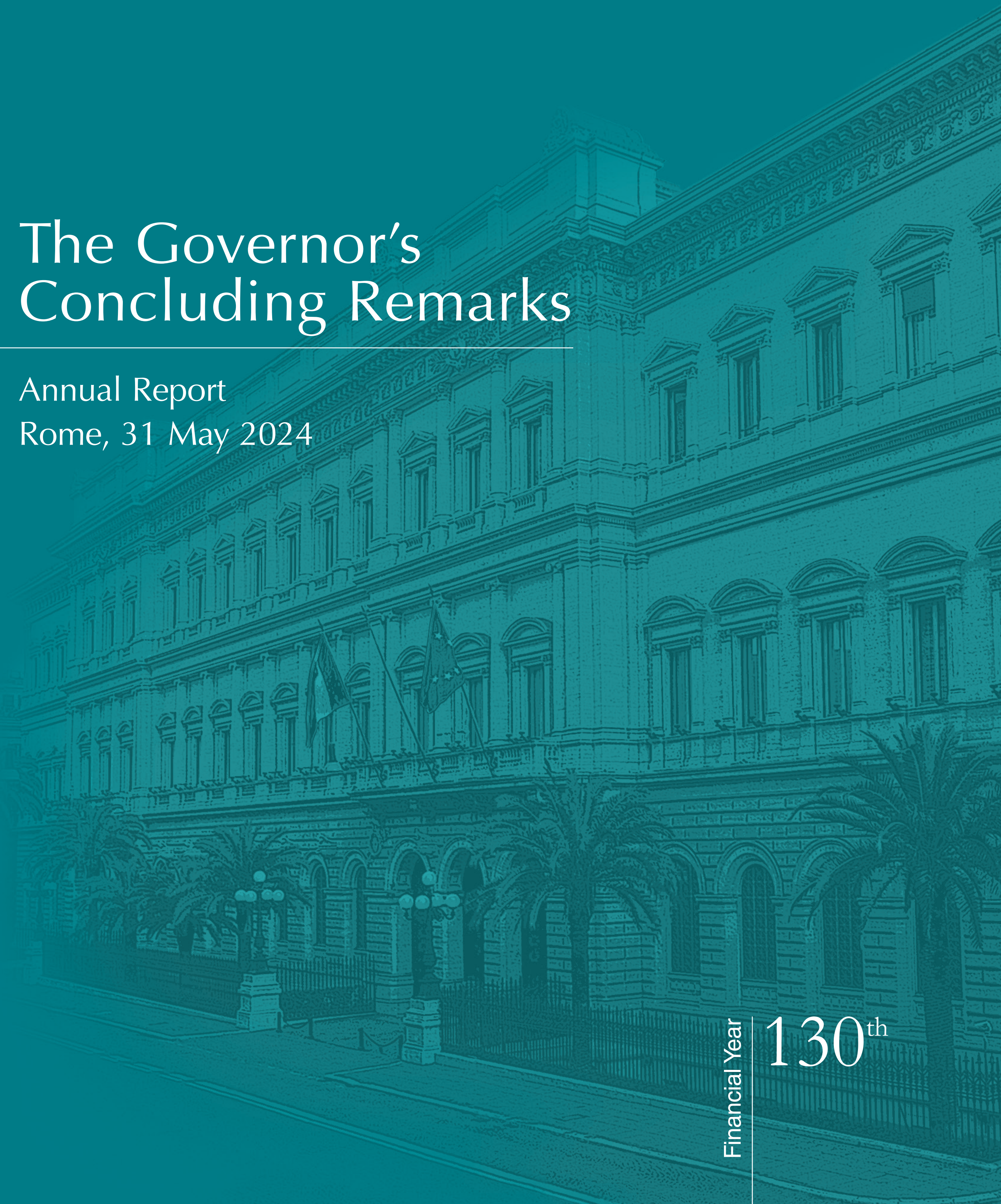
BANCA D'ITALIA
EUROSISTEMA

The Governor's Concluding Remarks

Annual Report
Rome, 31 May 2024



130th FINANCIAL YEAR

2023

Financial Year 130th

BANCA D'ITALIA
EUROSISTEMA

The Governor's Concluding Remarks

Annual Report
2023 – 130th Financial Year

Rome, 31 May 2024

Ladies and Gentlemen,

The global economy has continued to expand in recent months, despite the persistently restrictive tenor of monetary policy in many countries and the uncertainty caused by ongoing tensions and conflicts in several regions of the world.

The short-term outlook remains weak, however. Global GDP is expected to grow by around 3 per cent in 2024, significantly below the average for the first 20 years of this century. After stalling in 2023, trade is expected to return to growth this year, albeit less so than in the past.

Cyclical risks, long tilted to the downside, are becoming more balanced. The ongoing global disinflation suggests that monetary conditions will ease, but will do so at a different pace in each of the major economies.

Growth is uneven both among the advanced economies, with the United States proving to be particularly strong, and among emerging and low-income economies.

Growth in the latter countries since 2019 has not been enough to narrow welfare gaps vis-à-vis richer countries; high debt servicing costs place many of them in a vulnerable position. The default of one or more of the low-income economies would presumably produce only marginal systemic spillover effects on a global scale,[1] though the disorderly management of these crises would have serious consequences for the countries involved and could give rise to geopolitical disputes.

In the coming years, the global economy will be impacted by low productivity growth in many areas, by the phasing-out of the fiscal stimuli rolled out to counter the effects of the pandemic and – above all – by the geopolitical tensions that show no signs of easing. According to the International Monetary Fund, global growth is expected to continue at around 3 per cent until the end of the decade.

World trade

Signs of fragmentation in international trade and financial flows are intensifying. The contentious political and trade relationship between the United States and China has worsened; several areas of the world are plagued by tensions and armed conflicts.

It is too soon yet to speak of deglobalization, but it is clear that the process of rapid integration of the world economy has come to a standstill. World trade as a percentage of GDP has remained at 30 per cent over the last 15 years, after having doubled in the previous two decades.

Since 2010, foreign direct investment has also stagnated at global level. In recent years, there has been a decline in flows between blocs of politically distant countries and a marginalization of the poorest countries.

In the international monetary system, the role of the different currencies and that of the payment and market infrastructures has taken on a strategic importance that goes well beyond the purely economic sphere, particularly after sanctions were imposed on Russia.

The dollar and the euro are still the main reserve currencies. The Chinese renminbi is rapidly growing in importance, however, as its increasing use for cross-border payments and commercial transactions shows. Some central banks are also adjusting the composition of their reserves, reducing their holdings of the major currencies in favour of gold, partly in response to sanctions. The future moves on this front by the major economies will need to be assessed in light of the possible repercussions on the global monetary system.

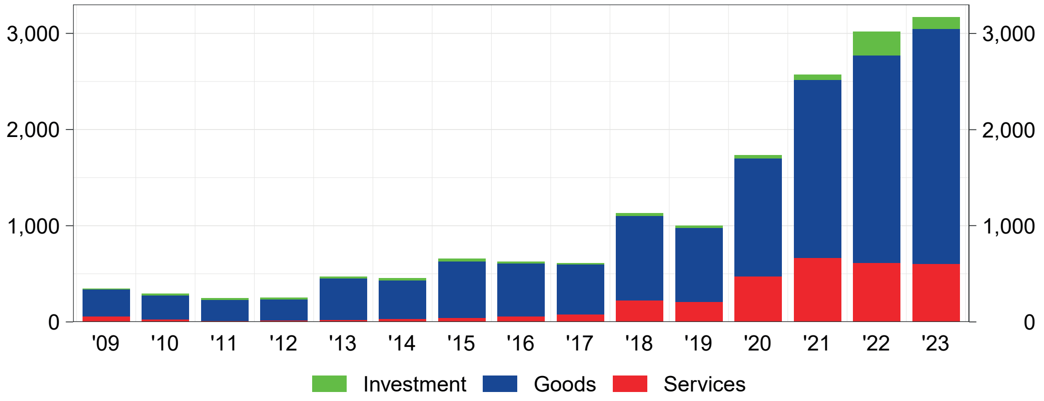
International political tensions have heightened the focus on the risks linked to reliance on long and complex global production chains, which had already emerged during the pandemic.

The governments of many of the advanced countries have become reluctant to depend economically on countries perceived as unreliable from a geopolitical standpoint. They have taken steps to achieve autonomy in strategic manufacturing sectors and to diversify the supply chains for critical resources such as agricultural, energy and technological goods. These measures have frequently taken the form of protectionist policies: the number of trade restrictions introduced in 2023 was three times higher than in 2019 (Figure 1).

Firms are reviewing their strategies, with a view to reorganizing on a national or regional basis the activities that were carried out on a global scale in the past, and to diversifying their sources of supply. Surveys conducted by Banca d'Italia with other central banks show that many European manufacturing firms are replacing their Chinese suppliers with EU-based ones.

Figure 1

New trade restrictions imposed at global level (1)
(number of restrictions)



Source: Global Trade Alert.
(1) Unilateral changes in the relative treatment of foreign versus domestic commercial interests, with reference to both trade flows and foreign direct investment.

We can no longer disregard the need to redress the balance between efficiency and security.

At the same time, the negative consequences of severe economic fragmentation and of a return to protectionism should not be underestimated. They are not limited to the countries concerned nor to the purely economic sphere. History teaches us that trade openness and the free movement of goods, capital, ideas and people are powerful drivers of integration and prosperity.

In a more challenging environment than in the past, we must therefore protect those principles of international cooperation and the multilateral institutions that have underpinned global economic development and have fostered a lasting peace among the major powers since the end of World War II.

Economic fragmentation and technological challenges in Europe today

Given how open it is to the rest of the world, the euro area is significantly exposed to the potential risk of global economic fragmentation.

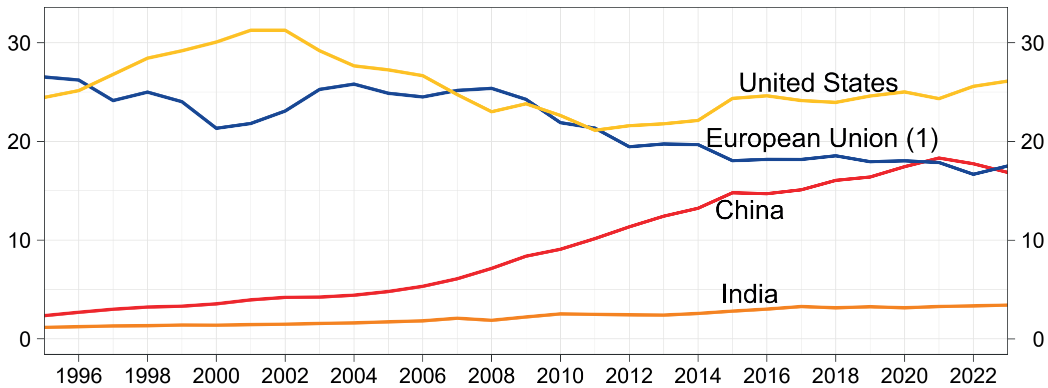
Trade with countries outside the euro area was in excess of 55 per cent of GDP in 2023, compared with foreign trade equal to 40 per cent of GDP for China and 25 per cent for the United States.[2] Exports contribute to overall demand to a far greater extent than in the United States.

The euro area is also dependent on foreign supplies of key resources: oil and natural gas, for instance, which account for over half of its total energy needs, originate almost entirely from third countries.

These vulnerabilities bear on the ongoing decline in Europe's international standing. The population of Europe is now only 5.7 per cent of the global population. Over the last two decades, the European Union's share of global GDP has fallen from 26 to 18 per cent, whereas that of the United States has remained almost unchanged, at 26 per cent, and that of China has quadrupled to 17 per cent (Figure 2). This decline mainly reflects the unsatisfactory growth in productivity, which has fallen behind the United States by 20 percentage points over the same period.

Figure 2

Global GDP shares of the world's main economies
(per cent)



Source: International Monetary Fund.
(1) The data refer to current EU Member States.

In the current geopolitical environment, Europe must act decisively to become more competitive and bolster its strategic autonomy. This is not in order to set itself against other countries or to retreat within its borders, but to safeguard the future of European citizens, to gain in global authority and to preserve the progress made so far towards a more integrated world.

The scale of the challenges ahead of us requires forthright action on different fronts.

First of all, the growth model of the past two decades needs redressing by limiting undue reliance on foreign demand. The single market must be optimized and expanded by strengthening integration in such strategic sectors as telecommunications, energy and finance.

Europe needs to remove the barriers that stand in the way of it achieving the full potential – in terms of economies of scale and number of consumers – of an internal market that compares with that of the United States, also with a view to increasing competition and innovation. Further, because greater competition and innovation entail greater risks, risk-sharing mechanisms also need to be strengthened. I will come back to this matter shortly.

The European Union also has to reduce its energy dependency by increasing the generation of renewable energy using its ample store of natural resources.

This will contain energy costs and make us more competitive, but it will not free us from our reliance on foreign suppliers of the metals and minerals that are needed for the energy transition. We must therefore establish dependable and mutually beneficial economic and diplomatic ties with the countries that are richest in critical inputs, on the strength of our capacity to provide them with the technologies they need to integrate into global production chains.[3]

A third area of intervention is the production of advanced technologies, in which Europe currently lacks sufficient specialization. At a time of technological protectionism, it is essential that investments in technology keep pace with those of other advanced countries, focusing on cutting-edge sectors such as robotics, digital and communication infrastructure, space exploration, biotechnology and artificial intelligence. This requires a regulatory environment that favours innovative business initiatives, being mindful that there are some sectors in which competition operates globally, not at European or national level.

Artificial intelligence will lead to potentially disruptive changes in the global economy. It will support productivity and growth, albeit with an uneven distribution of costs and benefits across sectors and across society, especially in the short term; it will also involve huge energy consumption.

European firms should aim to become involved in developing AI technology. Joint initiatives between players from different countries would make it easier to find the vast amount of financial resources required to compete with foreign producers and create the conditions for building on the outstanding scientific output of researchers working across the EU; they would also make it possible to counter the market power of foreign tech giants.

A common response

These lines of intervention do not cover all the fields in which the EU is called to act. There is a need for common policies when it comes to the environment, defence, immigration, and education and training, for instance.

This will require substantial resources: the European Commission estimates that over €800 billion in public and private investment will be needed annually until 2030 to sustain the climate and digital transitions and to raise military spending to 2 per cent of GDP.[4]

For individual nations to embark on such a vast plan would entail a duplication of spending and sacrificing the achievement of economies of scale. The fiscal capacity of many countries would be a limit and would risk compromising the endeavour, which has to be broad in scope, and would also risk increasing the fragmentation of the single market.

Since many of these projects address common public goods such as the environment and external security, insufficient expenditure would be to the detriment of all EU countries and citizens.

It is therefore necessary, in everyone's interest, to act on these initiatives at European level.

Completing the European economic architecture

The European economic architecture lacks two essential ingredients: a common fiscal policy and an integrated capital market. The banking union remains incomplete.

With a fully complete economic architecture, Europe could have been better able to weather the crises of the last fifteen years. There is a pressing need to address these issues in light of the current unstable geopolitical environment and of the huge investments that Europe has to make.

The new fiscal framework

In a monetary union, a central budget has two main functions: to finance shared public goods and to respond to cyclical fluctuations, both by smoothing out their impact over time – which can also be done at national level, to some extent – and by offsetting the effects of asymmetric shocks across countries.

A European budget would allow us to take a fiscal stance that fits the area as a whole, rather than being the mere sum of national policies. It would help us cope better with strong and long-lasting shocks, such as the pandemic or the energy crisis, making fiscal policy consistent with monetary policy.

The recent reform of European economic governance has not resulted in significant progress in these directions, nor has it streamlined the rules as necessary. Without any progress towards a common fiscal policy, any reform only tackling national policies risks making European rules appear to privilege austerity over development.

However, the new rules introduce innovations that are consistent with growth. They focus on the medium-term sustainability of public debt, rather than on the fine-tuning of fiscal policy, which should pave the way for longer-term planning and realistic paths for fiscal consolidation. They also acknowledge the relationship between the two levers of fiscal sustainability, i.e. fiscal policy and the reforms and investment needed for development.

The effects of the new framework will depend on how it is applied: it can reinvigorate the European economy if it combines the required fiscal discipline with the ultimate goal of promoting growth.

If the new rules prove effective, cooperation between EU Member States will grow stronger over time, as will public trust in European institutions and, ultimately, in the future of the EU. This would make it possible to move towards a full-fledged fiscal union, which can rely on adequate funding of its own and on debt issuance.

Building a European capital market

We must not deceive ourselves into believing that the huge investments needed for the competitiveness of the European economy can be funded without a major contribution from private investments and without drawing on the expertise of the financial industry. It is therefore essential to build a European capital market.

The euro area has been running a current account surplus for years. As a result, it generates savings that exceed investment and are partly redirected abroad. In order to retain domestic savings and attract international funds, we need an integrated, efficient, liquid, technologically advanced European capital market that can allocate these resources to the most capable entrepreneurs.

A single capital market would increase cross-border investment flows and provide households, firms and financial intermediaries with better opportunities for risk diversification, thus mitigating the impact of cyclical fluctuations. Only a quarter of local shocks are estimated to be currently absorbed through the banking and financial channels in the euro area, compared with three quarters in the United States.

These are the goals of the European Commission's Capital Markets Union project, which has been put forward several times over the past decade.

Yet European capital markets remain underdeveloped and fragmented, despite efforts to integrate them through EU legislation. In the euro area, the value of corporate bonds as a share of GDP is three times lower than in the United States. Furthermore, although equity is the main source of funding in both jurisdictions, in Europe it is largely unlisted, while in the US most equity is traded on the stock exchange, thereby offering US firms access to a greater pool of potential investors.

Today, there are 59 regulated stock markets in Europe, owned by over 30 groups,[5] with stock-market infrastructure including 27 central securities depositories (CSDs) and 10 central counterparties (CCPs). In the US there are 24 stock markets, mostly owned by four groups, one CSD and one CCP. The European market's fragmentation, I believe, has clear disadvantages in terms of operations and liquidity, and creates barriers to entry for investors as well as for businesses.

If we want to make progress towards a single European capital market, we need to address two key issues.

The first is the lack of a European sovereign safe asset.

A common safe asset would allow for better pricing of financial products, such as corporate bonds and derivatives, encouraging their expansion. It would provide a form of collateral that could be used across all market segments, including for cross-border transactions, and it would serve as the basis for foreign central banks' reserves in euro, strengthening the global role of our currency.[6]

The securities issued under the NextGenerationEU programme go in this direction. However, one-off placements do not mark a turning point: the scarce liquidity of these bonds discourages their inclusion in benchmarks and is an obstacle to the use of derivative contracts for risk management purposes.

The second obstacle to the creation of a European capital market is the fact that the banking union is incomplete.

Establishing the Single Supervisory Mechanism and the Single Resolution Mechanism was a major step forward, but it was not enough to create a fully integrated European banking market. The credit sector remains fragmented along national lines: there is no European deposit guarantee fund, the bank crisis management system is incomplete and obstacles to the transfer of banking groups' capital and liquidity across countries still exist. As banks play a key role in all capital market segments, it is hard to think of an integrated market if they cannot operate effectively across the euro area.

The introduction of a European safe asset and the completion of the banking union are preconditions for creating a single capital market, but they are not the only relevant issues. We must not forget the importance of drafting a single European Finance Act, of strengthening central supervision, and of harmonizing corporate crisis management mechanisms.

Despite the issues that I have described, I would like to stress the progress that Banca d'Italia and the Eurosystem are making in providing cutting-edge infrastructures for payment, securities and collateral transactions to the European market. Our goal is to ensure its security and efficiency using TARGET services and – looking ahead – through a digital euro and joint collateral management throughout the monetary union.

The economic situation and monetary policy in the euro area

The real economy

The euro-area economy has been stagnating since the end of 2022. Aggregate demand has been affected by tight monetary conditions, the impact of inflation on real household income, and the slowdown in global trade.

Manufacturing activity is now down to end-2020 levels. The difficulties in the manufacturing sector were particularly pronounced in Germany, which was hit hardest by the energy price increases and the uncertain performance of the Chinese economy.

However, there have been positive signs recently. Euro-area GDP rose by 0.3 per cent in the first quarter of 2024, reflecting better than expected performances in the main economies. Some leading indicators for services and international trade also showed encouraging signs.

Against a backdrop of disinflation, the rebound in consumers' purchasing power as a result of wage growth and the resilience of employment suggests that domestic demand may gain momentum in the months ahead.

The projections published by the European Central Bank in March point to recovery firming up this year and GDP growth strengthening to 1.5 per cent over the next two years.

These growth prospects are modest and subject to downside risks. Geopolitical tensions could curb the recovery in global trade and lead to higher commodity prices. The restrictive monetary policies implemented in several countries may dampen consumption and investment more than expected. Fiscal policies could become stricter due to a greater than expected consolidation of public finances.

Inflation

Inflation in the euro area stood at 2.4 per cent in April, down by 8 percentage points from its October-2022 peak. The reduction was exceptional in size and speed, just as the earlier increase had been.

The ongoing disinflation is confirmed by the slowdown in the core component of the consumer price index, which excludes the typically more volatile energy and food items. Inflation started falling again last month in the service sector too, mitigating fears that this component might dampen disinflation.

Price growth is set to decline further in the coming quarters, albeit with some fluctuations. Wage growth is expected to slow, as purchasing power gradually recovers. At the same time, high profitability allows firms to absorb the recent wage increases without raising their selling prices.

Moreover, the decline already recorded in energy prices and the expected fall in interest rates will make it less costly for firms to increase their capital per worker. This should result in higher productivity and slower growth in unit labour costs, thereby reducing the inflationary pressures that might stem from wage increases.

The ECB's projections and analysts' expectations point to a return of inflation to the 2 per cent target in 2025.

Monetary policy

Monetary policy has operated in a challenging economic environment over the past four years. The pandemic crisis called for highly expansionary measures, some of which were unprecedented. These had to be followed by a rapid normalization and then monetary tightening after the inflationary flare-up.

Overall, this process was necessary. The pandemic crisis has been overcome, with the help of fiscal policies, and a financial crisis has been avoided. Supply shocks, production bottlenecks and soaring energy prices have not triggered an inflationary spiral, as they had in the past. Medium- and long-term inflation expectations have remained in check, leading to relatively fast and painless disinflation.

But now, we need to prevent monetary policy from becoming excessively tight, pushing inflation below the ECB's symmetric target. Since last September, when we last increased the interest rates, real short-term rates have risen by almost half a percentage point.

Over the coming months, if the incoming data is consistent with the current projections, it will be appropriate to ease monetary conditions.

This will not stop the action to restore price stability. Even with several cuts in the key interest rates, the monetary policy stance will remain tight: expected real rates implied by the financial markets, which incorporate a cut in the reference rates of 60 basis points in 2024, will remain above any plausible estimate of the natural interest rate for many months (Figure 3).[7]

Figure 3

Real interest rate and natural interest rate in the euro area (1)
(per cent)

Sources: Based on ECB, Bloomberg and LSEG data.
(1) The figure shows the actual (solid blue line) and the expected (dashed blue line) one-year real interest rate as measured on 30 May 2024. It also shows estimates of the real natural interest rate: its median (red line) and the 10th-90th percentiles (grey band). For further details, see Chapter 3, *Annual Report for 2023*, 2024 (only in Italian).

The decisions of the US Federal Reserve will be a factor to be taken into account, not a constraint, during monetary easing. A tighter than expected US monetary policy stance could lead to a depreciation of the euro against the dollar and create inflationary pressures. Empirical studies suggest, however, that this effect would be overcome by the negative impact that the US monetary tightening would have on global demand and financial conditions, and therefore on euro-area inflation.

When defining the path of policy rate cuts, it should be borne in mind that prompt and gradual action contains macroeconomic volatility better than a tardy and hasty approach.

Unlike in the past, the decline in the near future in policy rates will be accompanied by a reduction in the monetary policy portfolios of securities, which will lead to a sharp contraction in outstanding liquidity and a consequent tightening impulse in the credit market.

A gradual normalization of the Eurosystem's balance sheet after the expansion of recent years is certainly appropriate. However, it is essential that this process does not interfere with the monetary policy stance and that the adjustment is carried out without creating liquidity shortages in the system or fragmentation in the transmission of monetary impulses.

The review of the monetary policy operational framework was concluded last March. The Governing Council decided that it will continue to implement its monetary policy action through the rate on the deposit facility.

Under the new framework, it is essential that liquidity remains abundant to ensure a firm control of short-term market rates. The liquidity needs will be partly met through a structural portfolio of securities and through longer-term refinancing operations. I believe that these components should be given a significant weight in order to ensure a large and stable supply of reserves.

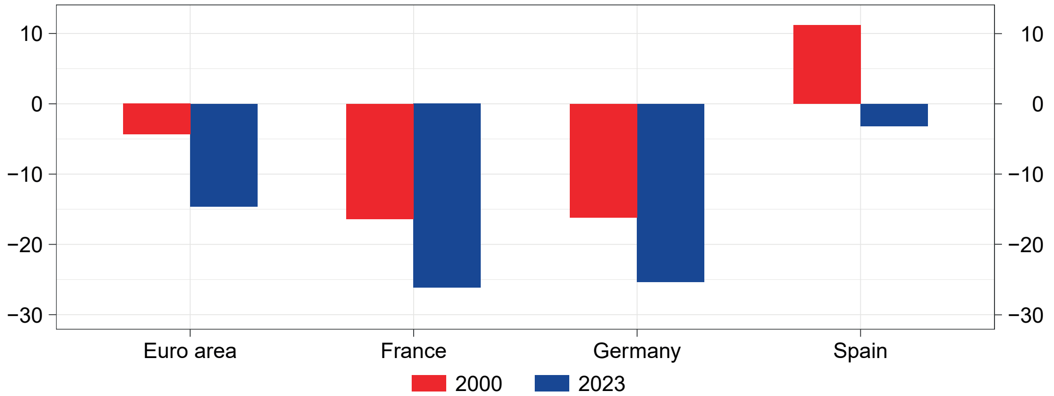
The Italian economy

The Italian economy has had the lowest per capita GDP growth rate in the euro area for the past 25 years. Labour productivity is at a standstill; investment only returned to above the levels recorded before the global financial crisis in 2023, while total hours worked have not caught up yet.

Wage growth reflected the stagnation in productivity: employees' hourly wages are one fourth lower than in France and Germany (Figure 4). In per capita terms, real household disposable income has been flat since 2000, while it has increased by more than one fifth in France and Germany since then.

Figure 4

Hourly wages: spread between Italy and the main European countries (1)
(percentage points)



Source: Based on Eurostat data.
(1) A negative spread indicates that hourly wages in the euro area or in a country of comparison are greater than in Italy. Hourly wages refer to payroll employment and are expressed in purchasing power parity.

A recent recovery, to be consolidated

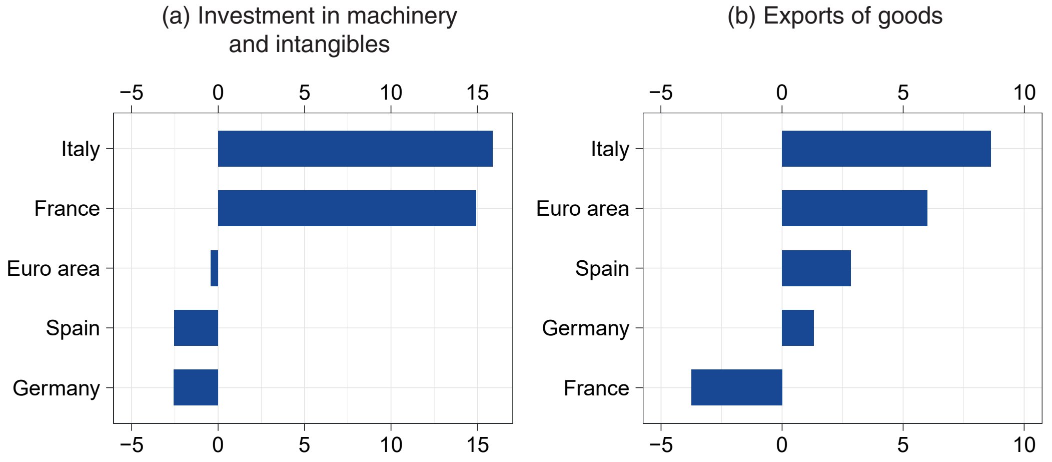
We are not doomed to stagnation, however: the recovery after the pandemic crisis has exceeded expectations and been stronger than in the other large euro-area economies. Unlike in previous crises, recovery has also been robust in the Italian Mezzogiorno.

Between 2019 and 2023, a time of great turmoil, Italy's GDP grew by 3.5 per cent, against 1.5 per cent in France and 0.7 per cent in Germany, and this gap is wider in per capita terms. Employment rose by 2.3 per cent – almost 600,000 people – mainly in permanent contracts. The unemployment rate, though still high, fell by 2.3 percentage points, to 7.7 per cent.

The recovery was fuelled by strong investment growth, also supported by tax incentives. Investment grew far more than in the other main European countries on average, not just in construction, which benefited from very generous incentives, but also in machinery and intangibles, which better reflect the technological progress and expectations about future demand (Figure 5).

Figure 5

Changes in investment and exports in Italy and in the main euro-area countries
(percentage change between 2019 and 2023)



Source: Based on Eurostat data.

Exports of goods increased by 9 per cent, more than potential foreign demand, thanks to the improvements in cost competitiveness and quality achieved in recent years and to the diversification by sector and destination market. They remained essentially stable in Germany and decreased in France.

Once the deterioration in the terms of trade caused by the energy shock had been reabsorbed, the trade balance rapidly turned positive again. Italy is now a net creditor to the rest of the world to the tune of €155 billion, or 7.4 per cent of GDP. Ten years ago, its net foreign position was negative by 23 per cent of GDP and was a source of vulnerability.

The Italian economy has certainly long benefited from expansionary monetary and fiscal policies, but also from overhauling its production fabric.

The profitability and capital position of firms have improved over the past decade.[8] The weight of larger firms has also increased, as they can better reap the benefits of technology and internationalization.[9]

There has been a significant, though still insufficient rise in productivity in industry and in non-financial private services. If we exclude transport equipment, Italy's manufacturing industry is the most automated of the main euro-area economies: in 2021, the share of robots per 1,000 workers was 13.4 in Italy, against 12.6 in Germany and 9.2 in France.[10] Since 2019, industrial firms have doubled their share of investment in digital technologies, to 17 per cent.

Their return to capital accumulation and their ability to succeed in international markets are encouraging signs of strength that need to be consolidated.

Looking ahead, the Italian economy will be able to achieve a sustained pace of growth if, on the one hand, it can deal with the consequences of population decline and ageing, and on the other hand speed up productivity significantly.

Population decline and labour market responses

According to Istat, the number of working age people will fall by 5.4 million between now and 2040, despite a net foreign inflow of 170,000 individuals per year. This decline is expected to cause GDP to fall by around 13 per cent, and by 9 per cent in per capita terms.[11]

Despite growing over the last decade, labour market participation is still 8 percentage points below the euro-area average, standing at 66.7 per cent. The gap is not large for men, but it widens to 13 points for both young people aged 20 to 34 and for women.

Youth employment has been affected by low growth.[12] Many have looked for better job prospects abroad: 525,000 young Italians emigrated between 2008 and 2022, and only one third of them came back to Italy. It is graduates above all who have left Italy, attracted by far better pay, employment and career opportunities.[13] This out-migration depletes Italy's human capital, which has traditionally suffered from low levels of education attainment.

The female employment rate is still 52.5 per cent. Balancing work and family life in Italy is a challenge. Women leaving the labour force after their first child is born is one of the main reasons for their low labour market participation, and it is good that the National Recovery and Resilience Plan (NRRP) has allocated considerable resources to childcare services.[14]

Measures to promote a different distribution between in-person and remote working time could help to increase employment, as could a revision of the deductions and cash transfers scheme in order to reduce work disincentives for second earners,[15] and policies to encourage the hiring of the long-term inactive.

Marked increases in employment rates – up to average euro-area levels – could offset the effects of population decline and keep headcount employment.[16] Support for employment may also come from a higher flow of legal immigrants than that expected by Istat. Managing this flow will require coordination with the other European countries, balancing the needs of the production system with social equilibria, and enhancing measures to integrate foreign citizens into the education system and the labour market.

However, it is clear that even with increased employment and migration flows, the contribution of labour to economic growth will inevitably be modest. Only productivity can ensure development, job opportunities and higher incomes.

Reviving productivity: more investment, more innovation

Investment is the main way to spread technological innovation, which accounts for most of the productivity gains.

For firms to invest, policies need first of all to ensure a suitable regulatory and competition framework and a stable macroeconomic environment.

The positive externalities of investing in innovation warrant targeted public measures, above all when there is a technological lag. The incentives introduced in recent years[17] have helped even the smaller firms to adopt new technologies and achieve productivity gains, especially when investment has been combined with a skilled labour force. Technology take-up costs can be limited not only through incentives, but also with an effective network of technology transfer agencies.[18]

However, we cannot just adopt solutions developed elsewhere; we need to improve our ability to develop new goods, services and technologies.[19]

The tax credit for research, in force in Italy since 2015, is an important measure, as shown by the great benefits for the entire production system. Over time, however, its effectiveness has been reduced by the numerous changes to the eligibility criteria and to the size of the incentive. The estimated cost of bringing the tax credit rate in line with the average in OECD countries – to 20 per cent, from the current 10 per cent – and making it stable would be less than €1 billion per year, but it could lead firms to increase their research expenditure by more than 15 per cent.

Our firms also need to step up their efforts to get the full benefit of the European Union's initiatives for fostering innovation.[20]

Lastly, innovation also requires considerable investment in human capital. This is a pressing need in Italy, given the lower availability of highly skilled workers compared with the rest of the euro area.

According to our estimates, the changes caused by artificial intelligence would affect two out of three workers in Italy. For most people there would be an increase in productivity and job opportunities, but the latter could be reduced for a significant minority.[21] During the transition phase, it will be necessary to guide workers in their vocational retraining or to help them find other jobs, while protecting those who will face higher adaptation costs.

Promoting innovative business initiatives

There are not many new firms in high-tech sectors in Italy and they have a limited capacity for growth and success. The 2012 law on start-ups introduced simplified rules and tax breaks for creating innovative firms.

Nevertheless, the drive of investors who are able to select and finance initiatives that are risky but have high growth potential remains crucial. This is the role of venture capital.

In the United States, the top six companies by stock market capitalization, each worth more than $1 trillion, were initially financed by these investors and are now key global players in the digital revolution.

In Italy, venture capital activity is underdeveloped, with an annual investment flow of between €0.5 billion and €1.5 billion over the years 2021-23, which is five times lower than in Germany and France. National operators are also few and small in size.

The low growth in the sector partly reflects the delay with which this activity began in Italy. It is penalized by the limited development of the stock market and the small average size of firms, which make it difficult to list the companies financed or to sell them to other larger companies once the initial growth phase is completed.

Venture capital would benefit if institutional investors were more involved: if the share of assets invested by insurance and pension funds in national funds were equal to that in France, funding would double.

Growth can also be fostered by removing legislative barriers. As regards the rules governing smaller fund managers in particular, Banca d'Italia will work to make implementing the enabling law that reforms the Consolidated Law on Finance an opportunity for considering a simplification of the relative obligations.

The increase in financing must be matched by greater investment opportunities. In Italy, research work has high productivity and quality ratios, but limited resources.[22] Boosting research and having better links with production would make it possible to turn as yet untapped potential into business opportunities.

Better public action

Public action plays a key role in the functioning of the economy, and not only because of the resources it makes available. Some of the reforms implemented in the last few years have had positive effects on productivity and growth. We must continue along that path: the results are only gradually emerging over time, but they are there.[23]

The reforms to civil justice and the digitalization of its procedures have made proceedings shorter and halved the number of pending cases compared with 15 years ago. The measures that have simplified market access for some services have made the entry of new firms easier and raised productivity in the sectors concerned. The digitalization of public administration has also increased.[24]

The NRRP commits Italy to implementing reforms and provides sizeable resources for modernizing its production system and public administration: according to our calculations, they amount to €16 billion for digitalization, €19 billion for research and innovation, €33 billion for transport infrastructures and €17 billion for business investment.

It is hard for general government to make the best use of these considerable sums in a limited time frame, but doing so is crucial to reviving the economy's growth potential. The full implementation of the reforms and investment envisaged in the NRRP – in addition to raising GDP by more than 2 percentage points in the short term – would have lasting effects on growth, due to estimated productivity increases of between 3 and 6 percentage points over a decade.[25]

The measures I have outlined are not all without a cost, and Italy has a high public debt as a result of the imbalances accumulated in the past. At the end of 2023, it amounted to 137 per cent of GDP, which is quite close to the pre-pandemic figure but higher than in the rest of the euro area. This heavy weight forces us to commit considerable public resources to interest payments every year, taking them away from innovation and development.

In order to deal with the debt problem, we need a credible plan to boost growth and productivity, and to gradually and steadily improve the public accounts. This plan will need to put the debt-to-GDP ratio on a firm downward trajectory.

The more credible the prospects for debt reduction, the lower the returns that investors will demand for holding it: this in turn will make the adjustment less difficult.

Careful choices are needed, especially on the expenditure side, in order to redirect its composition towards development and to cut out inefficiencies. The fight against tax evasion will have to play its part, following the positive results recorded in this field over the last decade.[26]

We will only be able to break free of the debt burden by combining fiscal prudence and growth.

The financial system

The Italian banking system

The year 2023 was a very positive one for Italian banks. Return on equity exceeded 12 per cent. Profitability benefited from an exceptional market situation, in which the abundant liquidity in circulation curbed the increase in the cost of funding, while the rise in the key interest rates quickly passed through to lending rates, thereby boosting net interest income. Capital rose to 15.6 per cent of risk-weighted assets.

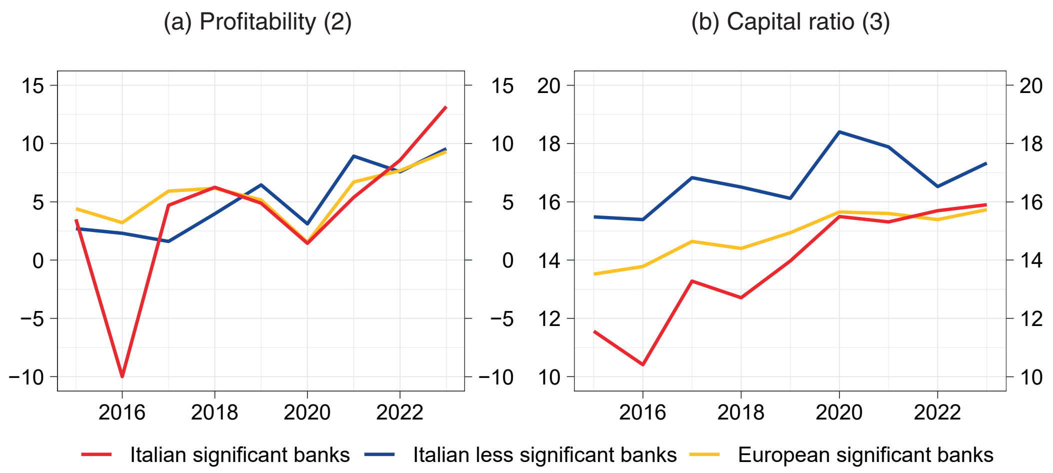
The latest data confirm that this positive phase is still underway.

Within the Italian banking system, the profitability and capital levels of Italian significant institutions are above the European average (Figure 6).

Figure 6

Profitability and capitalization of Italian and European banks (1)

(annual data; per cent)



Source: Based on supervisory reports.
(1) Banks based in European banking union countries. – (2) Return on equity. – (3) Ratio of common equity tier 1 capital to risk-weighted assets.

The situation has also improved for the less significant institutions directly supervised by Banca d'Italia. Capital ratios have increased, in part at our behest. This has reflected changes in the risk profiles, above all the risk of a rapid increase in interest rates, which did then materialize. We have stepped up our supervision to prevent and promptly address cases of banks in distress that can be traced back to weaknesses in corporate governance and in internal controls.

For the banking system as a whole, the improvements in its income and capital position reflect a multi-year process for restoring efficiency and strengthening balance sheets. The sound condition of banks today is a strong point for the entire Italian economy.

Over the past few months, however, I have made it clear that we must not let our guard down. I repeat: we cannot be caught unprepared by tensions that could arise in the future. In April, we asked Italian banks to set up a macroprudential capital buffer of 1.0 per cent of domestic exposures by mid-2025.[27]

The increase in the requirements will have a negligible impact on credit supply and will make it possible to limit the negative effects of adverse systemic events: if they occur, the Bank could authorize the release of the buffer, thus maintaining the capacity of banks to support the real economy.

With regard to the risks linked to the macroeconomic situation, there are two main aspects to consider.

The first is credit quality. The Italian real estate market is not showing any worrying signs like those emerging in the commercial real estate sector in other countries. However, for total loans, there has been an increase in the share of loans that are performing but have recorded late payments, especially among customers with adjustable-rate loans.

It is estimated that for firms, the annual flow of non-performing loans as a percentage of total loans will increase over the next two years by 1 percentage point, from the current 1.7 per cent. Loan loss provisions will remain low as a share of revenues.

Looking ahead, it remains crucial for banks to recognize expected losses promptly, by applying accounting standards scrupulously.

The second aspect is liquidity. The repayment of targeted longer-term refinancing operations is taking place in an orderly manner. However, careful liability management remains a priority, given that aggregate liquidity will continue to fall, pushing up the cost of funding.

The role of technology in the financial system

Going forward, technology will play a key role in shaping the activity of financial intermediaries, both banks and non-banks.

Payment service providers have improved the products on offer, such as instant payments and digital wallets, and the customer experience.

In the asset management sector, several credit funds already use digital platforms to match loan supply and demand more easily. Asset management companies have taken steps to start using distributed ledger technologies, both for the issuance and management of their shares and for investments in digital tokens. These innovations could enable companies to have greater direct access to external sources of funding.

Many banks are using technology to replace traditional channels. The resulting efficiency gains are bringing benefits to both banks and their customers.

Banks with a greater ability to operate online have higher profitability on average, show improved revenue diversification and increased their share of the lending market.

Customers benefit from lower service costs – with charges on online accounts being 60 per cent of what they are for traditional accounts[28] – as well as from easier access to banking services.

The use of technology is being reflected in a reduction in the number of bank branches, which may cause inconvenience for some segments of the population. To prevent financial exclusion and difficulties in accessing cash, we have started a conversation with the relevant ministries and major players. We have also strengthened our commitment to the Eurosystem's Cash 2030 Strategy and we have helped to design legislation to make it possible to withdraw cash from shops.

Investments in innovative technologies made by Italian banks have quadrupled since 2017, but they are still limited.[29] For significant banks, they are lower than those of their European competitors. They need to grow: it would be a serious mistake to continue to fall behind in this area.

Given the complexity of the projects, we are encouraging intermediaries to strengthen corporate governance systems in order to increase digital skills in the management and control bodies and to improve their ability to manage and aggregate data.

Technology is key when it comes to achieving efficiency. However, it must be used to improve the quality of services and ensure that the products offered match the needs of households and businesses.

Only this way will banks be able to build a stronger relationship with customers and strengthen their own reputation, which are their most valuable assets.

The risks posed by technology

The use of technology increases the use of outsourcing and the associated risks.

In 2022, financial intermediaries had more than 5,000 agreements in place for the outsourcing of critical functions of their business. Turning to third parties enables efficiency gains but creates operational risks that can eventually affect the entire financial system, when a small number of providers service a large number of financial intermediaries simultaneously. This is the case with tech giants – think of cloud services or the emerging market for AI-based services – but also with companies that provide data-related, administrative or credit services.

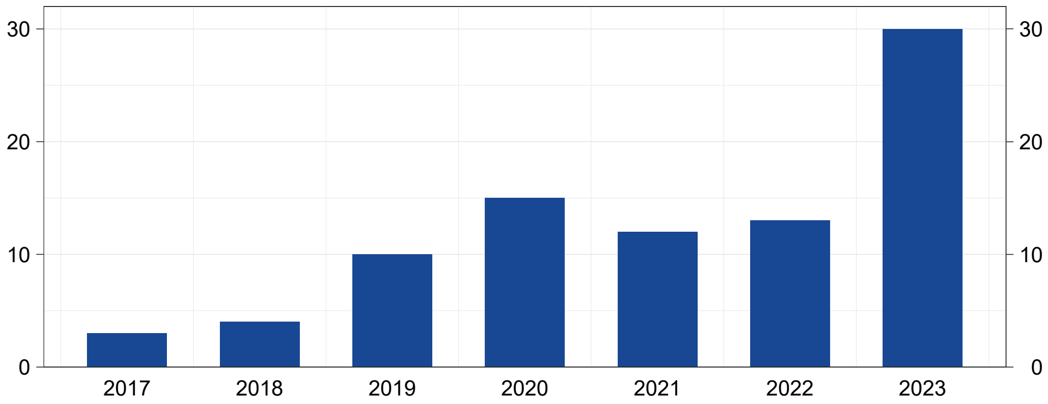
Outsourcing must not jeopardize the sound and prudent management of financial intermediaries, which remain ultimately responsible for the activities carried out by third parties. In recent months, we have stepped up our efforts, including through on-site inspections, to ensure adequate governance of outsourcing policies.

If shortfalls in the activity of these providers are detected, we ask for corrective actions using the information and inspection powers we have under the law. Supervisory authorities' power to intervene vis-à-vis suppliers, which is currently limited, will be strengthened with the entry into force of the EU regulation on digital operational resilience in the financial sector.[30]

Together with technology, cyber risks have acquired greater significance, also in connection with geopolitical tensions and the actions of nation state actors. The financial sector is an attractive target, given its dependence on digital data and procedures and its critical role in the economy. Financial intermediaries reported a sharp increase in serious incidents in 2023 (Figure 7).

Figure 7

Serious cyber incidents reported by Italian banks
(number of incidents)



Source: Supervisory reports.

The issue of cyber risks is high on the international agenda. As part of the work carried out at G7 level under the Italian Presidency, a second coordination exercise for combating large-scale attacks was held last April. In Europe, under the umbrella of the Single Supervisory Mechanism, the first bank stress test on cyber risks is under way. Its results will then be discussed between banks and supervisors.

In Italy, Banca d'Italia and the Italian Banking Association (ABI) created the Computer Emergency Response Team for the Italian financial sector (CERTFin) some years ago with the goal of enhancing the participants' IT risk management capabilities.[31]

Banca d'Italia has also established sound working relations with the National Cybersecurity Agency and with the main institutional players operating in the national cybersecurity system.[32] Sharing information and leveraging the experience of all the institutions involved is crucial for taking effective collective action to counter cyber threats.

Conclusions

When the single market was launched 30 years ago, the European Commission, chaired by Jacques Delors, published a White Paper on growth, competitiveness and employment. The challenge was to stimulate debate on the future of the EU economy.

It is striking that the changes in the global landscape that were being discussed then are the same as those that guide our thinking today: geopolitics, technology, demographics and finance.

Of course, the questions then were about the emergence of new competitors on the world stage and the end of the Soviet Union, whereas now they are about global economic fragmentation. At the time, we were facing the first, widespread wave of information technologies, while now it is robotics and artificial intelligence. At that time, the issue was the prospect of an ageing population, but today it is how to organize a society that has already aged and that is struggling to adapt to the changes under way. Then, the growing interdependence of financial markets in a context of free movement of capital was being debated, now we are talking about the strategic importance of currencies in an international financial system that has become part of the geopolitical disputes.

While back then the launch of the single market was the culmination of a long integration process, achieved amidst the tragic memories of the devastation of the Second World War, today progress in European integration is the answer to the changes in geopolitical balances and to the risk of irrelevance, to which individual Member States would otherwise be doomed by the sheer power of numbers.

Strengthening the capacity for joint action and mobilizing the resources needed to become an active part of the technological, climate and energy transitions is the way to overcome the current static phase.

This is true for Europe as a whole, but it is even more so for Italy.

We talked a great deal about decline in Italy at the start of this century. In those years, a gap was forming between growth in our economy and that in the rest of Europe, which itself was not doing well compared with the United States. Subsequent crises and shocks have hit the Italian economy hard.

Some of the indicators fuelling fears of decline at that time now seem to be telling us that we can reverse the trend. The swift recovery in exports and investment over the last four years points to an overhaul of the production system and a renewed capacity to compete in the international markets.

Yet we must not delude ourselves: our economy still has serious problems, some of which are deep-rooted and difficult to solve. The economic lag in the Italian Mezzogiorno and the high public debt are inescapable issues for economic policy, as are the competition constraints that create advantages for incumbent firms and limit access for new entrants in many sectors, thus holding back innovation, productivity and employment. We need to open up the economy to competition and give everyone the chance to make the most of their talents.

Human capital has a decisive role to play. The skills gap of young people and adults compared with many advanced countries is reflected in employment being tilted towards lower-skilled jobs. Skills and knowledge, which should be nurtured and cultivated throughout our lives, are the cornerstone not only of economic progress, but also and above all of civil progress.

It is on the technology front that the battle of the future will be waged, for Italy and for the rest of Europe. We will need to invest in research, support the production system during its transformation, while protecting the most disadvantaged, and create a legislative, economic and financial environment that allows people to take business risks in innovative sectors and limits the monopoly power of a few large players.

The agenda is clear and deliverable. It has to be done in order to return to growth and to make our presence count in Europe and, together with Europe, in the world.

I cannot believe that a country with our history, our resources and our potential, which together with other countries succeeded in creating a community that has guaranteed development, well-being and peaceful cohabitation for millions of Europeans, is now unable to overcome the difficulties that are there for all to see and on which we all agree.

Italy helped to found the European Union: now it can and it must contribute to its progress. We must channel the power of this perspective to look to the future with confidence.

Note

[1] This assessment rests on the limited amount of low income countries' debt, which stands at 1 per cent of global GDP.

[2] Foreign trade is measured by the sum of exports and imports.

[3] The objectives laid out in the text can be pursued by promoting partnerships and strengthening supply chains on such terms as those of the Italian government's 'Mattei plan' and of the Resilient and Inclusive Supply-chain Enhancement (RISE) project, backed by the G7 under the Italian Presidency, which is designed to integrate low-income countries into the supply chains for products that are key to the energy transition.

[4] Public and private climate-related investment needs stand at an average of €620 billion per year until 2030, according to the European Commission; see European Commission, '2023 Strategic Foresight Report. Sustainability and people's wellbeing at the heart of Europe's Open Strategic Autonomy', COM (2023), 376, final, 6 July 2023, p.7. A further €125 billion per year will be required for the digital transition and €75 billion to bring defence spending to 2 per cent of GDP, in keeping with NATO commitments.

[5] Data for the European Economic Area (which includes the European Union, Iceland, Liechtenstein and Norway). The number of groups includes both regulated markets and multilateral trading facilities; see ESMA, 'Evolution of EEA share market structure since MiFID II', 2023.

[6] The symbiotic relationship between the existence of sovereign bonds and the development of the capital market is confirmed by many centuries of experience. The wars that ravaged Europe and North America between the end of the 17th century and the 19th century led to a surge in public debt in leading countries such as the United Kingdom, France and the United States. Thanks in part to regulatory innovations that improved the credibility of sovereign issuers, government bonds gradually gained investors' confidence and were increasingly traded by professional brokers. Over time, this underpinned the development of an ever wider range of financial intermediaries and services, which were able to attract more risk-averse savers and investors and expand the roster of financial market players.

[7] The natural interest rate is the theoretical interest rate that is compatible with a level of GDP equal to the potential one and with inflation being in line with the central bank's target; see K. Wicksell, *Geldzins und Güterpreise: eine Studie über die den Tauschwert des Geldes bestimmenden Ursachen*, Jena, Fisher, 1898.

[8] Over the last decade, Italian firms have increased the ratio of own funds to total financial liabilities by 10 percentage points (i.e. the sum of financial debts and own funds).

[9] The share of people employed in firms with 250 or more workers in industry and private non-financial services rose to 24.5 per cent in 2022, almost 4 points higher than ten years earlier.

[10] For manufacturing as a whole, also including the transport equipment sector, the number of robots employed per 1,000 workers was 16.4 in Italy, against 27.3 and 15.2 respectively in Germany and in France. Automation has grown in recent years, especially in the pharmaceutical, metalworking and food sectors; see the box 'The use of industrial robots in Italy: an international comparison', Chapter 6, *Annual Report for 2023*, 2024.

[11] The estimate assumes that labour productivity and the employment rate by gender and age group remain at the same levels as in 2023.

[12] The employment rate in the 20-34 age group fell to 49.6 per cent in 2014 and has only recently begun to rise again, reaching 57.8 per cent; it is still below the peak of 62.1 per cent recorded in 2007.

[13] The unemployment rate in Italy for graduates aged between 20 and 34 was 12.3 per cent in 2019, more than double the average of the top five destination countries (the United Kingdom, Germany, Switzerland, France and Spain). In 2016, the last year for which the data can be compared, gross hourly wages were about one fifth lower in real terms.

[14] Italy has one of the lowest shares of children under the age of two enrolled at childcare facilities in Europe.

15 For example, individual income tax deductions for dependent spouses fall to zero as soon as the spouse's gross annual income exceeds €2,840. With regard to cash transfers, there are several cases where benefits diminish rapidly if households' resources increase, and the adjustments are modest for households that become richer when one of its members joins the labour market.

16 In this assessment, employment rates by gender and age group are assumed to catch up with the current euro-area average levels over the next 15 years.

17 See the measures envisaged by the Industry 4.0, Transition 4.0 and now the Transition 5.0 plans.

18 To promote the technological transfer and the digital transformation, there are six different types of set-up in Italy, with more than 400 offices throughout the country. They disseminate information on the potential of investing in advanced technologies and assist firms in measuring their digital maturity, helping them decide on priority areas for action. The current network is widespread but it could benefit from greater specialization in its tasks, given how much roles overlap in the various organizations involved.

19 Private expenditure on research and development accounted for barely 0.8 per cent of GDP in 2022, against 1.4 per cent in France and 2.1 per cent in Germany. The gaps were similar for registered patents.

20 Horizon Europe, the successor of Horizon 2020, is an EU programme that finances research and innovation. Its budget amounts to €95.5 billion for the years 2020-27. The share of funds allocated to Italy by the Horizon programmes is much lower (by around 30 per cent) than its contribution to their funding. It is the same in France and Germany, but both countries spend a much larger share of their own resources on research. By contrast, Member States such as Spain, the Netherlands, Belgium, Sweden, Denmark and Finland receive a share of funds that far exceeds what they contribute (see 'Executive Summary', Report on the system of higher training and research, ANVUR, 2023; only in Italian). There is further funding for the Platform for Strategic Technologies for Europe (STEP), which is concentrated in the field of artificial intelligence, robotics and quantum computing.

21 For further details, see the box 'The potential impact of AI on Italian workers', Chapter 7, *Annual Report for 2023*, 2024 (only in Italian).

22 According to Eurostat data, Italy had around 90,000 researchers in research institutes and universities in 2022, compared with 132,000 in France, 187,000 in Germany and 97,000 in Spain.

23 For further details, see Chapter 11, *Annual Report for 2023*, 2024 (only in Italian).

24 In Italy, the provision of digital public services to citizens and firms has grown by 38 and 43 per cent respectively since 2017. The increases are calculated based on the European Commission's Digital Economy and Society Index (DESI).

25 For further details, see the box 'The National Recovery and Resilience Plan', Chapter 4, *Annual Report for 2020*, 2021.

26 The 2023 Report on the unobserved economy and on tax and social security contribution evasion and its update in January estimate that the tax gap (i.e. non-compliance with declarations and payments) relative to the main taxes on firms and self-employment (IRAP, IVA, IRES and IRPEF for self-employment and firms) shrank significantly between 2014 and 2021 (by more than one percentage point of GDP, to 4 per cent). With reference to overall tax and social security contribution evasion, the Report shows that both the propensity to evasion and its size in absolute terms declined in the years 2016-21 (the only period for which homogeneous estimates are available), by 6 percentage points and by €24 billion respectively.

27 Or more accurately, the capital buffer is equal to 1.0 per cent of credit and counterparty risk-weighted exposures to Italian residents. Half of this target is to be established by the end of this year, and the remaining 0.5 per cent by 30 June 2025.

28 'Survey on the cost of bank accounts for 2022', Banca d'Italia, January 2024 (only in Italian).

29 'Fintech Survey of the Italian financial system', Banca d'Italia, April 2024.

[30] The Digital Operational Resilience Act (DORA).

[31] CERTFin's strategic committee is chaired by Banca d'Italia and ABI and includes the Italian Companies and Stock Exchange Commission (Consob), the Italian Insurance Supervisory Authority (IVASS) and the Italian Association of Insurers (ANIA).

[32] Cooperation in the field of cybersecurity has been established with the Ministry of Justice, the Department of Public Security of the Ministry of the Interior, the Carabinieri police force, and the Finance Police (Guardia di Finanza).

Printed
by the Printing and Publishing Division
of the Bank of Italy
Rome, 31 May 2024

Printed on EU-Ecolabel certified paper
(registration number FI/011/001)