank of Italy, the largest intermediaries (classified as 'significant' within the Single Supervisory Mechanism) must adopt strategies to improve the management of these assets together with ambitious operational plans to ensure their substantial and progressive reduction. Possible options include: the creation of separate and specialized management units, recourse to external managers, the sale of the portfolios on the market. We are working to extend the guidelines to the banks under our direct supervision.

#### Labour and growth

It is in the labour market in particular that we see the most painful legacy of the crisis: in 2014 the unemployment rate came to nearly 13 per cent, more than double that of 2007 (Figure 7); unemployment among young persons aged 15 to 24 increased from 20 to over 40 per cent; the figures are higher in the South. The gap between the quality of the positions offered and workers' expectations widened: nearly all fixed-term employees would prefer a permanent position, while two thirds of part-time workers would like a full-time job, compared with two fifths ten years ago. Households' living standards have fallen, especially for the most disadvantaged.

There has been some improvement in the last two years thanks to the cyclical recovery, social security contribution relief and measures to improve the efficiency of the labour market. However, at the end of 2016, less than 60 per cent of people aged 20 to 67 were employed and only one out of two women. About a quarter of people younger than 30, and a third in the South, were not in education, employment or training. These figures are far from those of most other European countries.

The question of labour is central. It relates to social integration and personal identity. On the economic level, it should not be seen solely as a cyclical problem: the economy's growth potential depends on the quantity and quality of the labour force and the capacity of the productive economy to provide adequate employment. Demographic and technological tendencies play an important role, destined to increase in the years to come.

According to Istat, whose forecasts even assume a net annual influx of about 150,000 migrants, the number of people aged 20 to 69 will fall by nearly 7 million in the next 30 years. The population older than 70 will increase to about 30 per cent of the total, with important repercussions on the composition of employment and further growth in the demand for jobs in personal care, assistance and health, which in the past 20 years have accounted for over a

third of the increase in employment. Increased labour market participation and the efficient and rational inclusion of migrants will be essential to Italy's future development. But productivity must return to growth.

Italy's economy, much of which lags far behind in the adoption of new technologies, suffered from excessively slow total factor productivity growth well before the onset of the crisis (Figure 8). It averaged annual growth of just 0.2 per cent between 1995 and 2007, roughly a quarter of the rate estimated for France and Germany; and in recent years it has recouped only a small part of the substantial decline experienced during the crisis. The gap with the other countries is particularly wide for small firms (with fewer than 20 employees), which account for 55 per cent of all workers in industry and in non-financial private services.

To avoid negative effects on the living standards of Italians, we must bridge this gap and take part in the ongoing digital revolution. Some have predicted that technological progress will sharply reduce jobs and increase inequality. But others maintain that the creation of new occupations will compensate for those supplanted by machines, as has been the case historically. Estimating these consequences is difficult, but the Italian economy appears vulnerable to the processes of automation: according to recent estimates by the OECD, the risk is very high for a tenth of all occupations and high for up to half.

Economic policy must take into account the risks and opportunities that stem from these long-term trends, in pursuit of the objective, which is no longer deferrable, of aligning the Italian economy with global dynamics. There is no alternative to increasing productive efficiency, and managerial and administrative capacity: only innovation in the production of goods and services can simultaneously ensure higher incomes and raise the quantity and quality of employment.

Improvements are emerging in the sectors where competitive pressures are strongest. In manufacturing, productivity has benefited from a shift of resources towards the more efficient firms, a trend that was under way before the crisis and has picked up further in recent years. The transformation is evident among firms active in international markets: the share of exports from medium- to large-sized firms, which are capable of keeping pace with global demand, has increased progressively. This change must extend to the entire productive system, particularly the service sector where the qualitative and technological lags by comparison with Italy's main competitors are most severe.

In the past the attempt was made to cope with these changes by means of cost reduction alone, especially labour costs. The benefits obtained in terms of employment, while significant, proved ephemeral, because they were not accompanied by the structural change required in many parts of our productive economy. In order for a larger and more highly skilled labour

supply to be fully utilized in jobs that satisfy the legitimate expectations of the younger generations, there must be a qualitative leap to help foster innovation and improve the mechanisms that drive resource allocation. To this end, the convinced participation of all concerned is needed: businesses, workers, and public administrators.

Over the last five years we have entered an intense period of reform. The aim is to increase the efficiency of the productive economy by modifying the legal framework for economic activity and by intervening on the functioning of the product, capital, and labour markets. We have begun a process designed to enhance efficiency of the public administration and the civil justice system. The battle against corruption has been stepped up. Measures have been introduced to reduce the costs and time needed for firms to enter and exit the market. Provisions have been made to facilitate a change in the composition of payroll employment towards open-ended contracts; active policies in favour of employment have been launched; unemployment benefit programmes have been reviewed.

These are the first steps on a long path, which must be followed resolutely, monitoring the implementation of the measures taken. The reform efforts must also be directed at encouraging new business ventures, increasing competitiveness in key service sectors, further simplifying crisis management procedures, reducing handling times in the courts to levels comparable to those of other advanced countries, and eliminating the regulatory and fiscal disincentives to the expansion of firms.

Regulatory reform is a complex process whose benefits are not immediate. It must be accompanied with measures to foster the continuous creation of new jobs, also in the short term. Encouraging results have stemmed from the introduction of allowances commensurate with increases in corporate equity, tax breaks for investment in the capital of innovative startups, and the creation of national venture capital funds based on the cooperation of the public and private sectors. The national plan 'Industry 4.0' introduced a series of measures to encourage the adoption of the new digital and automation technologies.

Ample room for rationalization remains in the allocation of public resources, which must be directed to serve medium- to long-term objectives. Spending on public investments must return to growth: falling since 2010, its ratio to GDP was slightly higher than 2 per cent in 2016, about 1 point less than pre-crisis levels and among the lowest in the euro area. An increase in the resources dedicated to the renovation of existing public and private buildings, the prevention of hydrogeological risks, and the reduction of earthquake damage would have appreciable effects on employment and economic activity, and to a greater extent in the Centre and South. This is not a task that the State can undertake on its own; the private sector must be involved.

To deal with change and seize the opportunities offered by the predictably profound transformation of the technological paradigm, economic policy must engage above all with human capital. In Italy, both formal education levels and reading comprehension and logical and analytical skills, are far below those of the other advanced countries, even among the young. There are widespread shortcomings in the school system and in higher education; private and public funding of research and instruction at university level remains very low by international standards. Also on account of the technological lag, many sectors of the productive system have little inclination to invest in on-the-job training, or, more generally, to offer opportunities to qualified workers; in the end, the returns on education are low, reducing the incentive for young people to improve their skills. Investing in education and knowledge creates citizens who are more aware and workers who are better able to discharge rapidly changing tasks and functions. This is an essential condition to the more equitable distribution of labour and its remuneration.

The effects of the reform will require time to materialize, relying as they do on the behaviour of citizens. The reforms will not suffice if the presence of firms whose profit margins depend on illegal activity, tax evasion and corruption continues to be widespread. These practices distort competition and reduce the resources available to invest in infrastructure and services for the community and in higher value-added projects. Illegality in all its forms is a source of injustice and the cause of diminished economic well-being.

# Banking supervision and the challenges for banks

During the years of crisis, banking supervision was engaged on several fronts. Liquidity checks were intensified, and at the moments of greatest tension conducted intraday. The volume of assets eligible as collateral for Eurosystem or market funding grew substantially.

A series of targeted inspections that commenced in the second half of 2012 resulted in significant value adjustments in respect of non-performing loans. Between 2009 and 2014 coverage ratios rose by 5 percentage points for the major banks and by almost 11 points for the others; today these ratios are higher than the European average.

We have urged – and where necessary required – banks to attain higher levels of capitalization; this action continued with the launch of Banking Union, even at times of tension in the credit and capital markets. Between the onset of the crisis and the end of 2016, the CET1 ratio of capital to risk-weighted assets was raised by 4 percentage points for the leading banks, to 10.4 per cent on average, and by 5 points, to 15.5 per cent for the rest of the system.

In an economy in which four fifths of firms' financing comes from banks, as I observed earlier the contraction in economic activity inevitably had repercussions on the banks. Their profitability and capacity to generate capital deteriorated, as revenues diminished while loan losses increased. On average in the three years 2013-2015 loan losses wiped out 90 per cent of their operating profit.

The benefits of the economic recovery are now slowly showing up in banks' balance sheets. Last year's negative results partly reflect the low level of interest rates and one-off costs sustained to incentivize early retirements; another contributing factor was the substantial write-downs on loans made in the closing months of 2016. In the first quarter of this year the operating profits of the leading groups held broadly stable, while write-downs were reduced by about a fifth. Lending to the non-financial private sector continued to grow at an annual rate of around 1 per cent. The success of the UniCredit Group's very substantial capital increase on the market is an important marker of confidence.

The crisis struck especially those banks which were already weak, owing in part to shortcomings in corporate governance and imprudent – in some cases illicit – granting of credit. This was the case of the four banks placed in resolution at the end of 2015 and of the groups currently engaged in capital strengthening.

In cases of serious irregularities, we imposed the most severe sanctions applicable under the law. In cases of malfeasance, suspected offences were promptly reported to the judicial authorities, initiating our cooperation during our on-site inspections.

The major reforms enacted in recent years were designed to correct the shortcomings of banks thrown into relief by the crisis. Since the end of 2015 eight of the ten largest cooperative banks, whose operations extend far beyond the sphere of the local community, have been transformed into public limited companies. The reform has strengthened the incentives for monitoring the activities of these banks' directors, improved transparency in corporate management and enhanced their capacity to tap the capital markets. It provides for increased members' attendance at meetings, defusing the risk of concentration of power in the hands of organized minorities. The merger of Banco Popolare and Banca Popolare di Milano at the start of this year created the third largest banking group in Italy. Mutual banks, with the reform currently being implemented, can have recourse to the market and increase their support for local economic activity with greater efficiency and security while preserving the mutualistic spirit that distinguishes them.

Our supervisory activity was conducted during a period of intensive change in international and European banking regulations. Above all, the design of a new system for managing bank crises and, before that, the more restrictive interpretation of the rules on State aid, marked a radical new departure, as I have observed on several occasions. In the downturn the risks of the transition were underestimated. In applying the new rules, financial stability must not be jeopardized. In adherence to the principles underpinning the new European rules, authorities' interventions must be designed to preserve the value of banking activity, to the benefit of savers and borrower firms. We cannot run the risk of undermining confidence in the banks and in the savings in their custody.

Effective crisis management requires extremely prompt and decisive action, close cooperation among all those involved, and the clear definition of responsibilities and priorities. This is how in the past even severe strains were overcome in Italy without damage to savers or the credit system as a whole. Today, under the new European arrangements, crisis interventions are assigned to multiple, mutually independent authorities and institutions, both national and supranational, with decision-making processes relatively incompatible with rapid intervention. Effective coordination is lacking.

In market conditions in which the transfer of banking assets is very difficult, the competent European authorities now treat preventive intervention by deposit protection funds as equivalent to State aid, even though these funds are completely private and their utilization is determined by entrepreneurial considerations, not by interventions by authorities. The use of public funds, even though it may be economically and financially advantageous, is subject to stringent limits even after shareholders and subordinated creditors have been bailed-in.

In recent weeks, at the end of a laborious and complex process, the procedure for the sale of three of the four banks placed in resolution was completed; for the fourth, the process is nearing conclusion. Negotiations are continuing between Italian and European authorities for precautionary public recapitalization – an instrument envisaged by the Bank Recovery and Resolution Directive – of Banca Monte Paschi di Siena, Banca Popolare di Vicenza and Veneto Banca. Negotiations are at an advanced stage for the sale of three small banks to a large French banking group, with the financial and operational intervention of a voluntary fund constituted by most Italian intermediaries.

The banks under our direct supervision are continuously monitored, which involves intense on-site inspection activity as well as off-site analysis. In years past these checks have enabled us to resolve problems in the areas of corporate governance, organization, and risk management. In 2016 we conducted 95 inspections of banks under our direct supervision, in line with the average of recent years. In most cases the inspections embraced the whole spectrum of the bank's business. The checks on credit risk, which centre on loan classification and the adequacy of the banks' write-downs, are very thorough; a selection of individual loans are screened and a very large proportion of the entire portfolio is checked.

For the 101 banks (not counting mutual banks) under our direct supervision, last year the prudential review process produced positive assessments in 60 per cent of the cases. The 35 per cent that were put on a 'watch list' will be subject to more intensive and stringent controls and interventions. The remaining 'critical' assessments referred to small banks at which corporate reorganizations and recapitalizations are now under way, among other purposes to deal with the potential capital shortfalls that emerged following the assessments of the effects of adverse scenarios.

In the mutual bank sector, in the three years 2014-16 on-site inspections were carried out at two thirds of the sector's 330 banks; 60 in 2016 alone. Also in this case the problems that emerged consequent to the prudential review involved only a limited number of intermediaries, at which interventions are under way or nearing completion to resolve the difficulties with a view to their inclusion in the larger groups that will be created as a result of the reform. For two large groups, together with the ECB in 2018 we will conduct a comprehensive assessment like that held in 2014 for the banks subject to joint European supervision.

At the Italian banks classed in 2016 as significant, 34 inspections were made last year on behalf of the Single Supervisory Mechanism, conducted mostly by Bank of Italy inspectors, and in the most important cases with the participation of staff from other member country authorities. Another 11 inspections dealt with questions of transparency and money laundering at those banks. Our inspectors also took part in checks at large foreign intermediaries.

In exercising the powers and duties that the law assigns to the Bank of Italy in the area of banking products, in 2016 we reminded 90 intermediaries of the need for full and prompt compliance with the rules on transparency and correctness in customer relations. Appropriate corrective measures were required and sanction proceedings initiated where necessary. As a result of these controls, banks refunded some €35 million of improperly debited fees to customers. The activity of the Banking and Financial Ombudsman, to which the Bank of Italy provides organizational support, is expanding rapidly. In 2016 alone the Ombudsman received some 22,000 complaints and handed down 14,000 decisions, three quarters of them in favour of the customer. Although these decisions are not binding, in virtually all cases the bank abided by them; this resulted in the refunding of another €13 million. The Bank of Italy's controls in this area are complemented by our financial education initiatives; we are taking an active part in the launch of a national financial education strategy.

The revision of Italy's anti-money laundering regulations for implementation of the fourth European directive has now been completed. The new framework confirms the role and organization of the supervisory

authorities and Italy's financial intelligence unit (UIF). The Unit's position within the Bank assures its independence and effective preventive action. In its ten years of existence our system has worked well, as is shown by the declining number and decreasing gravity of the criticisms raised in the course of inspections, the growing cooperation of financial institutions in reporting suspicious transactions, and the important contribution of the UIF to investigative and judicial activities. Given the high threat of terrorism, procedures for investigation and cooperation, including at international level, have been finalized to intercept and counter terrorist financing.

Today, Italian banks are called on to change in order to bring profitability back up to adequate levels. This is the spirit in which they must address the challenges of technological progress and the evolving structure of markets. They must proceed resolutely in the rationalization of branch networks, the even radical overhaul of governance structures, and the reduction of the cost of labour, at all levels. The spread of new forms of financing of the economy alternative to bank credit, involving the direct access of firms to investors and the capital market, may enable the banks themselves to broaden and diversify their sources of income. A significant contribution can come from corporate finance and asset management services; these lines of business, while permitting less stringent capital requirements, demand special attention to ensuring correct relations with customers.

The growth of forms of intermediation hinging on the use of technology heightens competition and itself makes possible a wider range of services. Digitalization also comes with operational risks, however, and makes infrastructures vulnerable to external attacks. Customers' confidence depends crucially on transparent information, correct conduct, and data security. The computer emergency response team formed together with the Italian Banking Association and the participation of banks and other financial sector entities is acting effectively. International coordination for IT security is indispensable. Within the framework of the G7 a programme of cooperation has been initiated with the objective of developing common lines of action to strengthen the protection of financial entities, private and public alike.

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The global economic scenario has been transformed by sweeping commercial, financial, technological and demographic change. Italy has struggled to respond, and this explains the difficulties it has encountered in lending vigour to the strengthening recovery.

The need to exit the crisis has called for, still calls for, an exceptional effort. Just as exceptional is the commitment necessary to return to a path of stable, high growth and to resolve the question of jobs, which are so difficult to create, maintain, and transform, a question that is of vital importance today not only in the economic sphere.

The main lesson of the crisis is that imbalances must be corrected quickly, otherwise sooner or later the price will have to be paid. On the subject of reforms, on the state of the public finances, on banks, we must keep moving forward, not backward. The structural adjustment of the economy requires the continued removal of restrictions on business activity and further encouragement of competition and innovation.

We must remain open to technological progress because there is no alternative if we want to create jobs and well-being. The choice of economic policies and the decisions made by each of us require a comprehensive vision: to respond to these challenges we need to invest heavily in knowledge and in new and interconnected skills, essential to combatting the threats to employment and attenuating the inequalities that the digital revolution risks accentuating.

Italy must take advantage of the consolidating recovery to accelerate the necessary structural adjustment to the public accounts; the high public debt is a serious source of vulnerability which weighs on the country's economy. A credible debt reduction plan may gather its own momentum. It could trigger a virtuous cycle similar to the one which allowed us to adopt the euro. We could pay no better tribute to the memory of Carlo Azeglio Ciampi, who defined just such a plan and implemented it.

The banking and financial sectors must profoundly modernize to meet the challenge posed by technological competition. Some, albeit hesitant and small, steps have been taken.

The legacy of the double-dip recession, endured but not caused by Italian banks, must be left behind. The banking system as a whole is not experiencing a crisis, but its strength is inextricably linked to the health of the economy. Various problematic situations pertaining to individual banks have been resolved or are in the process of being resolved; in Italy and Europe we are working on open cases intensively and with determination.

The flow of new non-performing loans is slowing; those inherited from the past must be actively managed in order to accelerate their reduction. We can debate the methods used to avoid excessive losses but this is an obligatory step to regain the trust of the markets and recover profitability. To this end, additional progress in reforming the civil justice system is important but not in itself sufficient.

We must continue with conviction along the path of cost reduction, corporate reorganization, and the adoption of efficient corporate governance structures. This is not something that only affects a few banks facing difficulties but also healthy banks if they want to remain so.

It is an illusion to think that Italy's economic problems could be solved more readily outside of Economic and Monetary Union. A departure from the euro, which is often discussed with scant knowledge of the facts, would not serve to heal the structural defects of our economy; it certainly would not lower interest expenses much less would it magically lower our debt level. On the contrary, it would generate serious risks of instability. Italy's competitiveness is not suffering from an overvalued currency; the current account in the balance of payments is in surplus; our spending power has been defended. The European rules on the public finances contain some elements of flexibility, to be invoked by always paying careful attention to the scale and rollover of the debt.

Monetary policy has done what had to be done for the area as a whole, aiming at guaranteeing price stability by sustaining demand; it will continue to do so in the appropriate time and manner. There is often talk about when we will commence monetary policy normalization, though not always with the necessary analytical rigour. Some speak of desiring a forced acceleration, others by contrast, conjure up the spectrum of potentially drastic consequences. When the decision is made it will mean that aggregate demand conditions and prices in the euro area have been restored to the desired levels. At national level the exit will be manageable if all the actors involved behave responsibly.

Looking forward, the gradual return to higher interest rates if growth levels increase should not concern us unduly. What should worry us instead is the risk that rates increase as a result of a fall in market confidence, the consequences of which, given the weight of public debt, could prove serious.

We are facing difficult issues in Europe: the exit of the United Kingdom from the European Union, growing migration flows, the threat of terrorism. The biggest obstacle is the dearth of confidence that has developed in recent years, the return of mutual mistrust and prejudice among member states and between the peoples of Europe and its institutions. We must take arms against these tendencies.

The process of European integration has guaranteed seventy years of peace and prosperity. It has made it possible for many generations of young adults to study abroad and to develop a sense of belonging, surmounting linguistic and cultural barriers; it has provided working adults with new job and professional growth opportunities; it has intensified trade and strengthened financial ties.

Europe must remain an anchor of stability in a world that appears ever more unstable and politically unpredictable. The willingness to cooperate more closely on issues such as immigration, defence, security, justice and representation at international fora is undoubtedly a positive signal. We must continue on this path, tackling the issues that still stand in the way of effective economic governance of the euro area.

At times we also criticize European rules that do not satisfy us completely or the decisions by European authorities of which we do not approve, but we do not do so to question the path of European integration. We believe – and we have reiterated this on many occasions – that one of the problems that the crisis has laid bare is precisely the incompleteness of European integration, especially in the areas of the economy and finance. European governance in these sectors has to date relied almost exclusively on rules that, in an exaggerated pursuit of mutual guarantees, constrain the choices of each country. The result has been a Union that is better at prohibiting things than at getting them done.

This is evident in the public finances; in the absence of a common budget, it has been hard to lend support to the economic recovery. It is also evident in the management of bank crises and in the preservation of financial stability, where the splitting of powers among a large number of authorities makes it difficult, at times, to identify the measures to be adopted and slows actions that, to be effective, must instead be taken extremely quickly.

Proceeding by means of compromises is becoming increasingly difficult. Completing Banking Union and establishing a capital markets union are clear and immediate objectives. The true completion of the European construction, however, will only be achieved with the development of democratically designated institutions mandated to exercise common sovereignty.

The difficulties we have faced in these critical years have been arduous as are the challenges that remain. For the Bank of Italy this means being increasingly effective in fulfilling its role, enlarging its scope and sharing responsibilities at European level.

The process of bringing Italy back to a path of growth has begun, but must be lent greater support. The changes will require time, commitment and sacrifice. Measures to sustain demand can moderate the economic and social costs of the transition, but economic policies must be far-sighted and highlight the benefits to society. Consensus must be built by setting out and communicating clear and ambitious plans that are firmly grounded in reality.

I am confident that, notwithstanding the political uncertainty, Italy will achieve results that serve the public interest, never forgetting those who have been left behind, freeing the economy of futile constraints, privileged positions, and accumulated and emerging delays. All the opportunities now afforded by innovation must be seized to develop a robust economy, a stable financial system, and a more equitable society for all.

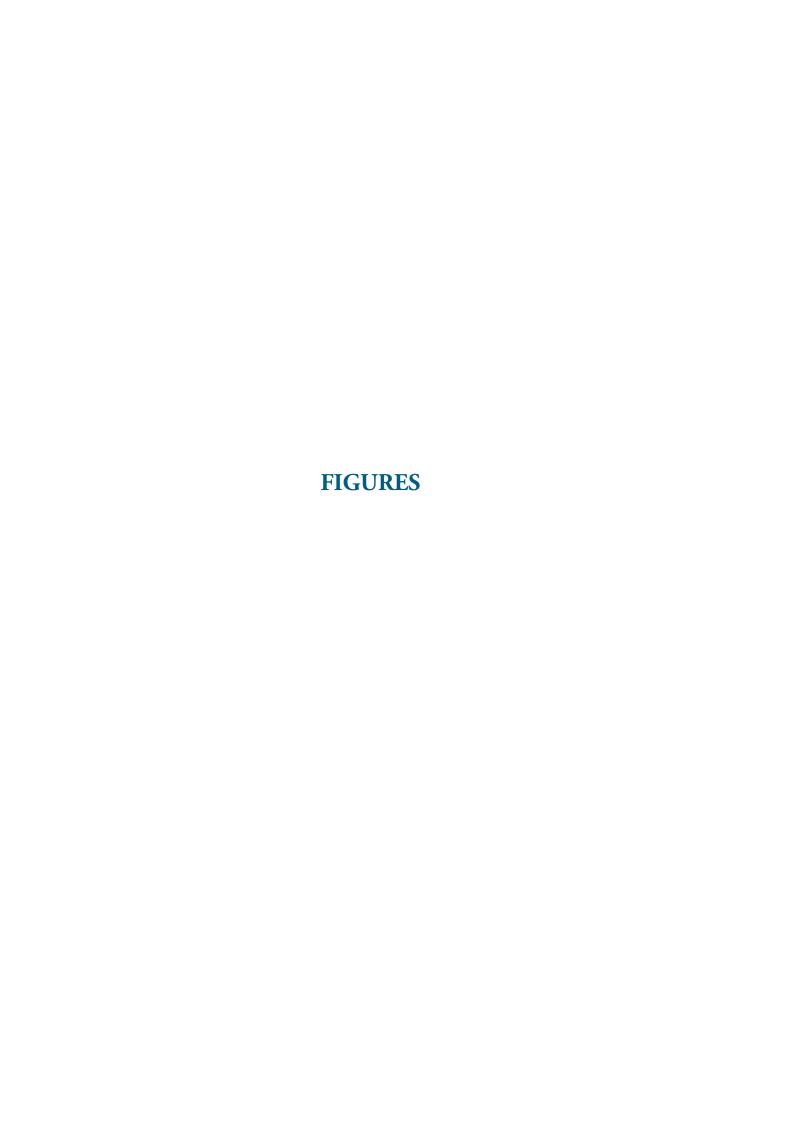
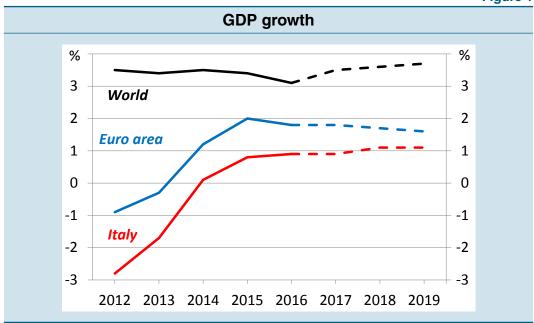
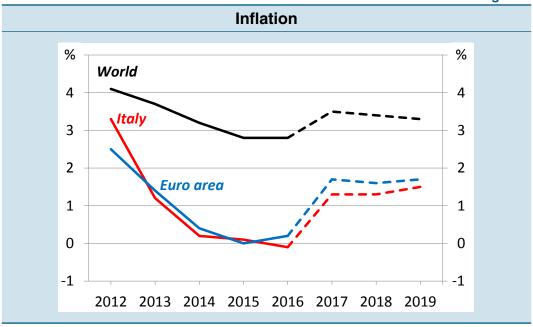


Figure 1



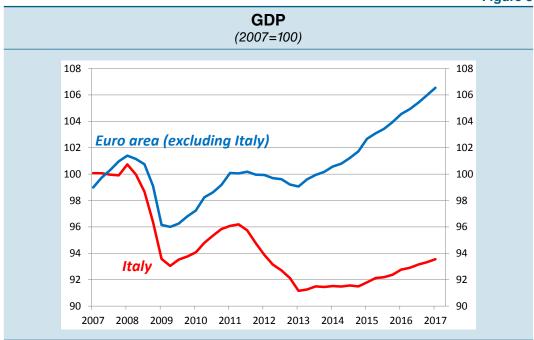
Sources: Istat, Eurostat and IMF. Forecasts: Bank of Italy, ECB and IMF.

Figure 2



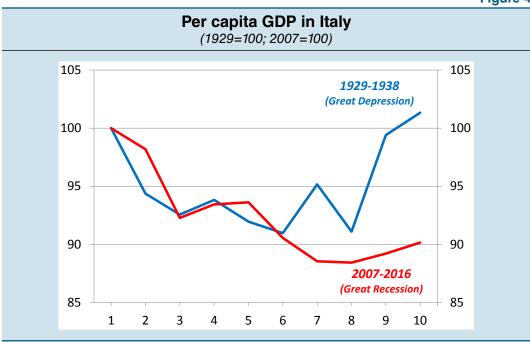
Sources: Eurostat and IMF. Forecasts: Bank of Italy, ECB and IMF.

Figure 3



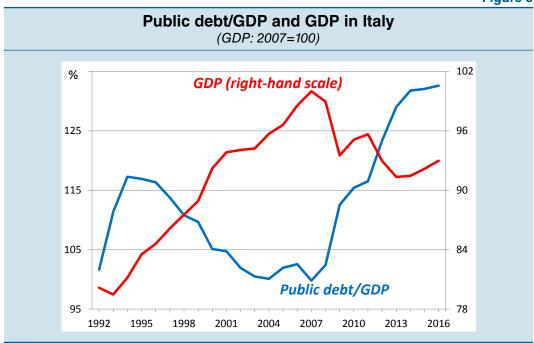
Sources: Based on Istat and Eurostat data. Note: GDP at chain-linked values.

Figure 4



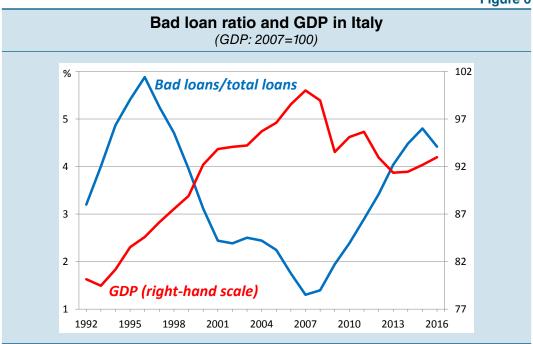
Source: Bank of Italy historical reconstruction. Note: GDP at chain-linked values.

Figure 5



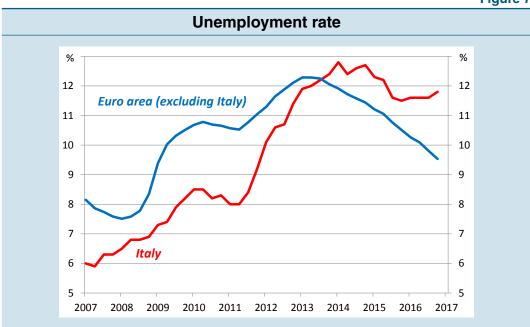
Source: Based on Bank of Italy and Istat data. Note: GDP at chain-linked values.

Figure 6



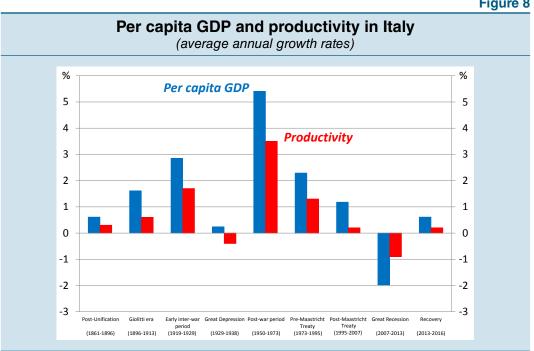
Sources: Based on Istat data and supervisory reports. Note: Ratio of bad loans to total loans, net of write-downs; GDP at chain-linked values.

Figure 7



Source: Based on Eurostat data.

Figure 8



Source: Bank of Italy historical reconstruction. Note: Total factor productivity; GDP at chain-linked values.

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