BANCA D'ITALIA
EUROSISTEMA

The Governor's Concluding Remarks

Annual Report
Rome, 29 May 2018

124th FINANCIAL YEAR

2017

Financial Year 124th

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Ladies and Gentlemen,

The Italian economy is gaining strength, employment continues to recover, and some of the sources of systemic risk in the banking system have been eliminated. To consolidate the results achieved, accomplish further progress, and remove structural fragilities, we must press on with the reform agenda.

It is necessary to respond with determination to the changes brought about by globalization, technological innovation, and demographic trends. The protection of savings, necessary to support economic growth, hinges upon orderly conditions in the financial markets. These, in turn, rely on the credibility of the policies to revamp the structure of the economy, enhance productivity and keep public debt in check.

The risks connected with the weakening of international cooperation, which are both geopolitical and related to the economy and trade, have been compounded by the current hesitations in furthering the European project and by the tensions in our country. Italy's must be a respected voice, including in the debate on redesigning the European Union's regulatory and institutional set-up, a voice that is all the more important in this period of profound social, economic and financial transformation.

These are the topics to which I will devote my attention today, which as always draw on the analyses included in the Annual Report and in our other publications on economic, financial, supervisory and regulatory issues, produced thanks to the professionalism and dedication of the Bank of Italy's staff. To them I would like to express my gratitude, both personally and on behalf of the Governing Board and the Board of Directors.

For an overview of our annual accounts and an analysis of the Bank of Italy's operations and activities, I refer you to our two dedicated publications. The first was released on 29 March on the occasion of the Meeting of Shareholders, while the second will be published today. A new volume describing the Bank's functions has also been added to the range of publications we use to account for the work we do.

The international economic situation and monetary policy in the euro area

In 2017 the world economy grew at a vigorous pace, at close to 4 per cent (Figure 1). This reflected a generalized acceleration in investment and world trade, whose growth outpaced that of GDP. The expansion in economic activity is widespread across all the major countries, and is expected to remain robust in the near future.

However, risks are in no short supply. The introduction of trade protection measures and possible retaliations would have serious repercussions for global production. The uncertainty generated by statements and announcements foreshadowing protectionist drifts is, in itself, negatively affecting the investment plans of firms active in the international markets. This is in part due to the ongoing debate between those who want to see a trade system based on bilateral agreements and those who underscore the importance of preserving the international rules on trade that have underpinned economic integration and development for decades.

Additional risks are associated with the high level of global debt, in both private and public hands, which in the third quarter of 2017 reached 245 per cent of GDP, 35 percentage points more than at the end of 2007. The increase was especially marked in the emerging economies (up from 121 to 192 per cent of GDP), where a large portion of corporate debt is denominated in foreign currency. Unexpected hikes in bond yields in the United States, also in connection with the possible effects of an excessively expansionary fiscal policy, and sharp fluctuations in exchange rates, could generate turbulence in capital markets.

GDP growth in the euro area is proceeding at a good pace. In 2017 it was equal to 2.4 per cent, owing to the resilience of consumption and investment which, as exports strengthened, continued to benefit from the increase in employment and favourable borrowing conditions. Despite the indications of a slowdown that emerged in the early months of this year, the outlook remains favourable.

Inflation is returning to levels consistent with the price stability objective, namely a rate of inflation below, but close to, 2 per cent over the medium term (Figure 2). Core inflation, which excludes food and energy products, remains weak; in order for it to strengthen, inflation expectations must recover fully and unemployment, which is still holding back wage growth in some countries, must be reabsorbed.

The improved economic situation has strengthened the ECB Governing Council's confidence in the convergence of inflation towards the objective and has created the conditions for a gradual recalibration of monetary policy measures. Uncertainty about the future performance of inflation means we must proceed with caution. So far, the recalibration of measures has occurred without creating the tensions on financial markets or surges in long-term yields feared by several observers.

At its last monetary policy meeting the Governing Council reiterated the need to maintain a high degree of accommodation. For this purpose it can rely on several instruments: the Eurosystem's sizeable stock of assets; the net purchases of securities that will continue at least until the end of September; the reinvestment of the principal payments from maturing securities; and the very low level of key interest rates and guidance on their future performance.

The normalization of monetary policy conditions in the euro area will reflect the gradual consolidation of economic activity and of the inflation outlook. This will make it easier to absorb future interest rate increases. The need for caution is also corroborated by the positive results on growth and inflation achieved by the Federal Reserve in the United States, where an expansionary monetary policy is being followed by very gradual normalization (Figure 3).

The Italian economy today

The Italian economy is recovering. GDP growth gained strength last year, reaching 1.5 per cent and exceeding the expectations of the main forecasters. Macroeconomic policies were still the main driver but growth is increasingly self-sustained.

Demand reflected the positive performance of consumption and, especially, investment, which rose by 3.8 per cent, though it is still far from pre-crisis levels. Increased capital formation, which was lacking in the early years of the expansionary phase, is laying the groundwork for a continuation of growth. Investment in capital goods benefited from tax breaks, incentives for technological innovation, favourable borrowing conditions, and the gradual increase in firms' confidence in the outlook for demand. Growth in consumption was partly attributable to that in employment, which in turn was driven by the measures supporting labour demand. Despite the increase in labour market participation owing to brighter employment prospects, unemployment actually decreased from the peak of just under 13 per cent recorded in 2014 to about 11 per cent (Figure 4).

Exports continue to be a major driver of growth. In 2017 they expanded by 5.4 per cent, more than in the other major euro-area countries. The increase was consolidated in the second half of the year despite the strong appreciation in the exchange rate since the spring. This is a sign of our firms' renewed ability to compete in the international markets. Mostly thanks to the current account surplus, Italy's net foreign liabilities have continued to diminish, falling from 23 per cent of GDP in 2013 to less than 7 per cent. This compares with net foreign assets equal to 60 per cent of GDP for Germany and net foreign liabilities equal to 20 and 80 per cent of GDP for France and Spain respectively (Figure 5).

The expansion in production was widespread across almost all sectors: value added accelerated in manufacturing and services and posted its first significant increase in construction since 2006. This was accompanied by a recovery in the demand for loans, supported by low interest rates. Credit access conditions improved, though difficulties persist for small businesses and construction firms, which still present higher risk.

Overall, consumer price inflation returned to positive territory in 2017, reaching 1.3 per cent, but it weakened in the early months of 2018. The core component has remained below 1 per cent since last autumn. Wages and productivity both recorded modest growth. Italian firms have retained the competitiveness gains achieved in recent years.

In the early months of 2018, in Italy too there were signs of a slowdown in manufacturing and of a slight decrease in business confidence indices. The prevailing view is that this is a temporary setback; industrial production appears to have recovered somewhat since March. A scenario of moderate growth and gradually rising inflation remains the most probable one. However, downward risks have increased, also in connection with international developments.

Preserving the confidence of households, firms and investors is a necessary condition for the continuation of economic growth. The effects of a less expansionary monetary policy would be moderate also thanks to the low indebtedness of households and to the reduction in that of firms, the limited exposure of financial intermediaries to the consequences of a rise in interest rates, and the high average residual maturity of the public debt, which currently stands at more than seven years. It is crucial that conditions in the financial markets remain favourable.

Our economy is in a different cyclical phase compared with the past. The crisis was much deeper and longer than any previous one, and the recovery slower than on other occasions. In five years output has recouped only half of the nine percentage points lost during the double-dip recession. There continue to be ample margins of idle production capacity and, in particular, of labour market slack.

Italy's economy is still expanding at below the average rates recorded in the other euro-area countries; last year the gap was one percentage point.

Labour productivity growth is insufficient; in 2017 it was less than half that of the rest of the area. Demographic trends indicate that in the years to come there will be a reduction in the active population and higher numbers of older people. The cyclical recovery aside, Italy's growth potential must be consolidated.

Structural issues

Much has already been said about the structural problems of Italy's economy. Essentially, growth potential is being impaired by the tough conditions in which firms operate; many struggle to remain on the market, few expand. Noted problems include the inefficiencies and delays characterizing general government and civil justice, the shortcomings in regulating the entry and exit of firms from the market, the constraints on competition and phenomena of illegality, the high taxation of the factors of production and underinvestment in innovation, research and human capital. Important initiatives have been taken in recent years but improving the body of institutions, rules and practices on which economic activity is based and which influences the behaviour of workers and firms is a long-term endeavour. The reforms that pursue these goals have a significant impact on growth and employment though their effects are distributed over a longer time horizon. Lazy short-termism cannot be allowed to dictate the agenda.

Italy's anaemic growth in the last twenty years is primarily the result of stagnant productivity, in itself a reflection of the country's fragmented economic structure in which small firms, on average poorly capitalized and often little inclined to expand, tend to dominate. Small businesses, which far outnumber those in the other advanced countries, are less productive in Italy, not only than their larger counterparts but also with respect to foreign firms of comparable size.

There are, however, signs of improvement. The reorganization of production, which had got under way even before the double-dip recession, has intensified in the wake of the crisis. The capacity of our economy to put resources and energy into more productive initiatives, while still low by international standards, is increasing. The exit of many firms from the market has been offset by the entry of new innovative businesses and the strengthening of those that succeeded in repositioning themselves on a path of growth. These developments have partly softened the negative impact on productivity of the fall in investment during the crisis.

The beneficial effects of a reallocation of activity towards the most efficient firms have been apparent among exporters; along with the recovery of price competitiveness, the reforms have enabled firms to staunch the losses in Italy's export market shares. Though still limited by international standards, innovative activities and the use of new technologies are on the rise. Spending on research and development, though still below that recorded in the other main economies, has risen by almost 20 per cent since 2015, reflecting strong growth in private investment.

Improvements in the field of innovation also reflect measures affecting the entire production chain since 2012. Support for innovative start-ups and tax credits for research and development have proven especially important, as have the hyper-amortization of investment in new technologies and the introduction of tax breaks on revenues generated from patents and other innovations. The tax incentives designed to facilitate recourse to equity capital have helped firms to strengthen their capital bases, enhancing their ability to absorb losses, fund innovative projects, and develop their activities.

Yet Italy's firms continue to be penalized by burdensome administrative procedures and lengthy civil trials. Productive activity also suffers from distortions of competition caused by tax evasion, corruption and organized crime. These phenomena feed into one another and, along with inadequate procedures for the planning and award of public works contracts and their execution, help explain the shortages in vital infrastructure that are hampering the economy's growth potential.

Low productivity and an insufficient ability to innovate also reflect gaps, by international standards, in the knowledge and skills of Italian students and adults, which act as both cause and effect. It is another vicious circle that contributes to keeping employment and labour force participation rates below the levels prevailing in the other European countries. The issue of human capital will become increasingly important as the use of new technologies increases and demand falls for workers who perform standardized and repetitive activities. Without sufficient public and private investment in training, there will be serious adverse effects on employment and income inequality will be aggravated. Addressing these risks requires decisive intervention: developing a collective appreciation of the importance of lifelong training beyond the years of formal education is a vital challenge for Italy.

The labour market has seen sweeping changes. The reforms have had a positive overall effect on trends in employment. Firms' propensity to hire workers on open-ended contracts has increased. And yet unemployment remains high, especially in Italy's Mezzogiorno and among young people. New social safety nets have increased unemployment benefits without generating excessive disincentives for jobseekers. The effects of the new set of active policies, however, are barely perceptible; the share of those drawing unemployment benefits without actively seeking work has not fallen.

The long crisis has increased social malaise. According to Istat data, in the last ten years the share of households in absolute poverty has practically doubled, climbing to almost 7 per cent. This share is higher in the Mezzogiorno and, above all, in households with foreign nationals; the position of young people has worsened with respect to older generations.

The resources unlocked by the introduction of a minimum income scheme (*reddito di inclusione*) cover around 40 per cent of households in absolute poverty. In any decision to broaden its scope, or to adopt other measures, care must be taken not only to avoid discouraging beneficiaries from seeking regular work but also in relation to the effects on the public finances.

The territorial disparities of Italy's economy encapsulate and lay bare all the structural fragilities listed above: in the country's capacity for economic growth, in the productivity of its firms, in the availability of work and the quality of public services. It is an age-old problem; after the progress recorded in the 1960s, the gap began to increase again; it widened further during the double-dip recession. Compared with 2007, GDP is lower by almost ten percentage points in the Mezzogiorno and by around four points in the Centre and North. The gap between the employment rates in the two areas, respectively 44 and 65.5 per cent, has widened by around three percentage points, reflecting the fall recorded in the Mezzogiorno. With the economic recovery under way, the government can more easily remove the obstacles to entrepreneurship and help close the gaps that have emerged in increasingly large swathes of the country.

Public finances

Public policy operates on two complementary levels. The first concerns legislative and regulatory aspects, and how general government is organized and administered; the second has to do with the raising and deployment of resources for infrastructure, public services and redistributive measures. If these interventions are to contribute effectively to the country's development and not end up endangering financial stability, they must be carried out in the full awareness of budgetary constraints.

At the end of last year, Italy's public debt amounted to almost 132 per cent of GDP. This is a very high figure by past standards. It is more than 50 percentage points above the average in the rest of the euro area and it is an element of constraint and the main source of vulnerability for the economy. It discourages investment by raising the cost of borrowing and fuelling uncertainty; it leads to greater distortions in taxation, impairing Italy's capacity to generate income, save, and invest. It reduces the scope for social and macroeconomic stabilization policies. It exposes the country to crises of confidence, especially dangerous when, in addition to covering annual borrowing requirements, very large volumes of securities nearing maturity must be refinanced (which together amount to €400 billion per year in Italy).

Debt-to-GDP dynamics largely depend on the primary fiscal balance – in other words on the difference between public revenue and expenditure net of interest expense – and on the gap between average borrowing costs and the nominal growth rate of the economy. These variables influence each other; in particular, a worsening of the primary balance, even if only anticipated, can stoke fears about the solidity of the public accounts and raise government borrowing costs (Figure 6).

Having widened considerably during the sovereign debt crisis, the spread between the average cost of the debt and GDP growth narrowed to around 1 per cent. It could narrow further over the next few years so long as the economic situation remains positive. If the tensions of the last few days subside, the cost of debt will also fall, if only slightly, when the securities that were placed at higher rates than newly issued ones come to maturity. This could be achieved even with the gradual normalization of monetary policy. To this end, it is essential to preserve the credibility of the process for consolidating the public finances.

The debt-to-GDP ratio could return to below 100 per cent over the next ten years by gradually achieving a primary surplus of between 3 and 4 per cent of GDP, two percentage points above the current level and consistent with a broadly balanced budget net of cyclical effects (Figure 7). The fall could be more rapid if the improvement in the primary surplus and the consolidation and continuation of structural reforms encouraged growth and lowered the risk premium on Italian government securities.

Reducing the debt ratio is indispensable. At a time of growth and with monetary policy still highly accommodative, increasing the deficit is not the answer. While there might well be a temporary positive impact on demand, though even this is rendered uncertain by possible financial tensions, it would have persistently negative repercussions on debt and on interest expense. The moderately restrictive effects of a rise in the primary surplus can be offset by a tax reform to make taxation less distortive and by a restructuring of public spending aimed at boosting production capacity.

Spending on public investment has been falling almost without interruption since 2010. Aside from the limited availability of financial resources, contributory factors include inefficient and slow processes for selecting and completing public works. More recently, investment may have encountered difficulties in adapting to the new Public Contracts Code; the total amounts involved in tenders for public works nonetheless returned to growth last year. But there is still work to be done on reducing the length and complexity of the procedures.

In the long term, curbing the deficit and debt rests largely on the ability of the public finances to cope with the increase in social expenditure caused by population ageing, particularly on social security and healthcare. The reforms introduced in the past have made spending on pensions manageable; they have responded to the need to take account of the increase in average life expectancy when determining the relationship between contributions paid and the size and duration of pensions; they have also placed Italy in a favourable position by international standards.

Any turning back would be risky. Targeted interventions to reduce specific rigidities are possible, and some have already been made, but they must always be adequately offset so as to ensure the actuarial balance of the pension system. Great care must be taken in modifying the basic rules that shape long-term trends in public spending. The sustainability indicators, calculated at European level, have recently worsened for Italy owing to the fall in potential GDP growth forecast for the next few decades, which is in turn partly due to the decrease in the active population connected with the downturn in expected migration flows.

The financial sector

The international financial industry is undergoing momentous change. Since the end of the last decade the role of banks in funding the economy has gradually declined, and there has been an increase in the relative importance of the capital market and of non-bank operators that perform some functions typical of traditional credit intermediation. The volume of bonds placed on the international markets by non-financial groups has more than doubled over the last ten years, reaching $6.5 trillion in 2017. At the end of 2016 the assets of non-bank intermediaries amounted to $160 trillion, nearly half of those held by financial intermediaries as a whole.

The rapid developments in technology are opening up credit and financial intermediation markets to competition from new operators, both in the advanced economies and in emerging countries. Several Fintech firms are already offering innovative, low-cost services in the electronic payments sector, in asset management and in brokerage. The biggest international technology companies are also starting to operate in credit and finance.

Experience teaches us that a diversified financial sector, with multiple funding channels and many different operators, can favour investment and growth and can bolster the resilience of the economy to adverse events. In the United States, firms have reacted to the restrictions on bank credit caused by the financial crisis by replacing it with bond issues, thereby mitigating the severity and duration of the recession.

However, the development of non-banking intermediation, if not properly supervised, can also be a source of risk. The strategies of large fund managers can have significant effects on the prices and liquidity of the underlying instruments. The spread of high-frequency trading could give rise to sudden increases in price volatility, especially if several intermediaries were to react in a similar way to market movements. Indirect links between banks and other intermediaries are also potential risk factors. The Financial Stability Board is working on defining regulatory measures for non-banking intermediation with a view to limiting the risks associated with the opportunities opened up by the changing financial landscape.

New technologies are increasing productivity and giving users greater choice, but due care must be taken as regards the potentially negative consequences. In a financial system by now steeped in digital technology, the damage caused by cyberattacks can go beyond individual operators and become systemically important. The central banks and supervisory authorities are committed, together with the other authorities and intermediaries, to safeguarding cyber security in the financial sector. The unregulated spread of crypto-assets could also put consumer protection at risk and encourage illegal activities; going forward, it could pose a threat to financial stability.

Italy's financial market is also evolving. On the eve of the crisis, Italian firms had a high debt-to-equity ratio and made very limited recourse to bond issues, factors which helped lengthen and deepen recessions. Nowadays firms' leverage (calculated as the ratio of financial debt to the sum of financial debt and net equity at market prices) is ten points below the peak of 50 per cent recorded in 2011. This decrease is attributable both to firms with high debt levels exiting the market and to the influx of new capital, partly as a result of tax incentives. The gap with respect to the euro-area average has narrowed markedly.

Of the more than 250 non-financial firms now on the stock exchange, around 80 were listed between 2013 and 2017. In many cases, using SPVs to raise the capital required to purchase unlisted companies has allowed firms, including small and medium-sized ones, to access the stock market more quickly compared with traditional IPOs. Nonetheless, the market capitalization of non-financial companies remains well below that of the other main economies: in Italy it amounts to around 25 per cent of GDP, in

Germany to just over 60 per cent, in France and in the United Kingdom it exceeds 70 per cent, in the United States, 125 per cent. In Italy the share of capital provided by intermediaries specializing in private equity is also limited.

Growth in firms' capitalization has gone hand in hand with a rebalancing in debt instruments. Between 2013 and 2017, gross bond issues rose to a yearly average of €35 billion, from €25 billion in the previous five-year period. The introduction of tax incentives encouraged around 150 firms that had never previously made bond placements to issue mini-bonds. Overall, over the last ten years the ratio of bonds to total financial debt has risen from 6 to 13 per cent, a slightly higher figure than that for Germany, but about 9 points lower than in France and the United Kingdom and more than 25 points lower than in the United States.

Broader access to market funding is possible above all for the largest firms. Small and medium-sized firms may derive significant benefits from the growth of individual savings plans, which were introduced at the end of 2016 with the objective of promoting investment in the financial instruments issued by Italian firms through tax incentives. For smaller firms, however, bank credit is likely to remain the main source of funding. Also in light of the tightening of prudential measures on non-performing loans, these firms' financial needs must be supported by banks with strict criteria to assess creditworthiness and by exploiting the opportunities provided by the new technologies. In order to facilitate access to credit for small and medium-sized firms, it is crucial to promote their capital strengthening.

Banks

Banks hold a large amount of information on firms, which they can either use to raise barriers to competition from other operators – in a fruitless defence of their positions – or instead, with foresight, leverage it to offer new services, including to facilitate firms' direct access to the market. Resolute strategies, however, are needed to tackle the challenges of technological development, competitive pressures and the new approaches to banking regulation and supervision. As well as limiting administrative expenses and staff costs, banks must diversify their sources of revenue. They have already set out on this path and must proceed without hesitation.

The finalization of Basel III reforms has improved the quality of the rules by ensuring that banks can no longer use their own internal models to excessively reduce their capital requirements, particularly in relation to trading. The new rules include a lowering of the requirements for loans to small and medium-sized businesses, on top of the existing provisions of European legislation.

Among the challenges facing banks are those of ensuring correct conduct vis-à-vis customers and compliance with the rule of law. In a number of instances, a lack of attention to transparency requirements and the sale of products unsuited to investors' financial needs – already serious problems – have amplified the effects of crises. Banks have a duty to preserve their customers' trust, which is also a means of improving competitiveness and is vital for the sustainability of their strategies in the new business and market environment. The banking system has shown a growing commitment to preventing money laundering and combating terrorist financing; it must continue in this direction in order to effectively counter the risks posed by continuous developments in financial crime, which also exploits new technologies.

Italian banks strengthened capital in 2017. Common equity increased by €23 billion, of which €4 billion was provided by the Government for the recapitalization of Monte dei Paschi di Siena. The CET1 ratio rose by more than 2 percentage points on average, to 13.8 per cent, compared with 7.1 per cent a decade ago. For the significant banking groups, the gap with the euro-area average has narrowed by 2 percentage points, to 1.3.

In recent years there has been a reduction in both banks' exposure to the public sector and in the volume of non-performing loans. The former has decreased by more than a quarter from the peak recorded in early 2015 and now amounts to about €300 billion. NPLs, net of loan loss provisions, have diminished by about a third with respect to the end of 2015, to €135 billion. The coverage ratio, i.e. the ratio of the stock of loan loss provisions to gross NPLs, has reached 53 per cent, a much higher level than the average for the leading European banks.

According to data published by the ECB, at the end of 2017 the ratio of Italian significant banks' gross NPLs to total lending, including interbank exposures and those to central banks, was 11.1 per cent, compared with an average of 4.1 per cent for other Eurozone significant banking groups; net of loan loss provisions the ratios were respectively 5.9 and 2.4 per cent. While still large, the gap has narrowed significantly in the last two years.

The decrease in the stock of NPLs is partly due to the sharp rise in sales on the secondary market, facilitated by the favourable economic situation (€35 billion in 2017 against a yearly average of €5 billion in the previous four years). This year sales are expected to reach €65 billion for the banking system as a whole. According to the plans submitted to the Single Supervisory Mechanism in March, by the end of 2020 the NPLs of Italy's significant banking groups should be almost half the level recorded at the end of 2017; in relation to total lending, net of loan loss provisions, they should fall to about 4 per cent for significant groups, and to an estimated 5 per cent for the system as a whole (Figure 8). On more than one occasion we have stressed that it is risky to set too tight a deadline for reducing NPLs, particularly in countries such as Italy where recovery proceedings are lengthier and potential buyers have long been fewer. But the reduction in NPLs must forge ahead, benefiting from the steady growth of the secondary market as the reforms to the foreclosure process begin to bear fruit.

A small percentage of last year's sales related to loans that were unlikely to be repaid, i.e. to exposures where there is a chance that the borrower will resume repayments; further sales are envisaged by the significant banking groups. The disposal of such exposures could benefit from the contribution of corporate restructuring specialists, something that is still relatively rare in Italy. These turnaround funds can offer firms not only new finance but also the managerial skills needed to relaunch their business.

In January we issued a set of guidelines on NPL management addressed to the less significant institutions that we supervise directly. While upholding the principle of proportionality, the guidelines essentially replicate the recommendations of the Single Supervisory Mechanism for significant banks. By autumn those small banks will also have to draw up ambitious yet sustainable plans to substantially reduce their NPLs.

The profitability of Italian banks improved in 2017: excluding extraordinary items, the return on equity was just over 4 per cent, against a negative result of -5.7 per cent in 2016. This trend continued throughout the first quarter of the current year among the leading banking groups, whose profits were generally satisfactory thanks to an increase in fee income and a reduction in costs.

Several banks, however, still have an inadequate level of profitability. The ability of smaller banks to generate profits is hampered by difficulties in increasing revenue and by lower operational efficiency. Continued large loan losses are another factor: for banks other than mutual banks (BCCs), last year the cost of risk, as measured by the ratio of loan loss provisions to the average stock of loans, was close to 190 basis points, against around 100 points for the leading banks. For a quarter of these smaller banks the return on equity was negative.

Profitability can be restored in part by outsourcing some functions, participating in consortiums to pool production processes and the procurement of goods and services, entering into agreements for the marketing of financial and insurance products, and carrying out mergers. Italy's small *popolari* banks could also benefit, as they do in other countries, from the creation of an institutional protection scheme based on agreements to provide reciprocal support if difficulties arise, with advantages in terms of capital requirements; this would be a step towards forms of closer integration.

For the mutual banking sector, pressing on with mergers has become a matter of urgency. In the last ten years, the capitalization of BCCs has been affected by low self-financing and legal constraints on access to the capital markets. Their solvency ratio has risen by just 2 percentage points, while that of the banking system as a whole has increased by about 7 points. This has likewise impaired their ability to react to the deterioration in loan quality: currently, BCCs have a higher than average ratio of non-performing exposures and a lower than average coverage ratio compared with the banking system as a whole.

The reform now being implemented will allow the BCCs to continue to support their local economies effectively, even under the new regulatory environment, while preserving their original mutualistic spirit. The joint and several guarantees incorporated in cohesion contracts and the capital which, thanks to the reform, new parent companies can raise on the market will make it possible to resolve any future difficulties in the most efficient way. Without these new groups, in fact, the law would require crises at individual BCCs to be resolved by liquidation. Improved efficiency and the removal of obstacles to raising equity on the market will also enable the banking groups being created to face the new challenges.

For Italian banks, the measures to reduce non-performing exposures, restore profitability and, more generally, strengthen balance sheets are particularly important given the transformation of the financial sector of which I spoke earlier. These measures are also necessary to adapt to the numerous regulatory and supervisory measures, approved and forthcoming. Complete compliance with the requirements on the amount of loss-absorbing liabilities in a crisis, the application of the new accounting standards, and the ongoing review of the internal models used to calculate capital requirements under the Single Supervisory Mechanism are some notable examples.

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When we look at the future of the world, we always see risks and opportunities. One cannot predict with certainty if it will be the former or the latter that will prevail. We can construct scenarios that assume specific trends and political measures and also take into account the role of chance.

The risks posed by technological change, demographic and migratory trends, and potential trade wars are plain to see. Major opportunities also come from technology and its role in stimulating and interacting with entrepreneurship; seizing them requires suitable government policies that are also able to safeguard against risks.

In this context, Italy has some cards to play. We come from a quarter of a century in which we have lost ground to the other advanced countries, culminating in a double-dip recession that caused damage comparable to that of a war. Though not without great exertion, we are now emerging from the crisis. We are succeeding in chipping away at that structural roadblock that chokes and limits firms.

Today, the first results of this collective effort are visible. The productive structure of the economy is slowly changing, employment is rising, and investment has started to grow again; this points to increased confidence in the future. The external accounts are performing well and our net foreign liabilities have plummeted. Banks are overcoming the serious difficulties originating in the real economy.

Sounder public finances have made it possible to channel financial resources to supporting the economy to the extent permitted by the continued need to keep debt, which is especially high in our country, under control. The exceptionally expansionary monetary policy stance, whose aim is to guarantee price stability in the euro area, is aiding the efforts of both the private and public sectors.

Public finance choices centre around the taxes needed to finance expenditure and on how to employ the resources available to assist growth and protect the weak. On one level, the severe crisis that hit us accentuated the tax burden; on the other it stoked the fears of those who have a job and the anxieties of those seeking one.

The ultimate objective of economic policy can only be to increase everyone's income and welfare: an economy that gets poorer is less equal and less happy. To achieve this goal, the system's growth potential, and therefore productivity, must be raised. If the public sector limited itself to contracting new debt without reorienting towards economic development the composition of its balance sheet and the rules and mechanisms governing the functioning of the economy, this would have grave consequences.

But it must be stressed once again that there are no shortcuts for cutting debt. A large portion of the financial savings accumulated by Italians can be directly or indirectly traced backed to the €2.3 trillion that make up our public debt. If the value of their wealth were to be imperilled, they would react by fleeing and seeking shelter elsewhere. And foreign investors would follow suit even more rapidly. The financial crisis that would ensue would put us back significantly. It would taint Italy's reputation forever.

We are not constrained by the European rules but by economic logic. And closely linked to this is the obligation not to compromise the future of the next generations; increasing the debt means saddling them with what we are unwilling to pay today.

Reducing public debt and at the same time boosting economic activity is difficult but not impossible. The situation is not unfavourable. We are not too far from a balanced budget, which would enable us to create a virtuous circle of lower borrowing costs and higher growth, competitiveness is improving, and financial conditions in Europe are relaxed. We can gradually channel resources to more productive uses by increasing public investment and working towards completing adequate infrastructures. Balance and patience are required to identify the necessary means, by cutting needless expenses and rethinking and simplifying the tax system as a whole, without ruling out increasing less distortive taxes.

Efforts in this direction must be made worldwide. Some phenomena inevitably require governance on an international scale: economic integration, technological progress, immigration and finance are all topics that cannot be managed within the narrow confines of national borders. Isolation is not the best seedbed for development.

Italy's destiny is that of Europe. We are part of a very large and deeply integrated economic area, whose development determines that of Italy and at the same time depends on it. It is important that Italy has an authoritative voice in forums where the future of the European Union is to be decided. All its member states must contribute to its progress. Some very important issues will be dealt with over the coming months: the governance of the EU, its multi-annual budget, and the revision of financial regulations.

Europe needs to overhaul its existing tools and to create new, shared ones to tackle economic and financial shocks, given that national tools are either weak or unavailable. Following the reforms of recent years, any further progress appears to be on hold for now owing to concerns about the public and private financial vulnerabilities accumulated during the crisis and by mutual distrust. The situation is a difficult one that we can overcome by creating the conditions that will enable us in the future to take the steps that today appear impossible. It is often recalled that the European Union and the euro area do not have a common government, yet it is precisely this major objective that has enlivened the history of modern Europe. There is still a long way to go, but this should not weaken our resolve to play a vigorous and leading role in the dialogue and deliberations upon which the prosperity of European citizens depends.

The delicateness and exceptionality of these times is clear to everyone. While it is to be hoped that the goals and the projects of the various political groups will be set with clarity and foresight, together with the plans to achieve them, it would not be wise to ignore financial compatibilities. This, not because of European rigidities or the threat of speculation, but because our actions and our plans send out the signals that guide the allocation of resources at national and global level.

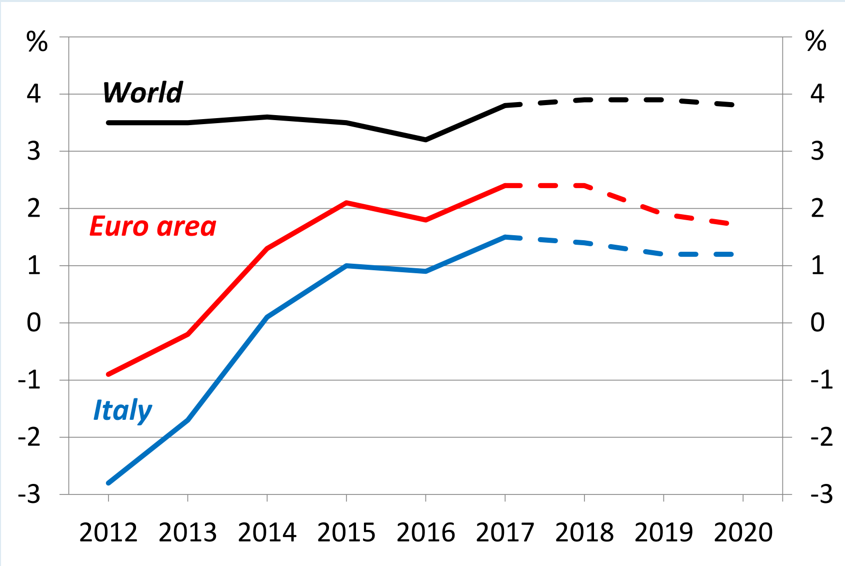
The rules of the game can be debated, even criticized; they can surely be improved. Yet we cannot disregard constitutional constraints: protecting savings, balancing the accounts and respecting the Treaties. Above all, we must never forget the very serious risk of losing the irreplaceable asset of trust: trust in the strength of our country which, aside from petty and untenable judgments, is great, from both an economic and a civic perspective; trust in the soundness of our savings, founded on the capacity to overcome financial, economic and social imbalances; and trust in our future, which must not be frittered away in actions that will not affect growth potential and may even risk reducing it.

If we all persevere in the endeavour to modernize we will be able to contribute to the success of the fundamental values of the European projects, return to sustained growth, and guarantee peace and wellbeing for future generations. Never before have the words of the illustrious Governors who have gone before me been so relevant: ‘It’s up to us’.

FIGURES

Figure 1

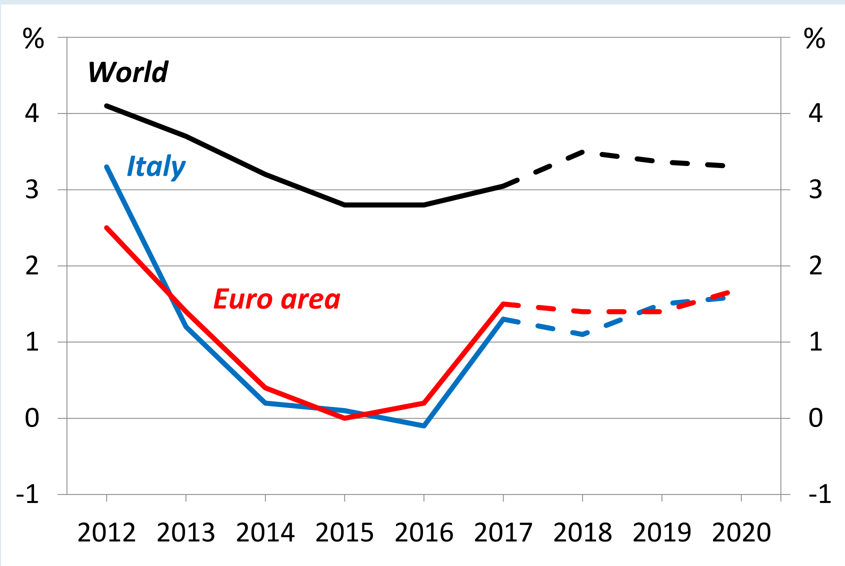
GDP growth



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

Figure 2

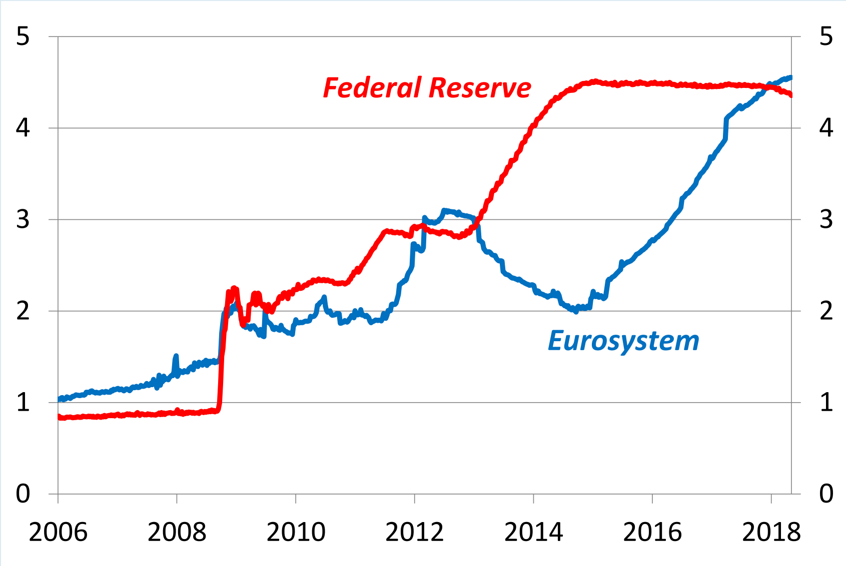
Inflation



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

Figure 3

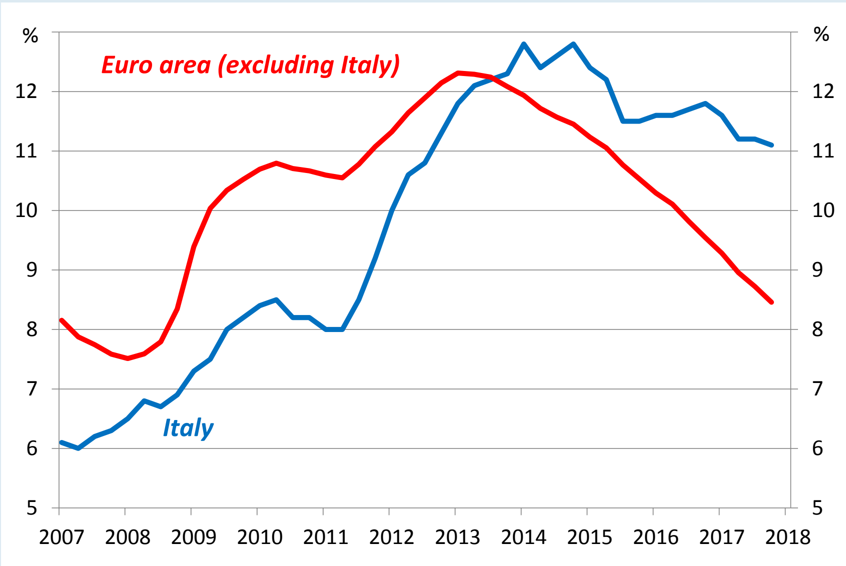
Eurosystem and Federal Reserve: total assets
(trillions of euros and dollars)



Sources: ECB and US Federal Reserve.

Figure 4

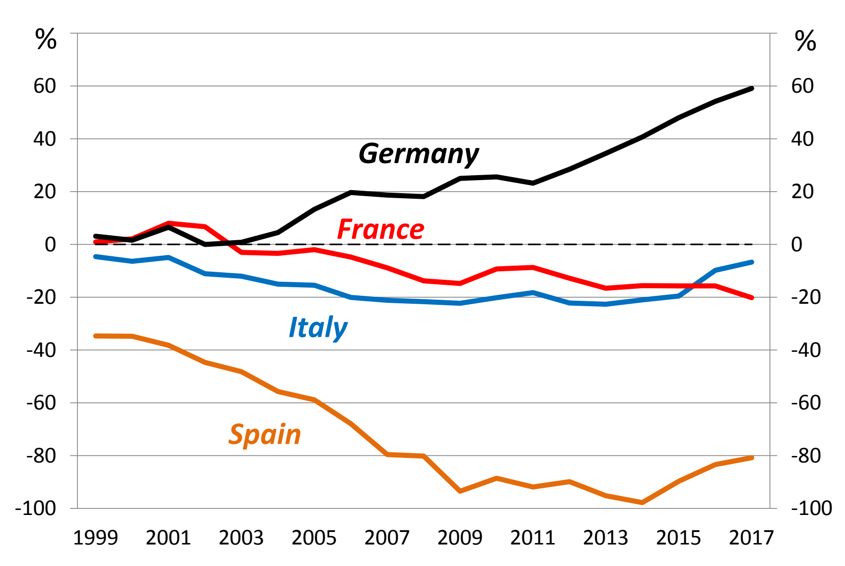
Unemployment rate



Source: Based on Eurostat data.

Figure 5

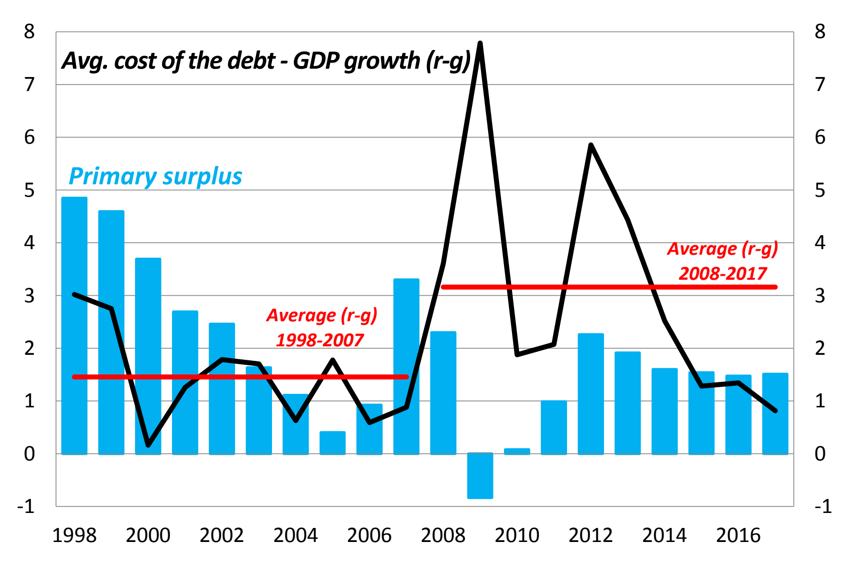
Net foreign asset position
(per cent of GDP)



Sources: Bank of Italy, Eurostat and Istat.

Figure 6

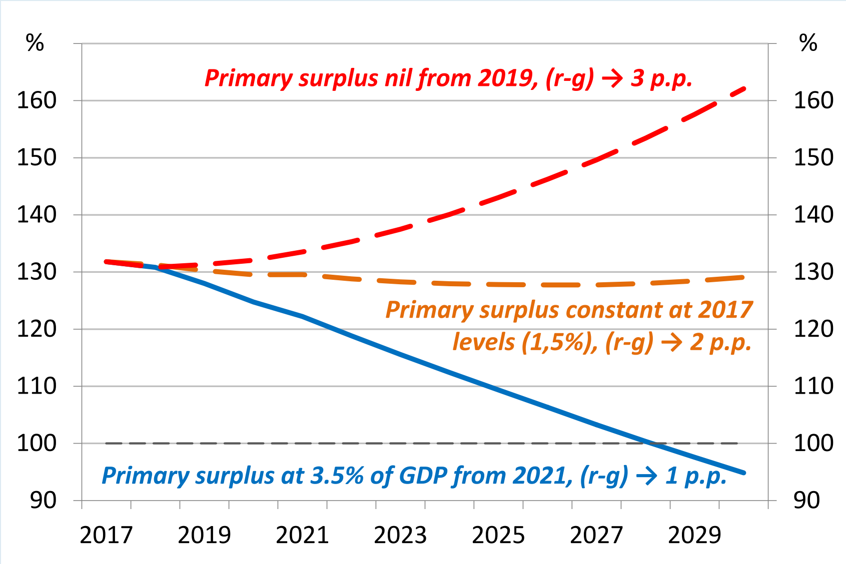
Primary surplus and differential between the average cost of public debt and nominal GDP growth in Italy
(per cent of GDP and percentage points)



Sources: Based on Bank of Italy and Istat data.

Figure 7

Ratio of public debt to GDP in Italy: scenarios

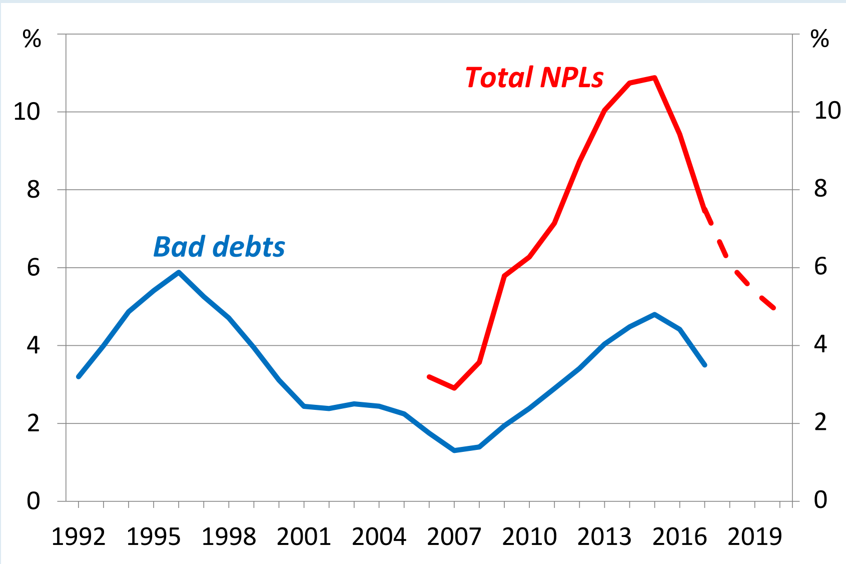


Sources: Based on Bank of Italy and Istat data.

Figure 8

Bank credit quality in Italy

(per cent of total lending)



Sources: Supervisory reports (consolidated for banking groups and individual for stand-alone banks). Note: bad debts are a subset of total non-performing loans (NPLs). The ratios are calculated net of loan loss provisions. The projections for total NPLs are based on the reduction plans of the significant groups.

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