BANCA D'ITALIA

EUROSISTEMA

The 2014 Annual Report at a glance

Rome, 26 May 2015

2014

THE 2014 ANNUAL REPORT AT A GLANCE

The World Economy and the Euro Area

[1] **In 2014 global economic activity fell short of expectations, growing at the same moderate rate as in the last two years.** In the advanced economies the gap widened between the faster pace of growth in the United States and the United Kingdom and the much weaker pace in Japan and the euro area. In the emerging and developing countries economic activity instead slowed overall, as it had in the previous three years, held back by structural weaknesses and, in some instances, by stronger external constraints, mostly of a financial nature.

Inflation declined in all the advanced economies, reflecting persistently weak global demand and the fall in commodity prices. Monetary policies remained accommodative everywhere but varied from area to area: the Federal Reserve stopped buying bonds and continued to signal that it would gradually raise interest rates, while the expansionary stance of policies in Japan and the euro area was strengthened. In the closing months of 2014 low inflation in China and India allowed monetary conditions to be relaxed.

Volatility on the financial markets was limited but there were occasional flare-ups at signs of a deterioration in the global outlook, in the economic situation in Greece, and in the geopolitical tensions in Ukraine. The strengthening of growth prospects in the United States triggered an appreciation of the dollar. Long-term interest rates fell in all the advanced economies. The sharp retrenchment in capital flows to emerging economies in the second half of 2014 stoked pressures on currencies, feeding through to inflation in the most vulnerable economies (Brazil, Russia and Turkey); their central banks responded by tightening monetary policies notwithstanding the worsening economic outlook.

BOXES

The secular stagnation hypothesis

The economic repercussions of the crisis in Ukraine

[2] **World trade also expanded at a much slower pace than expectations had suggested at the beginning of 2014**; contributory factors included sluggish global activity and the weaker response of trade flows to GDP developments compared with the years before the 2008 crisis. This weaker responsiveness could become entrenched since it can be attributed to the end of the one-off effects of structural shifts in world trade, which include the rapid expansion of global value chains in the past two decades.

In 2014 commodity markets witnessed a steep and rapid fall in oil prices, which has few historical precedents. Contributory factors included the upturn in supply, driven by the jump in crude oil production in the United States, OPEC's decision in November to keep output unchanged, and the slump in oil demand due to the progressive weakening of global growth expectations.

Balance of payments disequilibria have diminished considerably in recent years but still pose a risk to the world economy. The adjustments seen to date owe more to the abrupt fall-off in demand of the countries with a current account deficit than to any restructuring of expenditure on the part of surplus economies. The current account balances of the largest net debtors and creditors persisted in their signs, leading to a fresh increase in net foreign asset and liability positions, a source of vulnerability if global financial conditions were to worsen.

International financial assistance constitutes a first safeguard against these risks. The stalled reform to expand the resources of the International Monetary Fund and to give emerging economies a greater say in its governance is undermining the Fund's response capacity and driving these economies to seek alternative guarantees through regional funding agreements and the accumulation of currency reserves.

BOX

The sluggishness of world trade and the role of global value chains

[3] The recovery in the euro area remained fragile, partly because of the slower than expected growth in world trade. Signs of a comeback only strengthened at the end of the year and in the early months of 2015. The growth differentials between countries narrowed, but significant differences remain in the cyclical positions of the bloc's economies.

Inflation dipped well below the level compatible with the ECB Governing Council's definition of price stability, turning negative in December; even excluding the most volatile components it remained exceptionally low. For the first time since the launch of the Monetary Union, inflation expectations over the medium-term horizon reached levels far below 2 per cent.

The stance of fiscal policies was basically neutral, following the adjustments of the previous three years. The debate continued over the future of European governance and the creation of a fiscal capacity to promote macroeconomic stability and fund reforms.

BOXES

Macroeconomic imbalances in the European Union

An unemployment insurance scheme for the euro area

[4] As actual and expected inflation fell to exceptionally low levels, the Governing Council of the ECB eased monetary conditions considerably. In 2014 it cut its benchmark rates to a point beyond which it no longer deemed further downward revisions possible; it conducted longer-term refinancing operations to stimulate the flow of credit and it started purchasing private sector securities. Last January, as the outlook for prices deteriorated further, the Council concluded that its monetary stimulus was insufficient and decided to extend purchases to public sector securities. Under the expanded asset purchase programme the ECB will make monthly purchases amounting to €60 billion until the end of September 2016, and in any event until it sees a sustained adjustment in the path of inflation consistent with its mandate of price stability.

The Council's decisions were based on mounting evidence that trends in aggregate demand had greatly contributed to bring down inflation, on the particular importance of the risks of the disanchoring of expectations, and on awareness of the high potential costs of deflation.

These decisions have had wide-ranging effects on the financial markets; in the short to medium term, growth and inflation are set to reap significant benefits. Some of the effects of the expanded asset purchase programme were already being transmitted to yields and to the exchange rate from November 2014 when the Council announced that it was preparing these monetary measures.

BOXES

The expanded asset purchase programme

The risks of too low inflation over a prolonged period

The Italian Economy

[5] The prolonged decline in Italy's GDP slowed during 2014 before coming to a halt in the last quarter thanks to a timid revival of domestic demand. Economic activity picked up at the beginning of 2015. The Eurosystem's expanded asset purchase programme could stimulate growth in Italy in 2015-16.

Last year growth was hampered chiefly by falling investment, which nonetheless picked up in the fourth quarter, though only slightly. The slow recovery of household spending under way since mid-2013 continued. Exports rose sharply, boosted by the expansion of potential demand and gains in price competitiveness, which only benefited the most productive and innovative firms, however. The economy as a whole is weighed down by the large number of micro-enterprises, inadequate organizational and management systems, and a financial structure that offers little scope for risk capital. This stands in the way of an essential ingredient of growth, innovation, in which Italy lags behind the other main advanced countries.

The growth gap continued to widen between the South and the Centre and North, where there are more firms capable of exploiting the increase in foreign demand.

Italy can only overcome definitively its prolonged economic crisis if it eliminates the obstacles that have been hindering investment plans for many years, so that full advantage can be taken of the more favourable economic situation.

BOX

Italy's potential output and the output gap

[6] The contraction in investment slowed during the year and a slight recovery was registered in the fourth quarter. Corporate investment was held back by the uncertain prospects for demand and by persistently large margins of spare capacity. Credit supply conditions improved gradually, mainly as a result of the reduction of interest rates. According to the Bank of Italy's Survey of Industrial and Service Firms, investment will return to growth in 2015, especially that of the largest firms.

The differences between firms, already significant by international standards, continued to widen. Results were once again better for exporting firms and for the most innovative and least indebted ones, typically medium-sized and large enterprises. Italy's productive structure features a large proportion of small firms that innovate less and have high levels of debt, making them potentially less able to compete and constraining their financial choices.

The long recession has changed the productive system, with firms that are less profitable and have poor growth potential closing down and production inputs being reallocated to more efficient units. Banks' highly selective policies have led to a reduction in firms' borrowing and a shift in their financial structure towards a higher proportion of own funds. However, this shift is still hindered by an institutional environment that is not business friendly.

BOXES

The determinants of the decline in investment

Main financial support measures for firms

[7] Households' consumption expenditure increased last year for the first time since 2010, although it is still about 8 per cent below the 2007 level. There was an increase in purchases of durables in particular, which had been hardest hit by the global recession and subsequent sovereign debt crisis. The propensity to save diminished slightly and households' confidence picked up.

The decline in purchasing power was halted by the small rise in employment, the drop in inflation, and government transfers to payroll workers with average to low earnings. The ratio of household wealth to disposable income stabilized, mainly as a result of the increase in the value of financial assets. The Bank of Italy's Household Income and Wealth survey indicates that about 90 per cent of the tax bonus was in fact spent, and in the early months of 2015 a slightly smaller share of households reported difficulty making ends meet than a year before. According to Istat's surveys, the number of people living below the absolute poverty threshold, however, has more than doubled since 2007 and in 2013 was 10 per cent.

Although the property market was still weak, the first signs of a recovery in sales appeared, leading to an increase in new mortgage loans after three years of sharp contraction.

BOX

The recession and household consumption

[8] After declining for two years the number of persons in work stabilized in 2014 but unemployment was still very high. Employment was buoyed mainly by the fixed-term component, driven by labour demand from the firms that benefited most from the growth of foreign trade. While employment rose only moderately, the unemployment rate jumped to an exceptionally high level as the lengthening of working life and the persistently weak economic situation of households boosted labour supply.

High unemployment continued to affect contractual wages. The pay rises incorporated in the national labour contracts agreed in the first half of 2014 were in line with expected inflation at the time of renewal, which proved to be higher than the rate actually observed. The contracts signed in the second half of the year instead envisaged much lower pay rises, particularly in the sectors in greatest difficulty.

The enabling bill for the reform of the labour market (Jobs Act) was passed at the end of 2014. The first two enacting decrees, which took effect in March of this year, reinforce some of the principles underlying the measures introduced in 2012. They further extend the pool of potential recipients of unemployment benefits and clarify the legislation on dismissals, making the consequences of any firing decisions more predictable. Permanent hirings increased sharply in the first quarter of this year, partly thanks to the temporary relief on social security contributions. As a whole, these measures could help to shift hiring practices towards more stable contract forms.

[9] Downward pressures on prices, which were present throughout the euro area, also affected the Italian economy. Inflation turned negative in the summer owing both to the trend in food and energy prices and to weak demand, which affected the core components more than in the past. The drop in inflation shaped expectations, which diminished and only showed signs of a slight increase after the launch of the Eurosystem's expanded asset purchase programme at the beginning of this year.

Italy's price competitiveness has improved in recent months, as has that of the other main euro-area countries, mainly owing to the depreciation of the currency. Italy's price competitiveness is remained unchanged compared with the beginning of monetary union, while that of France and Germany has improved.

BOXES

Changes in firms' pricing policies during the recession

The drop in oil prices and the structure of the energy sector

[10] While demand remained weak, in 2014 exports accelerated and the current account of the balance of payments improved steadily, even when adjusted for the effects of the business cycle. The overall adjustment with respect to the low point reached in 2010 amounted to more than 5 percentage points of GDP, half of which ascribable to structural factors. One contribution came from the strong performance of goods exports, which outpaced demand on destination markets. However, the fact that firms generally tend to be smaller in Italy than in the other European countries continues to prevent them from expanding their commercial presence on foreign markets.

Capital inflows strengthened. Foreign investment in Italian portfolio securities, including public sector issues, is evidence of investor confidence in our country. The Bank of Italy's negative balance in the TARGET2 settlement system has therefore continued to improve, despite some fluctuations due to the Treasury's issuance policy and the banks' use of ECB financing.

BOXES

Italy's position in global value chains

The cyclically adjusted current account balance

[11] In a difficult macroeconomic environment, fiscal policy was largely neutral. Within the constraints imposed by European budgetary rules, the Government adopted measures to restructure the public finances to support the economy. In particular, the tax wedge was reduced for payroll workers with average to low earnings. Despite the persistence of the recession, Italy's general government deficit remained stable at 3 per cent of GDP. The debt-to-GDP ratio rose, reflecting the stagnation of nominal output; about one third of the increase was attributable to the payment of overdue general government commercial debts and financial support to other euro-area countries.

The Government's Economic and Financial Document indicates that in the current year Italy's fiscal policy stance will remain basically neutral: reduced interest rate costs will nevertheless lead to a slight improvement in the structural balance.

BOXES

Structural balance in the 2012 programmes and expenditure dynamics

Redistributive effects of local taxes on ownership of main residence

General government commercial debts

[12] The reform process continued in 2014: various amendments were made to corporate law to encourage firms to seek funding on the financial markets; changes were made to the civil justice system to reduce litigation and speed up proceedings; and the mandate of Italy's national anti-corruption authority was strengthened to make its action more effective. Lastly, in February 2015 the presentation to Parliament of the annual bill on competition brought the regulation of product markets, already the subject of substantial interventions in the previous three years, once again under the spotlight.

The reform process has already produced results: the number of court cases pending has diminished and there is increased openness to competition. Still, the effects of the reforms on economic activity have been blunted by the continued delays in implementation of many laws, the weak cyclical situation and by low inflation. Bankruptcy law remains critically important as regards both the winding up of insolvent firms and for restructuring viable companies when possible.

Business activity in Italy is conditioned by the weak regulatory framework and the institutional context. The reallocation of resources, vital for exiting the prolonged recession, is being impeded by an ineffective public administration, the slow civil justice system, and the perception of widespread corruption, as well as by the over-regulation of some markets and dysfunctions in insolvency procedures for firms.

BOXES

Competition reforms and macroeconomic developments

Distortions in the subjective measures of corruption

[13] In 2014 and the early months of 2015, the funding activity of banks and institutional investors was affected by the abundant market liquidity and low interest rates. The very low cost of both wholesale and retail funding allowed the banks, whose resources diminished overall, to reduce significantly their recourse to Eurosystem refinancing. Institutional investors instead raised €110 billion's worth of funds, the highest amount in the last 15 years, taking advantage of savers' preference for financial assets yielding higher returns.

Risks connected with a scenario of prolonged low interest rates remain modest for Italian banks and institutional investors, thanks to the good matching of duration and yields between financial assets and liabilities.

The lack of economic recovery has continued to penalize banks. Lending declined and credit quality worsened, though less than in 2013. However, some signs of improvement have appeared, faint as yet in the case of credit quality but clearer as regards the trend in lending. The progressive easing of credit supply conditions, as reported by the opinion surveys, continued in the first few months of 2015. A gradual recovery of lending is indicated by an increase in new loans for households and, since the start of 2015, for businesses as well.

The growth in lending favoured above all firms with no non-performing loans outstanding. In 2014 lending to manufacturing firms in this category increased. The quarterly bank lending survey noted a gradual easing of supply conditions during 2014, especially for less risky firms.

Banks' net profits were again negative, but their capitalization strengthened thanks to capital increases made in the first part of the year. Profitability was also negative for the other credit intermediaries. The reduction in the number of banks and branches continued with a view to pursuing efficiency gains. However, both administrative and labour costs increased slightly, partly as a result of early retirement incentives for employees.

Measures are under study to encourage a reduction of bad loans. The lack of a fully developed private market for bad loans is making it difficult to reabsorb the effects of the crisis.

Profits increased considerably for all categories of institutional investor, driven by the positive performance of funding.

The comprehensive assessment of the largest euro-area banks was conducted in 2014. Preparatory to the launch of the Single Supervisory Mechanism, the exercise helped to make banks' balance sheets more transparent and strengthened market confidence. The results for the Italian banks were generally positive and those with shortfalls presented recapitalization plans. As a member of the Supervisory Board, the Bank of Italy is monitoring their implementation.

BOX

The main euro-area banks: composition of assets and profitability

[14] Conditions on the Italian financial markets have been improving since mid-2012, following the most acute phase of the sovereign debt crisis. Increasingly relaxed conditions reflected not only the subsidence of fears about the solidity of the monetary union, but also the progressively more expansionary stance of monetary policy, as well as the start of government security purchases by the Eurosystem. Foreign investors showed renewed interest in Italian government securities. The risk premiums on bonds issued by Italian companies and banks fell markedly. In 2014 as a whole, share prices remained virtually unchanged, but they have risen sharply since the start of this year.

With the start of the Eurosystem's asset purchases, interest rates on Italian government bonds and spreads with respect to Germany dropped noticeably at all maturities. The subsequent partial recovery of long-term rates, which affected Italian and German securities equally, was due to a small initial increase in inflation expectations and the closing of some speculative positions. There has been no reduction in the availability of Italian government securities or in the overall liquidity of their secondary market since purchases began.

The fragmentation of the euro-area financial markets along national lines continued to diminish. The dispersion of yield spreads on private sector bonds between the euro-area countries narrowed considerably at the turn of the year. By reviving growth prospects, the start of the Eurosystem's expanded asset purchase programme improved investor perception of banks' and firms' creditworthiness, confirmed the cohesion of the monetary union, and increased the propensity to take risky positions.

There is a persistently high risk, however, of disorderly portfolio shifts, as shown by fluctuations in financial asset prices after the crisis between Russia and Ukraine, uncertainty over the situation in Greece, and the conflicts in the Middle East.

BOX

The fragmentation of the bank and corporate bond markets in the euro area

[15] Improving the quality of public administration can make an important contribution to economic activity: recent efforts in Italy to reduce bureaucratic requirements have been shown to have positive effects for firms.

Based on the World Bank's indicators, Italy's public administration continues to be less effective than in the other main economies, but the picture varies greatly across the country. For instance, according to one measure linked to the granting of new business licences by Italy's municipal authorities, while performing less well on average than the Centre and North, the South of Italy still boasts a significant number of efficient administrations. There is evidence that the piecemeal approach to amending laws has become more pronounced over time; implementation remains slow, creating uncertainty, but there has been considerable progress nonetheless.

Several aspects of the way Italy's public administration works make its action less effective. These include legislative and administrative decentralization; the low appeal of public sector jobs, due partly to career structures that do not properly reward merit and partly to recruitment methods that are insufficiently selective and increase uncertainty about the stability of the work contract; inefficient systems for assessing the performance of organizations and individuals; and the limited use of IT technology in customer services.

BOXES

Start-up costs and firm demography

Choosing to work in the public sector: the role of temporary contracts