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Speech by the Governor of the Bank of Italy
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Recent economic developments

Since mid-2018 the global economy has been slowing. The euro area has recorded a significant weakening of productive activity; in Italy it has declined. Several factors, some of which are temporary, have contributed to the deterioration of the macroeconomic situation; the foreign demand outlook, firms' expectations and investment trends have also worsened.

In the second half of 2018, industrial production in the euro area declined by 0.5 per cent. The fall was sharpest in Germany (2.2 per cent) and Italy (0.8 per cent), in part owing to the automotive sector's compliance with the new international legislation on emissions from light-duty vehicles.

In Italy domestic demand was affected by heightened uncertainty, initially linked to doubts about the country's stance on participation in the single currency and then to the difficult passage of the budget law, marked by clashes with the European Commission that were not resolved until the end of the year. The resulting increase in the risk premium on government debt was transmitted to private sector borrowing costs at a time when share prices were falling.

Our latest growth projections for Italy in 2019 published in January's *Economic Bulletin* stand at 0.6 per cent, in line with those of the leading national and international forecasters, but with significant risks on the downside. Compared with the early December estimates – when the central projection was for 1.0 per cent growth – the revision mostly reflects the incorporation of unfavourable economic data that have since become available, confirmed by those for the fourth quarter released this week by Istat. Other contributory factors were the cutbacks in investment plans reported by firms in our surveys and the worsening of foreign demand expectations.

The projections take account of the support given to aggregate demand in the expansionary budgetary measures for 2019, whose effective contribution will depend on how they are implemented. The agreement reached by the Government and the European Commission has partially lowered tensions in the government securities market, with generally positive effects on demand. Economic activity will benefit from the maintenance of highly accommodative monetary conditions.

The projections for this year and the subsequent two-year period, which indicate a return to growth of around 1 per cent, are subject to notable risk factors originating both inside and outside of Italy. The main external factors are the performance of foreign trade, vulnerabilities in emerging countries, and the eventual terms of the UK's departure from the European Union. On the home front, interest rates on government securities remain a significant risk factor.

The protectionist stance of US trade policy vis-à-vis China, with which a complex negotiation is under way, and the European Union, already hit by last year's introduction of aluminium and steel tariffs, could be accentuated. Further uncertainty stems from the slowdown under way in the Chinese economy, partly linked to initiatives designed to limit private sector borrowing, and from the difficult political and economic conditions of important emerging economies.

A no-deal Brexit could have serious consequences even if the direct impact on international trade, while strong for the United Kingdom, may prove limited for Italy and for the EU as a whole. Any financial market malfunctions could have major repercussions for all the countries involved and this issue is currently being looked at very closely.

Together with the supervisory authorities the Italian government has prepared a number of contingency measures. These provide for an adequate transition period to guarantee the integrity and business continuity of the markets and of intermediaries – both British intermediaries operating in Italy and Italian intermediaries established in the UK – and to safeguard investors and customers. Important decisions have already been taken by the European Commission, which is currently working to ensure the continuity of financial transactions between European intermediaries and British central counterparties. The Single Resolution Board (SRB) has also announced that it will be flexible with European banks in the event that securities issued in the UK no longer count towards the minimum requirement for own funds and eligible liabilities (MREL). As national and European authorities have recalled on many occasions, banks must nevertheless play an active role in the preparations for a no-deal scenario.

Since the mid-November peak, yield spreads between ten-year government bonds and the corresponding German securities have narrowed by around 80 basis points. At 250 basis points on average this week, the risk premium on Italian government bonds nonetheless remains high, around double what it was on average in the first four months of last year.

The uncertainty surrounding fiscal policy has not disappeared. An agreement with the Commission was reached for 2019, but for 2020-21 numerous questions remain open, especially the future of the 'safeguard clauses', whose cost has now gone up to 1.2 per cent of GDP in 2020 and 1.5 per cent in 2021. Were they to be deactivated without any countermeasures in place, the deficit would be around 3 per cent of GDP in both years.

For budgetary policy to support economic activity effectively, it must preserve confidence in the improvement of the public accounts and the reduction of the ratio of debt to GDP. The volume of public sector securities to be placed annually on the market is still massive: almost €340 billion just for the rollover of securities maturing in 2019, on top of the roughly €50 billion expected to be needed to finance the deficit.

Financial market conditions remain tense. Since last spring's peak, share prices have come down by 12 per cent in the euro area and by 17 per cent in Italy. In the same period, private bond yields have risen by 40 and 100 basis points respectively (to 1.6 and 2.5 per cent). Italy's divergence from the euro-area average has been most evident in the banking sector, where stock market indices have fallen by almost 40 per cent on average compared with 30 per cent in the euro area and bond yields have almost doubled, reaching 2.4 per cent, against an average increase of 0.3 percentage points in the euro area as a whole.

The higher borrowing costs borne by Italy's banks have up to now been transmitted to interest rates on loans to a lesser extent than in the past, thanks to the stronger balance sheets of credit institutions and the rebalancing of their liabilities towards financial instruments that are less vulnerable to changes in market interest rates. Signs of a moderate tightening in credit access conditions are nevertheless beginning to emerge from business surveys.

Last week the ECB's Governing Council expressed concern about the increased downside risks surrounding the euro-area growth outlook, which could affect inflation developments over the medium term. The reduction in consumer price inflation, to 1.4 per cent in January, primarily reflects the slowdown of the energy component but at 1.1 per cent core inflation is still struggling to recover. The transmission of the increase in wages to prices has been slowed by the weakness of economic activity in recent months, which has translated into lower profit margins for firms. The Council will continue to pursue the price stability objective – commonly defined as a rate of inflation below, but close to, 2 per cent in the medium term – with tenacity and patience.

Significant monetary stimulus will be guaranteed by low key interest rates, the large volumes of securities in central banks' portfolios and the reinvestment of principal payments from maturing securities, which will continue for an extended period of time. Should the macroeconomic conditions require it, the Council stands ready to utilize all the instruments at its disposal to ensure, with the support of aggregate demand, the rapid readjustment of inflation towards the price stability objective.

To reap in full the benefits of the expansionary conditions fostered by monetary policy requires the contribution of reforms to reduce the structural weaknesses of our economy, which magnify cyclical difficulties. Decisive progress must be made in promoting a more business and innovation-friendly environment, encouraging labour market participation, raising the quality of human capital and improving the efficiency of public services. Since 1999, Italy's annual average growth has been 1 percentage point below that of the euro area. In the absence of consistent structural progress, what at international level are cyclical slowdowns tend to be transformed here in Italy into stagnation and a decline in productive activity.

The wellbeing of households depends on numerous factors but the capacity of the economy to grow is vital. Public investment can support it, in tandem with private investment, if rapidly and efficiently executed in the context of a gradual rebalancing of the public finances. Above all, however, interventions to strengthen and modernize the productive structure, to render it more dynamic and capable of creating additional job opportunities, must continue to play a central role in Italian economic policy. Even if, as with past initiatives, they will take time to bear fruit, their implementation can immediately support firms and households' confidence and, in this way, their propensity to invest and consume.

Financial intermediaries

The improvement of credit quality in Italy, under way since mid-2015, continued in 2018. In the third quarter the non-performing loan rate decreased to 1.7 per cent, in line with the figures prevailing before the global financial crisis. For business lending, the decline came to a halt in the closing months of 2018 with the onset of the cyclical downturn. In the first nine months of 2018, also following a considerable number of disposals, the stock of non-performing loans (NPLs) decreased from €259 billion to €216 billion gross of loan loss provisions, and from €129 billion to €99 billion net of them. The NPL ratio declined from 6.1 to 4.8 per cent in net terms; the coverage ratio rose by almost 4 percentage points, to 54 per cent.

For the significant groups, the reduction in net NPLs, amounting to 4.5 per cent of total lending at the end of September 2018, is consistent with the plans that banks agreed with the supervisory authorities. The requests to raise the coverage ratios for the stock of NPLs, made to all euro-area significant banks, take account of each bank's specific situation; they will be effective as of next year and envisage the attainment of full coverage over a period extending to 2026 for banks with relatively high net NPL ratios.

For the less significant banks, the net NPL ratio stood at 7.1 per cent at the end of September 2018; it exceeded 10 per cent for 50 of the 270 mutual banks, which accounted for about half of the total NPLs held by that category. Of the roughly 100 intermediaries that are not mutual banks, an NPL ratio above 10 per cent was observed for 23 banks, accounting for one third of the NPLs of the sector. The plans to reduce NPLs prepared by the main less significant banks in recent months on the basis of the guidelines issued by the Bank of Italy at the beginning of 2018 are now being examined by the Bank's supervision department. Projects that envisage cooperation between banks and operators specializing in the management of NPLs can also be a good solution for unlikely-to-pay loans of firms in temporary difficulty.

Profitability improved in 2018. In the first nine months of the year, the annualized return on equity rose to 6 per cent for Italian banks as a whole, from 4 per cent in the same period of 2017. The share of revenue absorbed by operating costs, which averaged 65 per cent, nonetheless remains excessively high, especially for the less significant banks (which recorded an average share of 74 per cent). In the period considered, these banks saw their costs rise, while the significant groups reduced them; the gap was especially wide in the staff costs component.

The ratio of common equity tier 1 capital to risk-weighted assets (CET1 ratio) decreased from 13.8 to 13.1 per cent in the first nine months of 2018. The reduction reflected the losses connected to the tensions in the government bond market. The impact was greatest for the less significant banks, which generally invest a higher share of their assets in government bonds.

Since the end of 2017, when it had reached a low of €280 billion, banks' exposure to Italian government bonds has risen. At the end of November 2018, the value of the securities in banks' portfolios stood at about €330 billion, just under 10 per cent of total assets; it remains below the peak of €400 billion registered at the beginning of 2015. The purchases, which were concentrated in May and June, occurred in parallel with the rise in yields, at a time of weak credit demand. Banks' investments help to stabilize government bond prices in periods of heightened tension and can enable subsequent capital gains if prices recover; however, they expose intermediaries to the risks associated with further drops in prices.

The share of securities classified in the portfolio valued at amortized cost, whose temporary changes in value do not affect capital, rose from 18 to 49 per cent on average between the end of 2017 and November 2018; it reached 61 per cent for the less significant banks. This increase helps attenuate the impact of fluctuations in the value of government bonds. The decrease from 4.2 to 3.6 years in the residual maturity of the securities classified in fair-valued portfolios goes in the same direction. The expansion in economic activity and orderly conditions on the sovereign debt market facilitates, together with renewed investor confidence, a gradual decline in the stock of government securities held in banks' balance sheets, as shown by the significant reduction in exposures between the beginning of 2015 and the end of 2017.

The global financial crisis, the sovereign debt crisis and the attendant double-dip recession led to a significant restructuring of Italian banks' liabilities. There has been a sharp reduction in market funding; risk premiums have increased owing to factors specific to the banking sector and to the changes in the conditions of the public finances.

Since 2011, the decrease in interbank funding has been accompanied by a considerable increase in recourse to central bank refinancing. Over the last few years, in the four targeted longer-term refinancing operations carried out between June 2016 and March 2017, the Eurosystem allocated about €240 billion to Italian banks of the €740 billion destined for euro-area banks. These operations have helped to sustain the disbursement of loans to households and firms and to lower the cost.

From 2011 to today, net bond issuance on the international markets, mostly by large banks, has been negative overall, at -€47 billion; the share of bonds in total funding has gone down from 11.5 to 9.5 per cent. The recent resurfacing of tensions in the government securities market has made it harder to access international markets. The rate of return demanded by investors on uncovered senior bank bonds with a 5-year maturity is currently around 1 percentage point higher than that demanded for France and Germany's main banks.

The Eurosystem's liquidity support to banks will continue for as long as the euro area's financial situation requires it. However, restoring normal access to wholesale markets is a prerequisite for the proper functioning of banking activities;

it will also help to limit the costs incurred by medium-large banks for the creation of a buffer capable of absorbing losses, as provided for by the new European rules on crisis management. In the course of this year, the SRB will set an MREL target that is binding for most of Italy's significant banking groups, providing an adequate transition period for them to reach it, if necessary.

During the debate that led to the agreement on the 'banking package' at the end of last year (which updates the rules on prudential requirements and reviews the criteria for setting the MREL), we pointed out on more than one occasion the importance of reconciling the need to guarantee appropriate amounts of liabilities that can be used in the event of resolution with that of ensuring they are issued in a gradual and orderly manner, thereby avoiding repercussions on the funding of the economy.

Aside from the practical difficulties of implementing a bail-in, eligibility for the resolution procedure is in any case restricted to large banks when this is deemed to be in the public interest, justifying recourse to the Single Resolution Fund. In the event of a crisis for smaller banks, an orderly winding-up can only take place if a bank interested in acquiring assets and liabilities makes a rapid and systematic intervention. In the absence of a purchaser, however, there would be no alternatives to an ordinary or 'atomistic' winding-up.

This procedure, as well as destroying value, may compromise the continuity of critical services at local level, with possible episodes of more widespread contagion. I believe further reflection is necessary at European level, also in light of the experience of the American Federal Deposit Insurance Corporation (FIDC), on the institutions and measures designed to make the exit of smaller banks from the market less traumatic and as economical as possible.

Italy's banks must continue to strengthen their balance sheets and recover adequate efficiency and profitability levels to be able to deal with the current challenges of the financial sector at global level. More resources are needed to shoulder the costs of compliance, an area which has expanded considerably in recent years and whose legislative framework still requires work in order to make it more proportional. Investment is required to exploit digital technology so as to improve the services provided to customers.

To assist growth and make the allocation of resources more efficient, we need a more diversified financial system. The financial needs of firms that are innovative and active at international level cannot be met solely by banks. Despite the progress made over the last few years, the role of capital markets is still too limited, also in comparison with the other large economies in continental Europe. Policies to support non-banking funding sources for firms should be pursued; banks can accompany and benefit from these developments by expanding and innovating the range of services provided.

Looking ahead, the biggest challenge is that of technology, which is drastically lowering the cost of transmitting, processing and storing information and favouring the development of new forms of financial intermediation. Entire areas in the financial industry, from payment services to credit supply, from trading in securities to risk management, have already been heavily affected in some countries by digitalization and the rapid growth in the market share of non-bank entities (FinTech). Additional competitive pressures will come from global firms at the cutting edge of technological innovation (including the 'Big Tech' firms), which can exploit their presence in very big markets.

The authorities must ensure adequate forms of supervision for new intermediaries that take account of their potential and the risks associated with their activities. It is especially important to encourage both FinTech companies and banks to pay due attention to the possible negative consequences of cyber-attacks in a system now steeped in digital technology. We are working alongside the other authorities and intermediaries on maintaining cyber security in the financial sector. We have also reorganized our supervisory department, creating dedicated structures for analysing FinTech, with the aim of anticipating market developments and updating the methods and tools of intervention.

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The prospects for the Italian economy are less favourable today than they were a year ago. They are affected by downside risks, partly originating abroad, but which still primarily reflect Italy's own weaknesses, above all the uncertainty surrounding growth, the fiscal policy stance and the resumption of a credible path to reduce the burden of public debt on the economy.

A high sovereign risk premium exacerbates the imbalance of the public accounts, undermines the capacity of fiscal policy to support the economy and limits the resources available for investment in infrastructure. The fall in the value of government securities impacts negatively on household savings and leads to capital losses for institutional investors, such as insurance companies and pension funds. Banks also face losses, with repercussions on their funding conditions on the markets; this impairs their ability to supply credit to the private sector and thereby to support production.

The activation of this vicious circle has been slowed by the relatively high average maturity of the public debt, the expansionary monetary policy conditions and banks' capitalization levels. These are positive factors that may, however, turn out to be insufficient in the event of sudden financial market movements, a risk that we have already faced in the past.

This risk must be avoided by keeping a close watch on the public accounts – in the short and long term – and through the decisive implementation of cohesive reforms to preserve the trust of savers and regain that of investors. The ultimate goal, requiring perseverance and determination, has to be that of a lasting return to a path of social and economic development.

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