ACRI

Association of Italian Savings Banks

2018 World Savings Day

Address by the Governor of the Bank of Italy

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The protection of savings calls, in the first place, for economic policies to ensure balanced financial conditions, stabilize cyclical fluctuations in the economy, and improve growth potential. Supervising financial intermediaries contributes to the protection of savings; it acts to contain crises and their repercussions on the economy, although it cannot eliminate them entirely.

In Italy the long and severe recession was exacerbated by some instances of malfeasance within the banking system which, though few in number, had serious consequences at local level. The deployment of government resources in support of the financial sector was much lower than in the other main European countries. The latest Eurostat data show that its impact on the public debt reached a high of 1.3 per cent of GDP at the end of 2017, while in France, Spain, Germany and the Netherlands, the peaks in the crisis years were around 4, 5, 12 and 13 per cent.

At first, the Italian banking system was relatively shielded from the global financial crisis thanks to its traditional business model centred on lending to the economy and to supervisory actions aimed at reducing exposure to risks from structured financial products. Later on, when the recession recurred at the time of the sovereign debt crisis, banks' close ties with firms and households meant there was a greater impact on loan quality. Despite the adverse economic conditions, the Bank of Italy felt it was vital to ask the banks to significantly strengthen their capital bases, to build up resilience and maintain public trust in their soundness: last June, the common equity tier 1 ratio had risen on average to 13.2 per cent, from 7.0 per cent at the end of 2008.

The economic and social cost of even relatively small bank crises can be high, given the role of such banks in collecting deposits and funding investments and consumption. The new European crisis management rules, which were also motivated by a determination to avoid giving further public support to the banks, were introduced somewhat abruptly, making it complicated to manage cases of banks in difficulty. In Italy in particular, it was hard or even impossible to employ the tools that had been used in the past, sometimes also because of the interpretation of the new rules adopted by the European institutions.

To mitigate the effects of this situation, the financial sector made voluntary contributions to help resolve the most problematic cases. Measures were introduced to encourage more active management of non-performing loans and accelerate the recovery process; reforms were made to strengthen the governance and capitalization of the *popolari* banks and the mutual banks (*banche di credito cooperativo*, BCCs), in different ways according to the size and type of bank. Public funds were employed, where necessary and possible, including to maintain business continuity in cases of liquidation.

Financial conditions

The yields on Italian government bonds have increased steadily since mid-May; those on ten-year bonds reached 3.7 per cent, the highest figure since 2014; with respect to the equivalent German bond, the spread currently fluctuates around 300 basis points, compared with the average of about 130 basis points recorded in the first four months of this year (Figure 1).

Between May and August, foreign investors made net sales of Italian securities for a total of €82 billion, of which €67 billion concerned public sector securities. This is high, even taking account of the fact that in June and August the net Treasury issues were negative (by €17 billion overall). Net purchases of foreign securities on the part of Italian residents (€18 billion, mostly in August) contributed to the net outflow of capital.

These trends do not reflect a deterioration in the fundamentals of our economy, even if the current cyclical slowdown is more marked than in the rest of the euro area. Unemployment has fallen. The banks' capital and profitability conditions and credit quality have continued to improve. The surplus on the current account of the balance of payments remains high and has led to a further reduction in Italy's net international debtor position, which is now close to balance.

The uncertainty over the fiscal and structural policy stance and the evolution of relations with the European institutions has contributed to the increase in the risk premium on government bonds. The concerns of domestic and foreign investors about rising public debt and the risk of its redenomination have resurfaced.

The trend of the spread between the premium on credit default swap contracts on Italian public sector securities stipulated after the sovereign debt crisis (which also protect against the risk of debt redenomination) and those written before that crisis (which do not offer such protection), indicates that the increase in the spread reflected, in almost equal parts, the increase in the risks of default and redenomination (Figure 2) – risks that feed off one another. Contrary to what happened at the peak of the crisis, when fears had spread about the possibility of a euro break-up, the increase in the risk premium almost exclusively concerned Italy (Figure 3); in the rest of the euro area, investors perceived the risk of redenomination as being very low.

The consequences of a prolonged and large increase in the yields on government bonds can be very serious. An increase reduces the value of household wealth and may lead to a worsening of economic growth prospects. High premiums to cover sovereign risk make it more difficult to control the dynamics of the debt-to-GDP ratio. This ratio tends to rise in tandem with an increase in the difference between the average interest burden on the debt and the nominal GDP growth rate, compromising the ability of fiscal policy to stabilize the economy; there is then very little room for public investment. The rise in risk premiums on the public debt produces capital losses that worsen banks' balance sheets; it affects the cost and availability of the funding that financial intermediaries raise on the market and thus their capacity to lend to the economy.

Directly or indirectly, sovereign risk affects Italian households. Not only do they hold public sector securities with a nominal value of almost €100 billion, but on the asset side of the balance sheets of the financial intermediaries to which they entrust their savings – in the form of bank deposits, insurance policies, shares in pension funds and managed assets – there are public sector securities amounting to about €850 billion.

Since mid-May, the market value of government securities has decreased: for those with a maturity of more than one year, losses have totalled 8 per cent on average. The tensions have inevitably spread to the entire Italian financial market, with a strong depreciation of the indices relating to private sector bonds and to shares; for all the listed companies combined, the stock market index fell by about 20 per cent.

The rise in the yields on government securities negatively affects the public accounts as well. Should it not be reabsorbed, the increase recorded so far would

mean that interest payments would be higher by about 0.3 percentage points of GDP next year (i.e. more than €5 billion). This additional burden would increase to 0.5 points in 2020 and 0.7 points in 2021. This would increase the primary surplus necessary just to stabilize the public debt-to-GDP ratio.

Since the end of May, the cost that banks incur to raise funds by issuing bonds – approximated by the yields on the secondary market – has more than doubled; by 2020, bank bonds amounting to €110 billion will reach maturity, namely about 40 per cent of those currently outstanding. The increase in sovereign risk is reflected in bank share prices which, after growing by 13 per cent between the beginning of the year and mid-May, have subsequently fallen by 35 per cent.

Such trends ultimately have a negative impact on the cost and availability of credit for households and firms. So far, banks' higher capitalization and a more stable funding structure have helped to dampen the transmission of these tensions to bank lending.

An assessment of the overall impact on the economy of the increase in sovereign risk is an exercise that is subject to wide margins of error. Yet it is difficult to imagine that a reduction in household wealth, greater difficulties for firms in accessing credit and investing, and a reduced capacity for public sector intervention would not have significant consequences on economic activity.

Italy's public debt is sustainable, but there must be a clear determination to keep it so, by putting the debt-to-GDP ratio on a credible path towards lasting reduction. Any uncertainty about Italy's committed participation in the European Union and in the single currency must be dispelled, as it fuels volatility in the financial markets. On these conditions hinge the protection of household savings and the ability to support Italy's economic growth.

Cyclical conditions

In recent months the outlook for the world economy has become less favourable. Compared with April, the IMF has reduced its global economic growth forecast for both 2018 and 2019 by 0.2 percentage points. The worsening in the forecasts for world trade is more marked and equal to almost 1 percentage point this year and two thirds of a point for next year. The deterioration in the macroeconomic

scenario reflects the tensions in trade as well as those that have broken out in emerging countries such as Argentina, Brazil and Turkey.

The risks have increased, especially those that could stem from new protectionist measures on the part of the United States. Those implemented so far have affected a limited share of the goods traded at world level, but the reactions of the financial markets have been significant; the repercussions on global economic activity could be amplified by a revision of firms' spending plans.

According to the latest data, GDP growth in Italy will be in the order of 1 per cent this year and will then slow in 2019, net of the effects of the budgetary provisions for which detailed information is not yet available. Business surveys continue to be favourable overall, but there are signs that the trade tensions could lead to a revision of investment plans. This is also why a deterioration of funding conditions in the economy stemming from higher interest rates on public debt must be avoided. In a country such as Italy, where the pace of growth is already slow and has been below that of the euro area for many years now, a further slowdown in economic activity would be felt more deeply than elsewhere.

Fiscal policy has limited room for manoeuvre to compensate for a possible contraction in private demand. In this context, priority should be given to measures that incentivize investment in infrastructure, both material and immaterial, and labour market participation. Resources should be concentrated on measures that are clearly directed at supporting economic activity effectively.

The common monetary policy responds to the situation of the euro area as a whole. Last week the ECB's Governing Council, in view of ongoing economic growth and of the gradual increase in inflationary pressures, reiterated its intention to end the net asset purchases at the end of this year. However, taking into account the uncertainty surrounding the outlook for the world economy and for financial markets, as well as the need to support price dynamics in the medium term, the Council has confirmed that it intends to continue to provide significant monetary stimulus. Even after the end of the net purchases, this support will arise from the sizeable stock of assets in the Eurosystem's portfolio, the reinvestment of the principal as these securities mature and the indication that the key ECB interest rates will remain at their present levels for as long as necessary.

Monetary policy normalization is a very delicate process, as the experience of other countries has shown. As I have observed in the past, the Italian economy can withstand an end to the low interest rate regime with no risk to economic activity or the public finances, provided that fiscal policy remains anchored to stability and that the reform process aimed at strengthening the economy continues.

Growth potential

The growth gap between Italy and the rest of the euro area is a structural problem that cannot be resolved through monetary stabilization policies or by an expansionary fiscal stance. Its main cause is the low productivity of firms which have lagged behind in responding to the drastic technological changes that began a quarter of a century ago. In this period Italian firms have generally not been sufficiently innovative and have grown very little. In addition, Italy has an older population than other countries and a lower rate of labour force participation; young people and adults have lower levels of knowledge and skills compared with other Europeans. General government is not very efficient and conditions for doing business are less favourable than in the rest of Europe. There is less investment, both public and private.

This lag is more pronounced in the southern regions, where firms are smaller and less productive on average, where the working-age population has declined over the last ten years, against an increase in the Centre and North, and where the labour force participation rate is over 15 percentage points lower. It is vital to improve the quality of institutions at local level, foster the growth of business and boost education and training: around one third of young people aged 15 to 29 in the South neither study nor work, against just over one sixth in the Centre and North.

The measures adopted over the last few years to support innovation and investment have gone hand in hand with the restructuring of the production system launched after the global financial crisis, and the euro-area sovereign debt crisis, which had serious effects on the Italian economy. The rebalancing of the pension system has made an important contribution to the increase in labour force participation of those aged 55 to 64. Rules have been introduced to simplify the red tape for setting up new firms and improving relations between general government and the production sector. There has been a marked reduction in the number of civil litigation cases. The timeframe for the pre-sale phase in foreclosure procedures has

been reduced. The liberalization of professional services has led to a more efficient allocation of resources across different occupations.

The road to structural reform requires a significant commitment, as results mature slowly. Yet reform is essential. Changes to measures that have already been implemented should be assessed very carefully and the need to provide stability to the institutional and regulatory framework must be borne in mind. Past reforms must be supplemented by further measures to promote innovation, enhance the quality of human capital, increase employment (especially for young people and women), raise the degree of competition in the service sector, improve infrastructure, both material and immaterial, and make government action more effective. The analysis of these problems is shared at national and international level.

* * *

Against a backdrop of increasingly stringent regulations, Italy's banks have long been committed to capital strengthening to make them more resilient and expand their capacity to provide loans to households and firms. However, the costs they bear in raising funds on the markets are high.

The role of banks and other financial intermediaries is to support and encourage the economy to change and grow. To do this in full they must respond effectively to the challenges posed by technological developments by updating products and production processes, keeping costs down, increasing efficiency and investing in knowledge and staff training. They must continue to nurture their customers' trust through transparent and virtuous behaviour, thereby proving that banks and finance are not the 'enemies' of saving and savers, but rather support them both, for the benefit of the economy.

At the same time, banks must not be placed at a disadvantage vis-à-vis international competition. Financial tensions over public debt would ultimately damage banks' capital adequacy and compromise their access to capital markets, with serious consequences for the economy, for savings and for the well-being of Italians.

The protection of savings, like the fight against poverty, calls for the economy to return to lasting growth. The necessary reforms and changes may incur social costs in the short term that have to be alleviated, including through public intervention.

This can be discussed at European level: where applicable, all the margins available under the current rules and procedures can be used. Nevertheless, differences of opinion should not lead to an institutional conflict. The financial consequences of a temporary increase in the budget deficit can be mitigated if the necessary adjustment path is drawn up and managed in a climate of open and constructive dialogue, within the framework of the existing procedures. In 2019, almost €400 billion of government bonds will have to be placed on the market to finance those coming to maturity and to cover the deficit for the year.

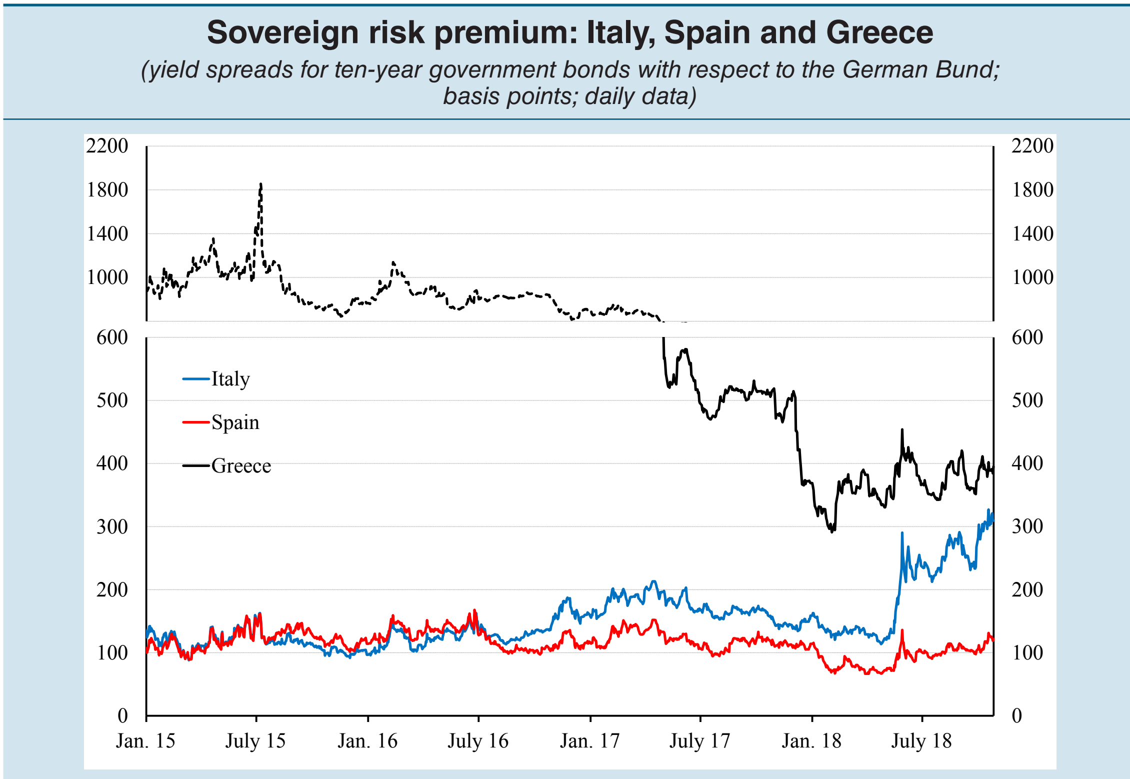
Reciprocal trust is essential if the reform of European economic governance is to be resumed and completed. Problems and challenges have taken on a global dimension in the third millennium and it is unrealistic to think they can be faced within the close confines of individual countries. It is for this reason that Italy's future cannot be separated from that of Europe as a whole.

FIGURES

Figure 1

Sovereign risk premium: Italy, Spain and Greece

(yield spreads for ten-year government bonds with respect to the German Bund; basis points; daily data)

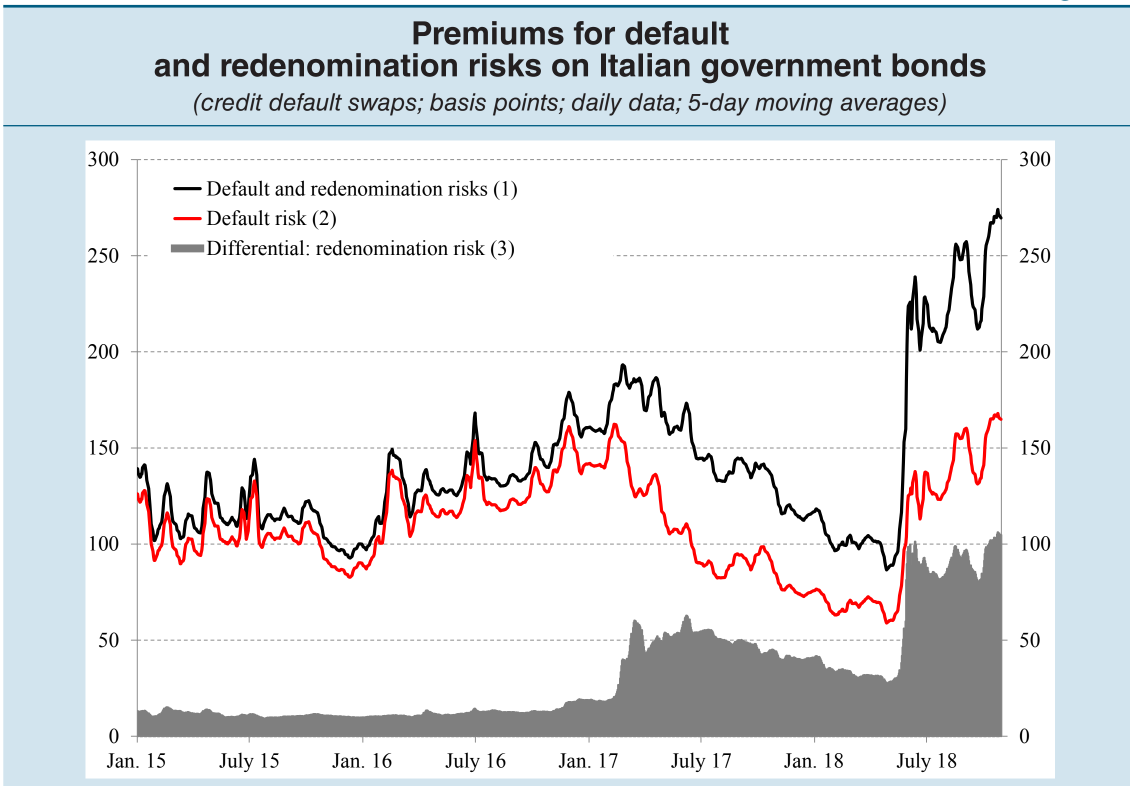


Source: Based on Bloomberg data.

Figure 2

Premiums for default and redenomination risks on Italian government bonds

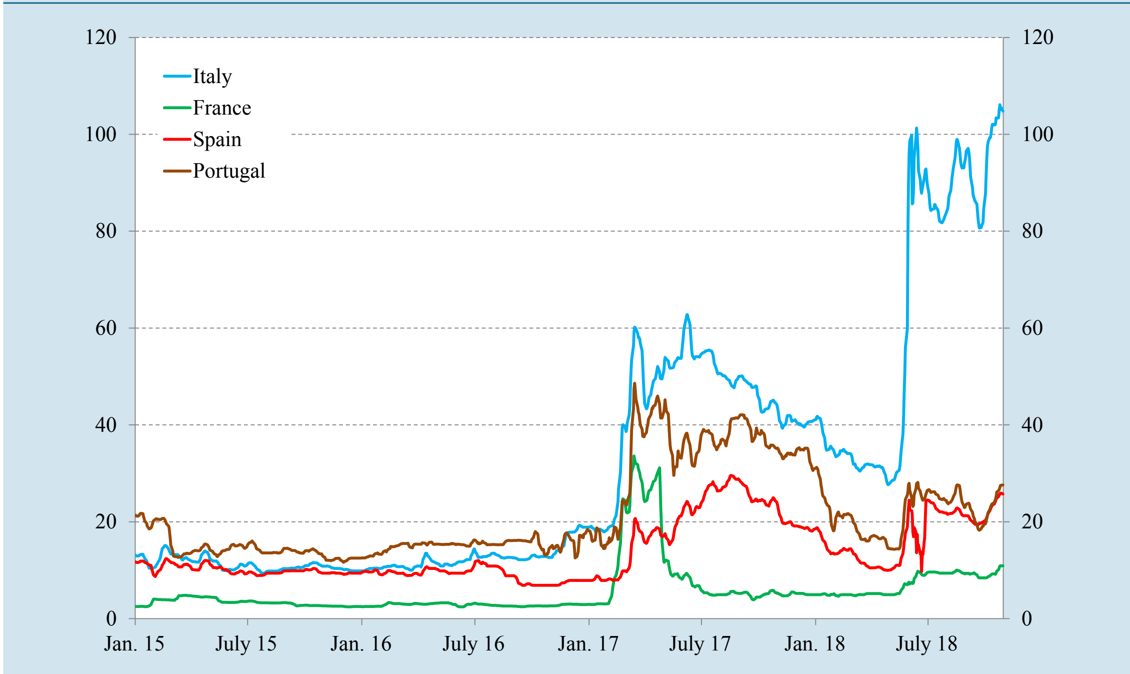
(credit default swaps; basis points; daily data; 5-day moving averages)



Source: Based on Thomson Reuters data.
(1) Premium on the Italian sovereign CDS ISDA 2014 contract with 5-year maturity. – (2) Premium on the Italian sovereign CDS ISDA 2003 contract with 5-year maturity. – (3) Spread between the premiums on the CDS ISDA 2014 and the CDS ISDA 2003 contracts with 5-year maturities.

Figure 3

Redenomination risk premium
on the government bonds of some euro-area countries (1)
(credit default swaps; basis points; daily data; 5-day moving averages)



Source: Based on Thomson Reuters data.
(1) Spread between the sovereign debt premiums on the CDS ISDA 2014 and the CDS ISDA 2003 contracts with 5-year maturities.

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