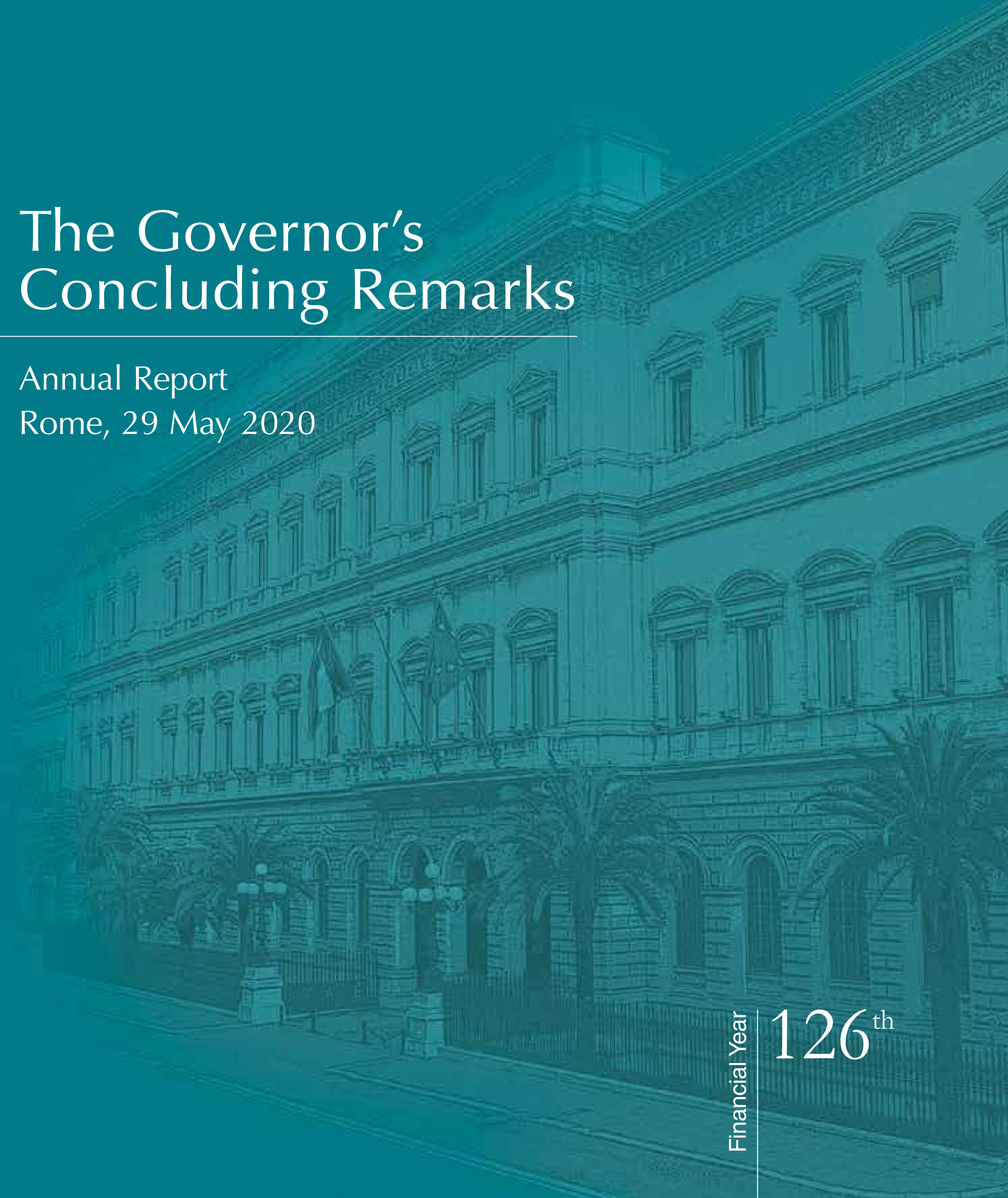
BANCA D'ITALIA
EUROSISTEMA

The Governor's Concluding Remarks

Annual Report
Rome, 29 May 2020



126th FINANCIAL YEAR

2019

Financial Year 126th

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Ladies and Gentlemen,

Since the beginning of the year, the rapid spread of the new coronavirus all over the world has led to an extremely serious public health emergency. Millions of people have been affected and hundreds of thousands have lost their lives. In order to contain the pandemic, it has been necessary to introduce drastic measures to curtail people's movements and social interaction, to suspend teaching in schools and universities, and to temporarily close down many productive activities. This is a crisis without parallel in recent history and it is putting the organization and resilience of the economy and society under severe strain.

The propagation of the virus has had serious financial repercussions, with a massive shift of funds towards assets deemed to be safer and an abrupt fall in market liquidity. The prices of oil, shares and the bonds of companies with lower credit ratings have plummeted. Sudden capital outflows have led to a marked depreciation in the currencies of the emerging economies. The risks of instability have greatly increased.

The immediate effects on worldwide productive activity have been pronounced. Those that have yet to be recorded are hard to estimate. They will reflect non-economic factors first, such as the course of the pandemic, with the possible appearance of new outbreaks, and the duration of the lockdown measures. Much will depend on the scale and effectiveness of the policies launched in various countries, on the confidence of households and firms, and on how much this experience changes our behaviour.

Disinflationary pressures could be strong and persistent, and a sign of this is the decline in short- and long-term inflation expectations in the major economies. The depth of the recession could be magnified by new turbulence in the markets, by the heightening of the protectionist tendencies that have emerged in the last two years, and by the spread of firm bankruptcies across economies sufficient to trigger systemic crises in the financial sector.

The international economy and the euro-area economy

In the scenario analysed by the International Monetary Fund in early April, which assumes an abatement of the pandemic in the second half of the year, the easing of the containment measures and the implementation of large-scale public interventions to support the economy, world trade declines by 11 per cent in 2020. GDP could fall by 3 per cent, in contrast to the 3 per cent increase forecast in January; this decrease is likely to be concentrated in the first half of the year, but the strength of the subsequent recovery remains highly uncertain. The risks in this scenario, which foresees poorer performances than those recorded during the global financial crisis, are tilted toward the downside (Figure 1).

The Eurosystem's projections will be published in a few days for the ECB's Governing Council meeting. According to the European Commission's estimates, the fall in production in the euro area will be close to 8 per cent, in line with the average of the latest consensus forecasts, which lie within a range of between 5 and 13 per cent.

The reaction of governments, central banks, and supervisory authorities in most countries has been swift and substantial. The advanced and emerging economies decided on extensive increases in spending and reductions in tax revenues: the IMF estimates that the measures adopted up to early April were close on average to 6 and 2 percentage points of GDP respectively; other interventions have subsequently been decided. Public guarantees for particularly large sums have also been introduced on bank loans to households and firms in several countries.

Central banks have used multiple instruments to make monetary conditions more accommodative, to counter the tensions on financial markets and to support lending to the economy. The composition and size of the measures introduced by the monetary authorities have reflected the specificities of the institutional frameworks and the role played by banks and markets in channelling credit to the various economies, as well as the differences in the seriousness of the repercussions of the pandemic. From the end of February until now, purchases of securities and loans to the private sector have increased the size of central banks' balance sheets in relation to GDP by 13 percentage points for the Federal Reserve, by around 8 points for the Bank of Japan and the Bank of England and by more than 6 points for the Eurosystem. Net of gold reserves, this share has risen to 33, 114, 34 and 42 per cent respectively (Figure 2).

The ECB Governing Council's intervention was immediate. In order to sustain lending to households and firms, new refinancing operations for banks were introduced and the conditions applied to the existing ones were improved.

The total amount of funds available for targeted longer-term operations was raised to around €3,000 billion; their cost, which was already negative, has been further reduced. To enable intermediaries to benefit in full from these loans and to limit the possible procyclical consequences on the availability of collateral of any downgrades of public and private sector securities by rating agencies, the eligibility criteria and the control measures for the risks applied to assets that can be used as collateral were also relaxed.

To counter the risks for economic activity and ensure the orderly transmission of monetary policy to all euro-area countries, which is hindered by widening yield spreads, the Governing Council first strengthened its existing asset purchase programmes (APP), increasing their volume to €360 billion until the end of 2020, and then introduced a new extraordinary programme specifically designed to deal with the consequences of the emergency (the pandemic emergency purchase programme or PEPP). The latter has an envelope of €750 billion this year to carry out purchases of public and private sector securities in a flexible manner, with changes to interventions so as to increase their effectiveness in the time frames, countries and market segments where particular tensions might arise.

In March and April, the Bank of Italy purchased Italian government securities at a rate of more than €10 billion a month under the APP alone; there were further interventions, for even greater amounts, as part of the new purchase programme.

The range of interventions decided to date is unprecedented; the Council announced that, if necessary, the amount of the extraordinary purchase programme will be increased and its composition reviewed. We stand ready to make further use of the other instruments at our disposal to guarantee that all sectors of the economy can benefit from accommodative borrowing conditions and an ample availability of funds and to ensure that inflation makes a steady return towards the objective of a level below, but close to, 2 per cent.

Steps must be taken to counter the significant risk of low inflation and the marked fall in economic activity from translating into a permanent reduction in expected inflation or into the possible resurfacing of the threat of deflation (Figure 3). Also as a result of the high levels of public and private debt in the euro area as a whole, this could trigger a dangerous spiral between the fall in prices and that in aggregate demand.

The measures adopted have helped to ease the tensions on financial markets that have nevertheless led to an increase in interest rates in all countries, particularly so in Italy. The yield spread between Italian ten-year government securities and the corresponding German Bund, which had been less than 140 basis points for most of February, widened rapidly to about 300 points towards mid-March; yesterday it stood at 185 points. The fact that it has narrowed over the last few weeks is comforting; it reflects the action of monetary policy and the European initiatives to support production and labour and to boost investment. However, the spread is still almost double those of Spain and Portugal, at figures not consistent with the fundamentals of our economy, which must however be consolidated and upon which we must build (Figure 4).

The action taken by the European supervisory authorities has also aimed to support the economy with measures designed to prevent the rules on prudential treatment of loans from exacerbating the recession. The full use of capital and liquidity buffers has been permitted. It has been made clear that the moratoriums on loans must not have undue consequences for accounting and prudential classification.

Banks have been invited not to distribute dividends, not to repurchase their own shares, and to be particularly prudent in paying the variable parts of remuneration to executives. Thanks to these measures, Italy's banks can count on further capital for continuing to finance the economy and dealing with any losses that might arise on loans.

Europe's institutions have made the use of structural and investment funds and the rules on State aid more flexible and have activated the general escape clause of the Stability and Growth Pact, which permits temporary deviations from public finance objectives. Large-scale expansionary budget measures have been launched at national level. According to the European Commission's assessments, the size of the discretionary policy interventions in the euro area has exceeded 3 percentage points of GDP on average (Figure 5).

The European Council and the Eurogroup have also approved the introduction this month of two new instruments designed to provide financial support to countries affected by the crisis, for a total sum of €340 billion. A European Commission fund that will raise resources on the financial markets will be able to grant loans, at favourable conditions and on a case-by-case basis, worth a total of €100 billion to EU countries to be used for temporary wage supplementation, if steady employment relationships are maintained, or for income support for the self-employed (Support to mitigate Unemployment Risks in an Emergency, SURE).

The European Stability Mechanism's new precautionary credit line (Pandemic Crisis Support credit line) will be able to provide loans with an average duration of up to ten years, to be used for the direct and indirect costs of prevention, treatment and healthcare linked to the pandemic. Each country will be able to obtain a credit line, at almost zero cost, for an amount not exceeding 2 per cent of their 2019 GDP; the maximum total amount that can be provided is around €240 billion; loans will not be conditional on adopting economic policy measures and will only be subject to oversight on the allocation of the resources used, as part of the European semester.

The European Investment Bank has also introduced a series of emergency measures and established the Pan-European Guarantee Fund (EFG) to mobilize resources of up to €200 billion, mainly to support lending to small and medium-sized enterprises. The Commission has just presented a detailed proposal for the establishment of a new recovery instrument (Next Generation EU).

The short-term outlook for Italy and the Government's interventions

The epidemic took hold in Italy earlier than in other European countries. Drastic social distancing measures were adopted to combat the virus and entire production sectors shut down for several weeks, which contribute nearly 30 per cent of national value added and account for around 35 per cent of total employment. The impact has been mitigated by recourse to teleworking. Other sectors not directly affected by the containment measures were also inevitably hard hit, above all the transport sector.

Italy's GDP recorded a fall of around 5 per cent in the first quarter of 2020; the available indicators point to an even bigger decline in the second quarter. As of mid-May, air traffic was down by over 80 per cent compared with last year, motorway traffic by almost 50 per cent, gas consumption for industrial use by almost 15 per cent and electricity consumption by 6 per cent. In the last few months, business confidence indicators and purchasing managers' indices have tumbled.

The measures to combat the virus have slowed its spread; the gradual but clear decrease in the rate of infection made it possible to start reopening production at the beginning of this month. The consequences of this crisis for our daily lives, for how we interact with others, and for the economic decisions of households and firms, may linger for some time to come. It will take time to return to normality, and things will presumably be different from what we were used to until just a few months ago.

The Italian government has acted according to the same priorities that have guided interventions at international level, focusing on the response capacity of the health sector and on help for workers, households and firms. The measures launched between March and May raise this year's government deficit by around €75 billion or 4.5 per cent of GDP.

The social welfare system, already streamlined and reinforced following the sovereign debt crisis, has been temporarily strengthened by extending the possibility of recourse to wage supplementation schemes and lengthening the duration of unemployment benefits. Support has been introduced for the self-employed, as have specific transfers for categories of workers only partly covered by social safety nets and for households in difficulty. There are further interventions in favour of firms, particularly transfers are envisaged for smaller firms whose turnover has fallen sharply.

To support the liquidity of small and medium-sized enterprises and of households, it has been made possible to take advantage of legally binding moratoriums on outstanding loans. Additional moratoriums have been implemented through voluntary agreements. The latest available data indicate that as of mid-May, banks had received nearly 2.4 million applications overall, for a total of just under €250 billion; of these, 84 per cent have been approved and 2 per cent refused, while the remaining share is being assessed.

To facilitate firms' access to bank credit, public guarantees have been made available to the tune of around €500 billion, six times the total of those available at the end of 2019. Based on the latest statement of the task force set up to promote the implementation of the measures adopted by the Government to support liquidity, as of 26 May, the Central Guarantee Fund had received about 395,000 loan applications, for a total sum of €18 billion. Some 90 per cent of applications are for loans of up to €25,000, which are entirely guaranteed by the State. The potential loans to medium-sized and large enterprises guaranteed by SACE and currently being evaluated and processed by banks amount to around €18.5 billion. The granting of guarantees is aimed at preventing liquidity shortages from turning into irreversible crisis situations; even assuming normal enforcement rates, the amount of guarantees available means that looking ahead, the public finances may be encumbered with significant outlays, albeit over a longer period.

The abundant liquidity provided by the Eurosystem and the guarantees made available by the State are making it possible to meet firms' demand for emergency funding. In the two months March and April, lending to non-financial corporations increased by €22 billion, after decreasing by €9 billion in the previous 10 months; annualized growth was equal to almost 17 per cent (Figure 6).

While indispensable, support measures for firms that focus on bank lending could destabilize their financial structure, increasing their indebtedness to an excessive degree. The Government has enacted measures to facilitate the capital strengthening of firms. Tax incentives have been introduced for medium-sized enterprises to help both firms making capital increases by the end of 2020 and those subscribing them. The largest firms will benefit from direct forms of public support via the Cassa Depositi e Prestiti.

The timing and strength of the recovery that will follow the emergency phase depend on factors that are hard to predict. In mid-May, we presented a scenario analysis for the Italian economy based on alternative hypotheses on the duration and extent of the epidemic, its impact on the global economy and its financial repercussions. The estimates will be updated as part of the Eurosystem staff macroeconomic projection exercise and will be published on 5 June.

In the baseline scenario, the fall in production in 2020 would be equal to 9 per cent, greater than that suffered at two different times between 2008 and 2013; the drop would be concentrated in the first two quarters of the year, with a partial recovery starting in the summer (Figure 7). Without the support for demand provided by the fiscal policies set out so far, the contraction in economic activity would exceed 11 per cent. Debt moratoriums and public guarantees on new loans to firms drastically reduce the risk of further amplificatory effects due to a widespread liquidity crisis. In 2021, GDP would recoup about half of the fall. These estimates assume that the containment of contagion at national and global level will continue.

A second scenario based on more pessimistic, though not extreme, assumptions regarding the evolution of the epidemic, the magnitude of the drop in world trade and the intensity of the deterioration in financial conditions, would see GDP fall by 13 per cent this year, and a much slower recovery in 2021. In both scenarios, about half of the fall in GDP would be due to the restrictions connected with the provisions suspending business activity and the consequent contraction in disposable income; the remaining half would reflect the slowdown in world trade and the virtual halt in international tourist flows.

In any case, the fall in investment would be especially sharp, owing to the marked uncertainty regarding the economic outlook. This is already being confirmed by the traditional surveys of firms, which show a large and widespread downward revision of investment plans; for the first time since 2014, a contraction in investment has been reported, to a similar degree in industry and services, greater for small businesses.

The impact of the epidemic on the various economic sectors has been uneven. The immediate effects have been stronger in transport, catering, accommodation, recreation and culture, personal services, and in large swathes of retail trade, all sectors brought to a near halt by the restrictions imposed by the containment measures. Even with a gradual easing of the distancing measures, recovery in these segments will depend on the time it takes for the fears accumulated in the past months to be dispelled.

A significant share of the demand for these sectors' products and services relies on tourism, to which over 5 per cent of GDP and 6 per cent of employment is directly attributable. After the abrupt stop caused by the epidemic, tourism is expected to recover only partially in the second half of this year and in the next; the recovery will be held back above all by the reduction in the number of foreign visitors. This will result in a narrowing of the contribution of tourism to the surplus of the balance of payments, which has traditionally been large.

In retail trade, the upward trend in the use of digital sales channels has intensified. The share of online purchases made with electronic cards, equal to 23 per cent last year, rose to 40 per cent in April, buoyed by the food and clothing sectors, and by retail sales of personal or household goods. In the two months March and April, online purchases of food products and basic necessities from large retailers grew by 170 per cent compared with the same period in 2019. These trends are likely to continue in the coming months, accelerating the recomposition of supply, with further developments in business models featuring a mix of traditional and online sales, including for smaller retailers. This process creates new opportunities, but also transition costs; it will tend to reward the most dynamic and innovative firms.

The recession will have significant repercussions on the labour market. Compared with other countries, the impact on employment in Italy is mitigated by the freezing of layoffs and ample recourse to wage supplementation, which has affected around 7 million workers so far, almost half of all private sector payroll employees. Labour market participation has decreased by almost 300,000, discouraged by the worsening economic outlook and the restrictions on mobility and production that remain in some sectors. Against this backdrop, the unemployment rate (which declined to 8.4 per cent in March, almost 1 percentage point lower than in February) does not provide a full picture of the true impact of the epidemic.

The fall in economic activity has reduced new employment opportunities, affecting above all young people entering the labour market for the first time, seasonal workers, fixed-term employees, and apprentices. It is having a greater impact on the jobs traditionally performed by self-employed workers and on undeclared labour, which is still too widespread in our country.

In the short term, social safety nets are countering the impoverishment of large portions of the population and a widening of economic differences, increased by the greater presence of low-income workers in the most affected sectors. Limits to the availability of liquid financial assets among lower-income households can amplify the consequences of the shock, leading to a significant increase in the number of households unable to maintain an acceptable standard of living.

The recession and the measures adopted to mitigate its consequences are having a strong impact on public finances. For 2020, the Government's macroeconomic outlook envisages a deficit of 10.4 per cent of GDP and an increase of 21 percentage points in the debt-to-GDP ratio, to 156 per cent. Such a burdensome debt legacy requires full awareness of the scale of the challenges ahead. Italy's economy must find the strength to break free from the inertia of the past and to restore a capacity for growth that has been stunted for too long. Despite the deep wounds inflicted by this crisis and the lingering effects of the previous ones that have yet to be absorbed, there will be no shortage of opportunities in the future, and Italy has the means to exploit them.

Returning to the path of development

The pandemic and the recession have opened up extremely uncertain scenarios that make it very difficult to map out what form future equilibriums will take. Uncertainty is another reason to act immediately to strengthen our economy and to press on with that comprehensive package of reforms whose course, for the most part, has already been charted. Only time will reveal the results of our actions, but a comprehensive plan makes the future clearer, shapes expectations, and bolsters confidence; it can draw on a number of strengths that have become apparent in these past difficult years.

Thanks to the recovery of our exports' competitiveness and to the high trade surpluses recorded since 2012, Italy's net external position has reached substantial equilibrium. The financial conditions of banks and firms are better today than in 2007. Italian households' net, real and financial wealth is high: 8.1 times disposable income against 7.3 times on average in the euro area. Household debt is low by international standards, and is concentrated among those with a greater debt repayment capacity; at the end of 2019, it was less than 62 per cent of their disposable income, against 95 per cent for the euro area on average (with a peak of over 200 per cent in the Netherlands), 96 per cent in the United States, and 124 per cent in the United Kingdom. At the end of 2019, corporate debt amounted to 68 per cent of GDP, compared with 108 per cent in the euro area and more than 150 per cent in France and the Netherlands. In the private sector as a whole, debt was equal to 110 per cent of GDP, more than 50 points lower than the euro-area average (Figure 8).

These data nevertheless reveal a disconnect between the resources available and the country's capacity to utilize them to regain the path of sustained and balanced growth, to return Italy as swiftly as possible to levels of well-being not experienced for more than ten years now, and to offer future generations the chance to improve their standards of living, health and general culture.

The demographic trends are not favourable: even taking account of the contribution of immigration (estimated by Eurostat to amount to approximately 200,000 persons on average per year), the population aged between 15 and 64 will decline by more than 3 million over the next 15 years. Nevertheless, assuming that the trends of the last ten years continue in a similar vein, higher female labour market participation and the extension of working lives can enable employment to make a positive contribution to growth, of more than half a percentage point per year. To restore GDP growth to around 1.5 per cent (the average annual level recorded in the ten years leading up to the global financial crisis) will require an average increase in labour productivity of a little under 1 percentage point per year (Figure 9).

This objective calls for a sharp rise in tangible and intangible capital investment, and for productive efficiency gains comparable to those observed in the other main European countries. In any event, its achievement presupposes a break from the recent past; it calls for the resolution of those structural problems, which for too long now we have failed to address, and which have become increasingly pressing in a new technological context and a more integrated world. Last year, the ratio of investment to GDP was still three percentage points below what it was in 2007: this year it will decline further (Figure 10).

The lags with respect to the most advanced economies cannot be recouped by increasing public expenditure without first improving its efficacy and without making structural adjustments to the economy. While it will remain extraordinarily accommodative for a long time, monetary policy is no substitute for the measures needed to raise growth potential.

Resources must be channelled to where the social returns are highest; to do so requires ongoing and substantial improvement in public services, with the necessary simplifications and the right distribution and mindful assumption of responsibilities. The technologies used and the quality and motivational levels of human resources have a profound impact on how administrations operate. We have learnt a lot from this crisis; it has demonstrated the need to fast track the digitalization of working processes and to rethink their organization. The heavy turnover expected in public administration in the coming years will make it possible to hire young, highly-skilled and motivated workers from a variety of backgrounds; we must support and invest in them.

The accumulated lag in infrastructure must be overcome, as regards both traditional infrastructure, which must be upgraded and made more efficient, and highly innovative infrastructure, such as the telecommunication networks, which are necessary to support the technological transformation of the Italian economy. The fixed ultrafast broadband network reaches less than one fourth of households, compared with 60 per cent on average in Europe, and the South of the country is especially penalized. The European Commission ranks Italy nineteenth among the EU states for connectivity.

As has been underlined for too many years now, the quality of human capital must be improved, by tackling the underlying problems of schools, universities and the research sector. A better education system generates higher returns; a country that innovates creates better and more widespread job opportunities. The differences in educational outcomes across local territories perpetuate and increase inequalities of income and opportunity. In many cases, school and university buildings fall short on security, comfort and technology, while teacher quality and motivational levels are of vital importance.

Households must also be convinced of the importance of investing in knowledge: Italy ranks second last in the European Union on the proportion of young people aged between 25 and 34 with tertiary education; it is ranked first for the share of young people aged between 15 and 29 who neither study nor work. This is a loss of individual opportunities that exposes them to the risk of exclusion and is a waste for society as a whole.

Notwithstanding the high degree of efficiency and quality for which research in Italy in renowned, the State invests about €8 billion in its university system, half of what countries similar to Italy invest relative to GDP. Even just the reallocation of a modest portion of the government budget would lead to a marked improvement in youth training and in the ability to produce innovation. This would strengthen Italy's ability to tap into the European resources allocated to research and would also benefit the productive sector, which invests barely 0.9 per cent of GDP in research, compared with the 1.7 per cent invested on average by OECD countries (Figure 11). The hiring of new researchers, envisaged in the recent decrees, marks a significant break with the past.

To stay competitive, businesses must invest in new technology and innovation, open up to sources of external funding and outside professional expertise, and attend to staff training: only by raising productive efficiency and the quality of the goods and services provided can they set their sights on growth. The available tax incentives are substantial by any measure. The positive results of the allowance for corporate equity (ACE) and Industry 4.0 can be built on, by rationalizing and stabilizing these instruments, and by providing certainty to those willing to take up the innovation challenge.

The crisis in the tourist sector has made immediately appreciable the economic importance, and not only, of Italy's natural and historical-artistic heritage that goes to the heart of this country's identity. This heritage must be protected and made increasingly easy to access in ways that are safe for tourists, so that after the pandemic it can contribute again to growth, even more so than before. The opportunities that will come from the inevitably faster transition to an economy with lower greenhouse gas emissions and more digital technology must be seized.

The public resources needed to finance all these measures and to favour the productive use of private funds must come from a restructuring of the public budget, the recovery of the tax base, a reduction in the risk premium on government bonds, and the pragmatic and judicious use of European funds. Excluding interest payments, Italy's public expenditure is comparable with the average for the euro area as a whole, even if the share of pension expenditure is higher and is destined to increase further, driven by the ageing population. Tax revenues are also broadly aligned with the average of the other countries, even if the tax wedge on labour is higher. Where Italy differs most from the other advanced economies is in the extent of its underground economy and tax evasion, which translates into an excessive tax burden for those who play by the rules. The resulting injustices and profound distortionary effects dent the economy's ability to grow and firms' capacity to innovate; they generate privileges of position that damage the efficiency of the productive system. A comprehensive rethinking of the tax system that also takes account of the changes in the social welfare system must set itself the objective of reducing the tax levy on the factors of production.

Policies, reforms and actions that return Italy to the path of sustained, widespread and balanced growth would also help to maintain relaxed conditions on the financial markets, thereby lowering the average cost of the debt and favouring the gradual and necessary rebalancing of the public accounts. The underlying uncertainty that weighs on Government bond yields and makes them so high compared with countries that have similar characteristics, can only be dispelled through economic policy choices that look beyond the short term.

The sustainability of the public debt is not in doubt, but its high level relative to GDP is being maintained by the low growth potential of the country and is, at the same time, an obstacle to economic growth. Compared with the average for the rest of the euro area, economic growth in Italy is lower and the cost of the debt higher; in the last five years as a whole, together with Greece, Italy is the only euro-area country to have recorded a positive and ample gap between the cost of the debt and economic growth. In these circumstances, a primary surplus in the order of 1.5 per cent of GDP, such as the one recorded over the past six years, would be necessary if only to stabilize the ratio of debt to GDP.

By contrast, with an economic growth rate of between 1 and 2 per cent and the narrowing of the yield spread between Italian and German government bonds to levels in line with the two countries' fundamentals, a primary surplus of that size would suffice to reduce the debt burden by around 2 percentage points on average per year. Growth and fiscal policies would reinforce each other, in a virtuous circle that our country is certainly capable of activating.

Italy and Europe

A return to robust and lasting growth by Italy is also important for the future of the European economy as a whole. Within the EU, Italy is in third place for population size and GDP. Taking account of the intermediate goods traded in Europe's value chains, Italy's share of EU exports to other countries stands at 14 per cent. Italy holds almost €300 billion worth of direct investment in the rest of Europe and more than €1,200 billion in portfolio investment. In the last decade, more than 100,000 European citizens have moved to our country each year on average. Italy contributes decisively to making Europe more attractive to tourists and investors. In 2019, there were more than 60 million European visitors to Italy and 35 million from other countries.

In the same way, Europe is important for Italy. European Union countries constitute the main outlet market for Italy's goods, accounting for 50 per cent of our exports. The trade tensions triggered in 2018 by the resurgence of protectionist pressures on the global scene had already underlined the political and economic importance of the European project in navigating an increasingly complex global situation. The pandemic has abruptly intensified the decline in international trade and highlighted the risks connected with an extremely fragmented production system, based on value chains spread across the globe.

In the last two decades, there have certainly been significant economic benefits from production being organized on a global scale but even in more recent times, these benefits had started to wane, particularly in the manufacturing sector and partly as a result of the progress in automation.

Trade with the rest of the world accounts for almost 20 per cent of EU GDP. If globalization continues to regress after the crisis, the growth outlook for European countries will depend more than ever on internal demand within the area and their capacity to act as one.

The European Union is an impressive resource for its citizens. The painful experience of the pandemic today strengthens the case for staying together and not just from an economic point of view. This has been clearly proven by the show of solidarity by the highest representatives of the European institutions, by the leaders and by the peoples of the European nations towards the countries most affected by the pandemic. As I mentioned before, the Commission and the European Council acted rapidly to facilitate national interventions in support of households and firms and new financial instruments were created to support countries in difficulty. The European Central Bank acted decisively, promptly and very effectively.

The reciprocal fears and prejudices that resurfaced during the two crises of the last decade, and which have also at times weighed on the important decisions to be made in this delicate phase, must be definitively overcome and rejected with the responsible contribution of each one of us. European countries are called on to face the same challenges. The exceptional fall in demand exposes households, firms, and financial institutions in all countries to risks for which there can only be a joint response. The pandemic has revealed the potential benefits of a common health strategy. Similar considerations to those valid for health apply to other essential services as well, such as education, defence, security and justice. Both public and private debt are destined to rise in relation to GDP in all countries. In the longer term, there will be a generalized increase in public spending connected with population ageing.

There must also be a joint effort to protect the environment and take full advantage of technological innovation: the amount of investment needed will call for the economies of scale that only a large market such as Europe's can guarantee. The environment and innovation were and still are central to the European Commission's vision for the continent's development. The investment plan proposed in January under the European Green Deal will mobilize at least €1 trillion in sustainable public and private investment over the next ten years. Considerable financial commitments have been made for innovation as well.

The proposal presented by the Commission to the European Parliament two days ago for the creation of new instrument called 'Next Generation EU', reasserts the centrality of the environmental and digital transitions. These are flanked by the objective of reinforcing cooperation in the field of health. The proposal includes the establishment of a €750 billion fund for grants and loans to the Member States (€500 billion and €250 billion respectively). The finance raised on the market by the European Commission would be assigned within the multiannual financial framework of the European Union, favouring the countries that have been hardest hit by the crisis.

This is an important opportunity to prepare a common response which, alongside the monetary measures, is proportionate to the seriousness of the crisis. In such an integrated area as ours, the difficulties of each country inevitably have repercussions on all the others. Only strong, united and coordinated action will enable us to protect and relaunch productive capacity and employment throughout Europe's economy. Putting aside any calculations of the financial advantage for each country, the significance of the Commission's initiative lies in the idea that, in exceptional circumstances, the spending capacity of the EU budget could be increased by borrowing, in order to intervene when and where necessary. The Fund would in fact be financed by the issuance of a common debt instrument by the European Union, which would be the responsibility of all the member countries. Some countries would be net beneficiaries, others net contributors. The role that each country will have to play will depend on its relative needs but also on its capacity to use the resources that will be made available.

By participating in defining the current European strategy, Italy is called upon to make an extraordinary effort, both on a technical front and in terms of planning, to make better use of the opportunities offered than it has done in recent decades under EU programmes. By following a path forged together with our partners towards an innovative and more sustainable economy, we would be more likely to return to the path of development. We would contribute to redefining the economic and social model on which the wellbeing of all the peoples of Europe jointly depends, moving in the direction of justice and efficiency.

This is the third crisis that the European Union has had to face in little more than ten years. We know very well how difficult it is to manage emergency situations when the institutional framework is incomplete, within which the interventions of individual countries may be constrained by weak conditions and the actions of the European institutions may be limited by a lack of instruments. It is worth repeating that the complex system of legal sources, institutional architecture and competencies must not favour uncertain interpretations of the rules guiding its actions. Some steps – even strides – forward have been taken, but we are still waiting for the qualitative leap described in the reports prepared by the presidents of the main European institutions immediately after the sovereign debt crisis.

The financial system and the action taken by the Bank of Italy

Italian banks find themselves facing the crisis from a stronger position than the one they were in before the double-dip recession of 2008-13. The ratio of the highest loss-absorbing capital to risk-weighted assets rose from 7.1 per cent in 2007 to 13.9 per cent last December. The balance sheets have been cleared of most non-performing loans, which have fallen by two thirds over the last four years (Figure 12).

In the first quarter of this year, the banking system's capital position improved further; a contributory factor was the decision not to distribute dividends, in accordance with the recommendations of the supervisory authorities. No liquidity tensions were recorded and retail deposits continued to grow. So far, the impact of the recession has been apparent in difficulties accessing the bond market, which have been widespread across Europe, and in a moderate increase in loan loss provisions attributable to those banks that have incorporated the unfavourable economic outlook into the models used to compute expected losses.

The consequences of the crisis have so far been modest for institutional investors as well. The sharp drop in the prices of financial assets and the rise in their volatility have led to a reduction in the solvency ratio of insurance companies, which nevertheless remains well above the regulatory minimum. The considerable requests for redemptions in the investment funds segment have been met in an orderly fashion, also thanks to the limits on investment in illiquid assets provided for under Italian regulations.

Also thanks to the strengthening achieved in recent years, and to the refinancing operations of the ECB, the banking system is now able to support the substantial liquidity needs of households and firms. As a member of the task force established by the Ministry of Economy and Finance charged with overseeing the efficient and rapid roll-out of the support measures for firms, we have issued clarifications and recommendations to intermediaries. In recent weeks, we have also begun to collect targeted data from banks so that we can monitor the extent to which these measures have been implemented.

As I recalled earlier, the vast majority of applications for a moratorium have been approved. There have been some frictions in the granting of loans backed by public guarantees. The difficulties leading to delays stem from multiple causes.

The volume of applications has been, and continues to be, exceptional; organizational problems and differences between banks' IT systems may help explain some of the lag times recorded in responses to applications, which have been more marked for smaller banks. The procedures required to implement the measures are complex and involve numerous actors. The legislature has had to strike a difficult balance between conflicting needs: on the one hand, the need to rapidly channel resources to those seriously affected by the fallout of the epidemic; on the other, to safeguard the State, ensuring that the guarantees do not extend to loans that are at very high risk of default or that are susceptible to criminal use. Furthermore, the legislative framework is new and not yet stable.

In the absence of any explicit regulatory provisions, banks that fail to conduct a creditworthiness assessment expose themselves to the risk of committing a crime. Intermediaries are also rightly required to carry out the controls provided for by anti-mafia and anti-money laundering legislation, which safeguard against risks that have increased significantly during the emergency. Several amendments are designed to resolve or mitigate some of these problems; in the testimonies we have given before the Parliamentary committees we have addressed these problems and proposed some possible solutions. I am confident that in the coming weeks, with the cooperation of all those involved, we will see substantial improvements in the flow of resources to the economy.

Notwithstanding the progress of the last few years, the depth of the recession will inevitably affect banks' balance sheets in the medium term. The increase in non-performing loans will have to be dealt with in a timely manner, using all available instruments, including those for their restructuring and sale on the market. Should it prove necessary, we must stand ready to explore solutions to safeguard the system's stability, considering preventive tools to help banks that are facing severe, even if presumably temporary, difficulties.

The fall in productive output could exacerbate the problems of some intermediaries that do not have ample capital reserves, especially small banks with traditional business models. We welcome the recent measures designed to facilitate the management of crisis situations at these intermediaries, and view the resources allocated as a first sign of willingness to intervene. However, we continue to be concerned about the inadequacy of the European bank crisis management framework, about which we have spoken on many occasions.

The cooperative banking groups formed just under a year ago are now in a position to face the challenges posed by the recession by reaping the benefits of integration. The ability to raise funds on the capital markets is vital today; any steps backward from what has already been achieved would constitute a grave and costly regression. Close ties to local communities and their mutualistic spirit do not remove the need for strong governance and skilled managers, both in the parent company and in the member cooperative credit banks. Profitability must be sufficient to ensure that they are adequately capitalized, a precondition for the performance of their cooperative role.

In financial intermediation, too, the public health emergency and the containment measures have made the advantages of digital solutions even more tangible. This will inevitably lead to an acceleration of investment in new technologies, which with the achievement of appropriate economies of scale can be made at a lower cost and to greater advantage. These savings, in turn, will make it easier to raise the resources necessary to support investment, including through access to the financial market.

There are many areas that could benefit from technological innovation: service distribution, customer creditworthiness assessment and monitoring, and regulatory compliance processes. In the retail payments sector, a traditional incubator of innovation, the opportunities offered by technology can provide real benefits to users of the services. The supply of bank loans to firms through digital channels, which is still very limited in Italy, can now make rapid and substantial progress.

The Bank of Italy is active on a number of fronts to address the changes prompted by technological innovation in financial services. We have strengthened dialogue with operators through our innovation hub, our FinTech Channel, and through new procedures to authorize market access; we are collaborating with the Ministry of Economy and Finance in a forum for authorities on digital innovation and participating in the launch of a regulatory sandbox; we support the development of system solutions designed to ensure the proper balance between the need for standardization and competition in innovative sectors, procedures for updating regulations and legal certainty, new investments and risk mitigation.

We will soon establish a dedicated unit tasked with proposing and coordinating Fintech initiatives, as well as monitoring retail payment services and instruments. This will allow us to capitalize on the synergies between banknote circulation, electronic payments and digital services, and strengthen our capacity to observe phenomena that could lead to the development of new products in the future.

Our efforts remain focused on supporting the development of a broad-based and safe digital economy, providing support for innovative projects promoted by the private sector and ensuring that households, firms and general government derive the maximum benefit. We will promote the nation's main financial centre, namely Milan, as a digital innovation hub on a European scale. There will also be an office in Milan dedicated to experimentation, to gathering the contributions of Italian and international independent experts and companies, to collaborating with institutions and universities, and to engaging in dialogue with market operators.

Advanced data analysis techniques enable us to improve the efficacy of our supervision and control in the areas of anti-money laundering and transparency. The Financial Intelligence Unit for Italy regularly uses them to identify anomalies in financial transactions and to assess, together with the bank's supervisory arm, the degree of risk of money laundering to which intermediaries are exposed. We are also experimenting new ways of using artificial intelligence to extract specific data from suspicious transaction reports and complaints, with the aim of both identifying phenomena requiring intervention by the FIU and of guiding the work of prudential supervision and consumer protection initiatives.

The new Directorate General for Consumer Protection and Financial Education will allow us to focus on improving and making more effective the channels of communication with users of banking and financial services, on strengthening controls on intermediaries' behaviour, on the drafting of regulations, on reinforcing the Banking and Financial Ombudsman (ABF), and on promoting financial education. The new prudential supervision and supervisory protection organizational framework will strengthen our synergies and collaboration with the other authorities working on the same fronts: Consob in the area of financial services, IVASS as regards insurance products, COVIP for supplementary pension schemes, and the Competition Authority (AGCM) for unfair commercial practices. We continue to cooperate in many areas with the judicial authorities to prevent and combat crime, and to support the efforts of the investigative bodies and the judiciary.

Our commitment in the area of financial stability extends to overseeing the markets and the relative infrastructures, especially those that help the government securities market and the payments system function smoothly. We have devoted particular attention to strengthening the financial sector's cyber resilience, in line with the Government's national security strategies.

Throughout this emergency, we have never failed to ensure the orderly and continuous functioning of the payment and settlement systems that we manage at national and European level. We have continued to provide services to general government and to citizens, including through the online channels that have been gradually set up in recent years.

The Bank of Italy's tasks also still include the crucial one of managing monetary policy. Even at this difficult time, we have contributed to its definition and implementation. Against a backdrop of rising complexity and heightened financial tensions, the frequency and scope of our daily market operations has increased significantly. We have greatly expanded our refinancing of banks, including among eligible loans also those backed by the State guarantees provided for under the recent Government measures.

As happens each year, more detailed information on our operations is provided in our Annual Accounts, published at the end of March, and in the Report on Operations and Activities of the Bank of Italy, available to you here today, along with our Annual Report.

* * *

We are living through the greatest public health and economic crisis in recent history. In Italy, as in many other countries, doctors and nurses have been placed under unprecedented pressure. Thanks to their commitment, in the most difficult of conditions, even more dire consequences have been averted. Our thoughts are with the many among them who have paid the ultimate price, with all the victims of this tragedy and with their families.

In Italy as in the rest of the world, the economic policy response was aimed first and foremost at managing the health crisis and at slowing the spread of the virus, including through drastic lockdown measures. Extraordinary budgetary provisions have brought relief to households and firms whose jobs, livelihoods, and income have all been affected. If not curbed by these measures, and by grantedly massive and timely monetary policy interventions, such a profound crisis would have had even more deleterious effects on the productive sector and on society as a whole. However, just as social distancing flattens the curve of contagion without eradicating the virus, so do the support measures help to dilute and mitigate the repercussions of the crisis over time without eliminating its causes.

Today uncertainty is rife, not only about the course of the pandemic but also about the repercussions on behavioural patterns, on consumption and on investment decisions. We ask ourselves what new needs will emerge and what social mores will be definitively left behind. And we wonder about the possible consequences beyond the immediate term, for how our society and productive activity is organized.

In the coming months, demand will slowly begin to pick up. It will be necessary to avoid imprudent behaviour and to keep our guard up to prevent the infection curve from rising again. The productive system must guarantee safe working conditions and address changes in global value chains; supply will also be recalibrated to satisfy the new needs of customers; and investment plans will be revised. During this transition, employment may fall and workers may remain furloughed; consumption will be held back, also owing to the possible increase in precautionary spending driven by apprehension not only about the economic outlook. Social unrest may grow; the budgetary measures are designed to counter this eventuality.

After the pandemic wanes, the world will be a different place. While we may to some extent perceive and combat, with all of our strength, the gravity of the social and economic consequences in the short term, for the longer term effects we can only acknowledge what we know we do not know. It is very difficult to predict what shape these new equilibria will take or what new normal awaits us, if indeed it is possible to speak of such things as equilibria and normalcy. To cope with such uncertainty it is, however, vital that today, more than ever before, we rapidly bridge the gaps and overcome the constraints that have long since been identified. Today, more than ever before, because one thing is certain: after the pandemic there will be much higher levels of public and private debt and greater inequalities, not only of the economic kind. Only by consolidating the foundations from which to start again will it be possible to rise to the challenges that we must face.

The devastation wreaked by the pandemic is of a different kind to that experienced during a world war and it is hard to compare the two. We can, however, start from an image of how a great war can be managed. Eighty years ago John Maynard Keynes wrote: '…it is recognised that the best security for an early conclusion is a plan for long endurance…a plan conceived in a spirit of social justice, a plan which uses a time of general sacrifice' – we might well say such as the one being made in this period – 'not as an excuse for postponing desirable reforms, but as an opportunity for moving further than we have moved hitherto towards reducing inequalities.'

It will be vital to put the resources mobilized to good use to overcome the most serious difficulties, to create without delay the conditions for recouping lost ground, to use technological progress to our advantage to return to more balanced and sustainable growth, one that generates employment and also allows us to lower the burden of the public debt, with the right degree of graduality but fearlessly.

Let us recall here the strengths of our economy. Notwithstanding the delays and difficulties, especially at regional level, in recent months the network infrastructures have held up, enabling thousands to continue to work remotely. The manufacturing sector is flexible and, since the sovereign debt crisis, has rapidly recovered competitiveness, bringing the balance of payments into surplus. Italy's net external debt is practically nil. The real and financial wealth of households is high overall and their levels of indebtedness among the lowest in the advanced countries, while those of firms are below the European average. The financial system, stronger now despite the double-dip recession, is in decidedly better shape than it was on the eve of the financial crisis.

There are, however, some investments that cannot be avoided, in particular those addressed to innovation in productive activities and improving the environment, investments which must increasingly be interlinked. A business-friendly context requires resolute, rapid and sweeping interventions to raise the quality and efficiency of public services substantially. And we need to emphasize, if possible even more so today, how important it is to invest in increasing the levels of culture and knowledge, from school to university and to research.

A renewed economic environment could bear fruit if all the stakeholders who are part of it – firms and households, students and workers, financial intermediaries and savers – are each able to assume full responsibility for their own role. Yet it is not only a question of economics. While the transformations that the economy, society, politics and culture will undergo are uncertain, there will undoubtedly be interactions and reciprocal influences. We have to recognize and be open to many different points of view, interests and needs. It will be necessary to foster rational debate and constructive dialogue among those with different skills and among those whose responsibilities may differ but who nonetheless are neither distinct nor distant entities.

What is needed is a new relationship between the Government, businesses in the real economy and in finance, institutions, and civil society. We can avoid calling it, as has been suggested, a need for a new 'social contract', but here too we must move in the direction of rational debate and to breathe life into constructive dialogue.

A new kind of relationship is indispensable in Europe as well. Each country must use the resources placed at its disposal by the European institutions pragmatically, transparently and, above all, efficiently. European funds can never be 'free of charge': Europe's debt is everyone's debt and Italy will always contribute greatly to the funding of European initiatives, because it is the third largest economy in the EU. But joint, strong and coordinated action will protect and contribute to relaunching production capacity and employment throughout the European economy.

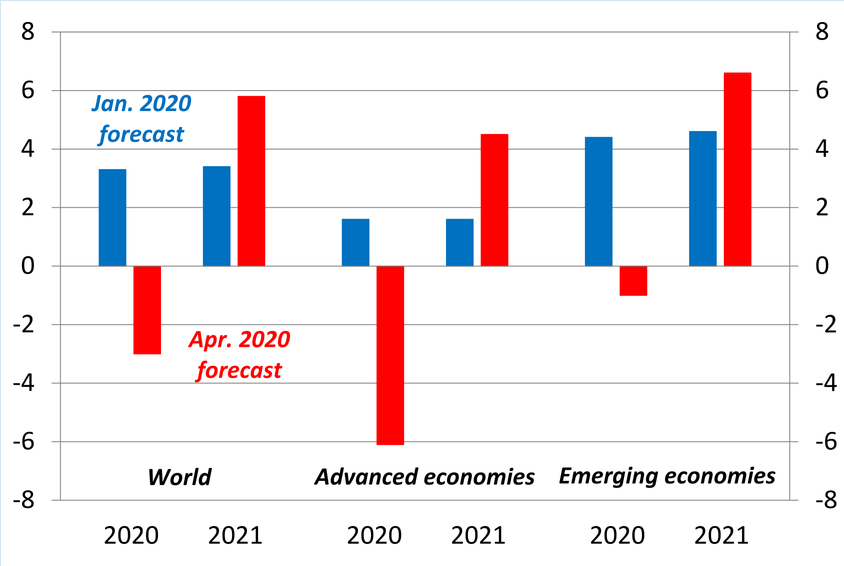
The importance of the Commission's recent proposal is not in grants substituting loans, but that there will be collective responsibility for funding the recovery: this would be the first step towards fiscal union and the completion of the European project. Embracing this idea with conviction in order to design it carefully and plan its implementation is a necessity that can no longer be postponed. A united commitment is in the collective interest: the dramatic circumstances of today bolster the reasons for standing together, they drive us to pursue a project that can mobilize resources to support growth that is both inclusive and sustainable.

Today we hear the phrase 'we can get through this' from many quarters. We say it too, but it must not be merely rhetorical optimism; rather we must take on a concrete commitment together. We will get through this by making wise and informed choices and by being farsighted. We will get through this, starting from strong points that we sometimes forget, by finally facing the weaknesses that we sometimes don't want to see. Many people have lost their lives, many are mourning their loved ones, many fear losing their jobs, but no-one must lose hope.

FIGURES

Figure 1

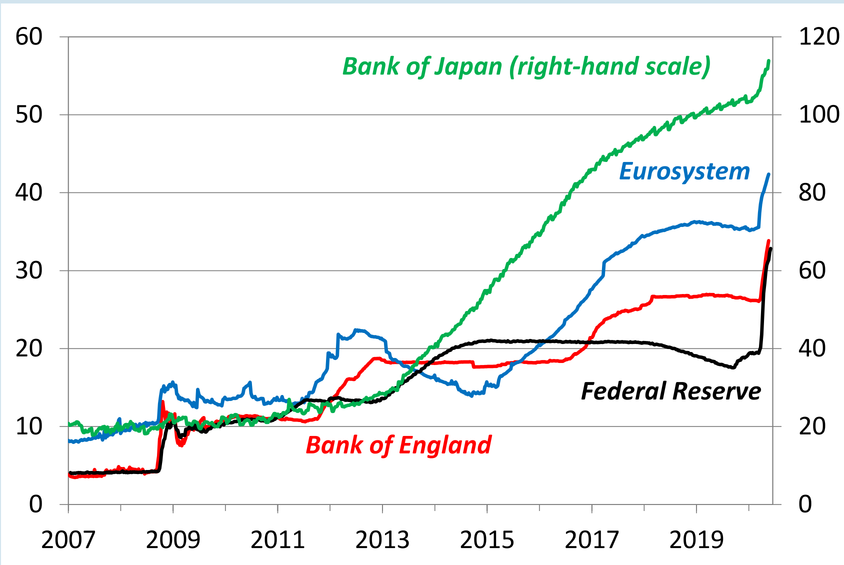
GDP growth forecasts
(per cent)



Source: IMF.

Figure 2

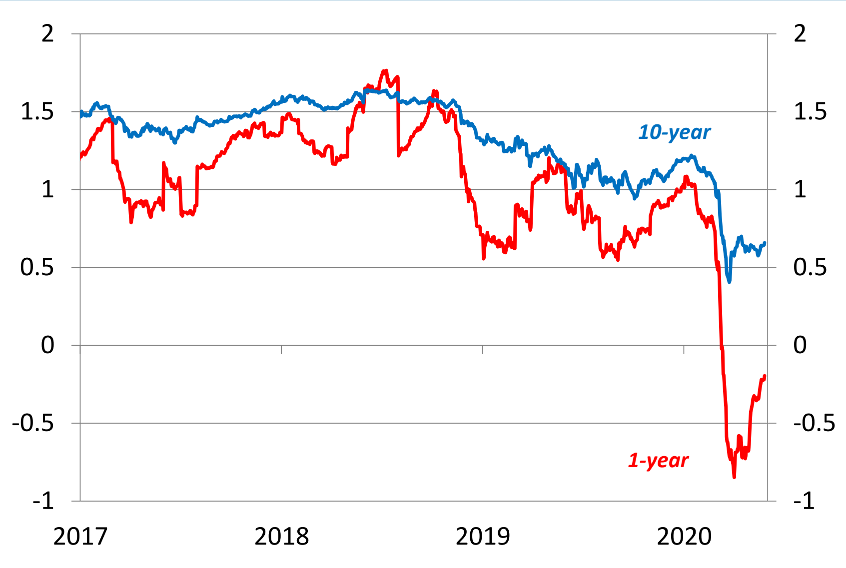
Balance sheets of the main central banks: total assets
(per cent of GDP)



Sources: Based on data from central banks and national statistics offices.
Note: Total assets, not including gold, as a percentage of GDP in 2019. Data at 22 May 2020.

Figure 3

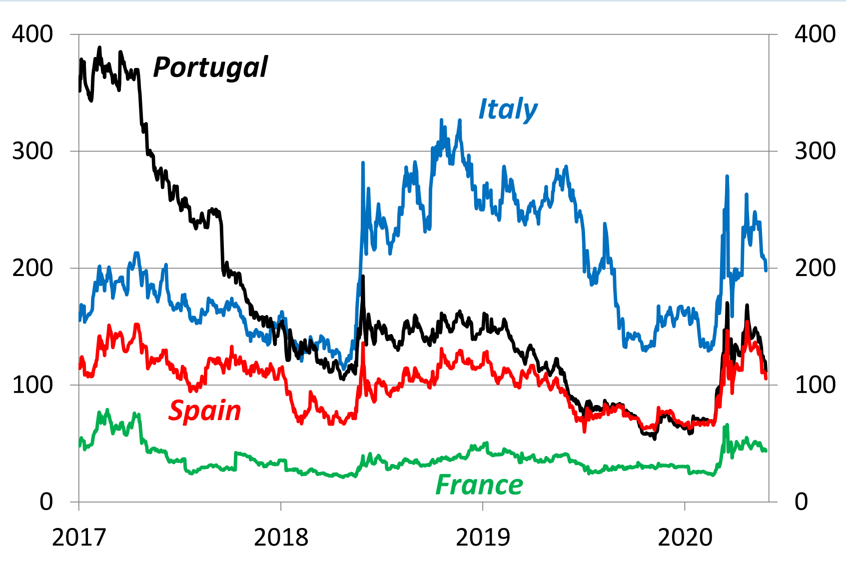
Inflation expectations in the euro area
(per cent)



Source: Bloomberg.
Note: Inflation swap rates. Data at 26 May 2020.

Figure 4

Sovereign spreads
(basis points)

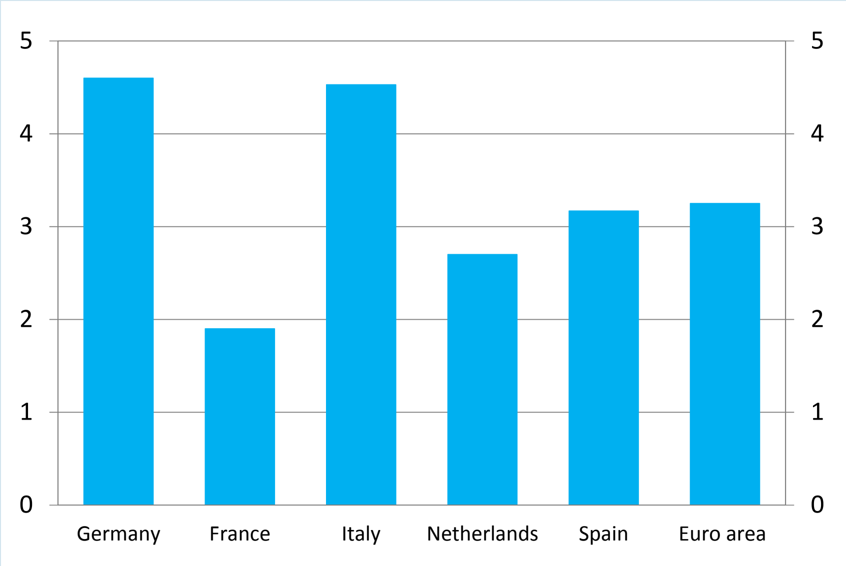


Source: Based on Bloomberg data.
Note: Yield spreads between the ten-year government bonds and the corresponding German Bund. Data at 26 May 2020.

Figure 5

Discretionary budgetary measures in response to the epidemic

(per cent of GDP)

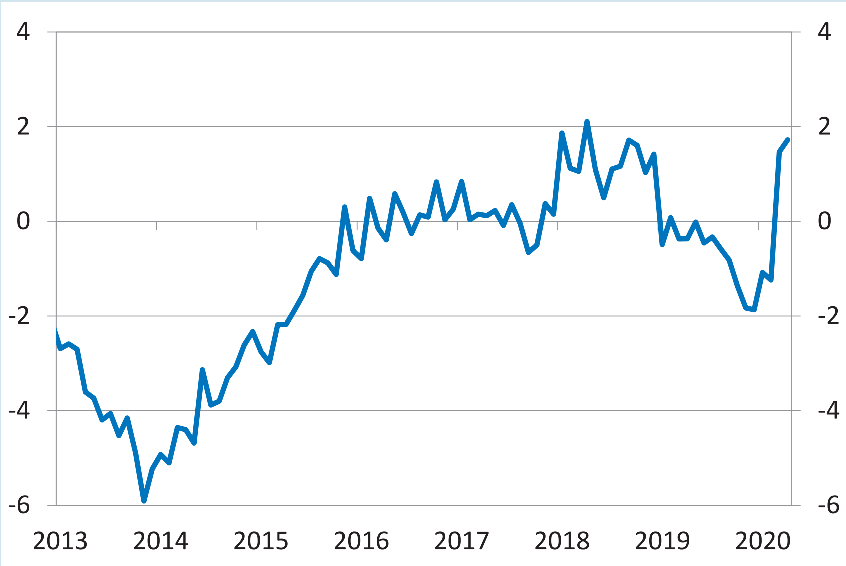


Sources: The European Commission for the euro area and the Netherlands; national Stability Programmes for Germany, France, Italy and Spain (April 2020).
Note: Increase in general government net borrowing in 2020 following the measures adopted in response to the epidemic.

Figure 6

Growth in bank lending to firms in Italy

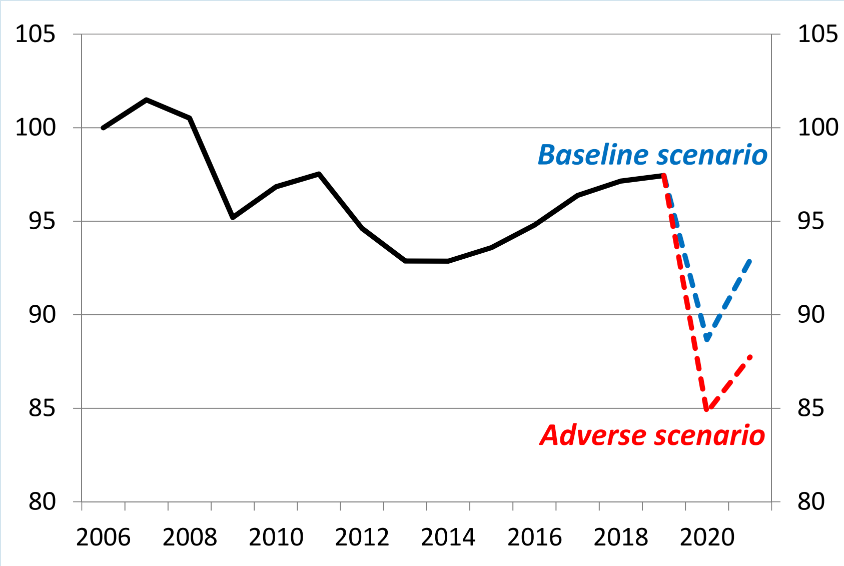
(12-month percentage change)



Source: Supervisory reports.
Note: Updated to April 2020.

Figure 7

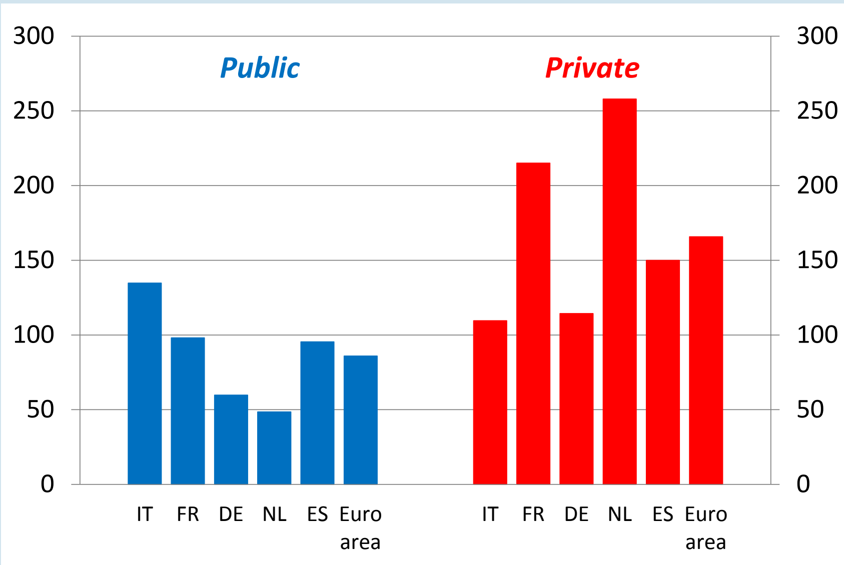
Level of GDP in Italy: scenario analysis
(2006=100)



Sources: Based on Istat data. For the scenarios for 2020-21, Banca d'Italia, Note Covid-19, 15 May 2020.

Figure 8

Public and private debt
(per cent of GDP)

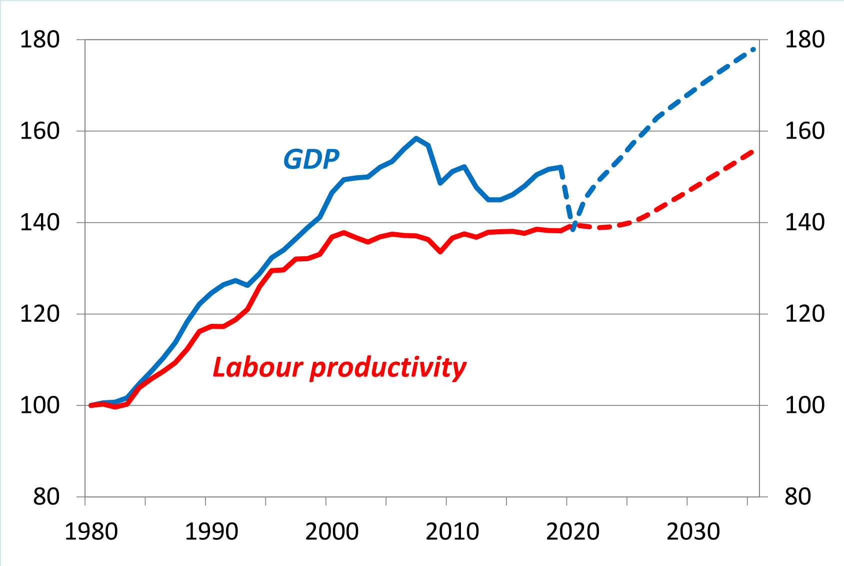


Sources: Based on data from Banca d'Italia, ECB, European Commission, Eurostat and Istat.
Note: End-2019 data. Private debt: households' and firms' financial debt.

Figure 9

Long-term scenario for GDP and labour productivity in Italy

(1980=100)

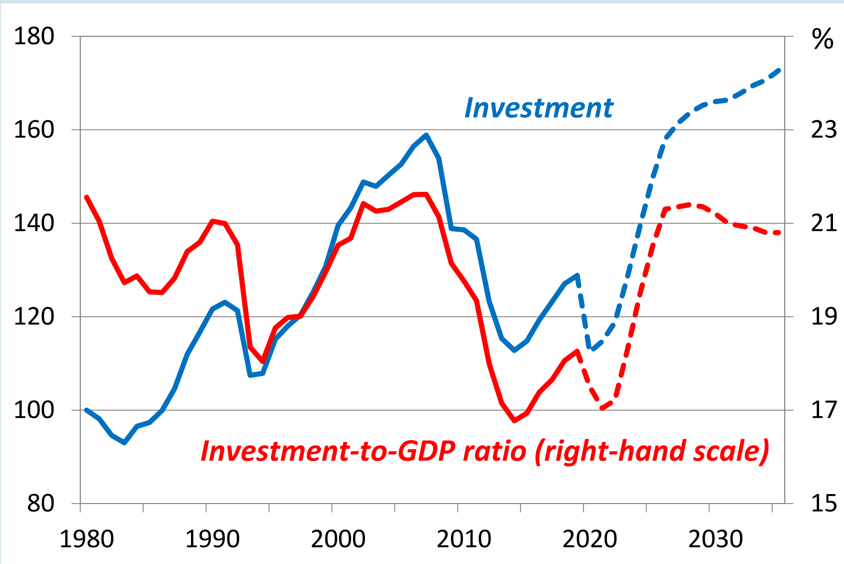


Source: Based on Istat data.
Note: Assessment horizon of the long-term scenario: 2020-35.

Figure 10

Long-term scenario for investment in Italy

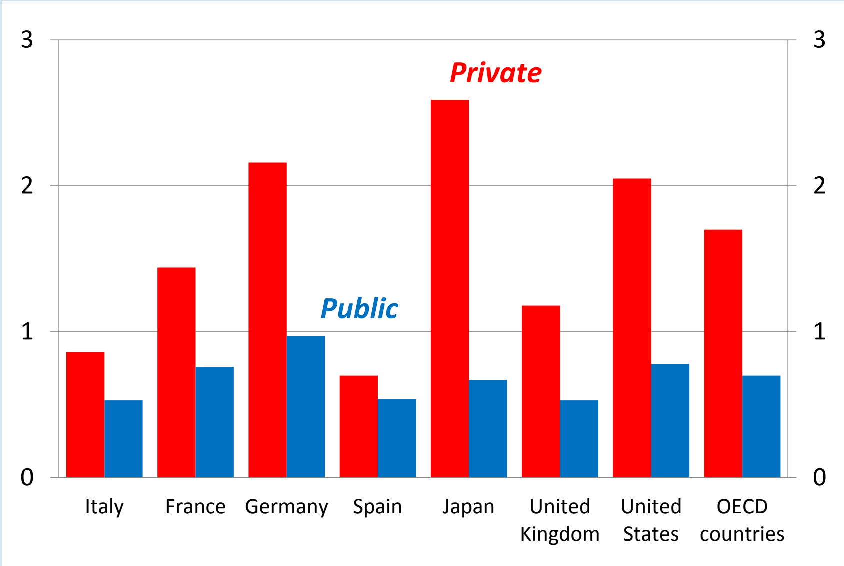
(1980=100)



Source: Based on Istat data.
Note: Assessment horizon of the long-term scenario: 2020-35.

Figure 11

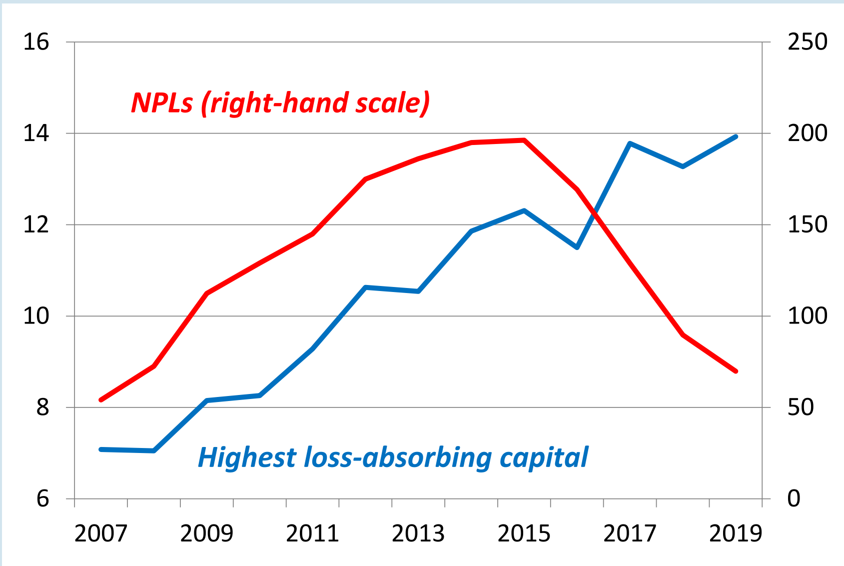
Spending on research and development
(per cent of GDP)



Source: Based on OECD data, Main Science and Technology Indicators, 2019/2.
Note: 2018 data.

Figure 12

Italian banks' capital and NPLs
(per cent of risk-weighted assets and billions of euros)



Sources: Supervisory reports (consolidated for banking groups and individual for stand-alone banks).
Note: End-of-period data; highest loss-absorbing capital: Core Tier 1 to 2013 and Common Equity Tier 1 subsequently; total NPLs net of loan loss provisions.

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