BANCA D'ITALIA
EUROSISTEMA

Annual Report 2015

Rome, 31 May 2016

122nd FINANCIAL YEAR

2015

Financial Year 122nd

BANCA D'ITALIA
EUROSISTEMA

Annual Report

2015 – 122nd Financial Year

Rome, 31 May 2016

Address
Via Nazionale, 91
00184 Rome - Italy

Telephone
+39 0647921

Website
www.bancaditalia.it

ISSN 2239-9674 (print)
ISSN 2280-4145 (online)

Printed by the Printing and Publishing Division
of the Bank of Italy, Rome, July 2016

The statistical appendix to the Annual Report is available on the Bank of Italy's website

CONTENTS

THE INTERNATIONAL ECONOMY AND THE EURO AREA

1. MACROECONOMIC DEVELOPMENTS AND POLICIES AND THE INTERNATIONAL FINANCIAL MARKETS

In 2015 global economic activity fell short of expectations, as it had in the previous year. Growth slowed overall to 3.1 per cent, compared with 3.4 per cent in 2014. The emerging and developing countries experienced a sharper than expected slowdown. In the United States and the United Kingdom the pace of growth held up, while in Japan it was fairly uneven. The Chinese economy continued to slow, although fears of a brusque downturn that surfaced on several occasions have abated in recent months.

Weak global demand and especially the drop in oil prices exerted downward pressure on inflation. Japan introduced further expansionary measures. The Federal Reserve raised interest rates in December, indicating a more gradual pace of policy normalization. The dollar ceased to gain strength.

Uncertainty over developments in China and the outlook for the world economy led to bouts of turmoil in the global financial markets that were short-lived but worryingly intense. Share prices have come down considerably from the peaks recorded in 2015; yields on long-term bonds of the main advanced countries have fallen and in some cases turned negative in the early months of the current year. The financial situation of the emerging countries worsened overall: net capital outflows were recorded for the first time in fifteen years.

The main advanced countries

The economies of the advanced countries grew by 1.9 per cent in 2015, just 0.1 percentage points faster than in 2014 and half a point less than forecast a year ago by the IMF.[1] The drop in oil prices (see Chapter 2, 'World trade, commodity prices and payments balances') reflected weak demand globally, especially on the part of China, and was partly responsible for almost zero inflation in the second half of the year. The decrease in energy costs did boost households' purchasing power and consumption, but it undermined investment in the extractive industry in both the US and UK. Output grew nonetheless in both countries as a result of the increase in employment, despite flagging somewhat towards the end of the year. Although Japan's economy began to expand once again, growth was uneven.

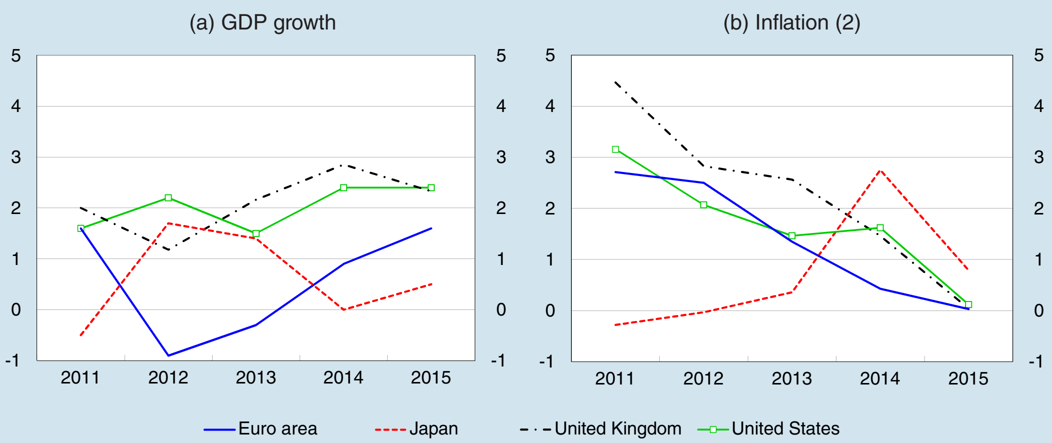
United States. – Output increased by 2.4 per cent in 2015, the same as in the previous year (Figure 1.1.a), driven by the growth in consumption, which accelerated

[1] IMF, *World Economic Outlook*, April 2015.

to 3.7 per cent. Two factors had a dampening effect, however. The first was weak foreign demand which, together with the sharp appreciation of the dollar from the spring of 2014, undermined manufacturing exports and output, both of which grew by just 1.1 per cent. The second was the brusque fall (by one third on average during the year) in investment in the extractive industry caused by the drop in raw material prices (see the box 'The decline in oil prices and global growth', *Economic Bulletin*, No. 2, 2016). The growth in non-residential fixed investment slowed to 2.8 per cent overall.

Figure 1.1

GDP and inflation in the main advanced economies (1)



Source: National statistics.
(1) Annual data; percentage changes on previous year. – (2) For the United States, the consumption deflator; for Japan, the consumer price index; for the euro area and the United Kingdom, the HICP.

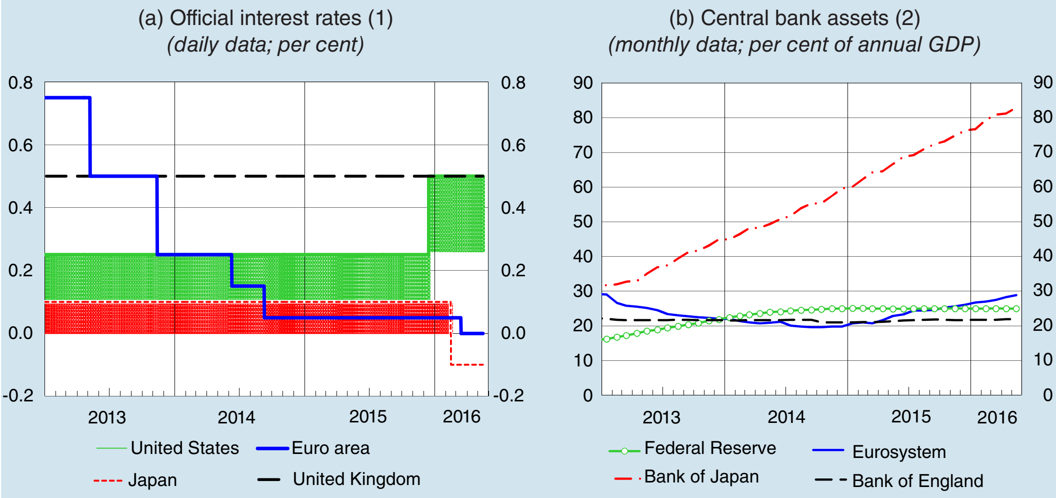
Conditions on the labour market continued to improve. Unemployment decreased from 5.6 to 5.0 per cent, in line with the long-term equilibrium rate estimated by the Federal Reserve. The underemployment rate, which includes part-time workers seeking full-time work and the marginally attached, fell from 11.2 to 9.8 per cent. Because this rate had been as low as 8.0 per cent before the recession, there would appear to be scope for greater use of labour even without cost-side tensions. Last year's moderate increase in wages and salaries once again helped to keep core inflation (net of the most volatile components, i.e. food and energy products) at about 1.3 per cent, well below the Fed's target. Consumer price inflation was close to zero (0.1 per cent on average; Figure 1.1.b).

In view of the improvement in the labour market, in December the Fed raised the target range for the federal funds rate by 25 basis points to 0.25-0.50 per cent (Figure 1.2.a). The decision was taken later than the Federal Open Market Committee had anticipated just a few months before; expectations of further rate rises have been moved progressively forwards. The Fed's caution stems partly from the fact that deflationary shocks are harder to control when rates are close to zero and partly from fears that inflation expectations, despite easing in recent years, might continue to move off-target even though there has been no sign of a de-anchoring to date.[2]

[2] I. Buono and S. Formai, '*The evolution of the anchoring of inflation expectations*', Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), 321, 2016; F. Natoli and L. Sigalotti, 'An indicator of inflation expectations anchoring', Banca d'Italia, Temi di Discussione (Working Papers), forthcoming.

Figure 1.2

Official interest rates and balance sheets of the main central banks



Sources: ECB and national statistics.
(1) For the United States, federal funds target range; for Japan, uncollateralized overnight call rate (up to 15 February 2016 the Bank of Japan's monetary policy was based on a quantitative target; since then it has also been based on the official reference rate); for the euro area, rate on main refinancing operations; for the United Kingdom, rate on commercial banks' reserve deposits with the Bank of England. – (2) For the Bank of England, from 2 October 2014, only assets purchased in monetary policy operations (over 90 per cent of the total).

Japan. – The Japanese economy returned to growth (0.6 per cent), although the pace over the year was uneven. The effect of the further decline in consumption and of the slowdown in non-residential investment was negative; residential investment declined for the second year running. Exports flagged and their contribution to growth, net of imports which stagnated, was barely positive.

Efforts to bring inflation closer to the 2 per cent target were initially successful but subsequently faltered. The central bank repeatedly postponed the deadline for achieving its objective, which is now set at mid-2017. Average inflation in 2015 fell to 0.8 per cent, partly as a result of comparison with the previous year when consumption tax had been raised. Inflation was zero in the second half of the year, while core inflation hovered around 0.8 per cent. Medium- and long-term inflation expectations, which had risen with the launch of the quantitative easing programme in 2013, also appear to have steadied. Clearly, it is by no means easy to bring actual and expected price increases firmly back on target after a prolonged period of low or negative inflation such as Japan's economy has experienced.[3] Last January the Bank of Japan set a negative interest rate of -0.1 per cent on reserve funds for the first time, although this only applies to a very small portion of excess reserves (about ¥10 trillion) to curb the pressure on banks' profitability.

United Kingdom. – GDP growth in the UK slowed to 2.3 per cent in 2015, from 2.9 per cent in 2014. It was buoyed by consumption and fixed investment, despite a contraction in investment in the extractive industry; net exports made a negative contribution, as in the previous year. Unemployment fell from 5.7 to 5.1 per cent, without repercussions for wages or inflation (core inflation diminished from 1.5 to 1.1

[3] R. Piazza, 'Self-fulfilling deflations', Banca d'Italia, Temi di Discussione (Working Papers), forthcoming.

per cent). The Bank of England kept its bank rate unchanged at 0.5 per cent; market expectations now put the start of a period of rate rises even further ahead, with the first projected to take place some time in the second half of this year.

The June 23 referendum on whether the UK should remain in or leave the European Union is creating a climate of uncertainty. It follows a series of complex negotiations around the demands advanced by the British Government, designed to modify the governance and functioning of the EU so as to safeguard specific interests of the UK and other member states that have not adopted the euro. On 19 February the European Council agreed on a set of compromise solutions to each of these issues, which will be adopted if the British public vote in favour of remaining in the EU. Leaving the EU could have major repercussions on trade flows,[4] particularly if no subsequent trade agreement is reached of the kind signed with, say, Switzerland or Norway. The long-term economic cost to the UK, though impossible to assess with any certainty, could be substantial – as much as 10 per cent of GDP according to the British Treasury – stemming mainly from a loss of economic competitiveness and dynamism.

The EU countries of Central and Eastern Europe. – In the countries of this region that have not yet adopted the euro, GDP growth accelerated last year to 3.6 per cent on average, from 2.8 per cent in 2014, driven by consumption and exports to the euro area. Consumer price inflation turned negative (-0.5 per cent) and core inflation was barely positive at 0.5 per cent. The reference rates for monetary policy in Poland, Romania and Hungary, which do not have a fixed or managed floating exchange rate regime with the euro, were cut by between 50 and 100 basis points; in the Czech Republic the rate stayed closed to zero. In some cases unconventional measures were taken. Despite the expansionary monetary policies, lending growth remained weak overall, still affected by the tight supply conditions imposed by banks.

The main emerging economies

Last year the expansion of economic activity in the emerging and developing countries slowed to 4 per cent (4.6 per cent in 2014), the lowest value recorded since 2009. In China the slowdown continued in line with the IMF's forecasts, although fears that it would gain pace flared on several occasions, causing tensions on world financial markets and underlining the country's growing importance in global economic and financial developments (see the box 'The slowdown in China and the repercussions for the world economy', *Economic Bulletin*, No. 4, 2015). The further drop in commodity prices compounded the situation in exporting countries, among which Brazil and Russia, where the recession has proved stronger than expected and the public finances have deteriorated sharply. As in 2014, India's economic performance bucked the trend.

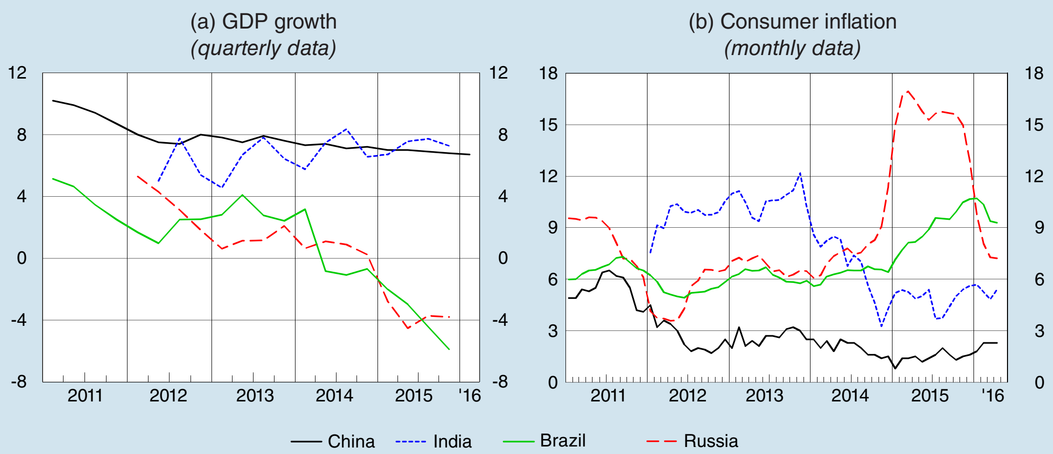
China. – GDP grew by 6.9 per cent in 2015, against 7.3 per cent the year before, generally in line with the government's target; consumer price inflation declined to 1.4 per cent (Figure 1.3). Consumption was again fairly buoyant, thanks to the rise in households' disposable income, but investment remained slack, especially among firms in real estate and auxiliary services. On the production side, the shift continued

[4] IMF, *World Economic Outlook*, April 2016.

towards services – the sector's share has risen to 51 per cent of GDP against 43 per cent in 2010 – and light industry, and away from heavy industry, which continues to have ample margins of spare capacity.

Figure 1.3

GDP and inflation in the main emerging countries (1)



Source: National statistics.
(1) Percentage change on corresponding period of previous year.

The Chinese Government's objective of increasing the weight of consumption in aggregate demand and of services in supply is one aspect of the transition towards a developmental model based on slower, more balanced and sustainable growth, and more efficient resource allocation.[5] The transition is complicated by the country's legacy of financial imbalances, notably the high level of indebtedness in sectors with easy access to credit, and by the need to ensure a steady growth in employment. The Government enacted moderately expansionary economic policies to reduce the risk of an overly rapid slowdown. The central bank lowered the compulsory reserve ratios and cut the reference rates on several occasions; it also injected liquidity to counter the restrictive effects of capital outflows. The deficit rose to 2.7 per cent of GDP from 0.9 per cent in 2014, mainly owing to increased central government spending. In May 2015 a plan was launched to restructure the debt of local governments – bank loans maturing during the year were converted into long-term bonds – and boost their spending capacity, which is especially important for building infrastructure.

The authorities continued their efforts to allow market forces to play a greater role in the allocation of credit. In August they modified the exchange rate regime (see the section 'The financial and foreign exchange markets' below). Another major, long awaited reform was the abolition of the ceiling on the interest paid on bank deposits, which in the past had allowed banks to lend at extremely low interest rates. The main beneficiaries of this had been state-owned enterprises (SOEs) in heavy industry and construction, rendered inefficient by a duty to put employment objectives before profitability. Last year the stock of loans to SOEs, for the most part from public banks, climbed to 110 per cent of GDP, with a sharp rise in NPLs caused by the

[5] E. Di Stefano and D. Marconi, 'Structural transformation and allocation efficiency in China and India', Banca d'Italia, Temi di Discussione (Working Papers), forthcoming.

recent decline in profits. The Government hopes to restore the SOEs and the public banking system to health while minimizing the fall-out for the financial system and social cohesion.

India. – In 2015 GDP growth, driven chiefly by private consumption, accelerated to 7.3 per cent, the highest rate of all the main emerging economies. Consumer price inflation was moderate (4.9 per cent), in part owing to lower food prices. The fiscal stance remained prudent; net borrowing in 2015-16 decreased from 4.5 to 3.9 per cent of GDP. A tax reform was launched which will further decentralize the budget, devolving additional resources to the federal states.

The Government took advantage of the fall in oil prices to halve spending on fuel subsidies and simultaneously raise excise duties without increasing inflation; it was thus able to plan additional investment without undermining efforts to restore budget balance. This circumspection made the central bank's inflation target of 2 to 6 per cent more credible and provided scope for a mildly expansionary monetary policy. This generally favourable environment nonetheless presents two main weaknesses: on the one hand, the difficulties of the banking system caused by an increase in NPLs; on the other hand, the failure to realize structural reforms, chiefly of the labour market, with excessively fragmented regulations among the federal states and marked dualism between workers on standard and atypical contracts.[6]

Brazil and Russia. – The recession worsened in Brazil, with output contracting by 3.8 per cent, pushing up unemployment to 10.9 per cent last March. Consumption fell by 4 per cent and investment by over 14 per cent, partly as a reaction to considerable political uncertainty. The depreciation of the currency and raising of regulated prices brought consumer price inflation close to 11 per cent last January, well above the tolerance threshold of 6.5 per cent set by the central bank. The leeway for countercyclical policy action narrowed. Interest expense soared, almost doubling the budget deficit to 10.4 per cent of GDP. After raising its benchmark Selic rate by 250 basis points in the first half of the year, to 14.25 per cent, the central bank maintained a restrictive stance in order to limit inflationary pressures and capital outflows.

The macroeconomic situation in Russia deteriorated further as oil revenues plummeted and international sanctions produced effects (see the box 'The economic repercussions of the crisis in Ukraine', *Annual Report*, 2014). GDP contracted by 3.7 per cent – after growth of 0.7 per cent the year before – reflecting the decline in domestic demand. The central bank sought to buoy the economy by lowering its policy rate on several occasions (from 17 to 11 per cent), even though the depreciation of the rouble caused inflation to jump to almost 16 per cent in August.

The financial and foreign exchange markets

From the summer of 2015 to the early months of this year the global financial markets alternated between periods of relative calm and phases of extreme turbulence,

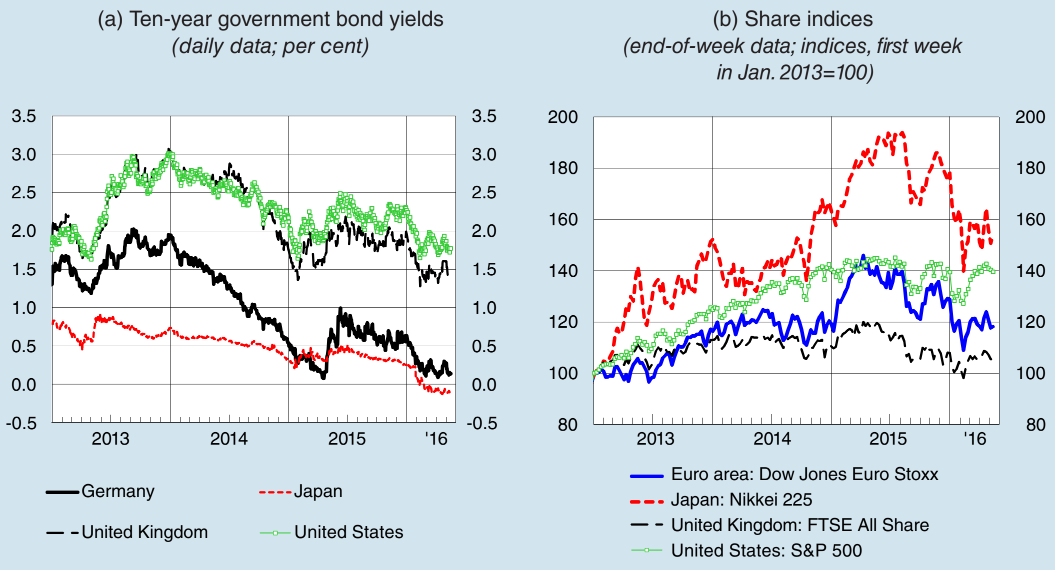
---

[6] A. Borin and E. Di Stefano, 'Economic reforms in China and India: past and future challenges', Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), forthcoming.

with spikes in volatility and decreases in the prices of high risk assets (Figure 1.4.b). The first episode of tension, from June to July, was mild and coincided with negotiations to prolong financial support for Greece and with a brusque adjustment of China's stock market. The second episode came after the Chinese authorities' decision on 11 August to modify the exchange rate mechanism and devalue the renminbi against the dollar.

Figure 1.4

Long-term interest rates and share indices in the main advanced countries



Source: Thomson Reuters Datastream.

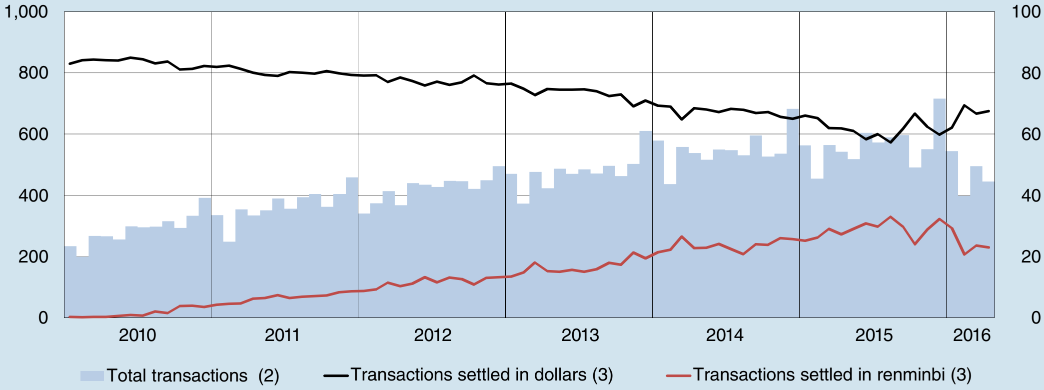
The decision was intended to allow market forces greater say in fixing the daily parity against the US currency but it fuelled fears that it was part of a strategy to weaken the renminbi in order to make competitive gains and avoid an overly sharp slowdown in economic activity. The move sparked heavy speculative pressures, which the central bank countered by intervening massively on the foreign exchange market. Between 11 August 2015 and mid-May this year the renminbi lost 4.8 per cent against the dollar. Offshore deposits in renminbi were also severely reduced during this period, having previously increased as the internationalization of the Chinese currency proceeded (see the box 'The renminbi's new international role').

THE RENMINBI'S NEW INTERNATIONAL ROLE

International use of the Chinese currency has increased rapidly over the last five years. In 2015 about 30 per cent of China's cross-border transactions were settled in renminbi – the amount was nil in 2010 – to the detriment of the dollar (see the figure). According to data released by the Society for Worldwide Interbank Financial Telecommunications (SWIFT) the renminbi is now the fifth most used currency in international payments, after the dollar, euro, pound sterling and yen. However, it is still not widely employed in global commercial and financial transactions (less than 3 per cent of the total) considering the size of

China's economy;[1] this is due to inertia in currency use as well as to China's lack of financial integration with the rest of the world. The IMF estimates that at the end of 2014 barely 1.1 per cent of global foreign currency reserves were invested in renminbi-denominated assets. The Chinese currency's low acceptance as a reserve currency is due to its limited convertibility; only since last autumn have foreign central banks been allowed to freely convert renminbi into other currencies on the Chinese interbank market.

Use of dollar and renminbi to settle China's international transactions (1)



Sources: Based on data from People's Bank of China and State Administration of Foreign Exchange.
(1) Cross-border payments made and received by Chinese banks on behalf of customers. – (2) Billions of dollars; left-hand scale. – (3) Per cent; right-hand scale.

The renminbi is gaining ground above all as a means of payment in China's commercial transactions with countries of the Asia-Pacific region.[2] Some 60 per cent of China's international trade and 80 per cent of cross-border renminbi payments take place within the region and indeed the Chinese currency looks set to play an increasingly important role there. The available information indicates that since 2005, as the renminbi's exchange rate has become more flexible, the Asia-Pacific currencies have co-moved more closely with it against the US dollar.[3]

The renminbi's use in international transactions generates liquidity in that currency for non-residents who are willing to accept and hold it depending on the investment opportunities and availability of financial instruments to hedge against exchange rate risk. So far non-residents have been discouraged from using the renminbi by China's restrictions on capital movements and underdeveloped financial market. The Chinese authorities have therefore taken steps to support the internationalization of the currency by promoting the development of

[1] According to SWIFT the dollar is used in 43 per cent of global transactions and the euro in 23 per cent. China accounts for 11.4 per cent of world goods and services exports, more than either the US (10.6 per cent) or Germany (7.5 per cent).

[2] Chinese exporters are encouraged to invoice and receive payment in renminbi to eliminate exchange rate risk. For their part, importers from China who use the same currency can obtain discounts on list prices. Foreign exporters to China may consider it worthwhile to bill in renminbi if this helps them gain access to the market.

[3] D. Marconi, 'Currency co-movements in Asia-Pacific: the regional role of the renminbi', Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), forthcoming.

offshore markets – there are currently 16, the main one being Hong Kong[4] – where non-residents can freely exchange their renminbi at flexible exchange rates and invest in locally issued renminbi-denominated financial products. China's restrictions on capital movements have driven a wedge between offshore markets and the domestic market which prevents full arbitrage on exchange and interest rates.

The offshore markets rest on three pillars designed to guarantee liquidity: (a) designation of a Chinese commercial bank as clearing bank for interbank positions in renminbi and for the settlement of transactions in that currency between offshore markets and the Chinese market; (b) a bilateral agreement on swap lines between the central bank of the host country and the People's Bank of China; and (c) a certain degree of access to China's financial market under the Renminbi Qualified Foreign Institutional Investor Program (R-QFII), available to those who apply.

Europe now counts six offshore renminbi markets: London, Frankfurt, Luxembourg, Paris, Zurich and Budapest, the last two of which have not yet been fully launched. European interest reflects not only growing demand for the Chinese currency, for settling commercial transactions and for the liquidity management strategies of European multinationals operating in China, but also a drive towards closer commercial and financial ties with the country. The European markets, whose renminbi segment is still small, are competing with each other for more business, relying on their comparative advantages.[5]

According to the Survey of Industrial and Service Firms, conducted by the Bank of Italy in March and April, only 5 per cent of Italian firms (with over 50 employees) exporting to China also bill in renminbi. Given the large size of these firms, it is estimated that in 2015 about 10 per cent of Italian exports to China were invoiced in renminbi. The reasons for this decision include (a) satisfying the requests of Chinese customers (75 per cent); (b) maintaining agreements in intra-group transactions (40 per cent); and (c) keeping prices in line with those of competitors on the Chinese market (31 per cent). On the other hand, more than 80 per cent of the firms interviewed that export to China reported that they invoice in euros; for them, exchange rate risk is the main deterrent to using other currencies.

In China, the renminbi's internationalization has been accompanied by a gradual, though still incomplete, easing of the restrictions on capital movements, a series of measures to liberalize the financial system, and increased exchange rate flexibility. This strategy was stepped up in 2015 as the Chinese authorities sought to obtain their currency's inclusion in the basket of currencies making up the special drawing right (SDR); it proved successful and last November the IMF

4 Personal use of the renminbi in the Hong Kong Special Administrative Region was already allowed in 2004 under the special administrative and economic arrangement with Mainland China.

5 D. Marconi, L. Bencivelli, A. Marra, A. Schiavone and R. Tartaglia-Polcini, 'Offshore RMB markets in Europe: prospects for greater financial integration between Europe and China', Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), forthcoming.

decided to include the renminbi in the basket as of October this year. In the Fund's opinion the renminbi fulfils the requirements of a freely usable currency at international level.

The offshore renminbi markets are not very deep as yet and are subject to considerable volatility. The episodes of financial instability that China experienced after the middle of 2015 eroded foreign investors' confidence (see the section 'The financial and foreign exchange markets' in this chapter) causing a sharp reduction in renminbi deposits in offshore markets – on the Hong Kong market they decreased by 20 per cent in the twelve months to February this year to RMB800 billion, equal to about €110 billion. R-QFII approved foreign investors also briefly lost interest, probably owing to the uncertain future direction of the exchange rate.

The timing and the effects of the measures to definitively abolish all restrictions on capital movements will determine how the renminbi's internationalization progresses and its future role as a global reserve currency. The recent episodes of instability have highlighted the risks associated with the domestic market's increased permeability to the climate of confidence among foreign investors. The Chinese authorities will probably proceed cautiously with the programme of liberalization as a result, and the offshore markets will continue to play an important role in China's financial integration with the rest of the world.

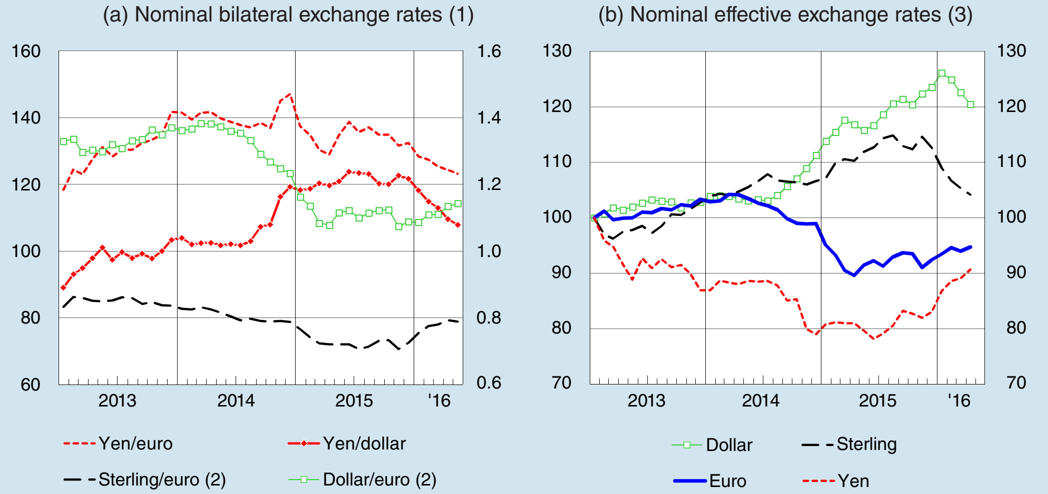
The third episode of instability, which took place in the early weeks of this year, was triggered by the release of worse than expected macroeconomic data for China and was probably more closely connected than in the past with the global weakening of economic activity. Two factors made this phase particularly bad: on the one hand, the collapse of oil prices to new lows, regarded as a major source of risk for energy commodity exporting countries; on the other hand, the brusque fall in bank share prices. The latter was due not just to the worsening global situation but to more specific concerns as well, including the possible consequences of negative interest rates and, in Europe, the high proportion of NPLs and uncertainty about some regulatory aspects, not least how to apply the new bail-in rules (see *Financial Stability Report*, No. 1, 2016).

Risk appetite has increased since mid-February, partly because fears regarding China have abated. By mid-May the stock market indices of the main advanced countries were back at the levels of early 2015; they were still well below the peaks recorded at other times of the year though, by almost 20 per cent in the euro area and Japan, and by over 10 per cent in the UK. Again with respect to the peaks of 2015, bank stock indices were down nearly 20 per cent in the US, 30 per cent in the UK and 40 per cent in Japan. Risk premiums on high-yield corporate bonds practically doubled to 9 percentage points between the summer of 2015 and mid-February this year but have since fallen back to 6.3 points. These movements are largely connected with the performance of energy companies' stock, even though such firms represent just a sixth of this market segment.

The new expansionary monetary policy measures adopted by the ECB (see Chapter 4, 'Monetary policy in the euro area') and the Bank of Japan have led to

Figure 1.5

Exchange rates of the main currencies
(average monthly data)



Sources: Bank of Italy and ECB.
(1) Units of the first currency per unit of the second. – (2) Right-hand scale. – (3) Indices, January 2013=100. An increase indicates an appreciation.

a drop in yields on government securities. In mid-May of this year, ten-year yields stood at around 0.1 per cent in Germany and -0.1 per cent in Japan (Figure 1.5.a).

The Fed's interest rate hike did not create tension on long-term US bond yields, which on the contrary diminished at the beginning of 2016, to 1.8 per cent in mid-May (Figure 1.4.a). The decline, which was due in part to the lack of inflationary pressure, can be put down to three main factors. First, US interest rates may have gained from the reductions in the other leading economies because the markets are so highly correlated. Second, the Fed had been planning a series of rate hikes for some time and operators had therefore factored them in well in advance. Last, the projections released by the Fed signalled that future increases would be more and more gradual: last March the median value of the interest rate expectations of FOMC members for the end of 2017 (1.9 per cent) was almost 2 percentage points lower than a year earlier. As it became less likely that the Bank of England was going to reverse its stance, long-term interest rates fell in the UK as well, to 1.4 per cent in mid-May this year.

In March last year the dollar stabilized against the euro, after depreciating by 25 per cent in 2014 (Figure 1.5). The prolonged weakness of the yen came to an end in the summer and since then the currency has gained more than 10 per cent against the dollar. The pound sterling began to depreciate against the euro in November in response to uncertainty about the outcome of the 23 June referendum.

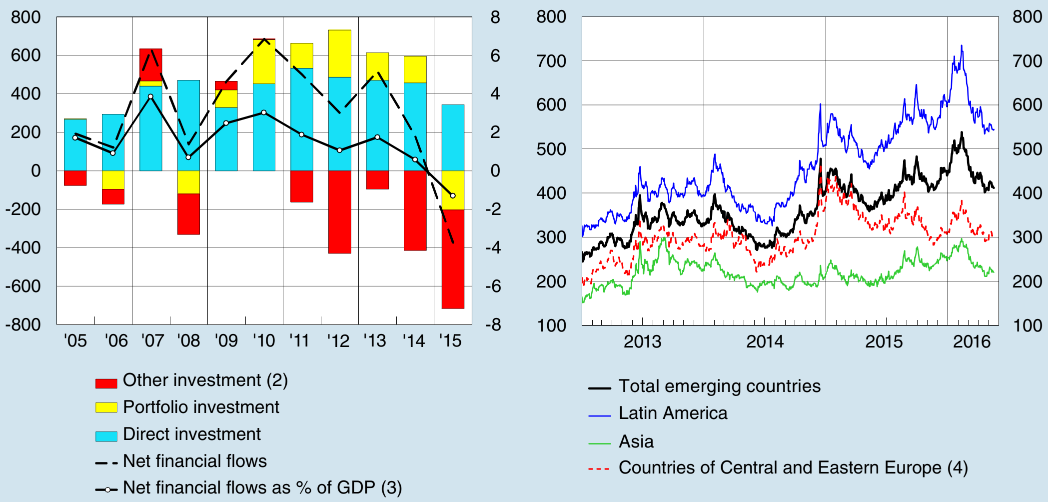
The financial conditions of the emerging countries deteriorated overall in 2015. For the first time since 2000 net capital outflows were recorded last year, totalling US$374 billion (Figure 1.6.a), mainly consisting of portfolio investment (about US$200 billion) and 'other investment' (US$615 billion) which includes bank transactions. Both categories of outflow stemmed above all from the fact that many Chinese firms with foreign currency debts reacted to fears of a depreciation of the renminbi by paying off their loans.

Figure 1.6

Capital flows and sovereign spreads in the emerging and developing countries

(a) Net capital flows (1)
(billions of dollars unless otherwise specified)

(b) Yield spreads between dollar-denominated long-term sovereign bonds and the corresponding US Treasury securities
(daily data; basis points)



Sources: Based on IMF, Thomson Reuters Datastream and JP Morgan Chase Bank data.
(1) Balance between capital inflows and outflows; excludes changes in official reserves and other flows relating to the official sector. – (2) Bank and commercial loans, currency deposits, other assets and liabilities. – (3) Right-hand scale. – (4) Includes Russia.

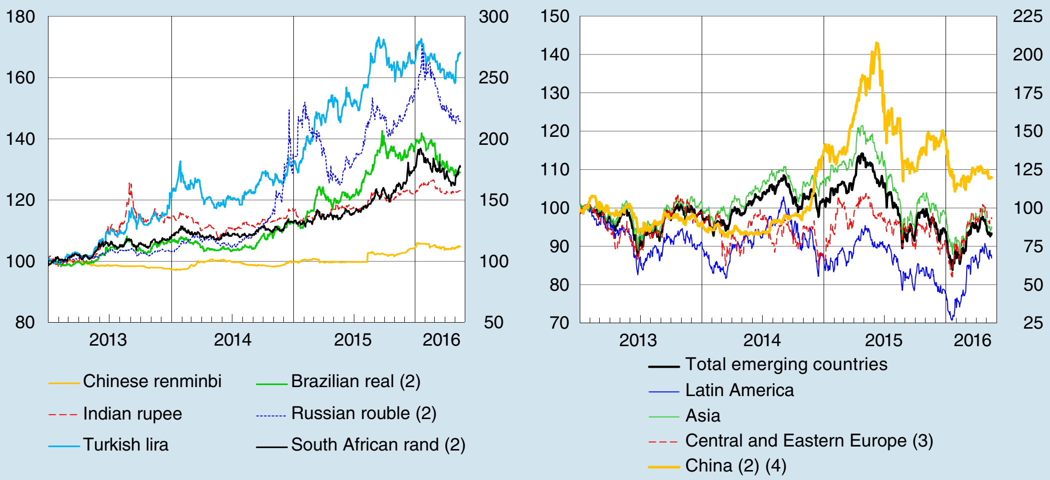
The currencies of the commodity exporting countries (Brazil, Russia and South Africa) and of those with larger external imbalances (Turkey) depreciated steeply against the dollar (Figure 1.7.a). Their stock indices began to fall in the summer;

Figure 1.7

Exchange rates and share indices of the emerging countries
(daily data; indices, average Jan. 2013=100)

(a) Exchange rates of the main currencies (1)

(b) Share indices in local currency



Sources: Thomson Reuters Datastream and Morgan Stanley.
(1) Exchange rates against the dollar. An increase in the index indicates a depreciation. – (2) Right-hand scale. – (3) Includes Russia. – (4) Compound index of Shanghai and Shenzhen markets.

China's, which had more than doubled from mid-2014 to mid-2015, subsequently lost over 40 per cent (Figure 1.7.b). Sovereign debt risk premiums soared to a five-year high at the beginning of 2016 (Figure 1.6.b); the largest increases were recorded for the politically unstable countries and those with growing balance of payments difficulties, such as Brazil and South Africa. In Russia and Turkey the financial tensions of recent years reflect structural and institutional vulnerabilities.[7]

The financial markets in Central and Eastern Europe benefited indirectly from the Eurosystem's Public Sector Purchase Programme[8] (see Chapter 4, 'Monetary policy in the euro area'), being only marginally affected by the global turbulence. Sovereign risk premiums came down slightly as of the beginning of 2015, settling at low values except in Croatia. The currencies of this group of countries held virtually stable against the euro.

Since the middle of February of this year renewed risk appetite has produced a generalized improvement, with share prices rallying and sovereign spreads declining.

---

7 S. Auer, E. Cocozza and A. Colabella, 'The financial system in Russia and Turkey: recent developments and challenges', Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), forthcoming.

8 A. Ciarlone and A. Colabella, 'Spillovers of the ECB's non-standard monetary policy on CESEE economies', Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), forthcoming.

2. WORLD TRADE, COMMODITY PRICES AND PAYMENTS BALANCES

World trade growth was held down by sluggish global demand and by the sharp contraction in Chinese trade. Trade in goods and services grew at a slower pace than output in 2015, a virtually unprecedented occurrence in the past fifty years. World trade continued to slow in the early months of 2016.

The restructuring of production in China, with heavy industry and construction losing out to services and light industry, drove down further the prices of non-energy commodities, which had been falling since 2011. The slump in oil prices to the lowest levels on record since the global financial crisis was not matched by an equally rapid adjustment of crude oil supply: as US shale oil production increased throughout most of the year, so did supply from the main OPEC countries, intent on safeguarding their market shares.

Global current account imbalances increased slightly; the steep drop in commodity prices triggered a significant shift in their composition. The emerging countries most dependent on commodity exports which were structurally in surplus moved into deficit, tapping official reserves for finance, partly to counter the depreciation of their currencies. The economies of the emerging and advanced importing countries, on the other hand, registered a clear improvement in their current account balances.

China's foreign exchange reserves decreased markedly as a result of large-scale interventions to counter capital outflows triggered by expectations of a depreciation of the renminbi and fears of an even sharper slowdown in the Chinese economy.

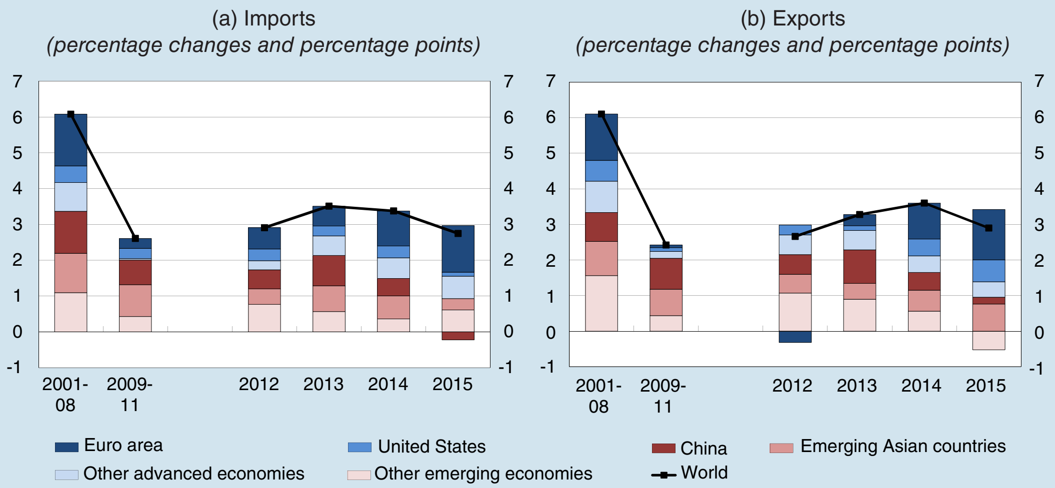
World trade

World trade in goods and services grew by less than 3 per cent in 2015, about 1 point slower than the forecasts made by international institutions at the beginning of the year. The increase in euro-area trade and the stronger growth in United States' imports only partially offset the smaller contribution of the emerging economies (Figure 2.1), which were adversely affected by the substantial reduction in Chinese foreign trade. World trade continued to weaken in the early months of 2016.

In China, for the first time since the end of the 1980s, goods imports decreased in terms of volume (by 0.7 per cent in 2015) owing to the slowdown of the economy and the lower demand for intermediate goods used in production for foreign markets. Exports of goods also fell (-2.2 per cent), held down by the loss of competitiveness associated with the appreciation of the exchange rate in nominal effective terms and the diminishing capacity to penetrate traditional sectors and advanced economies (see the box 'The slowdown in China and the repercussions for the world economy', *Economic Bulletin*, No. 4, 2015).

Figure 2.1

Growth in volume of world trade in goods and services and contributions of the main geographical areas



Source: Based on IMF, *World Economic Outlook*, April 2016.

In line with the last three years, the growth in global imports was close to that of GDP, in contrast to much higher figures in the past (in 1976-2011 the ratio between the two growth rates averaged 1.5). Cyclical factors, such as the weakness of investment, which has a higher intensity of intermediate products, and structural factors linked to the fading effects of productive fragmentation and expiry of agreements on trade liberalization contribute equally to reducing the elasticity of world trade to GDP.[1]

Liberalization initiatives. – The most recent trade negotiations for liberalization have been mainly at regional level. As well as promoting trade in goods and services, these negotiations aim to foster production and investment on an international scale with potentially positive effects on productivity and efficiency[2] which, however, require a greater regulatory affinity among the economies involved. Last October saw the end of the negotiations on the Trans-Pacific Partnership, under way since 2010 among the 12 main Pacific Ocean countries excluding China; for the agreement to become effective, each country will have to ratify it, a process that may turn out to be lengthy and problematic. The Transatlantic Trade and Investment Partnership between the United States and the European Union is still under negotiation, and there remain divergences between the countries on the issues of public procurement, safeguarding foreign investors, defending intellectual property rights, food security and customs duties applied to agriculture (see Chapter 3, 'World trade and payments balances', *Annual Report,* 2013).

1 A. Borin, V. Di Nino, M. Mancini and M. Sbracia, 'The cyclicality of the income elasticity of trade', Banca d'Italia, Temi di Discussione (Working Papers), forthcoming.

2 S. Formai and F. Vergara Caffarelli, 'Quantifying the productivity effects of sourcing from global value chains', Banca d'Italia, Temi di Discussione (Working Papers), forthcoming.

In 2015, the United States, China and the EU signed the Trade Facilitation Agreement promoted by the World Trade Organization (WTO), thereby greatly increasing the number of its adherents; the aim is to reduce the administrative burdens linked to international trade. The implementation of the agreement, the first achieved at a multilateral level since 1995, could give an important boost to world trade.

Commodity prices and markets

Oil prices. – The price of oil, which started to decline in 2014, continued to fall in 2015 too; in January 2016 it had plummeted to $25 a barrel,[3] lower than the level reached at the end of 2008 during the global financial crisis. Contributory factors were the lowering of expectations for global demand (particularly in the second half of the year because of fears regarding the slowdown in China) and the increase in the actual supply of crude oil, driven by growing production in the United States and the OPEC countries and by the expected output in Iran following the lifting of economic sanctions (see the box 'The fall in the price of oil', *Economic Bulletin*, No. 1, 2015)

In 2015, with extremely low prices, global demand for oil as estimated by the International Energy Agency (IEA) increased by 1.8 million barrels a day, about 2 per cent more than in 2014. Supply, however, grew at a brisker pace (by 3 per cent or 2.7 mb/d), a third of which from increased production in the United States (0.9 mb/d higher than in 2014), where the marginal cost of crude oil was significantly cut by rapid technological progress in extraction techniques from non-conventional sources considerably reduced the marginal cost of crude oil.[4] At the same time the major OPEC countries' decision to defend their market share prevented any adjustment of global oil supply. Only in the second half of 2015 did production of light tight oil begin to slow in the United States, partly as a result of massive cuts in investment plans by oil companies involved in unconventional extraction (see Chapter 1, 'Macroeconomic developments and policies and the international financial markets'). This led to an increase in the surplus production on the market to roughly 1.7 mb/d on average over the year, double the amount in 2014 (Figure 2.2a). It was matched by an increase in crude oil stocks in advanced and emerging economies, while in the OPEC countries stocks reached an all-time high at the end of 2015 (equal to 100 days of consumption, a week longer than in 2014).

In the early months of 2016 oil prices recouped over $20 a barrel compared with the minimum levels recorded in January as some of the excess supply of crude oil was soaked up on the world market.

Other commodity prices. – The decline in non-oil commodity prices that began in 2011 continued in 2015 (Figure 2.2b). The overall year-on-year reduction was 23 per cent for industrial metals prices, with even greater decreases for iron ore, nickel and copper which were harder hit by the slowdown in China's heavy industry and

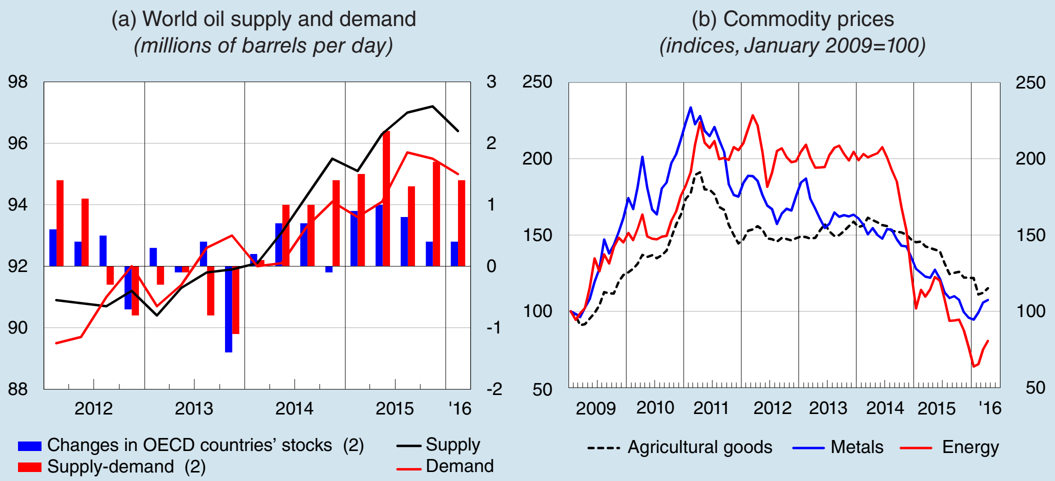
3 Average of WTI, Brent and Dubai, the three benchmarks for the global market.

4 R. Cristadoro, V. Di Nino and L. Painelli, 'Più greggio per tutti: la rivoluzione shale negli USA e la reazione dell'OPEC', Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), 296, 2015.

construction. The production cuts made by several mining companies last year have only provided support for prices since the early months of 2016.

Figure 2.2

Oil supply and demand and commodity prices



Sources: Based on IMF and IEA data.
(1) The IEA calculates supply by adding the output of refineries to newly extracted oil; demand, as estimated by the IEA, excludes changes in stocks. For the worldwide aggregate, the difference between supply and demand is attributable to changes in stocks and statistical discrepancies. Direct information on changes in stocks is only available for OECD countries. – (2) Right-hand scale.

At the end of 2015 the prices of agricultural commodities were about 36 per cent below the peaks of 2011. As with other commodities, this decline is the result of massive investment in productive capacity induced by the high prices of the preceding years; exceptionally abundant harvests in many places around the world also contributed.

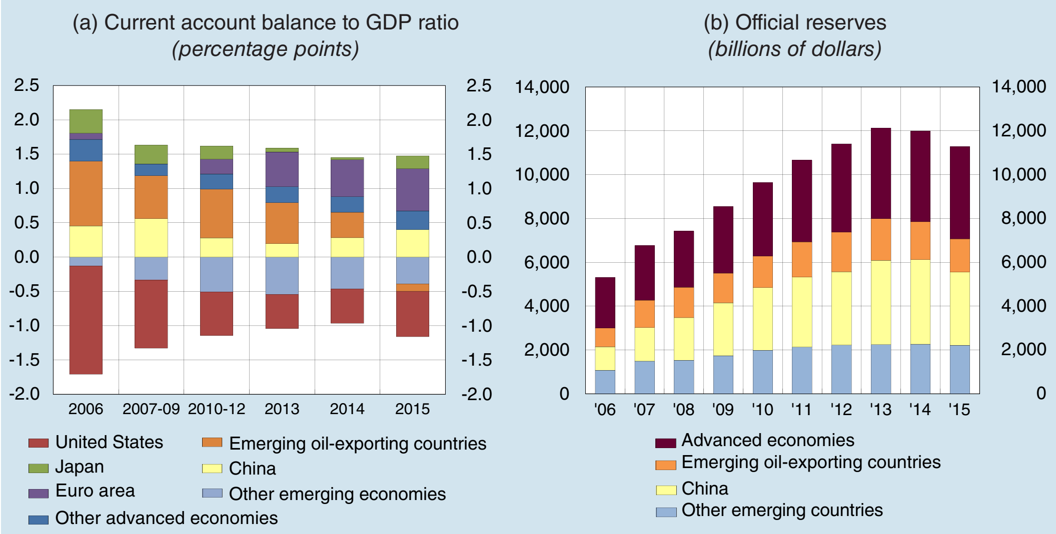
Global imbalances

The sharp fall in energy product prices led to a significant shift in global current account imbalances, which rose slightly overall in 2015 (to 3.8 per cent of world GDP, measured as the sum of the absolute values of current account deficits and surpluses). For the first time since the Asian Crisis of 1998, the emerging oil-exporting countries recorded a current account deficit ($79 billion compared with a surplus of $288 billion in 2014), causing their authorities to launch drastic plans for fiscal consolidation. Saudi Arabia, which exports about a tenth of the world's crude oil, had to sell official reserves to finance its external deficit under a fixed exchange rate regime and last April made its first issuance of sovereign debt on international financial markets.

By contrast, the advanced and emerging oil-exporting countries improved their current account balances (Figure 2.3.a). Japan's surplus rose to 3.3 per cent of GDP, and that of the euro area reached 3.2 per cent, driven mainly by the increase recorded in Germany (see Chapter 3, 'Macroeconomic developments and fiscal policies in the euro area'). The United States' deficit rose again after a five-year period, reaching 2.7 per cent of GDP: the worsening of the balance of goods trade and the income balance owing to the appreciation of the dollar and weak foreign demand was only partially offset by the reduction of the energy deficit.

Figure 2.3

Current account balances and foreign exchange reserves



Source: Based on IMF, *World Economic Outlook*, April 2016.

China's current account surplus rose from 2.1 to 2.7 per cent of GDP as exports of goods and services contracted less (-4.1 per cent) than imports (-8.4 per cent). Despite the growth in demand for energy products, partly to increase stocks at low prices, the energy deficit decreased by almost $100 billion.

Foreign exchange reserves. – In 2015 the reserves held by emerging countries decreased considerably (by 10 per cent over the previous year; Figure 2.3.b). Oil-exporting countries made wide use of their reserves ($220 billion) to counter the downward pressures on their currencies. In China reserves decreased by over $500 billion as a result of intervention to counter the growing capital outflows triggered by the unexpected announcement of the renminbi's devaluation and fears of a sharper slowdown of the economy. In the first quarter of 2016, following interventions on the domestic and offshore exchange markets and the adoption of stricter capital controls, the Chinese authorities began to stem the fall in reserves.

Looking ahead, the progressive liberalization of China's capital account and the internationalization of the renminbi (see the box 'The new international role of the renminbi', Chapter 1) will encourage a change in the composition of the country's foreign exchange assets, a reduction in the still high stock of official reserves and an increase in the assets held by the private sector.[5]

Uncertainty as to whether the multilateral and regional support network is truly adequate and effective continues to encourage most emerging countries to hold and accumulate ample reserves in order to cope with future liquidity crises and counter excessive fluctuations in capital flows (see the box 'Adequacy and effectiveness of the global financial

[5] E.S. Prasad, *China's efforts to expand the international use of the renminbi*, report prepared for the U.S.-China Economic and Security Review Commission, Brookings Institution, 2016.

support network'). India's central bank, for example, built up reserves of over $30 billion in 2015, benefiting from the still high capital inflows and a smaller current account deficit.

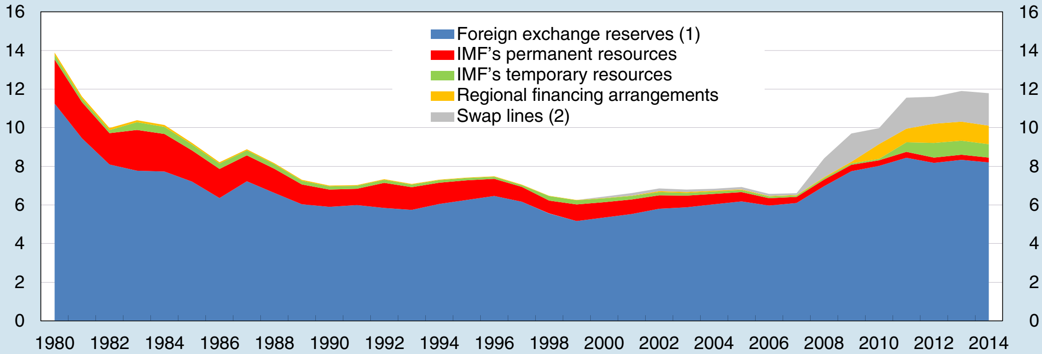
ADEQUACY AND EFFECTIVENESS OF THE GLOBAL FINANCIAL SAFETY NET

The global financial safety net – comprising the IMF's resources, regional and bilateral financing arrangements, central bank swap lines and international reserves – is one of the keystones of the international monetary system. Widespread use of these resources during the global financial crisis and the European sovereign debt crisis made even clearer the importance of having an adequate safety net to deal with liquidity shortages, which vary in degree and form according to the international financial integration.

The IMF's credit outstanding (which does not take into account resources allocated, particularly in the form of precautionary credit lines, but not disbursed) reached a maximum of just under 95 billion special drawing rights (SDR) in April 2012, equivalent to about $145 billion. The total credit granted to European countries by the European Financial Stability Facility (EFSF) and by the European Stability Mechanism (ESM) is now about €244 billion, or $279 billion; the liquidity offered overall by the Federal Reserve to other central banks through its own swap lines reached a peak of $586 billion at the height of the global financial crisis in December 2008.

Looking at how the size and composition of the global financial safety net have evolved over the last thirty-five years – assessing each component in relation to the overall stock of international financial liabilities – it is clear that the emerging countries stockpiled significant foreign exchange reserves following the 1997-98 crisis and that, more recently, regional financing arrangements have been upgraded and an extensive network of central bank swap lines has been set up in compliance with individual mandates (see the figure). The IMF's permanent resources instead diminished progressively in relative terms, a decline which was only partly offset by the effects of the 2010 reform (only ratified by the United States' Congress in

Global financial safety net as percentage of international financial liabilities
(percentage points)



Source: E. Denbee, C. Jung and F.釘aternò, 'Stitching together the global financial safety net', Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), 322, 2016.
(1) Does not include gold reserves. – (2) The value of the resources provided through swap lines between central banks is estimated by (a) assigning the maximum value reached during the activation periods to the swap lines activated in the past, and (b) assigning an average of the values (in relation to GDP) assigned to the activated swap lines to those that have never been activated.

December 2015), which led to the quotas doubling (from SDR 238.5 billion to 477 billion) and an almost equivalent reduction in temporary resources (see Chapter 4, 'International economic cooperation', *Annual Report,* 2012).

The adequacy of the existing global financial safety net should be assessed according to its capacity to deal with different kinds of systemic shock, taking into account the imperfect substitutability of the network's components. This type of evaluation can be made by separately hypothesizing three kinds of shock: (a) a sudden halt in capital flows towards emerging market economies, (b) a generalized disruption of advanced economies' banking sectors' funding of their foreign currency denominated assets, and (c) a sovereign debt crisis involving the advanced economies (except for the United States, Japan, the United Kingdom and euro-area economies with an AAA rating).

According to this type of evaluation the overall size of the global financial safety net is essentially adequate, though with some reservations.[1] The coverage is insufficient to protect all countries from potential systemic shocks, partly because of the limited number of regional financing arrangements among the emerging economies. Moreover, the potential demand for IMF funds could in some cases significantly exceed the limit for an individual country; the Fund's recent decision to adopt a more restrictive approach regarding the exceptional access policy could reveal further deficiencies in the network's coverage.

The assessment of the network's essential adequacy over the medium term also rests on the hypothesis that the IMF's resources remain unchanged in absolute value. Starting from October 2016, however, two factors could weaken the IMF's ability to combat systemic crises: the gradual extinction of bilateral loans (including that made by Italy for the sum of €23.48 billion; see Chapter 4, 'International economic cooperation', *Annual Report,* 2013) and a possible decision during the fifteenth general review of quotas scheduled for autumn 2017 not to go ahead with a substantial increase in the permanent resources. This could encourage the emerging market economies to further accumulate foreign exchange reserves as a precautionary measure.[2]

The central importance of the Fund's resources stems from their potential use in dealing with crises that might arise in any economy and is supported by empirical studies showing how the cost of financing on bond markets for emerging market economies decreases as the IMF's forward commitment capacity increases.

Ensuring greater coordination between the Fund and regional financing arrangements, upgrading such arrangements or, more simply, enhancing their credibility could limit, at least partially, the consequences of a weakening of the IMF's lending capacity. In the medium term, strengthening financial regulations could help to attenuate the link between international financial integration and the possible dimension of systemic liquidity crises.

---

1 E. Denbee, C. Jung and F. Paternò, 'Stitching together the global financial safety net', Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), 322,2016.

2 F. Corneli and E. Tarantino, 'Sovereign debt and reserves with liquidity and productivity crises', Banca d'Italia, Temi di Discussioni (Working Papers), 1012, 2015.

3. MACROECONOMIC DEVELOPMENTS AND FISCAL POLICIES IN THE EURO AREA

Last year the recovery continued in the euro area thanks to the strengthening of the domestic components of demand, which offset the slowdown in world trade. The cyclical expansion spread to almost all of the EMU countries, mainly in response to monetary policy stimulus. The growth differentials between the leading economies narrowed. GDP accelerated in the first quarter of 2016.

Inflation was nil on average for the year, dipping below zero on several occasions and turning negative last February; even excluding the most volatile components it came to barely 0.8 per cent. The rate of price increase reflected not only trends in oil prices but also the still ample margins of unutilized production capacity and available labour. Inflation expectations over longer horizons deduced from the financial markets are well below the ECB Governing Council's definition.

The euro area again faced major tensions in 2015, including those caused by the fraught negotiations between Greece and its international creditors and, in the second half of the year, by concerns about the banking sector, heightened by the slow progress towards the completion of banking union. Moreover, the risks stemming from the persistence of macroeconomic imbalances and from the lack of adequate common shock absorbers were compounded by those associated with increased geopolitical uncertainty and, particularly since last summer, the weakening external environment.

According to the estimates of the European Commission, following the fiscal adjustment carried out between 2011 and 2013, the euro area's fiscal policy stance was basically neutral in 2014 and 2015 and will become mildly expansionary in 2016. After peaking in 2014, the debt-to-GDP ratio declined by 1.5 percentage points last year, marking the beginning of a process that is expected to continue this year. The debate on creating a fiscal capacity for the euro area continued throughout 2015.

Cyclical developments

In 2015 output in the euro area expanded by 1.6 per cent, accelerating compared with 2014 (Table 3.1) thanks to stronger domestic demand which offset the gradual weakening of the external environment (see Chapter 2, 'World trade, commodity prices and payments balances'). Domestic demand and GDP were boosted by the extraordinary expansionary measures taken by the ECB[1] (see Chapter 4, 'Monetary policy in the euro area').

[1] ECB, *Annual Report 2015*, 2016.

Table 3.1

GDP in the main euro-area countries (1)
(volumes at chain-linked prices; percentage changes on previous period)

	2013	2014	2015	2015				2016
				Q1	Q2	Q3	Q4	Q1
France (2)	0.6	0.6	1.3	0.7	..	0.4	0.3	0.5
Germany	0.3	1.6	1.7	0.4	0.4	0.3	0.3	0.7
Italy	-1.7	-0.3	0.8	0.4	0.3	0.2	0.2	0.3
Spain (3)	-1.7	1.4	3.2	0.9	1.0	0.8	0.8	0.8
Euro area (4)	-0.3	0.9	1.6	0.6	0.4	0.3	0.3	0.5

Sources: Based on national statistics and Eurostat data.
(1) Adjusted for seasonal and calendar effects. – (2) The quarterly data do not include the revised annual data released on 17 May. – (3) The annual percentage change is based on raw quarterly data. – (4) Reference is to the current euro area, with 19 members.

Household spending rose by 1.7 per cent, strengthening the recovery under way since 2014. Greater disposable income was a contributory factor, boosted by the progress on employment; the saving rate stabilized at similar levels to the previous two years. The general improvement in confidence and households' less pessimistic assessment of employment prospects drove purchases of durables in particular. Gross fixed investment accelerated thanks to the further easing of financing conditions, the gradual recovery of profit margins and the growing confidence of firms. By historical standards, however, total investment growth remained subdued, deterred by the ample margins of spare capacity that still exceed long-term average levels, and by the risks that weigh on the prospects for demand, especially foreign demand.

The contribution of trade to GDP growth was slightly negative. While imports and exports within the euro area accelerated, sales of goods to countries outside the area expanded by just 1.6 per cent, a symptom of the modest growth of world trade. Exports to the rest of the world benefited from the gains in competitiveness from the depreciation of the euro, which fell by over 9 per cent in nominal effective terms in 2015 as a whole. The area's current account balance improved again, recording a surplus equal to 3.2 per cent of GDP, in part owing to the further drop in the prices of commodity imports.

GDP growth, driven by greater household expenditure, reached 3.2 per cent in Spain, 1.3 per cent in France and 0.8 per cent in Italy. It was virtually stable in Germany at 1.7 per cent, where the faster pace of private consumption was offset by the slowdown in investment and a smaller contribution from foreign trade.

In the first quarter of 2016 growth in the euro area strengthened further, expanding by 0.5 per cent compared with the previous quarter; for the first time output rose above the levels recorded in 2008 (Figure 3.1.a).

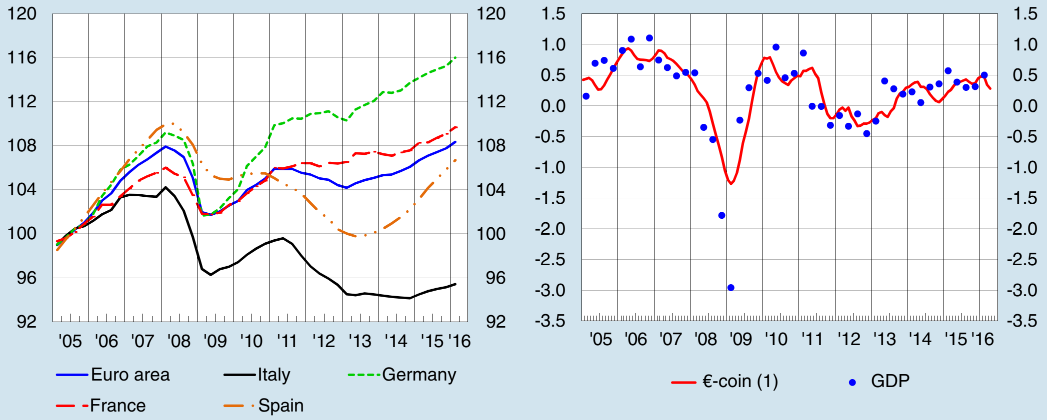
The Bank of Italy's monthly €-coin indicator, which estimates current GDP growth net of its most volatile components, edged upwards from autumn of last year until it peaked at 0.48 per cent in January; it then declined gradually, to 0.28 per cent in April (Figure 3.1.b).[2]

Figure 3.1

Euro-area GDP and €-coin

(a) GDP of the euro area and the main countries *(indices, 2005=100)*

(b) €-coin indicator and euro-area GDP *(3-month percentage changes)*



Sources: Bank of Italy, Eurostat and Istat.
(1) See the section dedicated to the *€-coin indicator* on the Bank of Italy's website (http://eurocoin.bancaditalia.it/media/notizia/coin-registra-un-ulteriore-incremento-in-aprile). The €-coin estimate for April 2016 was completed before GDP data for the first quarter of 2016 became available.

Although it fell from 11.6 to 10.9 per cent in 2015, the unemployment rate remains high compared with the average rate of 8.6 per cent recorded in the decade prior to 2009. Employment rose by 1.0 per cent, boosted by jobs growth throughout the euro area, which was especially marked in the countries most exposed to the sovereign debt crisis (2.9 per cent in Spain, 2.6 per cent in Ireland, 1.9 per cent in Greece and 1.4 per cent in Portugal). In Germany the number of those in employment hit a record high of 43 million.

Prices and costs

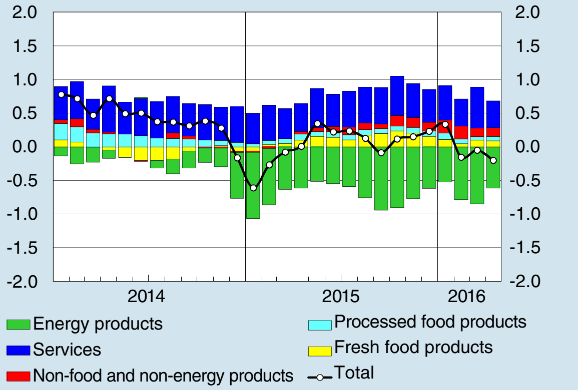
Inflation in the euro area measured by the Harmonised Index of Consumer Prices (HICP) was nil on average for the year (0.4 per cent in 2014). After turning negative in the first quarter, the rate of consumer price increase became barely positive from May onwards, but remains far below the levels consistent with the ECB Governing Council's definition of price stability, which aims at keeping inflation rates below, but close to, 2 per cent in the medium term. In the early months of 2016 inflation was negative again (-0.2 per cent in April).

[2] The indicator was developed based on the methodology described in F. Altissimo, R. Cristadoro, M. Forni, M. Lippi and G. Veronese, 'New eurocoin: tracking economic growth in real time', *The Review of Economics and Statistics*, 92, 2010, pp. 1024-1034, also published in Banca d'Italia, Temi di Discussione (Working Papers), 631, 2007. The monthly updates of the indicator have been published since May 2009 on the websites of the Bank of Italy and the Centre for Economic Policy Research (CEPR).

Factors contributing to weak inflation included the steep drop in the prices of energy commodities (-6.8 per cent) but also, and to a considerable extent, domestic components, in part as a consequence of the ample margins of spare capacity and available labour. Core inflation, measured by the HICP net of food and energy products, remained at very low levels (0.8 per cent, the lowest on record since the launch of Economic and Monetary Union; Figure 3.2); the very slow growth of unit labour costs was one contributory factor.

Figure 3.2

Inflation in the euro area and contributions of its components (1)
(monthly data; 12-month percentage changes and percentage points)



Sources: Based on Eurostat data.
(1) HICP.

To gauge the trends in inflation, the Bank of Italy has developed a synthetic indicator based on the main variables associated with price developments (see the box 'A measure of inflation tendencies in the euro area', *Economic Bulletin*, No. 2, 2016). Based on the indicator's recent values, the probability that in the next twelve months the change in consumer prices will rise to around 2 per cent appears very small and close to the all-time lows recorded in the past.

In 2015 the dispersion of price growth rates among the euro-area countries abated. Among the leading economies harmonized inflation stood at 0.1 per cent in Germany, France and Italy, while it was -0.6 per cent in Spain; in the early months of 2016 the rate of price increase slackened again.

The inflation expectations for 2016 of the professional forecasters polled by Consensus Economics remained at just over 1 per cent in 2015, before falling to just over zero in May 2016. Similar indications emerged for inflation expectations over longer horizons deduced from the financial markets (see Chapter 4, 'Monetary policy in the euro area'), which showed signs of a de-anchoring from the last quarter of 2014 (see the box 'Anchoring of inflation expectations and macroeconomic effects', Chapter 4).

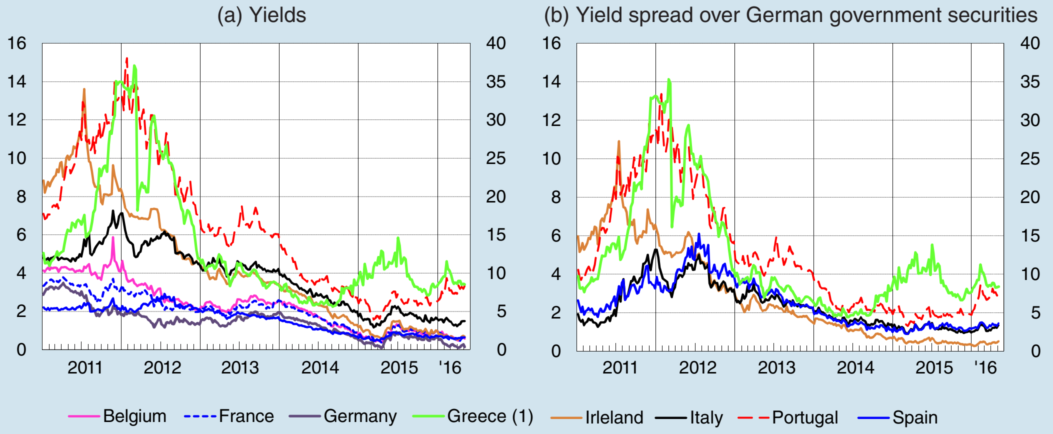
The financial markets

Last year saw a further, significant improvement in financial market conditions in the euro area, notwithstanding the fresh bouts of tension over share prices in early 2016.

The yields on government securities remained very low, on average below the levels of the previous year (Figure 3.3.a), in part thanks to the announcement and subsequent launch of the Eurosystem's Public Sector Purchase Programme (see Chapter 4, 'Monetary policy in the euro area').

Figure 3.3

Government securities yields and spreads
(weekly data; per cent and percentage points)



Source: Based on Bloomberg data.
(1) Right-hand scale.

Sovereign risk premiums continued to be low and relatively stable in most countries (Figure 3.3.b). The profound uncertainty generated around mid-2015 by the fraught negotiations between Greece and its international creditors led to heightened volatility across financial markets, but any contagious effects on the government securities of the other euro-area countries proved limited and short-lived; the greater resilience of sovereign debt markets is attributable to the toolbox of instruments available to the Eurosystem to counter episodes of instability, progress in European governance, and the reforms undertaken in various countries.

The average return on euro-denominated bonds issued by non-financial corporations increased slightly in the investment grade segment and, more markedly, in the high-yield segment, partly because of concerns about the impact of the drop in crude oil prices on credit risk associated with securities issued by companies operating in the oil sector.

Stock prices in the euro area were highly volatile, owing to both international factors such as fears of a slowdown in the global economy and the unexpected depreciation of the currencies of a number of emerging economies, including China (see Chapter 1, 'Macroeconomic developments and policies and the international financial markets') and to domestic ones such as the Greek crisis and the tensions in the European banking sector towards the end of the year. Share prices were, however, supported by the strengthening economic recovery in the euro area and the highly expansionary stance of monetary policy; at the end of 2015 the index for the main euro-area corporations had risen by about 10 per cent from a year earlier.

Tensions flared again in early 2016. The euro area's financial markets were buffeted by resurgent fears about the growth of emerging economies, fresh falls in commodity prices, and concerns about the banking sector (see the box 'Recent developments in banks' share prices in the euro area', *Financial Stability Report*, No. 1, 2016). From mid-February onwards conditions on the markets improved again, thanks above all to a partial recovery in commodity prices and mounting expectations of further expansionary measures by the ECB, duly announced on 10 March. The expansion of the Asset Purchase Programme to include non-financial corporate bonds led to a significant fall in their yields (25 basis points from the date of the announcement to end-April; see Chapter 14, 'The money and financial markets').

From early May there were fresh falls in share prices, especially those of banks; the further sharp deterioration in banks' current and expected earnings was one contributory factor.

Fiscal policies

The fiscal policy stance. – According to the latest estimates by the European Commission,[3] after the fiscal adjustment carried out in the previous three years, fiscal policy in the euro area was practically neutral in 2014 and 2015 and will be moderately expansionary in 2016.[4]

The overall stance derives from national budgetary policies which, in addition to being drawn up based on each country's cyclical position, are determined by differing public finance conditions. The Commission deems that this stance must strike the right balance between ensuring macroeconomic stability and safeguarding the sustainability of the public finances.[5]

In the main economies, budgetary policy in 2015 was slightly restrictive in Germany, broadly neutral in France, and expansionary in Italy and Spain. In the case of Italy and Spain the cyclically adjusted primary balance deteriorated by 0.6 and 1.2 percentage points of GDP. For 2016 the Commission's estimates suggest that the fiscal stance will be practically neutral in France and Spain, expansionary in Italy and Germany (with a reduction in the surplus of 0.7 and 0.5 percentage points of GDP respectively).

Budgetary outturns in 2015. – The decline in average general government net borrowing in the euro-area countries, under way since 2010, continued last year: the deficit came to 2.1 per cent of GDP, 0.5 points lower than in 2014 and 4.2 points below the level recorded in 2009. Virtually equal contributions to the improvement on 2014 came from the increase in the primary surplus and the fall in interest expense thanks to a reduction of 0.3 percentage points in average borrowing costs. The deficit is forecast to diminish by a further 0.2 percentage points in 2016.

The area-wide ratio of public debt to GDP, after rising considerably since the outbreak of the financial crisis (from 64.9 per cent of GDP in 2007 to 94.4 per cent in 2014), started to shrink last year. The decline, which amounted to 1.5 percentage points,

---

[3] Unless otherwise indicated, the data here come from European Commission, 'Spring forecasts', May 2016. Reference is to the current euro area, with 19 members.

[4] The fiscal policy stance is measured as the change in the cyclically adjusted primary budget balance.

[5] European Commission, *2016 Draft budgetary plans: overall assessment of the budgetary situation and prospects*, COM(2015) 800 final, 2015, pp. 14-15, and European Commission, *2016 European Semester: Country-specific Recommendations*, COM (2016) 321 final, 2016, p. 11.

was attributable to the faster pace of nominal GDP growth with respect to the average debt burden (0.3 percentage points), the primary surplus (0.3 points) and the stock flow adjustment (0.9 points). The latter mainly reflect the issuance of securities at a premium as well as the partial reabsorption – in some countries – of financial support for the banking system. The debt ratio should diminish by 0.7 percentage points this year.

Compliance with EU fiscal rules. – In 2015 the area-wide structural deficit (adjusted to take account of the effects of the business cycle and temporary measures) came to 1.0 per cent of GDP, in line with the previous year. The structural balance was basically stable in Germany, which ran a surplus of 0.8 per cent of GDP, and in Italy, which recorded a deficit of 1.0 per cent. Structural net borrowing fell slightly in France (from 2.7 to 2.4 per cent) while it rose by 1 percentage point of GDP in Spain (to 2.9 per cent of output). In 2016 it is forecast to increase by 0.3 percentage points of GDP in the area as a whole.

The number of countries subject to excessive deficit procedures or at risk of non-compliance with the Stability and Growth Pact diminished. In 2015 seven countries were still subject to the procedure, following the closure of the one opened for Malta. On 18 May 2016 the European Commission recommended the abrogation of the excessive deficit procedures for Cyprus, Ireland and Slovenia. Procedures are ongoing for France, Greece, Portugal and Spain. In particular, France's headline deficit came to 3.5 per cent of GDP in 2015, compared with the recommended target of 4.0 per cent. In Portugal, contrary to the recommendations of the EU Council in July last year, the deficit rose to well above 3 per cent (4.4 per cent of GDP). In its Post-Programme Surveillance Report published last April, the European Commission emphasized how in Portugal the planned structural and budget reforms have lost momentum and, in some respects, have suffered reversals. In particular, the previously announced comprehensive reform of the pension system is no longer on the agenda and important parts of planned public administration reforms are set to be reversed.

In November 2015, in relation to the draft budgetary plans for 2016, the Commission highlighted risks of non-compliance with the Stability and Growth Pact in 2015-16 in four countries: Austria, Italy, Lithuania (for the preventive arm of the Pact) and Spain (the corrective arm). In February it reported risks of non-compliance with the preventive arm of the Pact for Portugal, which had failed to transmit its plan on time.

In its assessments published on 18 May, after analysing the relevant factors, such as broad compliance with the preventive arm of the Pact, the unfavourable macroeconomic environment and the implementation of structural reforms, the Commission affirmed that the draft budgetary plans of Belgium, Finland and Italy complied with the debt criterion of the Treaty. For Italy the Commission said it would review its assessment in the autumn (see Chapter 11, 'The public finances').

The Commission further recommended that action be taken to correct Portugal and Spain's excessive deficits in 2016 and 2017 respectively (one year later than previously envisaged) by taking the necessary structural measures and by using all windfall gains for deficit and debt reduction. The position of these two countries will be reviewed in July.

Financial assistance to countries in difficulty. – In the first part of 2015 there was still profound uncertainty about the outcome of the negotiations on the financial assistance package for Greece. The second programme should have ended in 2014 but at the request of the Greek Government in February 2015 it was extended until June of this year to give the country time to implement the planned measures. Following lengthy negotiations, which stoked tensions over Greek debt (see *Economic Bulletin*, No. 3, 2015), in August 2015 a third financial assistance package was approved, mobilizing resources of up to €86 billion over three years from the European Stability Mechanism (ESM; see *Economic Bulletin*, No. 4, 2015).

The Eurogroup meeting held on 9 May welcomed the progress made on a number of fronts and the Greek Government's commitment to designing a policy package to compensate for any failures to meet the annual primary surplus targets. It also stated that it stood ready to consider, if necessary, possible additional debt measures to ensure that Greece's refinancing needs remain at sustainable levels in the long run.

In 2015 outlays for Greece amounted to €21.4 billion,[6] of which €5.4 billion for the recapitalization of the banking system (compared with €10 billion allocated for this purpose). The disbursements are conditional on a series of reforms to strengthen the stability of the financial system (with particular emphasis on the management of non-performing loans), deregulate the energy market, streamline tax collection and bolster the sustainability of the system pension. Overall, under the three programmes to date Greece has received aid equivalent to 135 per cent of output in 2015.

Turning to the country's budgetary performance, net borrowing doubled, reaching 7.2 per cent of output, owing to the adoption of measures to support domestic financial institutions amounting to 4.1 percentage points of GDP. Based on the forecasts of the European Commission, without these measures the deficit would have been lower by about half a percentage point, remaining basically stable in 2016.

As expected the Government of Cyprus requested the closure of the assistance programme last March. The funds available under the programme were not utilized in full (in particular, €2.7 billion allocated by the ESM). Last year €1 billion was disbursed, of which €0.4 billion by the IMF and €0.6 billion by the ESM. In 2015 total loans to Cyprus amounted to about 42 percentage points of GDP.

The amount of new loans granted in 2015 to countries in difficulty totalled just €11.5 billion, continuing the trend of the previous two years and reflecting the reduction in the number of countries still under a programme.[7] In the first three months of 2016 Cyprus was allocated €0.1 billion. Total resources disbursed since 2010 amount to around €430 billion (Table 3.2).

---

6 Net disbursements came to €10.5 billion, seeing as in February 2015 Greece returned the funds (€10.9 billion) allocated but never utilized under the second financial assistance programme of the European Financial Stability Facility (EFSF).

7 In 2014 the financial assistance programmes were closed for Ireland, Portugal and Spain. The European Commission, together with the ECB, carries out post-programme surveillance until at least 75 per cent of the loans granted have been reimbursed. The ESM also monitors risks of non-compliance until full repayment of its own loans and those of the EFSF.

Table 3.2

Financial assistance to euro-area countries in difficulty (1)
(billions of euros)

	2010	2011	2012	2013	2014	2015	Total to May 2016 (2)	Total support programme
Ireland	0.0	34.7	21.1	10.9	0.8	–	67.6	67.5
Portugal	–	34.0	27.5	10.0	5.2	–	76.6	78.0
Greece	31.5	41.5	109.9	32.0	11.7	10.5 (3)(4)	237.1 (3)	330.6
Spain	–	–	39.5	1.9	–	–	41.3	41.3
Cyprus	–	–	–	4.9	1.3	1.0	7.3	10.0
Total	**31.5**	**110.2**	**197.9**	**59.7**	**18.9**	**11.5**	**429.8**	**527.4**

Sources: For bilateral loans to Ireland, National Treasury Management Agency; for loans from EFSF, EFSM and ESM, those institutions' websites; for the first support programme for Greece, European Commission, (*The second economic adjustment programme for Greece)*, March 2012; for the IMF loans not part of that programme, press releases on the occasion of each disbursement.
(1) The support programmes consist in financial resources made available by EU countries on a bilateral basis and by the EFSF, EFSM, ESM and IMF for euro-area countries in financial difficulty; the disbursement of these resources is subject to strict conditionality in terms of the economic policies required to restore the orderly functioning of the national economic system. There may be discrepancies due to rounding or to variations in the exchange rate between the currency in which loans are denominated and the euro. – (2) Data updated to 19 May 2016. – (3) Takes into account the restitution to the EFSF in February 2015 of funds appropriated but not used (€10.9 billion). – (4) In July 2015 Greece received a bridging loan of €7.2 billion from the EFSM, which it repaid the following month.

European governance

As part of the ongoing review of European governance, the Five Presidents' Report,[8] published in June 2015, lists a series of reforms to safeguard and advance European Monetary Union by increasing integration in the political, economic, financial and budgetary policy spheres.

Turning to financial union, the report calls for the completion of banking union and the realization of a capital markets union.

The first pillar of banking union became operational in November 2014 with the launch of the Single Supervisory Mechanism (SSM), comprising the ECB, which directly supervises all 'significant' euro-area banks, and the national authorities of the participating member states, which supervise less significant banks. Decisions are taken collectively, based on proposals submitted by the Supervisory Board and approved by the ECB Governing Council.

The Single Resolution Mechanism (SRM) for banks, the second pillar of banking union, was launched at the start of this year; banks from the participating countries have already started to pay in contributions to the Single Resolution Fund which, after a transitional phase, will complete the mutualization of funds in 2023. However, the mechanism still lacks an agreement on a common backstop for the Resolution Fund to cover any capital shortfalls. In November 2015 the EU Bank Recovery and Resolution Directive (BRRD) was transposed into Italian law. It allows supervisors to intervene at the first signs of a deterioration in the financial situation of banks; during a crisis it aims to ensure the continuity of essential services, limit the use of taxpayers'

8 Drawn up by the President of the European Commission, the Report was produced in close concert with the Presidents of the European Council, the Eurogroup, the European Central Bank and the European Parliament. See European Commission, *Completing Europe's Economic and Monetary Union*, 22 June 2015.

resources, and protect depositors and investors. The new directive also provides for the full shouldering of costs by shareholders and some categories of creditor (bail-in) according to a pre-defined hierarchy; deposits of up to €100,000 are in any event secure. Use of public resources is limited to extraordinary circumstances and as a rule subject to the application of a minimum bail-in.

The Five Presidents' Report also considers it essential to launch a European Deposit Insurance Scheme (EDIS), the third pillar of banking union. At the end of 2015 the Commission proposed that this mechanism be phased in gradually and become fully operational in 2024. The proposal, however, has failed to find favour in a number of countries, which before any further mutualization of resources have called for a reduction of banking risks, including those arising from exposure to sovereign debtors, currently enjoying preferential prudential treatment.

According to the report the Capital Markets Union – launched in 2015 in an ambitious action plan drawn up by the European Commission and involving all member countries – is a necessary complement to banking union. Integrated capital markets allow financial resources to be diversified to the benefit of firms, especially SMEs, as well as enabling greater risk sharing compared with systems founded solely on banking intermediation. A proposal for the definition of simple, transparent and standardized securitizations is currently being negotiated at EU level: they would be subject to less stringent prudential requirements than at present in order to reactivate this important market. Another proposal under discussion is the one to modernize the Prospectus Directive for companies listed on regulated markets, envisaging simplifications in particular for issues by smaller firms.

Finally, the report calls for greater convergence and economic integration between the economies of European countries so that they can better respond to shocks, exploit their comparative advantages and boost competitiveness (see the box 'The recent evolution of macroeconomic imbalances in the EU'). The Commission has recommended the establishment of national Competiveness Boards to monitor the policies and reforms implemented at domestic level.

THE RECENT EVOLUTION OF MACROECONOMIC IMBALANCES IN THE EUROPEAN UNION

As part of the EU's multilateral surveillance system, the Macroeconomic Imbalance Procedure (MIP) detects vulnerabilities in member countries and proposes specific measures to address them.[1] It publishes an annual Alert Mechanism Report (AMR) which analyses economic trends in all the EU countries based on a scoreboard of indicators and identifies countries with risks meriting an In-Depth Review (IDR), thereby activating the MIP's preventive arm. The IDRs assesses the progress made on any corrective measures requested of governments in the previous year, with increasing emphasis on potential negative externalities for the EU as a whole.

As of this year, countries fall into one of three categories: (a) no imbalances; (b) imbalances; (c) excessive imbalances. Last February the Commission released

[1] The documents published by the European Commission during the various phases of the Procedure are available in English on the EU's website (http://ec.europa.eu/eurostat/web/macroeconomic-imbalances-procedure/publications).

the IDRs of the 19 countries previously deemed most exposed to macroeconomic vulnerabilities: Italy, Bulgaria, Cyprus, Croatia, France and Portugal continue to record excessive imbalances; Germany and Spain present imbalances; some countries (Belgium, the United Kingdom, Romania and Hungary) which have improved their position relative to the previous year, currently present no imbalance.

According to the Commission the biggest risks to the Italian economy continue to stem from its very high level of public debt and weak external competitiveness, which have both suffered as a result of persistently sluggish productivity growth. Other risk factors include the large stock of non-performing loans on banks' balance sheets and high levels of long-term unemployment. The Commission welcomed Italy's labour market reform and measures to strengthen corporate governance in the banking sector. It stressed, however, that the abolition of the property tax on primary residences, introduced by the 2016 Stability Law, runs counter to the Council recommendation to shift the tax burden away from productive factors and onto property and consumption; it also stressed the failure to revise cadastral values and tax expenditures. Finally, the Commission recalled the need for organizational reforms in public administration and for investment in human capital, especially to increase enrolment in university courses and combat early school leaving.

France's excessive imbalances stem from its low competitiveness, associated in particular with the sharp increase in the cost of labour, in a context of high and rising public indebtedness and insufficient measures to control expenditure. According to the Commission, Spain, which belongs to category (b), has greatly reduced its imbalances, although its high levels of public and private debt and its unemployment rate are still significant factors of vulnerability.

For the second consecutive year Germany was included among the countries with macroeconomic imbalances due to its large and growing current account surplus, which in the Commission's view cannot be attributed solely to temporary factors such as the fall in the price of oil products. Both the level of private and government investment (in particular, local government investment) have been deemed inadequate, held back by the overly restrictive regulation of some service sectors.

Turning to fiscal policy, the chief innovation of European governance in 2015 was the establishment of the European Fiscal Board (EFB), recommended by the Five Presidents' Report and defined in a decision issued by the European Commission in October 2015. The EFB carries out three main tasks. First, it contributes to the multilateral surveillance of budgetary policies, providing the Commission with an assessment of how consistently the different countries apply the rules and cases of significant non-compliance. Second, it provides a forward-looking assessment of the adequacy of the fiscal policy stance both at euro-area level and within individual countries. If it identifies risks to the proper functioning of EMU, the Board is empowered to make proposals in accordance with the rules of the Stability and Growth Pact. Finally, it cooperates with national fiscal councils to promote best practices across EU member states and achieve consensus on matters relating to European budgetary rules.

National automatic stabilizers may prove insufficient in a crisis, with negative repercussions for the euro area. The report therefore recommends that the euro area equip itself with a common fiscal capacity to absorb shocks that cannot be managed at national level, as already occurs in mature monetary unions (see Chapter 3, 'Macroeconomic developments and fiscal policies in the euro area', in last year's Annual Report). The Five Presidents' Report also indicated that the fiscal capacity should be defined in such a way as not to lead to permanent transfers of resources between member states and, in order to maintain appropriate incentives for fiscal discipline in individual countries, its activities should be bound by the rules on European governance. However, countries' participation in the fiscal capacity would be subject to their making significant progress in the economic convergence process. The report also argues that a further sharing of decision-making on national public budgets is a sine qua non of fiscal capacity.

4. MONETARY POLICY IN THE EURO AREA

With strong downward pressure on actual and expected inflation, the Governing Council of the ECB eased monetary conditions considerably, cutting official rates and increasing its balance sheet.

The Public Sector Purchase Programme was launched. When the decision was issued in January 2015, financial conditions in the euro area immediately became more expansionary, the euro fell against other currencies, and the cost of credit decreased further.

The risks associated with the performance of the global economy have increased since the middle of last year. The bleaker outlook for world growth and the tensions generated by the decline in commodity prices undermined the economic recovery and heightened the risk of a de-anchoring of inflation expectations over long-term horizons.

Additional expansionary measures were adopted in December and in March of this year. Both the size and composition of the securities purchase programme were expanded, official rates were reduced, and new LTROs were introduced at extremely advantageous conditions to support the flow of credit to the economy.

Monetary policy action

At the start of 2015 euro-area consumer price inflation remained in negative territory against a background of weak economic recovery (see Chapter 3 'Macroeconomic developments and fiscal policies in the euro area'). Expected inflation shifted further away from levels consistent with the definition of price stability (below, but close to, 2 per cent), even over longer-term horizons (see the section 'Interest rates and the exchange rate of the euro').

In January the Governing Council of the ECB announced a substantial expansion of the asset purchase programme to include euro-area public sector securities and euro-denominated bonds issued by euro-area agencies and institutions. The Expanded Asset Purchase Programme (APP) approved in January envisaged the purchase of €60 billion worth of securities every month until at least September 2016, and in any event until the Governing Council sees a sustained adjustment in the path of inflation that is consistent with the definition of price stability; national central banks continue to bear the risks associated with any losses on government securities they purchase. The effects on financial and foreign exchange markets, which began to appear after the announcement of preparations for the adoption of the APP in November 2014, were significant and have also spread to the prices of financial assets not included in the programme (see the box 'The effects of the Eurosystem's asset purchase programme', *Economic Bulletin*, No. 1, 2016) without, however, causing a misalignment with their fundamental values (see the box 'Misalignment of financial asset prices with their fundamental values').

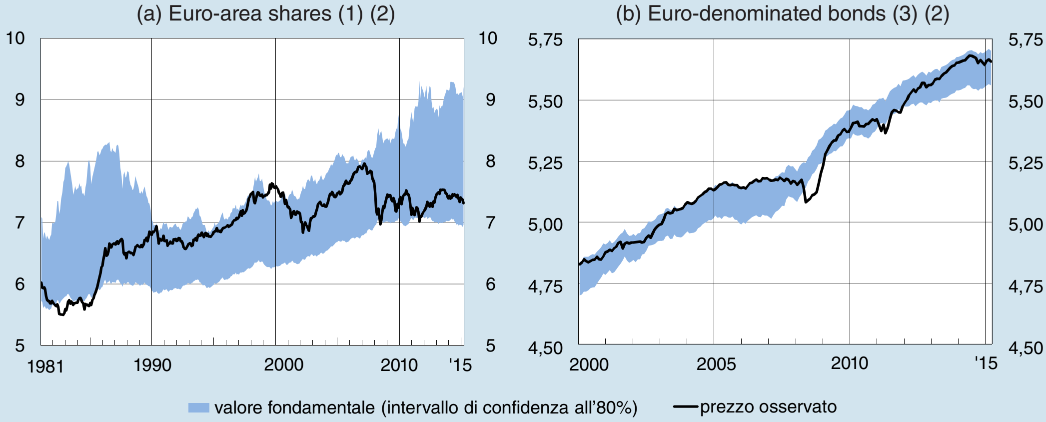
MISALIGNMENT OF FINANCIAL ASSET PRICES WITH THEIR FUNDAMENTAL VALUES

A prolonged period of monetary expansion could trigger an excessive increase in the prices of risky assets such as corporate shares and bonds, pushing them above levels consistent with their issuers' fundamentals. The impact could be especially pronounced when expansionary policy is pursued through securities purchase programmes, which affect the prices of a wide range of financial assets.

This risk can be measured by estimating the gaps between the share and bond prices and their fundamental values, consistent with the cash flows they generate (dividends in the case of shares, coupons and redemptions in the case of bonds) and with the returns demanded by long-term investors. Determining an asset's fundamental value is subject to considerable uncertainty, both because it is difficult to accurately forecast its cash flows and because the main determinants of the returns demanded by investors are not observable and can change over time.

A recent paper[1] takes into account this uncertainty in estimating the distribution of the plausible fundamental values of corporate shares and bonds[2] and comparing it with the actually observed prices. This comparison does not yield evidence in support of the thesis that the prices of shares of listed euro-area companies differ from their respective fundamental values (figure, panel a). Although the current listed prices imply expected real returns on shares slightly below their long-term

Financial asset prices in relation to their fundamental values



Sources: Based on Bloomberg and Thomson Reuters Datastream data.
(1) Overall euro-area stock market index. – (2) The black line represents the index price in logarithmic scale; the blue area represents the 80% confidence interval for the respective fundamental value. – (3) Bank of America Merrill Lynch bond index for BBB-rated instruments.

1 S. Cecchetti and M. Taboga, 'Assessing the risks of asset overvaluation: models and challenges', Banca d'Italia, Temi di Discussione (Working Papers), forthcoming.

2 Bayesian methods are used to calculate the confidence interval, employing non-informative prior distributions on the projected cash flows and on the returns demanded by investors.

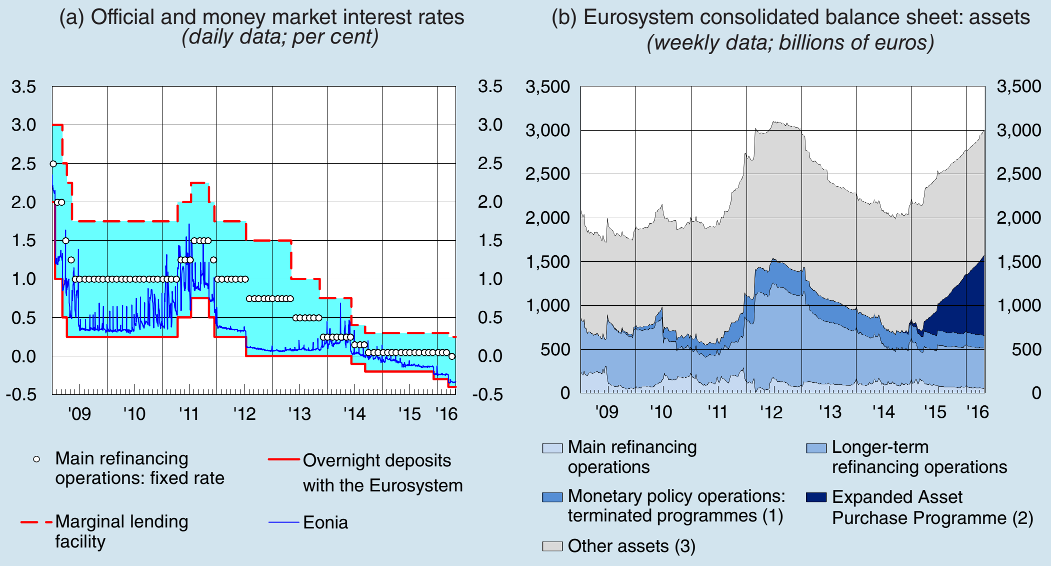
averages, the spreads between these returns and those of long-term government securities (risk premiums) are still rather high in historical terms. Euro-denominated corporate bonds do not show signs of misalignment during the most recent period either (figure, panel b), although the prices are close to the upper bound of the estimated distribution of the corresponding fundamental values.

During the summer financial conditions deteriorated as a result of both growing doubts about the outcome of negotiations between Greece and its official creditors (see Chapter 3 'Macroeconomic developments and fiscal policies in the euro area') and new fears concerning the growth outlook for some of the main emerging economies (see Chapter 1, 'Macroeconomic developments and policies and the international financial markets'). In October the Governing Council emphasized its determination to use all available tools, including adjusting the size, composition and duration of the APP, if necessary.

In the last few months of last year, the slowdown in foreign demand and the decline in commodity prices held back the rise in inflation. In December the Governing Council reduced the interest rate on the Eurosystem deposit facility, which was already negative, by 10 basis points to -0.30 per cent (Figure 4.1); it extended the duration of the APP by six months to at least March 2017, and expanded the range of eligible securities to include regional and local government bonds; it also decided to reinvest the principal payments on the securities purchased under the APP as they mature, for as long as necessary.

Figure 4.1

Official interest rates in the euro area and the Eurosystem's consolidated balance sheet



Sources: ECB and Thomson Reuters Datastream.
(1) Covered Bond Purchase Programme (CBPP, CBPP2) and Securities Markets Programme (SMP). – (2) Covered Bond Purchase Programme 3 (CBPP3), Asset-Backed Securities Purchase Programme (ABSPP) and Public Sector Purchase Programme (PSPP). – (3) Marginal lending facility, gold and other assets denominated in euros and in foreign currency.

At the start of this year the risks associated with the softening international economy and deteriorating financial conditions sharpened (see Chapter 1, 'Macroeconomic developments and policies and the international financial markets').

In March the Governing Council set out a comprehensive package of expansionary measures: it reduced the interest rates on the main refinancing operations and on the marginal lending facility by 5 basis points (respectively to 0.0 and 0.25 per cent) and on the deposit facility by 10 basis points (to -0.40 per cent); it expanded the monthly purchases under the APP to €80 billion starting in April; it decided to make bonds issued by non-bank corporations established in the euro area eligible for purchase through the Corporate Sector Purchase Programme (CSPP) starting at the end of the second quarter; and it introduced a new series of targeted longer-term refinancing operations (TLTRO2) with highly advantageous terms, which will be launched at the end of June 2016.

It is clear that the measures adopted by the Council may impact economic activity through several channels; in addition to enabling banks to be certain of the availability and cost of funding, these measures favour lower returns on and higher prices for financial and real assets, which may be passed on to consumer spending through the wealth effect; to overall investment through higher share prices and the lower cost of capital; and to residential investment by shoring up house prices (see the box 'The monetary policy measures adopted in March', *Economic Bulletin* No. 2, 2016).

DISTRIBUTIVE IMPLICATIONS OF A HIGHLY EXPANSIONARY MONETARY POLICY

Reducing inequality falls outside the mandate of central banks, whose objectives are instead price stability and keeping growth close to its potential level. In the discussion that has sprung up in the wake of the global financial and sovereign debt crises, the conjecture has been put forward that the impact of highly expansionary monetary policies on inequality could be significant and that, as a result, central banks should take into account the distributional implications of their decisions.

It has been asserted that reducing interest rates to very low levels and implementing large-scale purchase programmes have increased inequality, favouring the wealthy by increasing the value of their financial assets. Moreover, very low interest rates over a prolonged period of time would also constitute an 'expropriation of savings'.

A recent empirical analysis[1] studies the short-term impact of the adoption of highly expansionary monetary policies on various income and wealth inequality measures for Italy and estimates the relative importance of the different channels: labour and employment income, which has a stronger effect on individuals whose employment is more sensitive to economic cycles; return on savings and the cost of debt, whose effect on households depends on the structure of their balance sheets; and capital gains, which are connected with their portfolios.

The work uses data drawn from the Bank of Italy's Household Income and Wealth survey, making it possible to evaluate the repercussions of monetary policy on individual households based on the composition of income and wealth and on the different cyclical elasticity of the labour income of the single members, broken down by level of education, age, gender, income category and other characteristics.

1 M. Casiraghi, E. Gaiotti, L. Rodano and A. Secchi, 'A "reverse Robin Hood"? The distributional implications of non-standard monetary policy for Italian households', Banca d'Italia, Temi di Discussione (Working Papers), forthcoming.

The results do not indicate that unconventional monetary measures – like those adopted by the Eurosystem during the sovereign debt crisis or, prospectively, the APP – raise the inequality indices, nor are their distributional effects significantly different from those of a traditional expansion with only interest rate adjustments. According to this analysis, the distributional effects of conventional or unconventional monetary policies are mainly driven by the impact on economic activity and on the labour market.

The main distributional effect, in the short term, of expansionary monetary policy is tied to employment and wage support and has favourable repercussions on the weakest segments of the population in particular, whose employment and wage prospects are more sensitive to economic developments. This effect prevails over the financial effects; indeed it is only partially offset by the effect on capital income. The impact of expansionary monetary policies on net household wealth moreover does not increase with assets, but rather is 'U' shaped: the increase is largest for the wealthiest households, which hold a bigger share of financial assets that produce capital gains, as well as for the least affluent, whose debt load is reduced.

The analysis also suggests that a strongly expansionary monetary policy is not necessarily unfavourable for savers: since they are at the same time workers and holders of assets, the negative effects of low interest rates on returns on savings can be, on average, offset by income support for less affluent households and by capital gains for the better-off households.

Monetary policy operations

In 2015 and the early part of 2016 the Eurosystem continued to inject liquidity into the banking system through fixed rate tenders with full allotment, both in its main refinancing operations and in longer-term operations. In December the Governing Council determined that this policy would remain in effect at least until the end of 2017. The liquidity provided through three-month refinancing operations fell by €80 billion (to approximately €90 billion at the end of April), while that injected through targeted longer-term refinancing operations rose by €213 billion (to €425 billion).

Under the APP the Eurosystem purchased financial assets amounting to €918 billion at the end of April, of which €19 billion in asset-backed securities, €172 billion worth of covered bank bonds and €727 billion in public sector securities (€118 billion in Italian government bonds, of which about €108 billion purchased by the Bank of Italy). At that date the average residual maturity of the PSPP was eight years and that for the Italian government securities segment was just over nine years. The purchasing processes are designed to not compromise normal market functioning (see Chapter 14, 'The money and financial markets').

The liquidity held by the banking system with the Eurosystem in excess of the reserve requirement increased to €784 billion at the end of April, mainly owing to purchases of public sector securities under the APP. The size of the Eurosystem's balance sheet grew by 40 per cent, close to the high reported in mid-2012 (around €3,000 billion at 30 April; Figure 4.1).

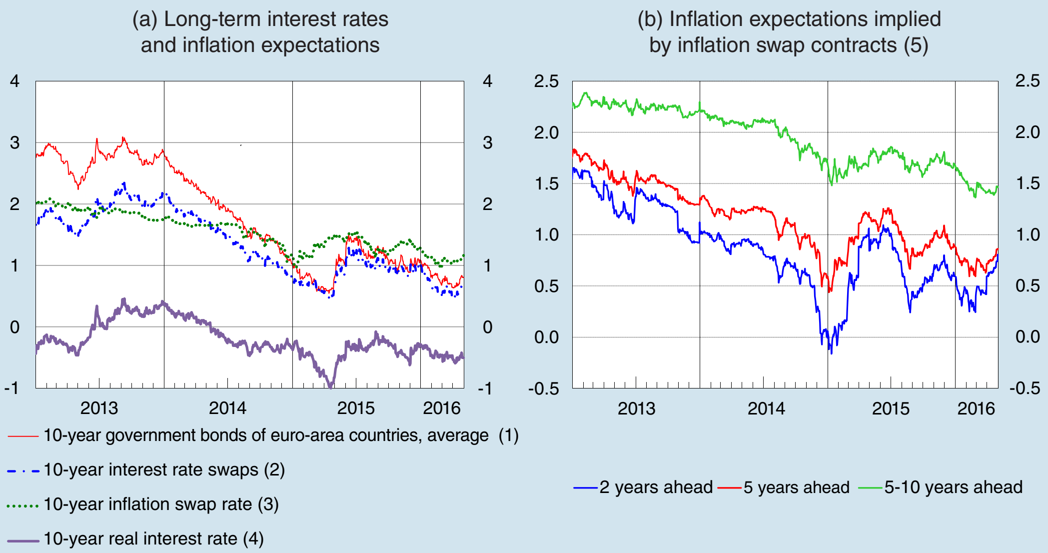
Interest rates and the exchange rate of the euro

The lowering of the key policy rates and the increase in excess liquidity led to a progressive reduction in short-term interest rates, which are close to the negative deposit facility rate. The overnight rate (Eonia) has stayed negative (-0.34 per cent on average in April; Figure 4.1); the three-month interbank deposit rate (Euribor) fell progressively during 2015, stabilizing at about -0.25 per cent in April 2016.

Nominal long-term interest rates remained at historically low levels in 2015. At the end of April of this year, the yields measured by ten-year swaps were close to 0.7 per cent (Figure 4.2), while the average yield on ten-year government securities in the main euro-area countries was 0.8 per cent.

Figure 4.2

Long-term interest rates and inflation expectations in the euro area
(daily data; per cent)



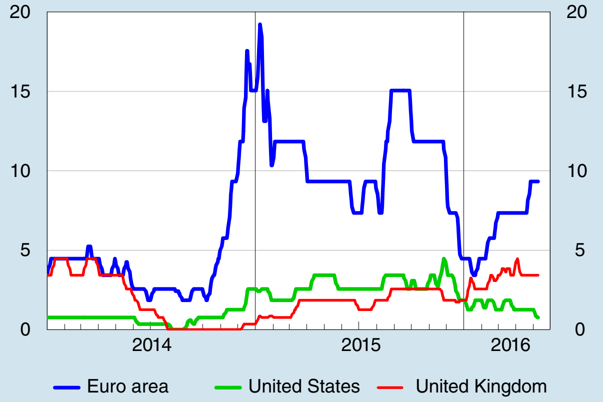
Sources: Based on Bloomberg and Thomson Reuters Datastream data.
(1) Average yields on benchmark 10-year government bonds of Austria, Belgium, Finland, France, Ireland, Italy, the Netherlands, Portugal, Spain and Germany, weighted by GDP at constant 2015 prices. – (2) Fixed rate on 10-year interest rate swaps in euros. – (3) Fixed rate on 10-year euro-area inflation swaps. – (4) Fixed rate on 10-year interest rate swaps deflated by the fixed rate on 10-year inflation swaps. – (5) Fixed rate implied by inflation swap contracts, 2 years ahead, 5 years ahead and 5-year 5 years ahead.

Expected inflation, which had risen following the announcement and launch of the APP, once again began to fall in the summer months across all time horizons. In April 2016 two- and five-year expectations implied by inflation swaps were 0.7 and 0.8 per cent respectively; five-year expectations five years ahead fell to the lowest level since the introduction of the euro at around 1.4 per cent (see the box 'Anchoring of inflation expectations and macroeconomic effects').

ANCHORING OF INFLATION EXPECTATIONS AND MACROECONOMIC EFFECTS

A prolonged period of low inflation heightens the risk of long-term expectations shifting away from the level consistent with the definition of price stability (de-anchoring). Signs of this risk appear when heavy downward movements in short-term inflation expectations, which should be the only expectations affected by temporary shocks, are mimicked by declines in longer-term expectations.[1] An indicator of the degree to which these variations are coincident for the euro area, calculated based on the expectations implied by inflation swap prices, climbed steeply between October 2014 and mid-January 2015, signalling a high risk of de-anchoring of inflation expectations (figure; see the box 'Euro-area inflation expectations and monetary policy measures', *Economic Bulletin*, No.1, 2016). During the same period, no increases were observed in either the United States or the United Kingdom. After the announcement of the Expanded Asset Purchase Programme, this indicator fell to below the levels prevailing at the end of 2014, although it remained highly volatile.

Co-movement of short-and long-term inflation expectations (1)
(daily data)



(1) The indicator is based on the probability of co-movement of long-term and short-term inflation expectations. Technically, it is calculated as an odds ratio over a rolling window of 250 working days and ranges from zero to infinity; an increase indicates a closer link between sharp decreases in short-term and long-term expectations; low values indicate that long-term averages are better anchored.

Empirical analysis demonstrates that euro-area inflation expectations differ among economic agents and are affected by observed consumer price dynamics. The implications of these characteristics for macroeconomic performance and for the effectiveness of monetary policy can be analysed using a general economic equilibrium model, in which it is assumed that, in formulating their inflation expectations, households and firms take into account both past inflation and the central bank's target inflation rate, reducing the weight given to the target where price growth is persistently off this mark.[2] Simulations made using this model indicate how a series of negative inflation shocks, similar to those that have hit the euro-area over the last two years, can lead to a de-anchoring of expectations and have significant negative repercussions on economic activity and prices. To avoid monetary policy losing its effectiveness, the central bank must respond swiftly and decisively to protracted deviations of the inflation rate from its target.

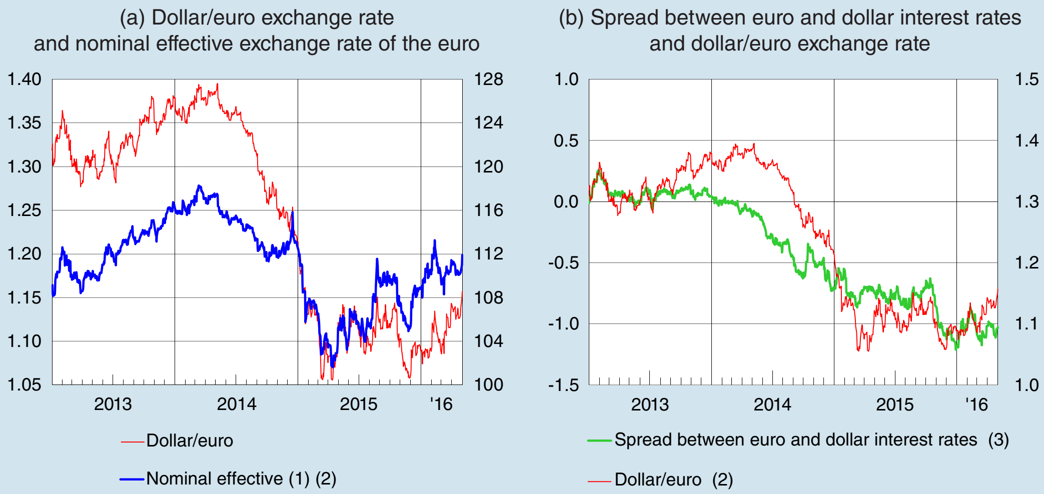
1 F. Natoli and L. Sigalotti, 'An indicator of inflation expectations anchoring', Banca d'Italia, Temi di Discussione (Working Papers), forthcoming.

2 F. Busetti, D. Delle Monache, A. Gerali and A. Locarno, 'Trust, but verify. De-anchoring of inflation expectations under learning and heterogeneity', Banca d'Italia, Temi di Discussione (Working Papers), forthcoming.

The euro exchange rate fluctuated widely. In the first half of 2015 the euro weakened, reflecting the impact of the adoption of the APP; starting at the end of April, it began to appreciate as a result of the rise in global risk aversion, expectations of a more gradual normalization of monetary conditions in the United States, and uncertainty about growth in the emerging economies (Figure 4.3). Between early May 2015 and late April 2016, the euro appreciated by 4.8 per cent in nominal effective terms and 2.3 per cent against the dollar. As compared with the start of 2014, before the significant slowdown in monetary conditions that began in June of that year, the euro depreciated a further 5 per cent in nominal effective terms and about 17 per cent against the dollar.

Figure 4.3

Exchange rates of the euro
(daily data)



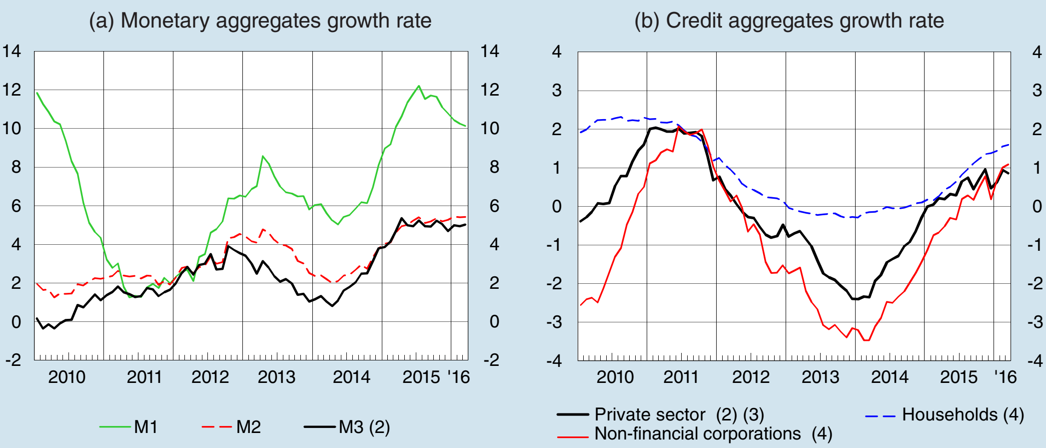
Sources: ECB and Thomson Reuters Datastream.
(1) Index, 1999 Q1=100. A rise in the index corresponds to an appreciation. – (2) Right-hand scale. – (3) Spread between fixed rate on 2-year interest rate swaps in euros and dollars; per cent.

Money and credit

In 2015 and the first half of this year, the twelve-month growth rate of M3 remained close to 5 per cent (Figure 4.4), mainly reflecting the adjustment of portfolios towards more liquid assets prompted by the flattening of the term structure of interest rates.

Figure 4.4

Monetary and credit aggregates in the euro area
(monthly data; 12-month percentage changes) (1)



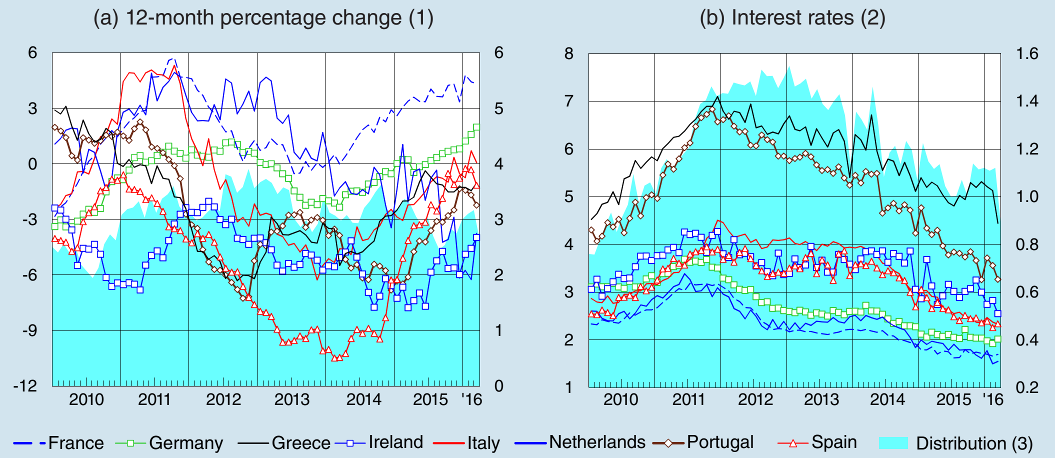
Source: ECB.
(1) Changes calculated on end-of-month data adjusted for calendar effects. – (2) From June 2010 onwards the data do not include repos with central counterparties. – (3) Loans in euros and other currencies granted by monetary financial institutions, adjusted for the accounting effects of securitizations. The private sector consists of households, non-profit institutions serving households, non-financial corporations, insurance companies and pension funds, non-money-market investment funds and other financial institutions. – (4) Loans in euros and other currencies granted by monetary financial institutions, adjusted for the accounting effects of securitizations.

In 2015 bank lending to the private sector gradually recovered, continuing into the early months of 2016 (0.9 per cent on a twelve-month basis in March, from -0.3 per cent at the end of 2014); credit growth benefited from expansionary monetary policy measures despite the weakness of the global macroeconomic framework and still high credit risk. The growth in lending to non-financial corporations once again became positive starting in mid-2015 (1.1 per cent in March); loans to households rose moderately (1.6 per cent).

The average cost of new loans to firms and to households fell further to reach all-time lows in March (around 2.0 per cent). In 2015 and in the early months of this year the degree of heterogeneity among countries in lending trends and the cost of credit to non-financial corporations diminished (Figure 4.5). The less fragmented lending conditions reflect improved standards for banks as a result of further monetary policy stimulus.

Figure 4.5

Loans to non-financial corporations in euro-area countries
(*monthly data*)



Source: EBC.
(1) Loans in euros and other currencies granted by monetary financial institutions, adjusted for the accounting effects of securitizations. – (2) Weighted average of interest rates on new short- and medium/long-term loans, with weights equal to the 24-month moving average of new disbursements; includes current account overdrafts. – (3) Unweighted standard deviation of growth and interest rates; right-hand scale.

According to the ECB's bank lending survey, the gradual recovery in lending in 2015 and the first quarter of 2016 was supported by less tight credit supply conditions and a moderate increase in demand, driven mainly by low interest rates.

THE ITALIAN ECONOMY

5. OVERVIEW

The Italian economy returned to growth in the course of 2015 for the first time since the beginning of the sovereign debt crisis, albeit at a still moderate pace (0.8 per cent) owing to the strong monetary expansion, a fiscal policy conducive to growth and the fall in oil prices (see the box 'The determinants of the recovery'). During the year, however, the strengthening of domestic demand was offset by the gradual deterioration of the euro area's external conditions. GDP growth, which had weakened in the second half of 2015, picked up again in the first quarter of 2016. Economic activity, however, remains below the pre-crisis levels by 8 percentage points. By contrast, Germany, France and, very slightly, the euro-area have now overtaken the pre-crisis levels.

THE DETERMINANTS OF THE RECOVERY

The revival of economic activity in Italy that began in 2015 and is expected to consolidate this year is still strongly dependent on the stimulus provided by expansionary monetary policy measures which, together with the positive impact of falling oil prices, offset the weaker impetus coming from the world economy.

GDP growth in 2015 was slightly livelier than our projections at the beginning of the year had indicated (see *Economic Bulletin*, No. 1, 2015), even though the contribution of the underlying factors changed substantially. Notwithstanding the inevitable uncertainties that come with counterfactual analyses, the Bank of Italy's quarterly econometric model, its main forecasting tool,[1] can assess how the changes since December 2014 in financial conditions, exchange rates, the international scenario (oil prices, foreign demand, deflationary pressures)[2] and fiscal policy (namely, the spate of measures introduced by the Stability Laws for 2015 and 2016) contributed to GDP growth, inflation and employment in the year that has just passed and how they will affect the current year.

The performance of interest rates and exchange rates can be traced back to the effects of the new expansionary monetary policy measures (i.e. the reduction in official interest rates, new targeted longer-term refinancing operations, asset purchases) that were announced or adopted starting in January 2015, but also to those of opposite

1 For an overview of the main features and properties of the econometric model, see the section 'Macroeconomic models' on the Bank of Italy's website.

2 The contributions are estimated in terms of the effects generated by revisions to the exogenous variables since January 2015. The estimates are based on counterfactual scenarios following the approach illustrated in M. Caivano, L. Rodano and S. Siviero, 'La trasmissione della crisi finanziaria globale all'economia italiana. Un'indagine controfattuale, 2008-2010', Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), 64, 2010, and F. Busetti and P. Cova, 'L'impatto macroeconomico della crisi del debito sovrano: un'analisi controfattuale per l'economia italiana', Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), 201, 2013.

sign stemming from trends in the global financial and foreign exchange markets. The decrease in interest rates and the depreciation in the exchange rate observed since the beginning of 2015 have contributed approximately 1 per cent to GDP growth, 0.6 percentage points to consumer price levels and 0.4 percentage points to employment growth (see the Table) over the whole two-year period 2015-16.

Main contributions to growth, inflation and employment; revisions to the projections made in January 2015 (1)
(differences in annual rates of growth; per cent)

	GDP		Inflation		Employment	
	2015	2016	2015	2016	2015	2016
Interest rates and exchange rates	0.3	0.6	0.3	0.3	0.1	0.3
Oil prices	0.0	0.2	-0.1	-0.8	0.0	0.1
Foreign demand	-0.1	-0.3	0.0	-0.1	0.0	-0.2
Global deflationary pressures	-0.2	-0.5	-0.1	-0.2	-0.1	-0.2
Fiscal policy (2) (net effect)	0.1	0.3	-0.1	-0.1	0.4	0.1
of which: IRAP and social contribution relief	0.2	0.2	-0.1	-0.2	0.4	0.1
Investment incentives	0.0	0.2	0.0	0.0	0.0	0.0

(1) The contributions to the revisions made to the data on GDP, inflation and employment stem from changes in the trend for each factor in the rows with respect to the scenario hypothesized in *Economic Bulletin*, No. 1, 2015. – (2) For fiscal policy, the effect of the whole set of measures provided for in the Stability Laws for 2015 and 2016 is given.

Based on annual simulations for 2015 and 2016 using the model for the Italian economy,[3] the overall effect of all the monetary policy measures adopted by the Governing Council since 2014 can be estimated at about 1 per cent of extra GDP growth and at an additional half a percentage point of inflation.[4]

Fiscal policy became once again supportive of growth, despite the limits set by the situation of the public finances following the unavoidable restrictive effects of the fiscal consolidation carried out at the height of the sovereign debt crisis.

According to the quarterly model simulation,[5] measures to support labour demand generated a significant stimulus to employment that can be estimated at 0.4 percentage points in 2015. There is also evidence of a significant contribution of the labour market reform, albeit smaller than that coming from the reduction of the regional tax on productive activities (IRAP) and the introduction of social contribution relief for firms (see the box 'The Jobs Act: a preliminary evaluation', Chapter 8).

---

[3] P. Cova and G. Ferrero, 'The Eurosystem's asset purchase programmes for monetary policy purposes', Questioni di Economia e Finanza (Occasional Papers), 270, 2015, and the boxes 'The macroeconomic impact for Italy of the Eurosystem's Asset Purchase Programme', *Economic Bulletin*, No. 2, 2015, and 'The effects of the Eurosystem's asset purchase programme', *Economic Bulletin*, No. 1, 2016). The estimate provided in the Report updates earlier figures by taking into account the most recent measures.

[4] Some of these effects were already known in December 2015; the table only includes those attributable to revisions to interest rates and exchange rates occurring after that date.

[5] In the model for the Italian economy the effects of the fiscal policy measures depend on which items of the government budget are considered. For the findings on the fiscal multipliers of the Bank of Italy model, see J. Henry, P. Hernández de Cos and S. Momigliano, 'The impact of government budgets on prices: evidence from macroeconometric models', *Journal of Policy Modeling*, 30, 2008, pp. 123-143. Studies based on dynamic general equilibrium models give similar indications; see A. Locarno, A. Notarpietro and M. Pisani, 'Sovereign risk, monetary policy and fiscal multipliers: a structural model-based assessment', Banca d'Italia, Temi di Discussione (Working Papers), 943, 2013. On average the net effects on GDP provided in the table correspond to an implicit fiscal multiplier of 0.7 in the second year.

These effects were countered by those of the new legislation passed to finance the measures. Overall, net of the funding needed to cover the cost of implementing the new legislation, the measures provided for in the Stability Law contributed 0.1 percentage points to GDP growth and 0.4 points to employment. Inflation decreased slightly owing to the diminishing cost of labour. The expansionary effects of fiscal policy are expected to increase this year mainly owing to the measures to support investment (which could contribute 2 to 3 percentage points to investment in machinery and equipment and in transport equipment in the current year, corresponding to 0.2 points of GDP growth) and reduce the tax burden.

The expansionary stance of monetary policy was countered by a progressively weakening outlook for global growth, mainly connected to the slowdown in the emerging economies and the fall in oil prices (see the box 'The decline in oil prices and global growth', *Economic Bulletin*, No. 2, 2016).

Dwindling oil prices helped to strengthen the recovery in households' purchasing power. Owing to structural changes in the Italian economy, however, the direct impact on disposable income was smaller than in the past.[6] At the beginning of 2015 oil prices were forecast to reach \$58.5 a barrel for Brent on average that year (10 per cent higher than the actual figure) and \$66.3 in 2016. Compared with the projections made at the beginning of 2015, lower oil prices are expected to provide an additional boost to growth, mostly in 2016; they have also, however, accentuated the downward pressures on consumer prices by 0.1 percentage points in 2015 and 0.8 points in 2016,[7] increasing the risk of a negative impact on inflation expectations (see the box 'Anchoring of inflation expectations and macroeconomic effects', Chapter 4).

The weakening of the emerging economies put a significant brake on economic activity: the recurrent downward revisions of foreign demand since the beginning of 2015 subtracted about half a point of GDP growth for Italy in 2015-16. Lower than expected world trade was accompanied by increased global deflationary pressures, which had negative repercussions on the price competitiveness of Italian firms. Based on simulations using the model for the Italian economy, all other things being equal, the drop in our main competitors' prices dampened GDP growth in 2015 by 0.2 percentage points and employment and inflation both by 0.1 points. The impact is expected to be even greater this year.

---

6 I. Faiella and A. Mistretta, 'Gli effetti della riduzione delle quotazioni del greggio sulla spesa energetica e sull'attività economica', Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), 279, 2015.

7 The effect of the overall decrease in oil prices since the summer of 2014 (when they were around \$100 a barrel) is stronger and can be estimated at 1.5 percentage points on GDP growth and at 2 percentage points on consumer price dynamics in 2015-16; taking into account the depreciation of the euro, which occurred at the same time, the effects are reduced by more than a third.

Domestic demand, which had subtracted 9.5 percentage points from GDP growth in the previous four years, was the main contributor in 2015 (Table 5.1). Household expenditure firmed up. The recovery extended to other components excluding durable goods. The revival in disposable income, which benefited from improvements on the labour market and from income support measures that the Government has now made permanent, was compounded by a moderate increase in real estate wealth, which had decelerated in previous years, in all likelihood contributing to the slowdown in households' consumption plans.

Table 5.1

Sources and uses of income in Italy

	Per cent of GDP in 2015 (volumes at previous-year prices)	2014			2015		
		Percentage changes		Contribution to GDP growth (volumes at chain-linked prices)	Percentage changes		Contribution to GDP growth (volumes at chain-linked prices)
		Volumes at chain-linked prices	Deflators		Volumes at chain-linked prices	Deflators	
Sources							
GDP	–	-0.3	0.8	–	0.8	0.8	–
Imports of goods fob and services (1)	28.0	3.2	-2.5	-0.8	6.0	-2.7	-1.6
of which: goods	22.8	3.4	-3.5	-0.7	8.1	-4.8	-1.7
Uses							
National demand	97.4	-0.4	0.2	-0.4	1.1	0.1	1.1
Consumption of resident households (2)	61.5	0.6	0.2	0.4	0.9	0.1	0.5
Consumption of general government	19.1	-1.0	0.1	-0.2	-0.7	-0.1	-0.1
Gross fixed investment	16.6	-3.4	0.1	-0.6	0.8	0.2	0.1
plant, machinery, armaments, cultivated biological resources	5.6	-2.7	-0.2	-0.2	3.4	0.4	0.2
products of intellectual property	2.6	0.4	0.9	..	-0.4	1.4	..
construction	8.4	-5.0	..	-0.5	-0.5	-0.3	..
Change in stocks (3)	–	–	–	..	–	–	0.5
Exports of goods fob and services (4)	30.6	3.1	-0.3	0.9	4.3	-0.4	1.3
of which: goods	25.1	3.4	-0.4	0.8	4.4	-0.4	1.1
Net exports	–	–	–	0.1	–	–	-0.3

Source: Istat, national accounts.
(1) Includes residents' expenditure abroad. – (2) Includes non-profit institutions serving households. – (3) Includes valuables. – (4) Includes non-residents' expenditure in Italy.

Investment in productive capital gradually resumed, buoyed by improved borrowing conditions as a result of the expansionary stance of monetary policy and the strong comeback in business confidence. Spending on transport equipment rose sharply, partly thanks to the tax incentives still in place in the early months of the year for the replacement of commercial vehicles. Investment in machinery and equipment began to increase again, though still hindered by significant margins of spare capacity. The contraction of investment in construction under way almost without interruption since 2007 has subsided in both the residential and the non-residential branches; the latter also benefited from early signs of recovery in spending on public works.

Exports were affected by the slowdown in world trade in the second half of the year. In 2015 as a whole, however, they rose by 4.3 per cent, outpacing the potential demand channelled to Italian firms, as has happened almost systematically since 2010; price competitiveness gains of 3 per cent on average for 2015 stemming from the nominal depreciation of the euro contributed. Imports soared, driven by the restocking of inventories and the marked recovery in Italian households' and firms' purchases of transport equipment, which feature a strong foreign component.

The start of the expansionary phase was accompanied by a slight decrease in the propensity to save in the private sector, particularly among firms, mainly reflecting the increase in dividends distributed by companies after the marked decline of the previous three years. Domestic savings climbed to 19.1 per cent of GDP owing entirely to the increase attributable to general government (Table 5.2). Gross investment expenditure, which includes inventories, rose to 17.0 per cent of GDP, halting the prolonged decline that had begun with the financial crisis. It is still, however, at historically very low levels. The current account balance was positive for the third consecutive year, reaching 2.2 per cent of national income (compared with -1.3 per cent on average for the previous ten-year period).

Table 5.2

Saving and gross investment in Italy
(per cent of gross national disposable income)

	Average 1981-1990	Average 1991-2000	Average 2001-2010	2011	2012	2013	2014	2015
General government saving	-6.6	-3.3	0.7	-0.4	0.7	0.1	0.3	1.2
Private sector saving	28.8	24.6	19.4	18.0	17.0	18.0	18.1	17.9
of which: consumer households (1)	20.0	14.0	7.9	5.6	4.6	5.8	5.5	5.5
Gross national saving	22.3	21.3	20.0	17.7	17.7	18.1	18.4	19.1
Gross investment	23.2	20.5	21.4	20.8	18.1	17.2	16.5	17.0
Memorandum item:								
Balance on current transactions with rest of world	-0.9	0.9	-1.3	-3.1	-0.4	0.9	1.9	2.2

Source: Based on Istat data.
(1) Includes non-profit institutions serving households.

The recovery in economic activity was highly uneven among sectors and firms. Value added recorded an early recovery in manufacturing spurred by transport equipment; it also increased in services, especially in commerce, but decreased in construction, albeit at a much slower pace compared with 2014. The upturn in domestic demand helped to close the gap in the sales turnover of export-oriented versus domestically-oriented firms, which had remained consistently positive throughout the recession.

In 2015 employment grew by 0.6 per cent, continuing the trend begun last year. The firming up was due to improved cyclical conditions, the introduction of social contribution relief for new permanent hirings and, to a lesser but still significant degree, the greater flexibility in dismissals provided by the Jobs Act. The number of people in employment rose in services but declined in industry, albeit less sharply than in 2014. The positive performance of employment triggered a drop in the unemployment rate, which fell to 11.9 per cent for the labour force as a whole and to 40.3 per cent for young adults up to age 24; in the early months of 2016 unemployment shrank further.

Preliminary estimates by Svimez and Prometeia suggest that the decline in the GDP of Italy's South and Islands came to a halt in 2015, after seven consecutive years of contraction. As the Centre and North boasted stronger growth, however, geographical differences continued to widen. The South and Islands' exports, which represent only one tenth of Italy's total, increased by 4 per cent in value, despite the negative contribution of the oil sector; employment rose by 1.6 per cent, compared with 0.6 in the Centre and North, where the recovery began in 2014.

Consumer price inflation remained extremely low, owing in part to the still ample margins of spare productive capacity and available labour; in 2015 it hit the historical minimum of 0.1 per cent, held back by the fall in the prices of energy products and the weak rise in the core components, which steadied at 0.7 per cent on average for the year. In the early months of 2016 the general index turned negative again and is only expected to recover in the final part of the year.

The protracted weakness of inflation led to worsening expectations which, compounded by the still high level of unemployment, could put a further brake on wage increases. In some sectors, accounting for 60 per cent of total wages in the second quarter, the failure to renegotiate the national labour contracts led to zero growth in nominal wages. In the future, downward pressures on prices could ensue from certain clauses included in recent contracts which provide for more frequent adjustments of wages to observed changes in prices (see the box 'Wage growth, unemployment and inflation expectations', *Economic Bulletin*, No. 2, 2016).

With economic activity still far below its potential, fiscal policy in 2015 was moderately expansionary. While complying with the European budget rules, the Government cut the tax wedge on labour significantly. In 2015 the general government deficit decreased from 3.0 per cent of GDP in 2014 to 2.6 per cent, reflecting a drop in interest expenditure; the debt-to-GDP ratio increased slightly, the reduction in the Treasury's available liquidity acting as a brake.

The reform effort to boost the efficiency and effectiveness of public policy continued with the enactment of bills on general government and public contracts and with a number of changes to bankruptcy law. In many cases, however, the impact of these measures on growth potential will be inevitably slow and contingent on how thoroughly they are implemented. Labour reforms are displaying more immediate positive effects, but these are offset by limited action in fostering competition, which is especially low in some areas of the service sectors.

The contraction of bank credit to the private sector has come to a halt. The recovery in loans that began last summer has proceeded in the early months of the current year, benefiting from the expansionary monetary policy in a context where credit risk is still high, even if gradually declining.

The progressive improvement in borrowing conditions in the first part of 2016 is expected to boost the spending of households and firms. Confidence indicators are positive: all the main sectors are expected to remain on cyclically high levels. In their assessments firms expect their investment plans to expand, benefiting from tax incentives on the depreciation of machinery and equipment and from the firmer outlook for demand. The favourable borrowing conditions for households and firms should contribute to the gradual revival of the real estate market.

Going forward, the strengthening of domestic demand will come up against a persistently weak external environment, which could dampen the recovery even beyond the direct effects on foreign trade, triggering a slowdown in investment. This is confirmed by the findings of some Bank of Italy surveys, which suggest that firms more exposed to geopolitical risks are more cautious in their investment plans.

6. FIRMS

Industrial production returned to growth in 2015, for the first time since the sovereign debt crisis, but it is still more than 20 percentage points lower than in the first quarter of 2008. Investment also resumed but remained low in relation to GDP.

Trends in economic activity were not uniform across sectors: in manufacturing, value added and labour productivity increased significantly; in the service sector output grew moderately but the sharp upturn in labour input reduced productivity. Sectoral differences also reflect the level of allocative efficiency, which in our analysis is lower in Italy than in the other main European countries. However, the improvement during the recession indicates that the selection process has tightened for firms.

The highly expansionary stance of monetary policy helped to ease lending conditions. The sharp contraction in lending to firms in the past three years virtually came to a halt in 2015. Credit growth was extremely uneven, though, reflecting above all differences in borrowers' riskiness.

As the economic situation has improved, firms have become less financially vulnerable. Lower levels of debt and capital strengthening have helped firms to return gradually to a balanced financial structure; they remain heavily dependent on bank loans, especially small and medium-sized firms.

Economic developments

Firm demographics. – Following the low point reached in 2013, the net birth rate of firms is returning to pre-crisis levels. Data from the Chambers of Commerce company registers show that in 2015 the balance between business births and deaths was over 45,000, equal to 0.88 per cent of the stock of existing businesses (0.62 per cent in 2014). One factor was the sharp decline in business deaths, which fell for the second year running, to 6.3 per cent.

The reduction in deaths was greater among medium-sized firms which, overall, showed they were more ready to take advantage of the cyclical recovery. Italian firms increasingly restructured into corporations, a legal form which facilitates access to credit and to government incentives for start-ups and for small and medium-sized firms; for the first time since 2010, the decline in sole proprietorships halted.

During the crisis persistent negative effects on the demand for labour, investment activity, and growth potential were caused by companies leaving the market permanently and by the weak birth rate of firms and slow development in their first years of life (see the box 'Firm demographics during the crisis and impact on growth').

FIRM DEMOGRAPHICS DURING THE CRISIS AND IMPACT ON GROWTH

Through its effects on firm demographics, the long recession that began in 2008 may have resulted in a fall in potential output and the still very moderate pace of economic recovery in Italy (see the box 'Italy's potential output and the output gap', Chapter 5, *Annual Report for 2014*).

The net birth rate of firms declined during the recession: a recent analysis of the manufacturing sector estimates the consequent loss of production capacity at about 5 percentage points, equal to roughly one third of the total estimated loss including the downsizing of the firms that remained in business.[1] Although, as a rule, the firms that leave the market are the least productive and have the lowest potential output, the severe and protracted crisis appears to have brought even relatively more efficient ones into the set of leavers. Companies began to reduce labour and capital inputs before exiting the market, more sharply than had been the case up to 2007. This trend was common to various sectors, but it appears to have been less pronounced in export- and innovation-oriented industries, presumably thanks to a more effective winnowing of firms before the recession.

According to a recent study, weak expansion in the first years of the firms born during the recession also undercut the growth of aggregate turnover, capital and employment.[2] The firms created during the recession, subject to more stringent selection but less numerous, had lower rates of capital formation and business growth than both those of the same sector and companies of the same age born in less adverse cyclical phases.

This can be traced to two factors linked to the functioning of the credit market during the recession. First, the lower level of capital at birth, by reducing the collateral that firms could provide in order to obtain credit, may have diminished their borrowing capacity in subsequent years, owing in part to banks' more stringent selection of borrowers. Second, the heightened uncertainty of the macroeconomic situation may have led banks and businesses to select less risky projects promising more certain returns, to the detriment of future growth potential.

---

1 A. Mistretta, L. Montefiore and G. Zevi, 'Manufacturing capacity in Italy and demography of firms', Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), forthcoming.

2 F. Manaresi and F. Scoccianti, 'Battle scars. New firms' capital, labour and revenue growth during the double-dip recession', Banca d'Italia, Temi di Discussione (Working Papers), forthcoming.

Value added and production. – At the start of last year, production returned to growth for the first time since 2011. There was an 0.6 per cent rise in value added in the Italian economy as a whole, but this was very uneven across the various sectors. Value added in the manufacturing sector recouped 1.5 per cent, thanks to a rise in transport equipment production, which benefited from the strong performance of the motor vehicles market, the large increase in purchases by firms, and also foreign demand. In the textiles and metals and metal products sectors, value added continued to contract in line with the longer-term trend towards the reallocation of production on a global scale.

Industrial output turned upwards in 2015, buoyed by capital goods and, to a lesser extent, by consumer goods. Activity has been growing since the start of 2015; the slowdown at the end of the year was partly due to calendar effects. In the first quarter of 2016 the cycle resumed, mainly thanks to the production of capital goods.

In construction the fall in value added slowed considerably over the year as a whole (-0.7 per cent against -4.6 per cent in 2014); the sector began to pick up last summer. The decline, which started in spring 2007, was very persistent, in line with the industry's relatively long cycle. The sector was badly affected by restrictions on lending to firms, especially to those that were less financially sound.

The added value of private services increased apace with the whole economy; growth was particularly positive for firms in the wholesale and retail trade, which benefited from the increase in private consumption (see Chapter 7, 'Households'), and in accommodation and food services owing to the expansion of flows of both resident and non-resident tourism. Business services, which had been badly hit by the long recession, returned to growth.

The Bank of Italy's Survey on Industrial and Services Firms (the 'BI Survey'), conducted by the Bank of Italy's branches at the beginning of this year on more than 4,000 firms with 20 or more employees in non-construction industry and private non-financial services, found that in 2015 sales turnover accelerated in real terms by 3.8 per cent against 0.3 per cent in the previous year. With the recovery in domestic demand, the gap between the sales growth of exporting firms and that of firms operating mainly inside Italy was eliminated.

Italy's extremely fragmented production structure (more than 97 per cent of firms have fewer than 20 employees) proved to be particularly vulnerable to the crisis: between 2007 and 2013 the value added of small firms fell by 18 per cent, a full 9 percentage points more than the overall average.

Innovation. – In 2015 investment in research and development continued to increase, albeit at a modest pace, partially recouping the fall recorded during the crisis. Investment in intellectual property declined slightly because of lower spending on software and databases. This is consistent with the tendency of this kind of spending to lag behind purchases of plant and machinery, which has contracted sharply in recent years. The share of spending on intellectual property in total investment has basically remained stable at just over 15 per cent, 3 points below the euro-area average.

There continues to be less innovation activity in Italy than the European average, with a generalized lag in most of the components of the European Commission's innovation survey,[1] which combines measures of context and inputs and innovative outputs. In recent years there has a been a clear improvement in context factors such as the availability of human capital and the quality of public research whereas the gap with the other countries has widened due to the low availability of venture capital.

[1] European Commission, *Innovation Union Scoreboard,* 2015.

The reluctance of firms to innovate can be linked to various factors which, in the case of Italy, may make it less advantageous for firms to expand, such as the heavy fiscal burden and high levels of tax evasion (see the box 'Taxation and corporate dynamics').

TAXATION AND CORPORATE DYNAMICS

Italy has a sizeable growth gap with respect to its main euro-area partners, as was the case even in the decade preceding the global crisis. A number of concurrent factors are responsible, some internal to business activities, others connected with the institutional and regulatory framework. Many studies have brought to light the importance of (a) a production structure skewed towards small and micro firms; (b) a poor ability to allocate resources to the more productive sectors and enterprises; and (c) insufficient innovative activity by firms.

Based on a general equilibrium model that takes account of firm heterogeneity, a recent study shows that a heavy fiscal burden and high levels of tax evasion can help to explain these structural characteristics and the weak growth of the economy.[1] On the assumption that the opportunities for evasion diminish as firm size increases, smaller companies have less incentive to invest in innovation and to expand their business, thereby keeping the competitive advantage tied to evasion. The unfair competition of these firms reduces the expected returns to innovation for all the others, which consequently undertake projects with less growth potential.

At the aggregate level, the lower rate of innovation resulting from the choices made by individual firms entails less selective pressure, which is reflected in the survival of small, less productive and less innovative firms and in an increase in the relative size of the underground economy.

Using Istat's official estimates of the shadow economy in Italy,[2] this model implies that, without evasion, from 1995 to 2006 the annual GDP growth rate would have been at least 0.2 percentage points higher, thanks to a larger number of innovative firms and a greater propensity to innovate. The productive economy would also have been marked by greater dynamism: a higher death rate of firms would have been accompanied by more vigorous growth in firm size.

Since the competitive advantage attaching to evasion increases with the level of tax rates, lowering these can push up the GDP growth rate considerably when the underground economy is relatively large. This result suggests that a gradual recovery of unpaid taxes in conjunction with a reduction in the tax rates can, fiscal revenue remaining unchanged, produce a significant boost to growth.

1 E. Bobbio, 'Tax evasion, firm dynamics and growth', Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), forthcoming.

2 Istat, *La misura dell'occupazione non regolare nelle stime di contabilità nazionale. Anni 1980-2010*, September 2011.

The strategy choices of firms, particularly the more innovative ones, affect their balance sheets: according to the BI Survey, in 2015 the growth in turnover was higher for those firms - about 10 per cent - that use the new technologies such as advanced robotics and artificial intelligence, even in the more traditional areas.

Investment. – Last year the prolonged contraction in capital accumulation, under way since the start of the global financial crisis, came to a halt. Gross fixed capital formation, which does not include inventories, increased by 0.8 per cent; as a percentage of GDP, which grew at the same pace (see Chapter 5, 'Overview'), it stabilized at an all-time low of 16.6 per cent (Table 6.1). The recovery of investment in Italy has been more moderate than in the euro area as a whole. The stock of capital excluding housing fell further: depreciation is still at levels similar to those seen in 2008, while gross investment flows contracted considerably following the crisis.

According to the BI Survey, last year's expansion of investment mainly concerned the largest non-financial private services firms (Table 6.2). In non-construction industry the recovery in investment was modest overall but significant for exporting firms, although less than planned, and for large firms restructuring their production lines.

The factors that had held down investment during the recession, such as weak current and expected demand, large margins of idle capacity and strains on the credit market, subsided in 2015 (see the box 'The determinants of the recovery' in Chapter 5 and also Chapter 6, *Annual Report*, 2014). Increased demand contributed greatly to the recovery in investment in a context of improving confidence. A survey coordinated last year by the European Commission showed that there were fewer obstacles to firms' investments thanks to higher demand and easier access to credit.[2]

Investment in transport equipment was particularly strong, benefiting from the cyclical recovery as well as from some tax incentives (Table 6.1.). There was a moderate recovery in spending on other plant and machinery, which directly affects production capacity and which during the recession had been depressed by lower demand on the part of service firms.

Table 6.1

Fixed investment in Italy

(volumes at chain-linked prices unless otherwise specified; per cent)

	% composition in 2015 (1) (volumes at previous year's prices)	Changes			Per cent of GDP (1) (volumes at previous year's prices)	
		2013	2014	2015	2000	2015
Construction	50.4	-8.0	-5.0	-0.5	9.8	8.4
Housing (2)	28.2	-4.4	-2.9	0.2	4.7	4.7
Other (2)	22.2	-11.8	-7.5	-1.3	5.1	3.7
Cost of change of ownership	3.8	-14.1	-2.7	6.2	0.8	0.6
Plant, machinery, arms and biological crops	33.6	-8.2	-2.7	3.4	7.9	5.6
of which: transport equipment	4.8	-23.0	0.7	19.7	1.6	0.8
Intellectual property	15.9	2.1	0.4	-0.4	2.5	2.6
Total gross fixed investment	**100.0**	**-6.6**	**-3.4**	**0.8**	**20.2**	**16.6**
Total excluding housing	–	-7.4	-3.6	1.1	15.4	11.9
Total excluding construction	–	-5.1	-1.7	2.2	10.4	8.2

Source: Istat, national accounts.
(1) Rounding may cause discrepancies in totals. – (2) Includes costs of change of ownership.

2 European Commission, *Business and Consumer Survey Results*, April 2016.

In 2015 firms purchased more capital goods, especially transport equipment, from abroad (see Chapter 10, 'Foreign demand and the balance of payments'). The Business Outlook Survey of Industrial and Service Firms ('Business Outlook Survey') conducted by Bank of Italy branches in the autumn showed that the increased demand for supplies from abroad compared with the preceding three years only applied to 15 per cent of all firms, mainly exporting manufacturing companies. The survey ascribes this mainly to considerations of cost but also to the lack of similar inputs on the domestic market.

The trend in investment in construction was once again negative, but much less so than in the recent past (Table 6.1). Residential construction showed signs of improvement, thanks to house sales recovering and prices stabilizing (see the box 'Trends in residential property prices in Italy and their determinants' in Chapter 7). Contributory factors include the less unfavourable conditions for accessing credit and the stabilization of profit margins after the prolonged contraction since early 2008. Demand for other buildings, however, is rather slow to pick up, despite the fact that the decline in public investment has come to a stop (see Chapter 11, 'The public finances'). According to the Business Outlook Survey conducted by the branches of the Bank of Italy in the early months of 2016 on a sample of more than 400 construction companies, last year the production of public works picked up, albeit at a moderate pace; firms expect activity levels to remain basically unchanged this year.

Table 6.2

Gross fixed investment of firms according to Bank of Italy surveys by size class, capacity utilization and change in turnover
(percentage changes at 2015 prices unless otherwise specified) (1)

	Total	Number of employees				Capacity utilization (2) (3)		Change in turnover (2)	
		20 to 49	50 to 199	200 to 499	500 & over	Low	High	Low	High
Industry excluding construction									
Outturn for 2015	3.3	1.8	5.7	8.4	1.0	6.6	-0.2	-0.1	7.1
Realization rate (4)	97.7	105.9	105.0	105.9	89.1	97.1	98.4	99.1	96.4
Planned investment for 2016	2.6	-2.9	-3.4	1.1	8.6	4.2	0.7	-1.8	7.1
of which: manufacturing									
2015 outturn	2.9	1.2	4.8	9.5	-0.1	8.7	-0.8	-0.8	6.6
realization rate (4)	98.2	106.5	107.5	107.7	85.8	97.3	98.7	100.7	96.0
2016 planned	1.8	-3.6	-3.4	-0.8	9.8	3.8	0.5	-3.3	6.3
Service sector (5)									
Outturn for 2015	8.9	3.1	5.3	-0.2	14.7	….	….	8.8	9.1
Realization rate (4)	104.0	106.8	100.5	105.1	104.1	….	….	103.7	104.6
Planned investment for 2016	2.1	2.8	-2.6	-10.4	6.3	….	….	4.8	-1.9
Total									
Outturn for 2015	6.4	2.6	5.6	4.0	8.9	6.6	-0.2	5.2	8.1
Planned investment for 2016	2.4	0.2	-3.0	-4.3	7.2	4.2	0.7	2.2	2.6

Source: Banca d'Italia, Survey of Industrial and Service Firms.
Robust means (Winsorized) of distributions of annual changes in investment. Investment is deflated using the individual deflators provided by the firms. – (2) Firms are divided according to whether they fall below (low) or above (high) the median, calculated separately for industry and services, relating to 2015 for the outturn and realization rate and relating to projections for 2016 for planned investment. – (3) Industrial firms only. – (4) Percentage ratio, at current prices, of realized investment to planned investment (recorded in last year's survey) for 2015. – (5) Private non-financial services.

For 2016 companies plan to expand overall investment by more than 2 per cent in both industry and the service sector; expectations are best for large firms with good sales prospects. An impetus to investment could come not only from a more strongly expansionary monetary policy stance (see Chapter 4, 'Monetary policy in the euro area') but also from tax benefits relating to depreciation. According to the BI Survey, about a quarter of firms questioned think this incentive has a positive impact, of which only a third think that the increase is simply due to investments being brought forward. Positive opinions concerning the measure were concentrated among large manufacturing companies geared towards innovation and whose balance sheets show a profit. However, spending plans are still affected by uncertainty about the external environment. According to the Bank of Italy's quarterly surveys, at the start of 2016 the balance between an expected increase or decrease in investment this year was positive; however, for those companies most sensitive to geopolitical risks the balance was around half that reported by other companies.

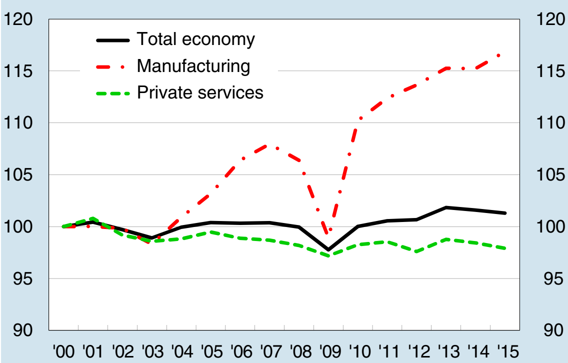
Labour demand. – Firms increased their labour utilization in 2015. According to national accounts figures, total hours worked by payroll employees in the non-farm private sector rose by 1.7 per cent (see Chapter 8, 'The labour market'). The upturn was more marked in the service sector, especially as regards business services and hotels and restaurants. In manufacturing the number of payroll workers remained basically stable, while the number of hours worked increased, above all in the sector producing transport equipment.

Productivity. – In 2015 hourly productivity growth in the economy as a whole again fell slightly (-0.3 per cent against -0.2 per cent in 2014). This was due to highly differentiated trends resulting mainly from cyclical differences in activity during the year: in manufacturing, it accelerated sharply to 1.4 per cent whereas in services it fell by a further 0.6 per cent.

In manufacturing the positive trend of 2015 was in line with the data – repeatedly revised upwards by Istat – of the previous years. Despite the sharp but brief collapse of 2008-09, cumulative growth since 2004 stands at 15.6 per cent (Figure 6.1), reflecting a more efficient allocation of resources (see the box 'Resource reallocation during the recession').

Figure 6.1

Hourly labour productivity in Italy (1)



Source: Istat, national accounts.
(1) Index, 2000=100.

RESOURCE REALLOCATION DURING THE RECESSION

The performance of aggregate productivity in an economy benefits not only from the efficiency gains achieved by individual enterprises but also from the ability to channel productive resources to more efficient firms (allocative efficiency).

Within economic sectors, allocative efficiency can be proxied by the covariance between firm size and productivity[1] or, alternatively, by the dispersion of the marginal productivity of productive factors among firms. In an efficient economic system one would expect to observe high covariance in the former case, inasmuch as it is the more productive firms that grow more; in the latter case one would expect low dispersion as a consequence of the reallocation of productive factors towards uses that deliver a higher rate of return.[2]

Studies using OECD data indicate that the contribution of allocative efficiency to aggregate productivity is smaller in Italy than in the other main advanced countries owing to a more restrictive regulation of the markets in goods, services and factors of production and to a less business-friendly institutional environment.[3]

The most recent trends signal an increase in the efficiency of reallocation in all the main European countries,[4] an improvement also recorded in Italy. According to a study based on the universe of Italian firms, between 2005 and 2013 the growth in labour productivity in manufacturing benefited chiefly from a progressive strengthening of allocative efficiency, measured by the covariance between firm size and productivity;[5] in the later part of the recession efficiency also improved in private non-financial services, where its level remains modest, however.

The difference between manufacturing and services in the intensity of resource reallocation towards more productive uses reflects, in part, the difference in competitive pressure: according to an analysis based on a finer sectoral disaggregation, the improvement in allocative efficiency is in fact positively correlated with the degree of competition.[6]

---

1 G.S. Olley and A. Pakes, 'The dynamics of productivity in the telecommunications equipment industry', *Econometrica*, 64, 6, 1996, pp. 1263-1297.

2 C.T. Hsieh and P.J. Klenow, 'Misallocation and manufacturing TFP in China and India', *Quarterly Journal of Economics*, 123, 4, 2009, pp. 1403-1448.

3 D. Andrews and F. Cingano, 'Public policy and resource allocation: evidence from firms in OECD countries', *Economic Policy*, 29, 78, 2014, pp. 253-296.

4 E. Gamberoni, C. Giordano and P. Lopez-Garcia, 'Capital and labour (mis)allocation in the euro area: some stylized facts and determinants', Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), forthcoming.

5 A. Linarello and A. Petrella, 'Productivity and reallocation. Evidence from the universe of Italian firm level data', Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), forthcoming.

6 E. Adamopoulou, E. Bobbio, M. De Philippis and F. Giorgi, 'Allocative efficiency and aggregate wage dynamics in Italy, 1990-2013', Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), forthcoming.

In the private non-financial services sector hourly productivity has declined by 0.4 per cent on average over the last fifteen years, mainly because of developments in the sector of professional, scientific, and business technical support activities.

A contributing factor to the weakness of productivity in Italy compared with the other leading European economies is its productive structure, which is biased towards small and micro enterprises. The productivity of Italian companies with 250 or more employees is more than double that of companies with fewer than 10 employees; the gap is only 48 per cent in Germany. These differences widened during the recession as productivity declined more in small Italian companies than in their German counterparts. By contrast Italy's medium-sized enterprises (50-249 employees), whose productivity was already slightly higher before the crisis, recorded greater improvements between 2007 and 2013 than similarly sized German firms.

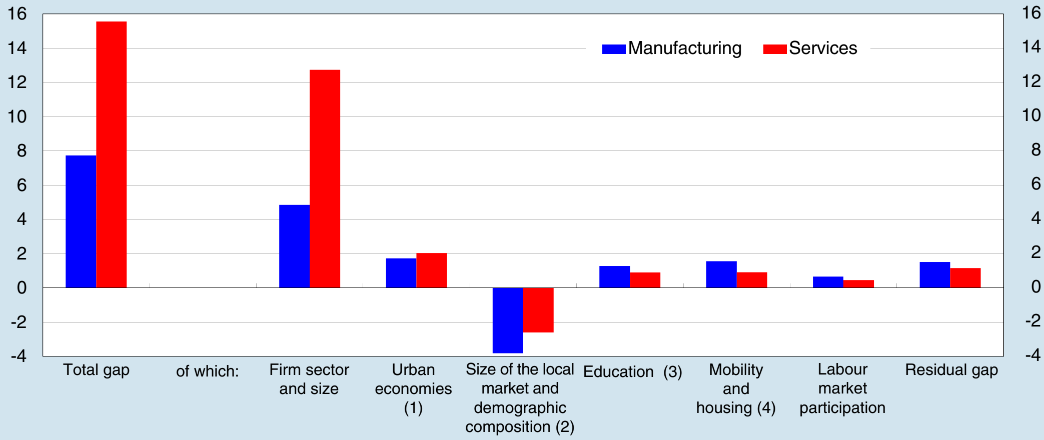
Where firms are located is an important determinant of productivity: other things being equal, companies working in urban agglomerations have, on average, higher levels of efficiency (see the box 'Urban agglomeration and productivity').

URBAN AGGLOMERATION AND PRODUCTIVITY

Urban agglomerations are the locus of a significant part of economic activity in the main advanced countries. In Italy, the urban areas of the 12 largest municipalities produced an average of one third of value added in the five years 2001-05, while they accounted for just over one quarter of the country's population.[1]

The firms located in Italy's 73 urban areas[2] are on average more productive than those located elsewhere: according to our estimates,[3] on a cyclically adjusted basis their advantage in terms of labour productivity is 7.7 percentage points in manufacturing and 15.6 points in services (see the figure).

Factors in the productivity gap between firms located in urban and non-urban areas
(contributions in percentage points)



Sources: Based on data from Archivio statistico delle imprese attive (ASIA).
(1) Proxied by the area's sectoral composition (shares of value added in real terms), by average firm size in the area and by specialization (Herfindahl-Hirschman index calculated on turnover in real terms). – (2) Proxied by population density, by the population, by the old-age dependency ratio, by the percentage of foreign residents, by the housing mobility index for foreigners, and by the school attendance index for foreigners. – (3) Proxied by the gender differentials for high-school education, by the illiteracy rate, by the school/training drop-out rate, by the percentage of adults with a high-school diploma or university degree, and by the level of educational attainment of the population aged 15-19. – (4) Contains variables that proxy for the quality of infrastructure (share of the population that (a) commutes daily from their municipality of residence for work; (b) uses public transport; and (c) makes journeys taking longer than 60 minutes for reasons of study or work) and variables that proxy for the housing supply (percentage of owner-occupied homes, share of residential building in the area, increase in residential building in the area, and residential mobility).

1 *L'economia delle regioni italiane. Dinamiche recenti e aspetti strutturali*, Banca d'Italia, Economie regionali, 43, 2015.

2 The definition of urban area used here adapts that of the OECD Urban Audit and of Eurostat (see *European cities. The EU-OECD functional urban area definition*, on Eurostat's website) to the local labour market areas identified by Istat. Accordingly, 73 urban areas are identified, corresponding to local labour market areas centred on municipalities or clusters of neighbouring municipalities with a population density of at least 1,500 per km.^{2}

3 A. Lamorgese and A. Petrella, 'An anatomy of Italian cities: evidence from firm level data', Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), forthcoming.

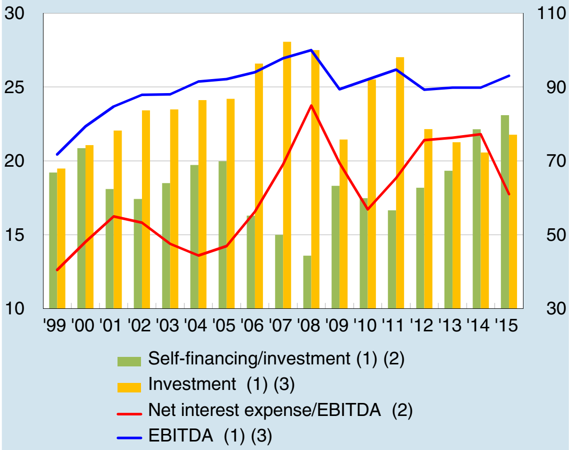
This gap reflects both the characteristics of the firms and those of the areas where they are located. Notable among the former, besides sector of specialization, is size, which explains a good part of the efficiency advantage of urban firms, particularly in services. As to the characteristics of the area, productivity benefits from the average levels of educational attainment and labour market participation, from higher mobility within the area and from the responsiveness of housing supply. Other characteristics that have a positive impact on productivity are the greater availability of knowledge-intensive services, less overall specialization, the larger average size of firms resident in the area, a larger local market, and a higher proportion of foreigners and young people in the population.

Profitability and financial balance. – In an economic environment of still moderate recovery, corporate profitability shows signs of picking up but remains low: in 2015 the gross operating profit (EBITDA) of non-financial corporations increased by 3.6 per cent, recouping only part of the reduction recorded since the start of the global economic crisis (Figure 6.2). The fall in interest rates led to a sharp reduction in net interest expense, which took up a smaller share of EBITDA (17.7 per cent). The BI Survey showed that the improvement in economic performance across all size classes of firms was significant: the share of companies in profit reached almost 70 per cent, 7 percentage points more than in 2014.

Figure 6.2

Profitability and coverage of investment

(per cent; indices)



Source: Based on Istat data.
(1) Right-hand scale. – (2) Net interest expense and self-financing are estimated on the basis of the national economic accounts of the non-financial corporations sector, 1995-2015. – (3) Indices, 2008=100.

Investment grew at a slow pace and relied more on internal resources than in the past; in this way firms' financial balance reached 1.8 per cent of GDP. This trend went hand in hand with a substantial reduction in financial debt (€31 billion) and a significant increase in firms' liquidity (€26 billion; Table 6.3).

Sources of funding

Financial structure. – The gradual reduction in the level of corporate indebtedness continued in 2015: financial debt fell to 78 per cent of GDP, partly as a result of the further decline in bank lending (Table 6.3).

Leverage has fallen by more than 6 percentage points since 2011 to stand at 43.3 per cent at the end of last year (Figure 6.3.a), helping firms to gradually rebalance their financial structure. According to the BI Survey, about a quarter of firms reported they had reduced their leverage in 2015; for more than half of them, a contributing factor was an increase in equity, achieved mainly by reinvesting profits. Leverage is particularly high for smaller firms (Figure 6.3.b), whose dependence on bank credit is still ingrained in their financial structure: despite the growth observed in the years of the financial crisis, bonds continue to be an important source of funding for large firms only.

Table 6.3

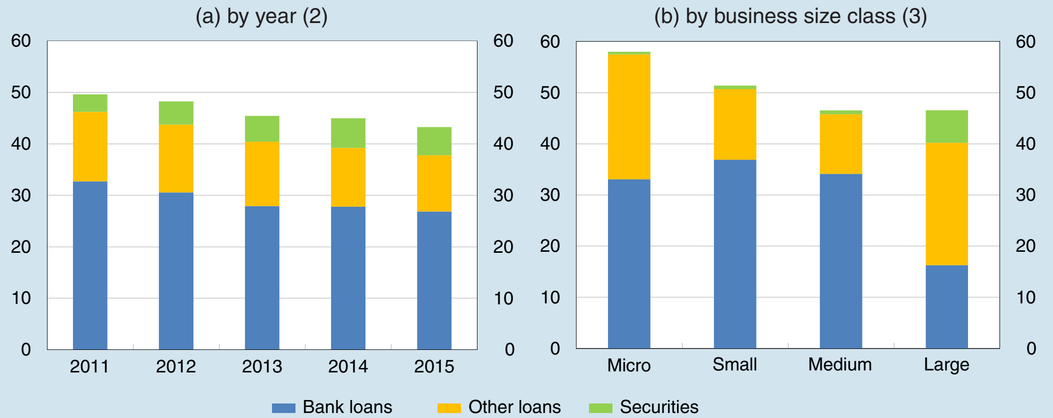
Financial assets and liabilities of firms (1)
(millions of euros and per cent)

	End-of-period stocks			Flows	
	2015	Percentage composition 2014	Percentage composition 2015	2014	2015
ASSETS					
Cash and deposits	313,502	17.4	18.7	13,764	26,250
Securities	61,214	3.9	3.6	-4,267	1,707
of which: Italian public sector	49,365	3.1	2.9	2,614	-1,041
Shares and other equity	566,326	34.0	33.7	49,571	11,791
Trade receivables	580,835	35.0	34.6	-38,864	15,515
Other assets (2)	158,327	9.7	9.4	4,854	-2,509
Total assets	**1,680,204**	**100.0**	**100.0**	**25,058**	**52,754**
of which: external	455,420	27.5	27.1	20,518	1,811
LIABILITIES					
Financial debt	1,278,915	36.4	34.8	2,344	-31,215
Bank loans	793,495	22.5	21.6	-7,768	-11,629
Other loans (3)	322,920	9.2	8.8	6,232	-17,795
Securities	162,500	4.7	4.4	3,880	-1,791
Shares and other equity	1,677,040	44.5	45.7	29,560	27,937
Trade payables	518,427	13.8	14.1	-36,117	20,272
Other liabilities (4)	198,471	5.3	5.4	1,072	4,312
Total liabilities	**3,672,853**	**100.0**	**100.0**	**-3,140**	**21,306**
of which: external	590,278	15.3	16.1	19,619	15,148
BALANCE	**-1,992,649**			**28,199**	**31,448**

Source: Bank of Italy, financial accounts.
(1) The data refer to the non-financial corporations sector. Rounding may cause discrepancies in totals. – (2) Short-term foreign claims, intra-group claims, insurance technical provisions, domestic derivatives and other minor items. – (3) Includes finance provided by leasing and factoring companies, intra-group loans and securitized loans. – (4) Postal current accounts, severance pay and pension provisions, domestic derivatives and other minor items.

Figure 6.3

Leverage and composition of financial debt (1)
(per cent)



Sources: Bank of Italy, financial accounts, and Cerved.
Leverage is the ratio of financial debt to the sum of financial debt and shareholders' equity. – (2) Based on financial accounts; market prices. – (3) Based on Cerved balance sheets for 2014 on a sample of about 700,000 firms; book values.

Credit. – After three years of marked contraction, during 2015 the decline in lending to firms by banks and financial companies virtually came to a halt: this stabilization continued in the early part of this year, to -0.7 per cent in March 2016 (Table 6.4). Credit growth was still very uneven: lending began to expand for financially sound firms but continued to contract for riskier ones (see *Financial Stability Report*, No. 1, 2016). There is still a large gap between large and small firms that penalizes the latter, primarily due to their financial situation (typically more fragile) and to sector specialization.

Credit continued to reflect the weak demand for loans, which was affected by the still irregular trend in investment and slack demand for working capital: according to the BI Survey, in the second half of 2015 the balance between the share of firms that increased their demand for credit and the share that reduced it narrowed to 5.2 percentage points, the lowest level since the start of the financial crisis.

The highly expansionary stance of monetary policy led to a generalized drop in the cost of credit, which is now particularly low. During 2015 the interest rate spread on new loans vis-à-vis the euro-area average was almost eliminated.

The steady easing of lending conditions has mitigated the difficulties in accessing credit: according to the BI Survey, the share of companies reporting they had not been granted all or part of the credit requested fell to 6 per cent in 2015 compared with the peak of 12 per cent observed in 2012. Although the dispersion of the cost of credit declined it remains high: the differential between the rates applied to micro and large

Table 6.4

Lending to firms (1)
(end-of-period data; per cent)

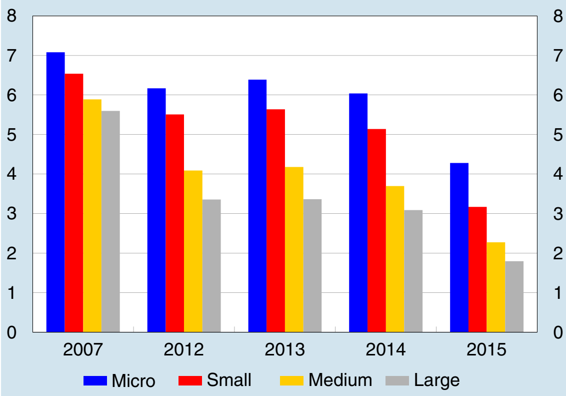
	12-month percentage changes				Percentage composition
	2013	2014	2015	March 2016	March 2016
			Banks		
Branch of economic activity					
Manufacturing	-6.1	0.0	1.6	1.4	22.0
Construction	-4.5	-3.0	-3.1	-3.2	15.0
Services	-6.8	-2.1	0.3	0.3	33.6
Real estate	-3.2	-3.1	-1.8	-1.8	11.6
Other	-4.7	-2.1	-4.1	-2.1	9.3
Size of firm					
Small (2)	-4.0	-2.3	-2.5	-2.5	17.2
Medium-sized and large	-5.3	-1.8	-0.3	-0.1	74.3
Total	**-5.1**	**-1.9**	**-0.7**	**-0.5**	**91.5**
			Financial companies		
Leasing	-4.2	-2.8	-3.8	-3.5	6.0
Factoring	-6.2	-4.1	4.0	3.7	1.8
Other financing	4.4	-0.4	-8.9	-10.5	0.7
Total	**-4.2**	**-3.1**	**-2.7**	**-2.7**	**8.5**
			Banks and financial companies		
Total	**-5.0**	**-2.2**	**-0.9**	**-0.7**	**100.0**

Source: Supervisory reports.
(1) The data refer to non-financial corporations and producer households. Loans include repos and bad debts. The data for financial companies refer to intermediaries under Article 107 of the Consolidated Law on Banking. The data for March 2016 are provisional. – (2) Limited partnerships, general partnerships, informal partnerships, de facto companies and sole proprietorships with less than 20 workers.

firms narrowed to 2.5 percentage points in 2015 from 3.0 percentage points in 2014, about 1 point more than at the start of the crisis (Figure 6.4).

Figure 6.4

Borrowing cost by firm size (1)
(per cent)



Sources: Based on Bank of Italy and Cerved data.
(1) Median values.

The obstacles faced by smaller companies continue to be mitigated by targeted financial support measures. From 2009 to 2015 the financial resources provided to SMEs through the Central Guarantee Fund and Cassa Depositi e Prestiti and by means of the partial suspension of loan repayments amounted to over €110 billion, equal to about 10 per cent of disbursements of bank loans below €1 million in the same period. According to an OECD comparative study,[3] government loan guarantee programmes – the tool most commonly adopted to facilitate lending to small and medium-sized enterprises – were widely used in Italy during the crisis. With the cyclical recovery and the return of credit risk to normal levels, the conditions are right to focus government intervention in the credit market on companies experiencing greater difficulty in obtaining loans, such as micro enterprises, in order to limit the distortionary effects on resource allocation.

Bonds. – In 2015 the volume of gross bond issues by Italian companies and their foreign subsidiaries increased slightly, reaching €30 billion. The recent decision of the ECB to extend its asset purchase programme to include bonds issued by non-bank financial companies has contributed to the improvement in market conditions observed last April (see Chapter 14, 'The money and financial markets'). After rising in the previous two years, the number of issuers began to shrink once again. The incentives to access the bond market are being undermined by the uncertain economic recovery, the steady improvement in bank lending conditions, and the poor demand for Italian firms' securities on the part of domestic investors (see the box 'Recourse to the bond market by Italian firms').

RECOURSE TO THE BOND MARKET BY ITALIAN FIRMS

Bonds make up 13 per cent of firms' financial debt in Italy, in line with the average proportion in the euro area but lower than in the United Kingdom and the United States (26 and 41 per cent respectively). Among small and medium-sized enterprises bond debt is practically negligible.

The state of development of this market in Italy reflects, in the first place, the characteristics of the entrepreneurial fabric: the limited number of listed companies and large firms, a high average level of debt, and a low propensity to

[3] OECD, *Financing SMEs and Entrepreneurs 2016, An OECD Scoreboard*, 2016.

invest in company expansion. An analysis of the Italian market shows, in keeping with the results of the international literature, that firms' recourse to the bond market depends essentially on three factors: good reputation and transparency towards investors, a sound economic and balance sheet situation, and a need to finance new investment.[1] Currently, only a very small number of firms in Italy meet these conditions.

In the case of small and medium-sized firms, recourse to the market is hindered not only by less availability of information on the firm, but also by the high fixed costs of issuance. The recent extension of tax advantages to the securities of unlisted companies (minibonds) has gone some way to reducing these costs, helping to increase placements. Between 2012 and 2015 minibond issuers, mostly medium-sized companies, numbered about 100. Firms' lack of knowledge about financing instruments alternative to bank credit continues to hold back the growth of this market: according to the Bank of Italy's Survey of Industrial and Service Firms, in 2015 nearly 40 per cent of firms did not know about the tax benefits introduced by the legislation on minibonds.

Firms' ability to access the bond market is also affected by the difficulty of placing their securities on the domestic market, where issue costs, especially for small companies, are generally lower than those obtaining on the international market. An analysis conducted on a sample of issues by Italian firms shows that resident investors hold only 27 per cent of the bonds issued, against 45 per cent in Germany and 49 per cent in France.[2] Investors' participation is hampered by the underdevelopment of intermediaries, such as private debt funds, specialized in placing and underwriting corporate debt instruments (see Chapter 13, 'Banks and institutional investors').

In the past few years Italian banks' and institutional investors' interest in the bond market has increased as a consequence both of low interest rates (which have spurred the search for higher-yielding assets) and of the new investment opportunities offered by the market in minibonds. Calculated with reference to a sample of issues by Italian small and medium enterprises, between 2013 and 2015 the share held by Italian banks rose from 13 to 17 per cent and that of institutional investors from 17 to 23 per cent, while that held by households fell from 58 to 36 per cent.

1 M. Accornero, P. Finaldi Russo, G. Guazzarotti and V. Nigro, 'First-time corporate bond issuers in Italy', Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), 269, 2015.

2 Based on ECB, Securities Holdings Statistics.

Equity. – In 2015 firms continued to strengthen their capital, driven by favourable conditions on the financial markets: net capital flows amounted to €28 billion (Table 6.3). As in the previous year, IPOs were concentrated in the market segment with a simplified admission process.

Based on the BI Survey, about half of the respondent firms said their equity capital had increased from 2012 to 2015; for over 10 per cent of these companies the decision was influenced by the presence of the tax incentives provided under the allowance for corporate equity (ACE), aimed at promoting business capitalization. A greater take-up of these fiscal incentives is still hampered by the lack of knowledge about it: over one third of firms, especially small ones, have never heard of it.

According to data released by AIFI, in 2015 investment by private equity and venture capital firms, relating to 342 transactions, amounted to €4.6 billion, more than 30 per cent higher than in 2014. Leveraged buy-outs accounted for 70 per cent of the resources. Investment in 'early stage' firms is increasing but still accounts for less than 2 per cent of the total.

Funding for start-ups, which operate mainly in the high-tech sectors, is small by international standards. Government incentives to encourage investment in equity, especially suitable for innovation activities, are therefore essential to address the problem of our country's growth lag (see the box 'Public sector support for innovative start-ups: a preliminary evaluation').

PUBLIC SECTOR SUPPORT FOR INNOVATIVE START-UPS: A PRELIMINARY EVALUATION

A number of public measures have been adopted in the past few years to stimulate innovation in Italian firms. In 2012 a separate section of the Company Register was instituted for innovative start-ups to encourage high-growth-potential firms and support them in their first years of activity;[1] entry is subject to quite stringent requirements in terms of age, size and propensity to innovate.[2] The law provides for numerous tax breaks, a considerable reduction in administrative costs, and facilitated access to outside financing: there are, in particular, significant tax incentives for investors in equity capital and simplified procedures for obtaining a public guarantee from the Central Guarantee Fund for Small and Medium-Sized Enterprises, which facilitates the granting of bank loans.

Since the law's entry into force more than 5,500 innovative start-ups have been listed in the register, over 70 per cent in business services and under 20 per cent in manufacturing; 60 per cent of the companies operate in high-technology sectors and more than half are based in northern Italy. An analysis of companies' financial statements for 2013 and 2014 shows that, compared with other start-ups, those entered in the register actually do have greater innovative capacity, as envisaged by the law: the share of their total assets consisting in intangibles, such as brands or patents, is more than 15 percentage points higher than that of other start-ups. They are slower to put their products or services on the market: 20 per cent of innovative start-ups still have no revenues up to two years after the commencement of activity, double the percentage for other start-ups. Innovative start-ups also have a higher investment rate (by more than 10 percentage points), more liquidity and equity capital, and thus a greater ability to sustain risky investments.[3]

---

1 Decree Law 179/2012, converted by Law 221/2012.

2 For a description of the requirements, the legislative references and the state of implementation of the support measures, see the section of website of the Ministry for Economic Development dedicated to innovative start-ups.

3 P. Finaldi Russo, S. Magri and C. Rampazzi, 'Innovative start-ups in Italy: their special features and the effects of the 2012 law',Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), forthcoming.

Many of the features described above may also derive from the standards of propensity to innovate that the law laid down for entry in the register. In order to separate out the effects deriving from the provisions of the law, a comparison was made between a small group of innovative start-ups and a sample of newly formed companies that had very similar features before the law's entry into force. The comparison shows that between 2012 and 2014 innovative start-ups operating in services – the most numerous group – had a higher growth rate of external financing, through debt or equity capital, as a result of the incentives provided by the law. However, a boost to investment rates compared with the firms in the control sample is only found where there is a significant increase in the level of equity capital, which again proves to be the most suitable source of financing for innovation.

7. HOUSEHOLDS

The upturn in household consumption that began in mid-2013 continued last year, spreading to all the main expenditure items. Purchasing power increased for the first time since 2008, partly thanks to better labour market conditions and the income support measures introduced by the Government in 2014 on a temporary basis and later made permanent. Household spending and purchasing power are still below pre-crisis levels, however, by about 6 and 10 percentage points respectively.

Household confidence has improved markedly. The share of households reporting difficulty making ends meet each month diminished further. The recovery in income is still weak, though, and unlike previous recessions has not gone hand in hand with a higher propensity to save, which remains unprecedentedly low. The poverty index continues to be high but is no longer rising rapidly as it did during the crisis.

Household wealth increased: the financial component was boosted by the revaluation of portfolio assets and the real estate component by the increase in the stock of residential property while prices held stable. The increase in property sales under way since 2014 gained traction thanks in part to better financing conditions. Lending to households began to pick up again; the increase in disposable income and low interest rates are gradually reducing the financial vulnerability of even the weakest segments of the population.

Income and income distribution

Households' purchasing power increased in 2015 (by 0.8 per cent) for the first time since 2008 (Table 7.1), thanks to faster growth in disposable income at current prices and virtually zero consumer price inflation (see Chapter 9, 'Prices, costs and competitiveness'). Employment income grew with the increase in dependent jobs (see Chapter 8, 'The labour market') and in per capita earnings. Self-employment income also rose, despite a further drop in the number of people working for themselves, as did net property income, which was boosted by rising rental income and dividends. The improvement in households' purchasing power was held back, however, by slower growth in disbursements of social security benefits in cash and by the increase in personal income tax revenue as a result of the larger tax base (see Chapter 11, 'The public finances').

According to the latest edition of the Bank of Italy's twice-yearly Survey on Household Income and Wealth, in 2014 the Gini index (computed on the basis of equivalent disposable income; Table 7.2) was virtually unchanged from 2012 and close to the levels recorded prior to 2008 (see Chapter 15, 'Italian households' income and

Table 7.1

Gross disposable income and the propensity to save (1)
(at current prices, unless otherwise indicated)

	% of households' gross disposable income in 2015	2013	2014	2015
		Percentage changes		
Employment income	61.0	-1.0	0.4	2.0
Income per full-time equivalent dependent worker	–	1.2	0.0	0.6
Self-employment income (2)	26.2	-1.3	-0.6	0.3
Income per full-time equivalent self-employed worker	–	1.7	-0.6	0.7
Net property income (3)	22.4	2.3	-2.0	0.7
Social benefits and other net transfers	32.5	2.4	2.2	1.7
of which: net social benefits	*33.7*	2.3	1.9	1.7
Net social security contributions (-)	23.3	-0.7	0.0	2.1
of which: paid by employers	*15.3*	-1.5	-0.4	1.7
Current taxes on income and wealth (-)	18.9	-0.7	0.4	3.2
Gross disposable income	**100.0**	**0.6**	**0.3**	**0.9**
In real terms (4)	–	-0.6	0.0	0.8
In real terms, adjusted for expected inflation (4) (5)	–	0.6	1.5	1.1
In real terms, adjusted for past inflation (4) (6)	–	0.9	0.8	0.6
		Percentage shares		
Average propensity to save (7)	–	**8.5**	**7.9**	**7.8**
Calculated on income adjusted for expected inflation	–	6.8	7.6	7.8
Calculated on income adjusted for past inflation	–	7.7	7.8	7.6

Sources: Calculations and estimates based on Istat and Bank of Italy data.
(1) Data for consumer households. – (2) Mixed income and income withdrawn by members of quasi-corporations. – (3) Gross operating profit (mainly rental income), net rents from land and intangible assets, actual net interest, dividends and other profits distributed by companies. – (4) Deflated using the consumer household consumption deflator. – (5) Gross disposable income net of expected losses on net financial assets due to inflation (estimated on the basis of the Consensus Economics survey). – (6) Gross disposable income net of losses on net financial assets due to inflation calculated ex-post. – (7) Ratio of saving (gross of depreciation and net of changes in pension fund reserves) to gross disposable income.

wealth: a long-term view'). Overall, the financial crisis had not significantly increased inequality:[1] the drop of about 14 per cent in real equivalent disposable income since 2006 affected almost the whole of income distribution equally.

According to Istat's estimates, available until 2014, the absolute poverty index[2] was unchanged from a year earlier at about 7 per cent of the population, having more than doubled during the financial crisis. The labour market recovery

[1] A. Brandolini, 'Il Grande Freddo. I bilanci delle famiglie italiane dopo la Grande Recessione', in C. Fusaro and A. Kreppel (eds.), *Politica in Italia. I fatti dell'anno e le interpretazioni. Edizione 2014*, Bologna, Il Mulino, 2014.

[2] 'Absolute poverty' is defined as a lack of sufficient resources to purchase a basket of essential goods and services.

Table 7.2

Equivalent disposable income (1) (2)
(euros at 2014 prices and percentage changes, unless otherwise indicated)

	2014	2008-06	2010-08	2012-10	2014-12
Average equivalent income	17,910	-2.7	0.5	-10.8	-1.3
Centre and North	20,428	-2.4	0.5	-12.9	-1.2
South and Islands	13,147	-4.2	0.0	-4.6	-1.6
Production worker, apprentice, sales assistant	13,337	-6.5	-1.3	-9.0	3.0
Clerical worker, technician, teacher	20,848	-1.3	2.5	-7.6	-2.0
Manager	34,152	-6.0	-9.0	-3.2	-10.9
Self-employed worker	23,516	-7.1	2.9	-11.1	-1.8
Pensioner	18,695	4.8	-1.7	-5.5	-2.2
Not employed non-pensioner	6,003	-9.3	6.2	-18.2	-10.3
1 member	19,207	-6.8	2.2	-13.1	3.1
2 members	21,313	-0.1	1.0	-10.0	1.5
3 members	19,222	2.2	-2.0	-7.8	-4.3
4 members	16,308	-3.7	1.7	-15.3	0.1
5 or more members	12,288	-16.7	-1.4	-3.4	-7.3
Home owner	20,665	-1.3	1.8	-9.3	-1.3
Tenant	10,193	-9.9	-3.1	-13.6	-5.7
Gini index (3) (4)	0.329	0.005	0.001	0.004	-0.002
Centre and North	0.294	0.004	0.001	0.013	-0.011
South and Islands	0.346	0.006	0.002	0.005	0.018
Interdecile ratio (4) (5)	4.7	0.1	0.1	0.1	0.1

Source: Bank of Italy, Historical Archives (Version 9.0, December 2015).
(1) Total household income (including imputed rents for owner-used dwellings) net of direct tax, divided by the household consumption deflator (national accounts) and made comparable using the OECD's modified equivalence scale (which attributes a value of 1 to the first adult member of the household, 0.5 to every other member aged over 13, and 0.3 to every member aged 13 or under). The observations are weighted for the number of members of the household to obtain an average equivalent income for each one of them. – (2) The occupational status is that of the household head, defined as the person with the highest labour or pension income. – (3) The Gini index ranges from 0 (perfect equality) to 1 (maximum inequality). – (4) Twice-yearly changes calculated as percentage differences. – (5) Ratio of equivalent disposable income at the 9th highest decile to that at the 1st lowest decile.

probably helped to reduce poverty in 2015; the share of jobless households[3] fell from 16.8 to 16.4 per cent and the proportion of average to low wage earners (i.e. with less than two thirds of the pre-recession median monthly wage) decreased from 19.6 to 18.5 per cent.

Average to low earning payroll workers again received the 'tax bonus' that was converted into a permanent income support measure by the 2015 Stability Law (Law 190/2014; see the box 'The tax bonus and household consumption'). As no changes were made to the design of the measure, though helping to support consumption it probably had a limited impact on poverty reduction, as in 2014, because most of the beneficiaries were from households in the middle quintiles of income distribution (see Chapter 7, 'Households', *Annual Report*, 2014).

[3] In line with the Eurostat definition, jobless households are those with at least one working-age person (18-59 years of age, excluding full-time students under 25 living with their parents) and no members in work.

THE TAX BONUS AND HOUSEHOLD CONSUMPTION

Since May 2014 a 'tax bonus' introduced by Legislative Decree 66/2014 has been paid to dependent workers with gross annual earnings of between €8,145 and €26,000. This income support measure, which became permanent last year, amounts to €80 a month for each payroll employee earning up to €24,000 per annum, decreasing thereafter and no longer paid on annual salaries of €26,000 and over (see Chapter 7, 'Households', *Annual Report*, 2014). According to the Survey on Household Income and Wealth,[1] just over one fifth of households (about 5.4 million) reported that they had received a monthly average bonus of €86 in 2014 (see the table). As the bonus is computed on individual income and not household income, it also went to a significant number of households with fairly high income (see Chapter 7, 'Households', *Annual Report*, 2014) and increased with the number of earners. The largest percentages of beneficiary households were in the North of the country (25 per cent) and were headed by someone under 45 years of age (38 per cent) or born abroad (33 per cent; see the table).

Households in receipt of the tax bonus and average amount obtained in 2014
(percentage changes, averages)

Head of household	Share of beneficiary households	Average monthly amount (€)
Age		
34 and under	37.5	89
35 to 44	37.5	85
45 to 54	25.1	87
64 and over	2.4	82
Education		
No qualification	2.2	69
Primary school	4.6	89
Middle school	28.1	85
Upper secondary school	28.7	87
University	20.8	84
Work status		
Payroll employee	42.2	87
Self-employed	10.8	77
Not in work	3.2	81
Number of recipients		
1	14.8	76
2	28.2	90
3	35.6	89
4 or more	43.7	120
Geographical area		
North	25.4	86
Centre	19.0	89
South and Islands	18.5	83
Country of origin		
Italy	20.8	86
Other	33.0	89

The households interviewed reported that they had spent 90 per cent of the bonus during 2014, setting the rest aside as savings or to repay debts; provisional figures for 2015 show the same trends. However, studies have often noted that the interviewees find it difficult to say precisely what they did with a specific source of

[1] *Household Income and Wealth in 2014*, Supplements to the Statistical Bulletin, 64, 2015, forthcoming in English.

income, particularly a small one – on average the monthly bonus amounts to about 3 per cent of beneficiary households' disposable income.

By collecting information from the same households over several years the Survey is able to overcome this problem and estimate the marginal propensity to consume[2] of the households that received the bonus compared with those that did not (controlling for socio-demographic differences between the two groups).[3] About half of the bonus disbursed in 2014 was spent that year; this fits in with the nature of the bonus, which also went to high-earning households that generally have less propensity to consume. Applying the resulting estimate to the transfer from the government we find that consumption increased by about €3.5 billion, or about 40 per cent of the total increase in household spending in 2014.

Households with cash constraints had a greater marginal propensity to consume the bonus. Indeed, those whose net financial wealth in 2014 was less than half their annual disposable income spent between 60 and 80 per cent of the bonus.

---

2 Marginal propensity to consume is the increase in household consumption per €1 increase in income.

3 A. Neri, C. Rondinelli and F. Scoccianti, 'The marginal propensity to consume out of a tax rebate: the case of Italy', paper presented at the conference 'The Bank of Italy's analysis of household finances. Fifty years of the Survey on Household Income and Wealth and the Financial Accounts', Rome, Bank of Italy, 3-4 December 2015.

Poverty has always been greater in Italy than in the leading European countries, partly because of the lack of universal policies to combat it. With the 2016 Stability Law (Law 208/2015) and associated draft enabling act, Italy is on the point of introducing an ad hoc measure by setting up the Fund for Combating Poverty and Social Exclusion, which will have an initial endowment of €600 million in 2016 and €1 billion in 2017 and in 2018. The resources for the current year, which added to the sums already allocated for a total of almost €1.4 billion, will be used to extend nationwide the Support for active inclusion scheme, aim to reduce poverty among households with minors (so far it has been trialled in towns with over 250,000 inhabitants) and to finance an unemployment allowance for low-wage earners whose ordinary income support has timed out (see the box 'The Jobs Act: a preliminary evaluation', Chapter 8).

The Government instead plans to use next year's resources to introduce a new nationwide measure to combat poverty that is not restricted to specific categories like the present measures, which are due for review.[4] The Ministry of Labour and Social Policies estimates that eliminating absolute poverty will require substantial resources, considerably more than the amount currently allocated for the purpose.

Consumption

Italian households' consumption increased by 0.9 per cent in 2015 (Table 7.3). The sharp rise in goods purchases was undermined only in part by a slackening of expenditure on services; spending on non-durable goods increased on an annual

---

4 'Audizione preliminare sulla delega recante norme relative al contrasto della povertà, al riordino delle prestazioni e al Sistema degli interventi e dei servizi sociali (collegato alla legge di stabilità 2016)', testimony of P. Sestito, Head of the Structural Economic Analysis Directorate of the Bank of Italy, before the Chamber of Deputies, Rome, 4 April 2016.

Table 7.3

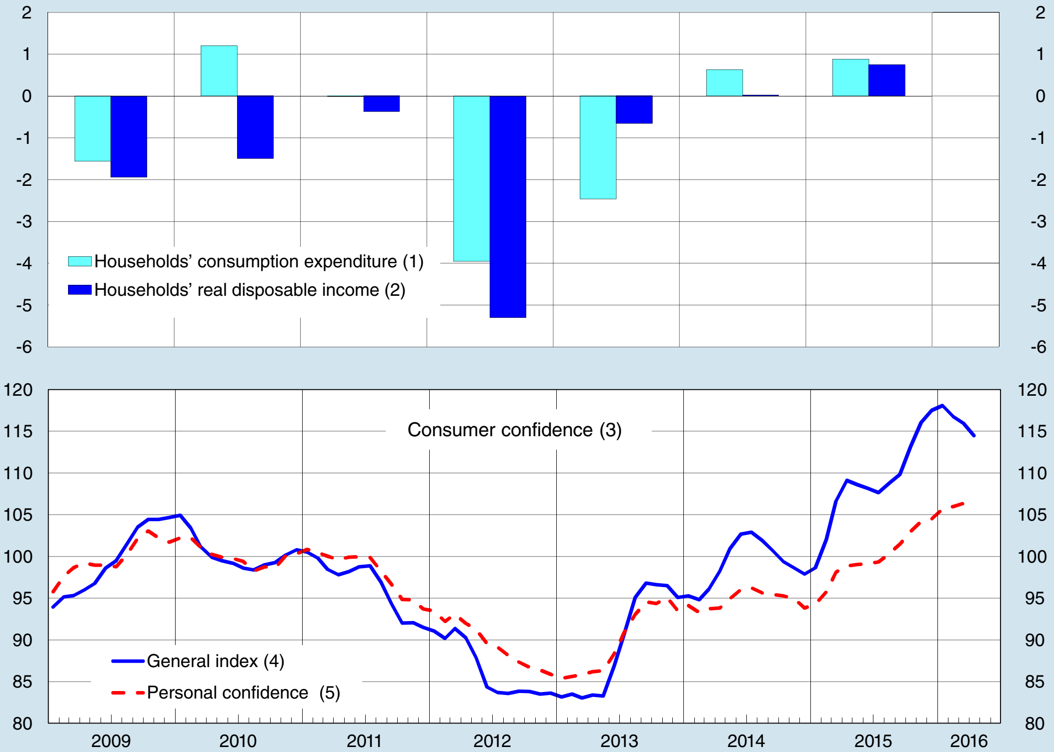
Households' expenditure
(chain-linked prices, unless otherwise indicated; percentage changes)

	% in 2015 (volumes at previous-year prices)	2012	2013	2014	2015
Goods	47.6	-6.3	-3.6	0.2	1.4
Non-durable goods	31.6	-4.4	-3.0	-0.6	0.3
of which: food and non-alcoholic beverages	14.1	-4.0	-2.4	-0.3	0.2
Semi-durable goods	8.9	-9.2	-4.5	0.4	1.2
of which: clothing and footwear	6.2	-7.9	-2.6	0.3	1.4
Durable goods	7.2	-10.2	-5.2	3.5	6.9
Services	52.4	-1.3	-1.2	1.0	0.7
of which: hotels and restaurants	9.7	-1.1	-1.4	0.3	1.1
education	1.1	-1.6	-4.3	1.2	2.7
Total domestic expenditure	**100.0**	**-3.8**	**-2.4**	**0.6**	**1.1**
Spending abroad by Italian residents	(1)	-6.1	-1.6	6.8	-1.6
Spending in Italy by non-residents	(1)	0.8	1.8	3.4	4.6
Total national expenditure	–	**-3.9**	**-2.5**	**0.6**	**0.9**
Memo:					
National consumption deflator	–	2.7	1.2	0.2	0.1

Source: Istat, national accounts.
(1) In 2015 spending abroad by Italian residents and that in Italy by non-residents came to 1.7 per cent and 3.6 per cent of national expenditure respectively.

Figure 7.1

Consumption, real income and consumer confidence
(growth rates and indices)

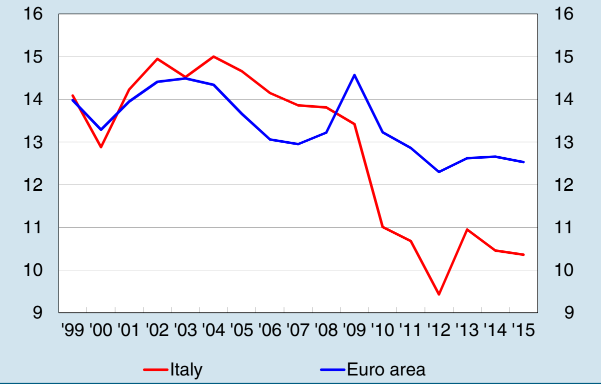


Source: Based on Istat data.
(1) Consumption expenditure of households and non-profit institutions serving households; chain-linked volumes; percentage changes on the previous year. – (2) Real disposable income of households and non-profit institutions serving households, deflated using the consumption expenditure deflator for resident households. – (3) Indices, 2010=100; seasonally adjusted data; moving averages for the 3 months ending in the reference month. – (4) Obtained by calculating the balances between the percentages of replies indicating a situation that is improving or worsening in response to questions on: the general economic situation in (a) the past 12 months and (b) over the next 12 months; the respondents' personal economic situation in (c) the past 12 months and (d) over the next 12 months; the advisability of durable goods purchases (e); expected unemployment (f); the possibility (g) and advisability (h) of saving; households' financial situation (i). – (5) Average of the balances between the percentages of replies to (c), (d), (e), (g), (h) and (i).

basis for the first time since 2010, while that on durables and semi-durables grew faster than in 2014. For the second consecutive year there was a marked increase in new car registrations, up by 15.4 per cent; the number continued to rise in the first four months of this year (by 18.6 per cent on the year-earlier period), signalling an even stronger recovery of consumption this year.

Figure 7.2

Households' saving ratio (1)
(annual data; per cent)



Source: Eurostat.
(1) Includes consumer and producer households and non-profit institutions serving households.

Households' expenditure was buoyed by the recovery of purchasing power, partly thanks to the income support measures (see the box 'The tax bonus and household consumption') and to improved confidence (Figure 7.1). Consumption also increased in response to better consumer credit conditions and greater financial and real estate wealth (see the section 'Household wealth, the housing market and borrowing'). Accordingly, households' saving rate, which they had reduced sharply during the recession in order to maintain consumption levels, stabilized at around 7.8 per cent net of changes in pension fund reserves (Table 7.1); in the Eurostat definition the saving rate is below the average for the euro area (Figure 7.2).

Istat's consumer confidence indicator was again high in the first four months of 2016, but with signs of less optimism for the future. The preliminary findings of the Bank of Italy's Survey on Household Income and Wealth conducted in the same period indicate that the share of households reporting difficulty making ends meet each month has dropped from 66 per cent a year earlier to 60 per cent, the lowest level since 2002. Nearly one in five households, however, reported serious financial difficulties, the same proportion as in the last two surveys. The percentage of households expecting to have saved part of their income by the end of this year is slightly up on last year's figure, from 24 to 26 per cent.

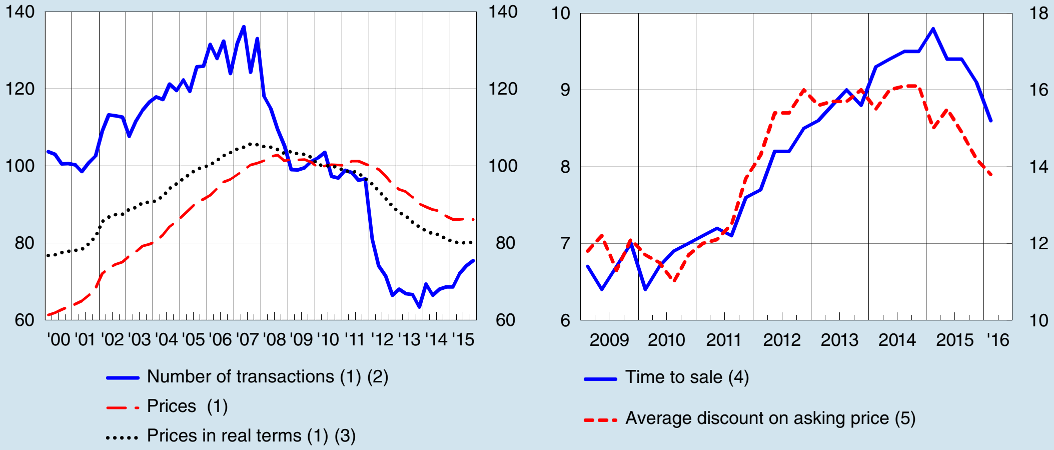
Household wealth, the housing market and borrowing

Household wealth increased by 1.2 per cent and at the end of the year amounted to 9.6 times disposable income (1.3 per cent and 8.8 times net of liabilities). Financial wealth increased by more than real assets.

Real assets and the housing market. – The value of households' accumulated real wealth began to rise again in 2015 as the stock of housing increased and property prices stabilized in the second half of the year after the sharp decline of 2014 (Figure 7.3). House prices have fallen by about 15 per cent since the start of the sovereign debt crisis (see the box 'Trends in residential property prices in Italy and their determinants').

Figure 7.3

Residential property market



Sources: Based on data from Agenzia delle Entrate, Bank of Italy, Istat, *Consulente immobiliare* and the quarterly *Italian Housing Market Survey. Short-term outlook*, conducted jointly by Bank of Italy, Tecnoborsa and OMI.
(1) Quarterly data; index numbers, 2010=100. – (2) Adjusted for seasonal and calendar effects. – (3) House prices deflated using the consumer price index. – (4) Measured in months. – (5) Right-hand scale; per cent.

TRENDS IN RESIDENTIAL PROPERTY PRICES IN ITALY AND THEIR DETERMINANTS

After rising steadily in Italy from the middle of 1995 until the end of 2008, house prices were virtually stable until the third quarter of 2011 and then fell until early 2015, losing 15 per cent overall. Prices peaked in real terms at the end of 2007 and then declined by about a quarter until they stabilized at the beginning of last year close to their 2001 values.

Econometric studies show a trend in house prices in line with that of the main underlying determinants during the various phases of the cycle, confirming that were no major risks of an overvaluation either in the twenty years prior to the global financial crisis or in the years after.[1]

The decrease in residential property prices since 2008 is due above all to the decline in households' disposable income, down about 10 per cent in real terms from 2007 to last year with an especially sharp drop during the sovereign debt crisis. A further contributory factor, particularly from the summer of 2011 to the beginning of 2014, has been households' increased difficulty in accessing credit, leading to slower growth in home purchase loans. House prices have also been affected, though to a smaller extent, by an easing of demographic pressure on the demand for habitable space as well as the numerous changes to property taxes since 2012 which have made the future taxation of housing appear uncertain.

The increasingly accommodative stance of monetary policy has to some extent offset these factors, notably through a reduction in money market rates – which has been passed on to the cost of lending to households – and the

[1] A. Nobili and F. Zollini, 'A structural model for the housing and credit markets in Italy', Banca d'Italia, Temi di Discussione (Working Papers), 887, 2012; M. Loberto and F. Zollino, 'Housing and credit markets in Italy in crisis time', Banca d'Italia, Temi di Discussione (Working Papers), forthcoming.

progressive easing of tension on the banking and financial markets – which has led to lower yields on public debt securities after their increase at the height of the crisis had weighed heavily on banks' lending standards. It is estimated that these two channels have boosted house prices by almost 1 percentage point in the last three years; however, the credit expansion has been held back by the need for Italian banks to strengthen their capital base.

The signs of housing market recovery gradually strengthened. According to the Revenue Agency's property market observatory (OMI) house sales increased by 6.5 per cent, against 3.6 per cent in 2014, notably in the North and in the provincial capitals. In autumn the seasonally adjusted number of sales was the highest of the last three years but still 45 per cent below the peak recorded in 2007 (Figure 7.3).

Although the stock of unsold new-builds remains large it is declining. In a survey of construction companies run by the Bank of Italy's branches, 62 per cent reported a larger than normal stock of unsold properties last year, down from 74 per cent in 2014. The drop in prices eased considerably over the year as a whole, from -4.4 per cent in 2014 to -2.4 per cent, thanks to the increase in households' disposable income and more relaxed conditions for home purchase loans; prices declined even less for new-builds. Uneven demand and supply conditions across the country have caused considerable variations in house prices which stem more from differences between urban and non-urban areas, and between centre and suburbs, that from the divergence between northern and southern regions (see the box 'Urban agglomeration and house prices').

URBAN AGGLOMERATION AND HOUSE PRICES

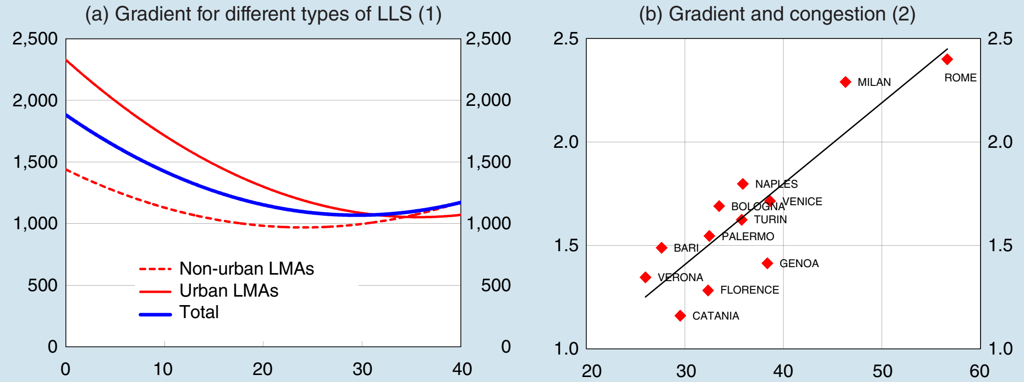
The agglomeration process and the advantages of spatial concentration of households and firms affect house prices, which are usually highest in urban areas; in turn, this can reduce labour mobility and the economic growth of cities. A recent study[1] examines nationwide price heterogeneity between different geographical areas and shows that the differences between urban and non-urban local labour market areas (LMAs), and within them between centre and periphery, are often greater than between the Centre and North and the South.

In urban LMAs house prices are usually more than 50 per cent higher than in non-urban ones. There are even greater differences within a single LMA, particularly according to the distance from the centre. The price curve expressed as a function of this distance (centre-periphery gradient) has a negative and steeper slope close to the point of origin: 20 kilometres further away, prices are about 50 per cent lower (figure, panel a). The slope becomes steeper in urban LMAs; however, the degree of urbanization explains only some of the observed heterogeneity: for example, the gradient is especially steep in Milan and Rome but fairly flat in some metropolitan areas of the South and Islands (Bari, Catania and Palermo).

[1] E. Manzoli and S. Mocetti, 'I prezzi delle case e il gradiente centro-periferia: evidenze dalle città italiane', Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), forthcoming.

The difference in gradient slope between LMAs depends on multiple factors: the gradient is steeper, for example, in LMAs heavily specialized in businesses with marked spatial concentration (services, above all financial and professional); in turn, increased congestion, which is generally associated with poor transport infrastructure compared with demand, makes the periphery less attractive and increases the pressure on prices in the central areas of the LMA (figure, panel b).

Centre-periphery gradient of house prices
(euros per square metre, kilometres and minutes)



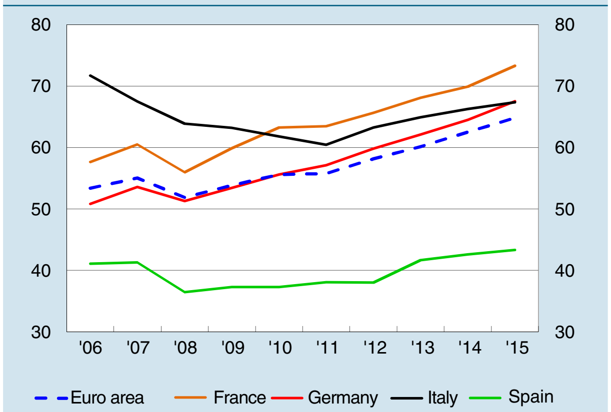
Sources: Based on OMI and Istat data.
(1) The lines join the prices of houses in each town (vertical axis) to the distance from the centre of their LMA (horizontal axis); for the centroid town, prices in the centre, semi-centre and periphery are considered separately. – (2) The gradient (vertical axis) is measured as the ratio of house prices in the centroid town to house prices in the other towns in the LMA; travel times (horizontal axis) correspond to the minutes taken by workers in the LMA to reach the centroid town.

According to the Housing Market Survey conducted in April by the Bank of Italy with Tecnoborsa and OMI, conditions on the residential housing market continued to improve slowly in the first quarter of this year. The number of potential buyers increased further, while the average discount on asking prices and average sale times continued to diminish, if only slightly (Figure 7.3; see 'Italian Household Market Survey. Short-term Outlook, April 2016', *Supplements to the Statistical Bulletin*, 25, 2016). Estate agents' expectations for the short and medium term have improved since the end of last year.

Financial wealth and investment. – Consumer and producer households' financial wealth increased by 2.2 per cent, or 2.8 per cent net of liabilities, mainly owing to the rise in the prices of financial assets. Per capita wealth returned to the level of 2007, when it was well above the euro-area average, whereas by the end of 2015 the gap had virtually closed (Figure 7.4). This was due not only to the larger drop in the value of financial assets, which continued

Figure 7.4

Per capita financial wealth (1)
(thousands of euros)



Sources: ECB and Eurostat.
(1) The population figure for 2015 is estimated.

to decline in Italy until 2011 owing to the sovereign debt crisis, but also to the lack of new investments in financial assets caused by the sharper reduction in the saving rate and weaker income growth.

Table 7.4

Households' financial assets and liabilities (1)
(millions of euros and per cent)

	End-of-period stocks			Flows	
	2015	Percentage composition		2014	2015
		2014	2015		
ASSETS (2)					
Bank deposits (3)	1,076,729	27.3	27.4	16,390	28,140
Italian	1,046,129	26.5	26.6	16,216	27,957
Sight deposits	543,734	13.1	13.8	10,648	42,063
Other deposits	502,395	13.5	12.8	5,568	-14,106
Foreign	30,600	0.8	0.8	174	183
Debt securities	526,149	16.6	13.4	-78,111	-123,965
Italian	417,358	13.6	10.6	-62,878	-116,269
of which: issued by the public sector	173,585	4.9	4.4	-23,165	-32,203
issued by banks	237,498	8.5	6.0	-40,128	-80,659
Foreign	108,791	3.0	2.8	-15,233	-7,697
Investment fund units	380,184	8.1	9.7	27,817	56,530
Italian	203,018	4.2	5.2	9,247	33,147
Foreign	177,166	3.8	4.5	18,570	23,383
Shares and other equity	864,239	21.7	22.0	27,313	2,016
Italian	818,854	20.7	20.8	25,385	1,263
Foreign	45,385	1.1	1.2	1,927	753
Insurance, pension fund reserves and severance pay entitlements	803,845	19.2	20.4	22,407	53,341
of which: life insurance reserves	518,867	11.9	13.2	18,625	46,399
Other assets (4)	282,794	7.1	7.2	4,219	12,826
Total assets	**3,933,939**	**100.0**	**100.0**	**20,034**	**28,887**
LIABILITIES					
Short-term debt	58,795	6.4	6.4	-529	1,052
of which: to banks	57,840	6.2	6.3	-230	1,498
Medium- and long-term debt	634,042	69.7	69.2	-9,894	-7,112
of which: to banks	538,832	59.4	58.8	-7,235	-6,995
Other liabilities (5)	222,911	23.9	24.3	1,715	3,252
Total liabilities	**915,747**	**100.0**	**100.0**	**-8,708**	**-2,808**
BALANCE	**3,018,192**			**28,741**	**31,695**

Source: Bank of Italy, financial accounts.
(1) Consumer households, producer households and non-profit institutions serving households. Rounding may cause discrepancies in totals. – (2) Individually managed portfolios are not shown; their assets are included under the individual types of investment. – (3) Includes those of Cassa Depositi e Prestiti. – (4) Accounts receivable, BancoPosta current accounts, banknotes, coins and some minor items. – (5) Accounts payable, severance pay and pension provisions, and some minor items.

Households purchased financial assets, net of sales, for €24 billion, about one third of the figure for 2007 (Table 7.4). Their investment decisions continued to reflect the search for a better risk/return trade-off given the low level of interest rates. They continued to replace public sector securities and bank bonds with asset management products (investment fund units and insurance products), which overtook the share of liquid assets (cash and deposits) in their portfolios as in the period before 2007.

According to data from the Survey on Household Income and Wealth, the households with the most diversified portfolios belong to the highest quartile of equivalent income distribution; 16 per cent of these hold at least two types of financial instrument, mostly public sector securities and bank stock, in addition to deposits. Households in the low-income quartile have at most deposits.

Borrowing. – Household debt to banks and finance companies began to rise again in 2015; by international standards, though, borrowing was still low in relation to disposable income. Borrowing from just banks grew at a faster pace from the middle of 2015, reaching 1.1 per cent in March this year. The overall area-wide increase was slightly greater, at 1.6 per cent, with an acceleration in France and Germany, to 3.7 and 2.9 per cent respectively, and a further slowdown in Spain (-1.8 per cent).

New mortgage lending to consumer households accelerated (see *Financial Stability Report*, No. 1, 2016) thanks to stronger demand underpinned by low interest rates and a better outlook for the housing market, as well as by more relaxed supply conditions. In March this year the total value of house purchase loans was up 0.7 per cent on twelve months earlier (Table 7.5).

Table 7.5

Lending to consumer households (1)
(end-of-period data; millions of euros and per cent)

	12-month percentage changes					Stocks at March 2016 (2)
	December 2013	December 2014	June 2015	December 2015	March 2016	
			Loans for house purchase			
Banks	-1.1	-0.6	-0.2	0.5	0.7	344,373
			Consumer credit			
Banks	-1.9	-0.7	1.5	5.1	6.8	82,345
Financial companies	-1.9	0.3	-1.7	-2.0	-1.6	33,517
Banks and financial companies	**-1.9**	**-0.2**	**0.0**	**2.1**	**3.4**	**115,862**
			Other loans (3)			
Banks	0.1	1.9	1.6	1.0	0.7	110,059
			Total loans			
Banks and financial companies	**-1.0**	**-0.1**	**0.2**	**1.0**	**1.3**	**570,293**

Source: Supervisory reports.
(1) Loans include repos and bad debts. For March 2016, provisional data. – (2) Including securitized loans. – (3) Mainly current account overdrafts and loans other than those for the purchase, construction or restructuring of residential properties.

Thanks to better supply conditions, mainly in the form of a reduction in the interest spreads applied by banks, the annual percentage rate of charge (APRC) on new mortgage loans has fallen steadily, reaching 2.7 per cent in March this year. Interest spreads have contracted more in the case of fixed rate mortgages since the end of 2014; they were down to 2.7 per cent in March, though still 0.4 percentage points above the area-wide average. The gap with respect to new adjustable rate mortgages has narrowed, prompting more borrowers to choose fixed rate loans and to renegotiate, transfer or replace existing mortgages in order to lower their debt service costs: together, the reduction in interest rates and rise in disposable income helped to make households less financially vulnerable (see *Financial Stability Report*, No. 1, 2016 and the box 'The effect of low interest rates on household debt').

THE EFFECT OF LOW INTEREST RATES ON HOUSEHOLD DEBT

The annual percentage rate of charge (APRC) on new mortgage loans, which make up most of household debt, was reduced to 2 percentage points below the level recorded in early 2012 at the time of the sovereign debt crisis. At first, the reduction was the result of a lowering of reference rates in response to expansionary monetary policies; later, banks also reduced their interest spreads.

As for the stock of loans, the lowering of reference rates had a direct and immediate effect on adjustable rate mortgage loans, which accounted for three quarters of outstanding mortgages from 2012 to 2015. Interest spreads, on the other hand, can only be narrowed in the case of renegotiated, transfer or replacement mortages. Such operations related to €26 billion of mortgage loans from the beginning of 2015 to March this year, that is more than a third of the total value of loans granted in 2012-14, on which the interest spread was high.[1] According to the Survey on Household Income and Wealth, 5 per cent of households with a mortgage loan had obtained better conditions in 2014. Preliminary estimates for 2015 indicate that the proportion of households that have renegotiated rose to 9 per cent; half of the borrowers who have not changed their contract are still paying almost 1 percentage point over the interest rate on new mortgage loans.

Overall, it appears that while many borrowers have benefited from lower interest rates, an even larger number have failed to do so. Borrowers in other countries are equally slow to renegotiate their mortgage loans:[2] because the operation is complex and involves setting the benefit of better conditions against the cost and time of renegotiation, the households that most often took advantage of the possibility had the highest incomes, higher than the median, and better financial education.

Lower interest rates led to a decrease in debt service between 2012 and 2014. The proportion of vulnerable households – those whose mortgage instalments represent more than 30 per cent of their income, which is below the median value – decreased from 2.8 to 2.1 per cent of total households.

Low interest rates boosted credit demand and encouraged a preference for fixed rate mortgage loans. Disbursements of new mortgages began to pick up in 2014 and the following year rose by over 30 per cent. The Survey on Household Income and Wealth found that the percentage of households applying for a home purchase loan

---

1 For fixed rate mortgages, it is not only narrower interest spreads that are important but also lower reference rates, which were at their highest in 2008. If we include fixed rate mortgage loans disbursed from 2007 to 2011 the share of mortgage loan contracts that were amended from 2012 drops to just over 20 per cent.

2 J. Campbell, 'Household Finance', *The Journal of Finance*, 61, 4, 2006, pp.1553-1604.

had increased. New fixed rate mortgage loans have now soared to 60 per cent, partly because of the narrower gap between their cost and that of adjustable rate mortgages; in March this year the difference was 0.7 percentage points, a quarter of the peak recorded in 2009. More widespread use of fixed rate mortgages reduces the interest rate risk for households.

According to the regional bank lending survey conducted by the Bank of Italy's branches, the average loan to value ratio rose further in 2015, from 58.6 per cent in 2014 to 59.4 per cent. Moreover, the share of outstanding mortgages that can be extended or temporarily suspended at no charge almost doubled, to 38 per cent. In 2015 repayment holidays were granted on 2.5 per cent of mortgages in value terms, against 2.9 per cent in 2014; almost three quarters of these suspensions were either envisaged in the loan contract or conceded by private arrangement with the bank; the remainder were financed from the solidarity fund or the agreement between the Italian Banking Association (ABI) and consumer associations to which households resorted mainly because of job loss.

The growth in consumer credit outstripped that of 2014. Demand increased mainly in response to the upturn in household spending and generally better economic outlook. Banks and finance companies gradually became more accommodating: the APRC fluctuated around 8.4 per cent, about half a percentage point below the average for 2014 but still 2 points higher than the area average. In December 2015 consumer credit was 2.1 per cent up on a year earlier, in March this year 3.4 per cent (Table 7.5). Most of the increase was in lending for specific purchases, in line with the rapid growth in spending on durables.

According to the Survey on Household Income and Wealth, in 2014 just over one third of consumer loans were taken out by households whose equivalent income was at or below the median value, a small share by previous standards. In order to assist households having difficulty meeting payments on their consumer loans, in April last year the ABI and several consumer associations signed an agreement for the period 2015-17 that would allow repayments of principal to be postponed for a maximum of twelve months; previously the only available repayment holidays were for mortgages. By February 2016 a total of 7,000 contracts had been suspended, equal to about 0.1 per cent of the existing ones, mostly owing to job termination.

8. THE LABOUR MARKET

As economic growth resumed, employment rose more steadily last year, benefiting from the social security contribution relief for permanent hirings introduced at the beginning of the year and, to a smaller but still significant extent, from the changes to the rules on lay-offs under the Jobs Act. The two measures also fostered a shift in the composition of employment towards stable contracts.

Employment increased in the service sector and fell less than in the past in industry. With labour supply basically unchanged, the jobless rate fell by 0.8 percentage points, while remaining nonetheless high.

The Jobs Act overhauled the labour market, changing the rules on individual lay-offs, unemployment benefits, labour contract and job duty regulation, as well as on active labour market policies.

Contractual wages have risen moderately. Since the end of the year about half of private sector employees are still waiting for the renewal of their collective contract. Given the recent and repeated downward revisions of inflation, the possibility offered by some freshly renewed contracts of adjusting pay rises more often for differences between expected inflation at renewal time and actual inflation could limit wage growth.

Employment and hours worked

The growth in employment that began in 2014 gathered momentum in the course of 2015. Both the number of persons employed and the number of hours worked increased. In the fourth quarter, persons in employment, according to the national accounts, numbered 230,000 more than in the year-earlier quarter and employment gained 0.6 per cent on average for the year (Table 8.1). However, this was still 900,000 (3.4 per cent) below the peak recorded in the fourth quarter of 2007.

Last year's employment growth benefited from the social security contribution relief enacted with the 2015 Stability Law (Law 190/2014) and also, less substantially, from the reform of the dismissal rules relating to open-ended contracts (Legislative Decree 23/2015).

The shift towards payroll employment intensified, as a sharp fall in self-employment was more than offset by the 0.9 per cent increase in payroll jobs, with open-ended positions sustained by the contribution relief and the new dismissal rules (see the box 'The Jobs Act: a preliminary evaluation').

Table 8.1

Labour input in the Italian economy by sector (1) (annual percentage changes)	Persons in employment			Hours worked		
	2009-2011	2012-14	2014-15	2009-2011	2012-14	2014-15
Agriculture, forestry, fisheries	**0.0**	**-1.4**	**2.2**	**-2.4**	**-0.7**	**3.1**
Industry excl. construction	**-2.1**	**-1.9**	**-0.8**	**-1.1**	**-1.5**	**0.1**
of which: manufacturing	-2.3	-2.0	-0.9	-1.1	-1.6	0.1
Construction	**-2.0**	**-6.1**	**-1.6**	**-2.1**	**-7.7**	**-0.3**
Services	**0.5**	**-0.1**	**1.0**	**0.4**	**-0.6**	**1.0**
of which: primarily public (1)	-0.4	0.1	0.4	-0.7	0.0	0.8
Total	**-0.2**	**-0.8**	**0.6**	**-0.2**	**-1.3**	**0.9**
Employees	-0.3	-0.8	0.9	-0.4	-1.2	1.4
Self-employed	0.3	-1.1	-0.4	0.0	-1.5	-0.2

Source: Based on Istat, national accounts.
(1) Defence, compulsory social insurance, education, health and welfare.

THE JOBS ACT: A PRELIMINARY EVALUATION

Eight legislative decrees implementing Enabling Law 183/2014 (the Jobs Act) were passed in 2015. The reform was designed to increase flexibility in the utilization of the workforce and to extend and rationalize the system of unemployment benefits and active labour market policies. Work-life balance measures of limited impact were also introduced, while no decree on minimum wages was issued.

Regarding the regulation of labour, the new legislation brought together in a single text many of the pre-existing rules on labour contracts, abolishing some of the least common types. There was a clear extension of the scope for flexibility in job tasks allocation in cases of company reorganization, and the rules on dismissals of permanent employees were modified for new open-ended contracts signed starting 7 March 2015. The new rules further restricted the grounds for reinstatement in cases of dismissal without just cause in firms with 15 or more workers (already restricted by Law 92/2012, the Fornero reform); they also determined the amount of the indemnity to be paid by the employer, making it proportional to the duration of employment. The decree increased the economic advantage of out-of-court settlement procedures; it reduced the amount of the indemnity by comparison with the worker's potential award in a court proceeding but made the sums received tax-exempt. The new rules made the cost to firms of individual dismissals less uncertain.

The change in the rules on dismissals had a positive impact on permanent employment positions, which came in addition to the larger effect of the social contribution relief for new permanent hirings enacted with the 2015 Stability Law. There is evidence, as well, that the new dismissal rules made employers less reluctant to offer permanent contracts to workers without previous experience at the firm.[1]

[1] P. Sestito and E. Viviano, 'Hiring incentives and/or firing cost reduction? Evaluating the impact of the 2015 policies on the Italian labour market,' Questioni di Economia e Finanza (Occasional Papers), 326, 2016.

The Jobs Act also extended eligibility for unemployment benefits, introducing a new social insurance benefit for employment (Nuova prestazione di assicurazione sociale per l'impiego, NASpI) and rationalizing the benefit structure, easing eligibility requirements while tightening the link between the number of weeks worked and the length of the benefit period. The schedule for benefit payments was also revised so as not to discourage acceptance of a new job. The provisions relating to unemployment benefits – historically very modest in terms of amount, duration and extent of coverage, as well as highly uneven – complete Italy's transition to a system of universal unemployment insurance comparable to those of the other main European countries.

The decree also introduced a new unemployment subsidy for jobless workers in economic difficulty whose regular unemployment insurance benefits have expired (see Chapter 7, 'Households').

Continuing along the path traced by the Fornero reform, the Jobs Act rationalized the procedures for access to the wage supplementation programme starting in September 2015. It extended entitlement to these benefits to new categories of workers, shortened the maximum duration of benefits, and reduced compulsory employer contributions but made them variable with each firm's actual use of the programme over the previous five years. The purpose of these measures was to restore the programme to its original function of buffering the employment impact of temporary shocks while leaving income support for jobless workers to the new social insurance benefit. The provision for more proportional sharing in the costs has the merit of discouraging opportunistic conduct, thus reducing systematic transfers of resources between firms.

As to active labour market policies, the reform instituted a national network bringing together the central and local bodies already engaged in this field under the coordination of a new National Agency for Active Labour Policies. Although the regional governments continue to have jurisdiction in this sphere, pending the possible entry into force of a constitutional amendment, essential service levels will be set by the Ministry of Labour and Social Policy. The Agency will provide support to the regions that are not able to attain these levels, directly managing the services where necessary. The legislation also introduces a retraining benefit for workers unemployed for more than four months, to be used at public employment centres or accredited training and placement agencies; and a nationwide information system is instituted to facilitate data exchange among regions, make sure that benefit recipients comply with the eligibility conditions, and monitor the services provided. Given the large number of entities and the various levels of government involved, the efficacy of the provision will depend on the results of a complicated process of implementation.

Part-time employment increased, but so did the number of hours worked per capita, thanks in part to reduced recourse to wage supplementation. The number of involuntary part-time workers continued to rise, but less sharply than in the past.

The number of persons employed in services, which has been rising since 2013, reached 17.8 million, its all-time high since the start of this series in 1995; however, the total number of hours worked was still 2 per cent less than the 2008 peak. Employment in industry excluding construction contracted again, but less sharply than in the past, and the number of hours worked rose slightly. As the difficulties of the construction industry eased (see Chapter 6, 'Firms'), the decline in labour input in this sector slowed.

Employment increased for both men and women but for the first time since 2005 job growth was stronger for men. Foreigner employment grew more rapidly than that of Italians owing to the faster rise in the working-age immigrant population (see the box 'Immigration and refugees: initial assessment and possible impact'). However, the rise in the employment rate was sharper among Italian citizens.

IMMIGRATION AND REFUGEES: INITIAL ASSESSMENT AND POSSIBLE IMPACT

The immigrant population in Italy, whose share of the total population had risen from 2.6 per cent in 2002 to 5.8 per cent in 2008, continued to grow at a slower pace during the subsequent recession. At the end of 2014, the share was 8.2 per cent. The slowdown, which resulted from both a halving of inflows and a doubling of outflows, reflected the deterioration in the labour market. Between 2008 and 2014 the foreigner employment rate fell by over 8 percentage points, 6 points more than that of Italians. Istat's latest labour force survey data indicate that in 2015 immigration grew more slowly than in the past.

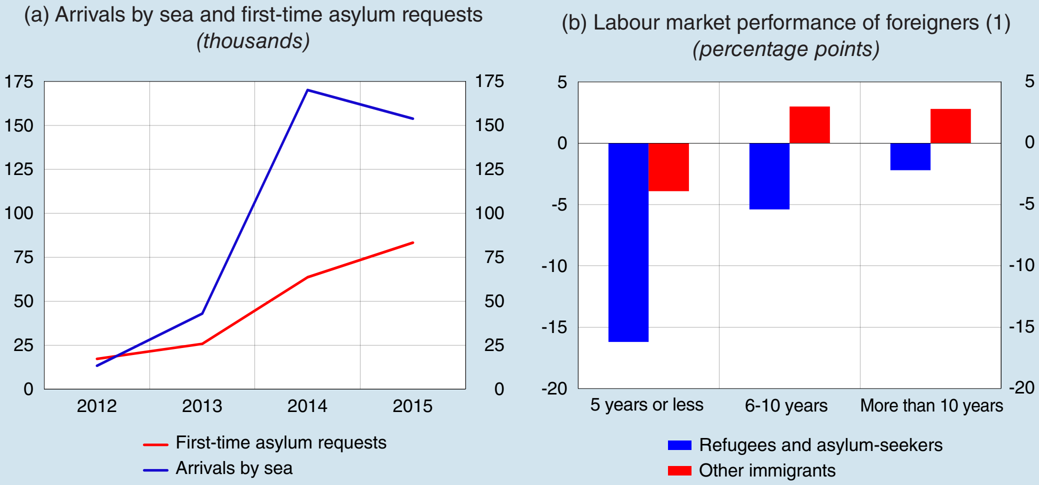
However, recent years have also witnessed a marked rise in unauthorized arrivals by sea, which increased from slightly more than 55,000 in 2012-13 to about 325,000 in 2014-15. This is smaller than the flow to Greece which, with 900,000 arrivals, was the main European entry point during these two years. The data for the first four months of 2016 indicate about the same number of arrivals on Italy's shores as in the year-earlier period.

Not even a fifth of the persons disembarking in Italy in 2014-15 were residents of war-torn countries in the Middle East. However, the flow from that area could increase in the near future with the closure of the route to Europe through Turkey and Greece following the recent agreement between the European Commission and Turkey. Over 60 per cent of sea arrivals in Italy are due to the rapid growth of the younger age groups and civil strife in sub-Saharan Africa (Eritrea, Nigeria, Gambia, Somalia and Mali).

Of those arriving in Italy in the last two years, 45.3 per cent applied for asylum (see the figure, panel a); the others avoided the identification procedure, often in order to move on, unauthorized, to other European destinations. This is the case of Eritreans in particular: while forming the most numerous national group among seaborne arrivals in Italy, they have made very few applications for asylum, counting on the fact that their refugee status is recognized more readily in all EU member countries under the Geneva Convention. A large number of applications were made instead by Nigerians and Pakistanis, who are more likely to be granted subsidiary or humanitarian protection in Italy than to be accorded refugee status.

Data from the Ministry for Economy and Finance and the Ministry of the Interior show that in the two years 2014-15 the management of foreigners arriving

Recent immigration trends and labour market inclusion



Sources: For panel a, UNHCR and Eurostat; for panel b, based on Istat, labour force surveys.
(1) Difference, in percentage points, with respect to Italians in the probability of finding employment of refugees and asylum-seekers and of other immigrants. Estimates for 2009-15, controlling for gender, age, education, Italian region of residence and time fixed effects. Refugees and asylum-seekers are identified as foreigners belonging to the top ten nationalities by number of requests for asylum in 1990-2014: former Yugoslavia, Nigeria, Iraq, Albania, Turkey, Pakistan, Somalia, Eritrea, Mali and Afghanistan. Foreigners who came to Italy before 1990 are excluded.

by sea has entailed an estimated direct outlay of €3.3 billion, equally divided between the immediate arrival process and subsequent reception and hospitality for those who decide to remain in Italy. The latter costs are affected by the considerable length of stays in reception facilities during the procedure for recognition of refugee status. Over the same period, other immigrant-related expenditure – for administration, health care, and schooling – came to around €1.6 billion.

Against the short-term costs, the longer-run economic benefits depend on the integration of the immigrants into the labour market. According to our estimates,[1] five years after their arrival refugees and asylum-seekers are less likely to be employed not only than Italians but also than other immigrants (by 16 and 12 percentage points respectively; figure, panel b). Ten years after arrival the disparity is reduced but not eliminated. In any event, immigrants as a whole, thanks to their high labour market participation and low average age, can have a positive effect on the State budget, contributing more to revenue than to expenditure (see Annual Report for 2008, Chapter 11, 'Immigration'). In addition, the employment of foreign workers, who are more highly concentrated in lower-skilled occupations and domestic services, could foster a reallocation of Italians towards more complex tasks and facilitate women's participation in the labour market.

[1] R. M. Ballatore, A. Grompone, L. Lucci, P. Passiglia and A. Sechi, 'I rifugiati e i richiedenti asilo in Italia e nel confronto europeo,' Questioni di Economia e Finanza (Occasional Papers), forthcoming.

The rise in employment was common to all parts of the country but was most pronounced in the South, where the economy returned to growth after seven years (see Chapter 5, 'Overview'). During the recession, employment trends in the South were more closely correlated with those in economic activity. The Centre and North have now practically regained the peak level of employment attained in 2008, even though GDP in those two areas is still 6 per cent lower; in the South, where output is down by 11 per cent, employment has remained 7 per cent lower.

Unemployment and labour supply

After peaking in 2014, the unemployment rate fell last year to 12.1 per cent for persons aged 15 to 64 and 40.3 per cent for those under 25 (Table 8.2). The youth unemployment rate is 2.4 percentage points lower than in 2014 thanks to the increase in training activities, but it is still nearly twice the rate registered in 2008.

Table 8.2

Participation, employment and unemployment rates, 2015
(per cent)

	Aged 15-24		Aged 25-34		Aged 35-54		Aged 55-64		Aged 15-64	
	Rate	Change 2014-15 in % points	Rate	Change 2014-15 in % points	Rate	Change 2014-15 in % points	Rate	Change 2014-15 in % points	Rate	Change 2014-15 in % points
Participation rate	**26.2**	**-1.0**	**72.6**	**-0.4**	**78.3**	**-0.2**	**51.1**	**2.2**	**64.0**	**0.1**
Men	30.4	-0.5	81.1	0.2	90.2	0.0	63.3	3.1	74.1	0.5
Women	21.7	-1.4	63.9	-1.0	66.6	-0.3	39.6	1.3	54.1	-0.3
Employment rate	**15.6**	**0.1**	**59.7**	**0.3**	**71.3**	**0.3**	**48.2**	**2.0**	**56.3**	**0.6**
Men	18.6	0.4	67.8	0.9	82.7	0.2	59.3	2.7	65.5	0.8
Women	12.4	-0.3	51.4	-0.4	60.2	0.5	37.9	1.3	47.2	0.3
Unemployment rate	**40.3**	**-2.4**	**17.8**	**-0.8**	**8.9**	**-0.6**	**5.5**	**0.1**	**12.1**	**-0.8**
Men	38.8	-2.5	16.4	-0.9	8.4	-0.3	6.4	0.2	11.6	-0.6
Women	42.6	-2.0	19.6	-0.5	9.6	-1.1	4.3	-0.2	12.8	-1.1

Source: Based on Istat, labour force surveys.

The decline in the unemployment rate for persons of working age came despite a slight increase in the labour force; the participation rate rose to 64 per cent, its highest level since the start of the series in 1977. The overall increase in participation is the net outcome of a decline among persons aged 15-54 and a substantial increase among older workers.

The increase in the labour force participation of workers over 55, which came to 190,000 last year, was accompanied by an equal increase in their employment. As a consequence, the unemployment rate for this age group was unchanged at more than 6 percentage points below the overall rate. The rise in labour force participation by older workers is part of a longer-term trend: it is the result of the series of laws passed in the last decade to raise the retirement age, culminating with Law 214/2011. These measures have made the public pension system more resilient in the face of the progressive ageing of the population, but they have also prompted a sharp drop in retirement which firms had not anticipated.

Collective bargaining and industrial relations

Hourly contractual earnings in the private sector rose by 1.6 per cent in 2015, about the same as in the previous two years, while the progressive slowing of inflation, which had not been anticipated in the latest series of three-year contract renewals, accelerated the rate of real wage growth to 1.5 per cent, three times the average for the past decade.

Contracts covering just over a fifth of total employee compensation were renewed last year. The most important numerically were those for workers in retail and wholesale trade, where wage increments did not differ significantly from the projected rise in the consumer price index, and banking, where raises were substantially smaller owing to the radical restructuring of the industry.

The new contract for the chemical industry, signed in the autumn, provides for wage increases starting in 2017 and for more frequent adjustment for any discrepancy between the rate of inflation assumed in the contract and the actual inflation outturn. A number of contracts, including that for metalworkers, expired in December, raising the share of private sector workers whose contracts have lapsed from 20 to 50 per cent. The low inflation rate, which reduces the need for renegotiation to maintain purchasing power, and the discussion now under way between business and labour with a view to substantial modification of bargaining arrangements could make for more drawn-out negotiations, further compressing nominal wage increases (see Chapter 9, 'Prices, costs and competitiveness').

As far as bargaining rules are concerned, data on the representativeness of the various trade unions, which is required for majority endorsement of industrywide contracts under the consolidated law on union representation passed in 2014, has not yet been fully collected. The scope of this agreement, which is restricted to the signatories, has been broadened by the adherence of some employer organizations in service industries.

In the national reform programme presented this spring the Government pledged to clarify the regulatory framework and give decentralized bargaining a more independent role in settling issues of work organization. As a further means of fostering second-level bargaining, the 2016 Stability Law (Law 208/2015) reinstated the tax reduction for productivity-linked wages paid under company-level or local agreements, at the same time making company fringe benefits non-taxable.

9. PRICES, COSTS AND COMPETITIVENESS

Throughout 2015 inflation in Italy stayed at historically low levels and on average was virtually nil. After recovering briefly in the central months of the year, prices began to flag again in the autumn, affected not only by trends in oil prices but also by the weakness of the core components; in the early months of 2016 inflation turned negative. Ample spare capacity and high unemployment appear to have weighed increasingly on low inflation in Italy. In part owing to the unexpected stagnation of prices, private sector wages grew in real terms.

The fall in inflation led to a gradual downsizing of expectations, which could eventually result in lower nominal wage growth, putting fresh downward pressure on prices.

Italian firms' price competitiveness improved thanks to the nominal depreciation of the euro, which nonetheless has halted in recent months.

Consumer prices

In 2015 average inflation, measured by the HICP, fell to a new all-time low of 0.1 per cent (Table 9.1). After a brief recovery around mid-year, inflation began to decline again in the autumn owing largely to the sharp drop in the prices of energy products as world oil prices plunged.

The core index, net of the most volatile components, also contributed to the weak inflationary environment; partly owing to still ample spare capacity, it continued to grow at a slow pace (0.7 per cent).

Table 9.1

Consumer prices

	Percentage changes on previous year		Percentage weights
	2014	2015	2015
HICP	**0.2**	**0.1**	**100.0**
Unprocessed food	-0.7	1.9	9.1
Processed food	0.5	0.9	11.9
Energy products	-3.0	-6.8	10.0
Non-food and non-energy products	0.5	0.7	25.5
Services	0.8	0.6	43.6
Regulated goods and services	0.5	-0.3	11.5
Overall index excluding food and energy	0.7	0.7	69.0

Source: Based on Istat data.

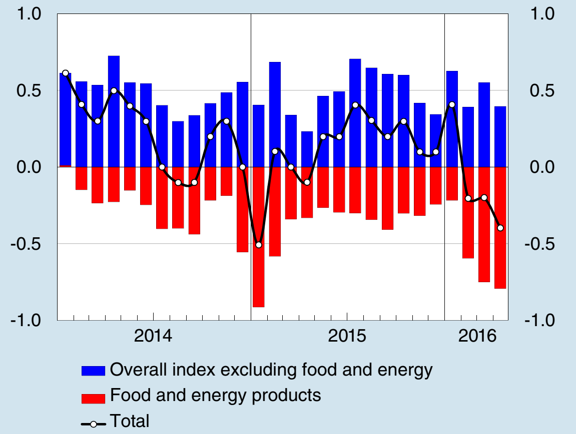
The twelve-month change in the HIPC turned negative again in the early months of 2016. In April it was -0.4 per cent (Figure 9.1), continuing to reflect low energy prices and the weakness of the core components.

The slackening trend in prices has further dampened inflation expectations. The forecasters polled by Consensus Economics have revised their 2016 inflation projections steadily downwards, from 1.1 per cent in the middle of last year to 0.1 per cent this May. They expect inflation to remain low in 2017 as well, at 1.1 per cent, and not to rise back above 1.5 per cent until 2019. The businesses surveyed in March by the Bank of Italy together with *Il Sole 24 Ore* expect price increases of 1.0 per cent over a three-to-five-year horizon ('Survey on Inflation and Growth Expectations. March 2016', *Supplements to the Statistical Bulletin*, 17, 2016).

Figure 9.1

Inflation in Italy and contributions of the main components (1)

(monthly data; 12-month percentage changes and percentage points)



Source: Based on Eurostat data.
(1) HICP.

Producer and import prices

The producer prices of goods sold on the domestic market decreased at a faster rate last year, falling by 3.4 per cent overall compared with 1.8 per cent in 2014. This was mainly due to a sharper drop in energy prices, down by 9.6 per cent. Given the weak cyclical recovery, prices of non-food consumer goods rose by just 0.2 per cent against 0.8 per cent in 2014. Firms' pricing policies are also affected by the conditions of access to external finance (see the box 'Italian firms' price policies during the crisis').

ITALIAN FIRMS' PRICE POLICIES DURING THE CRISIS

Firms' price policies in the various phases of the economic cycle have formed the subject of a good many studies, both theoretical and empirical, intended to determine why prices may move counter-cyclically, staying high when demand is low or vice versa. One of the most recurrent explanations relates to financial constraints: at a time of slack demand and difficulty in obtaining outside finance, firms may set prices (or margins) higher in order to increase short-term profits and so procure liquidity, temporarily forgoing any effort to gain market shares.

With the Great Recession, the discussion on the role of financial constraints in corporate pricing policies gathered pace. In many advanced economies the pronounced contraction in economic activity was accompanied, at first, by only a small reduction in inflation. A recent study discloses the importance of this mechanism for Italy, using data drawn from a survey on wage and price policies conducted by the ESCB on European firms and covering the period from 2010 to 2013.[1]

During the sovereign debt crisis, the sharp contraction in demand and increasingly severe difficulty in obtaining credit were accompanied by a relatively steep increase in prices, which rose by 9.4 per cent overall from 2010 to 2013, compared with 8.8 per cent in the previous four years.[2] Some 60 per cent of the firms surveyed reported a decline in demand and 70 per cent noted negative effects in connection with demand volatility; slightly over half the respondents reported borrowing constraints. An econometric analysis was conducted to correlate the probability of limiting downward price adjustments by increasing the margin over costs not only with a set of firm characteristics (e.g. sector, size and group membership) but also with the state of demand, its volatility, the degree of competition and the presence or absence of financial constraints.

The estimates, conducted on about 1,000 Italian manufacturing and service firms, confirm that between 2010 and 2013, other things being equal, financially constrained firms were more likely to react to the fall in demand by widening their profit margins. With no prospect of an economic upturn in the short run, these firms sought to procure liquidity by increasing margins.

All in all the findings suggest that along the lines of events in the United States and Spain during the Great Recession, in Italy from 2010 to 2013 firms' difficulty in obtaining credit was a factor in boosting price dynamics, despite the sharp contraction of output.

The effects on inflation of the decline in economic activity did emerge, however, with a lag, from mid-2013 onwards, in conjunction with the heightened responsiveness of prices to the underutilization of productive factors, which increased significantly in the course of the recession.[3]

---

1 I. Duca, J.M. Montero, M. Riggi and R. Zizza, 'I will survive. Pricing strategies of financially distressed firms,' Banca d'Italia, Temi di Discussione (Working Papers), forthcoming.

2 F. D'Amuri, S. Fabiani, R. Sabbatini, R. Tartaglia Polcini, F. Venditti, E. Viviano and R. Zizza, 'Wages and prices in Italy during the crisis: the firms' perspective,' Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), 289, 2015.

3 G. Bulligan and E. Viviano, 'Has the wage Phillips curve changed in the euro area?', Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), forthcoming; M. Riggi and F. Venditti, 'Surprise! Euro area inflation has fallen,' Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), 237, 2014; see also the box 'Wage growth, unemployment and inflation expectations,' *Economic Bulletin,* 2, 2016.

Non-energy intermediate inputs also contributed, if less markedly, to lowering firms' costs. Their producer prices came down by an average of half a percentage point in 2015, as in 2014; the price trend for imported intermediate inputs was similar.

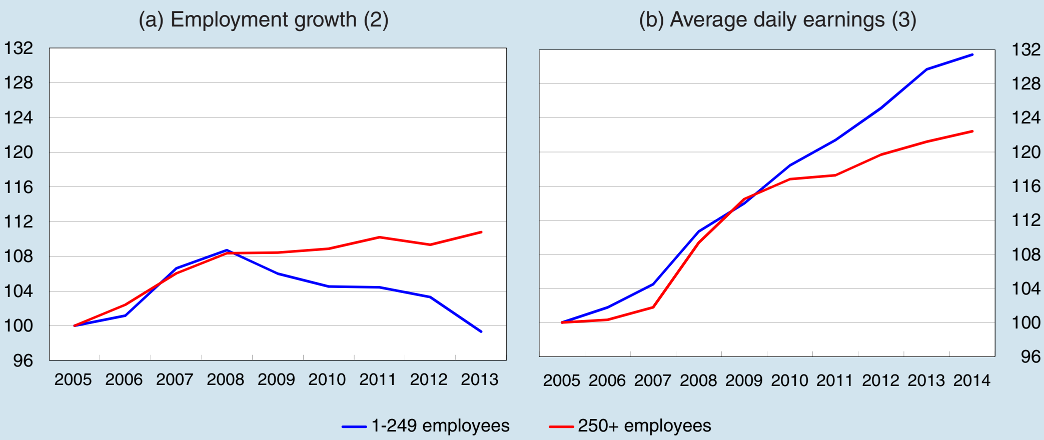
Labour costs

Nominal hourly earnings increased by 0.5 per cent last year, about the same as in 2014. The difference between wage trends in the public and private sectors was also unchanged from the previous year: the public sector wage freeze remained in effect, while private sector earnings rose by 1.2 per cent (1.1 per cent in 2014), held down by persistently high unemployment (see the box 'Wage dynamics and rigidities: firm heterogeneity and macroeconomic impact') but supported by contractual increases under agreements made in previous years In a situation of virtual price stagnation, real wages in the private sector increased.

WAGE DYNAMICS AND RIGIDITIES: FIRM HETEROGENEITY AND MACROECONOMIC IMPACT

Our estimates – based on INPS data on all Italian firms with at least one employee for the period 1990-2013 – show that since the turn of the century the rise in aggregate earnings has been buoyed by the steadily increasing share of total employment accounted for by firms paying higher average wages.[1] The trend has been more pronounced in the sectors that registered the greatest productivity gains, indicating an improvement in allocative efficiency.

Adjustment of labour costs in the non-farm private sector during the recession: sample of firms existing in 2007 by size class (1)
(indices: 2005 = 100)



Sources: Based on INPS and Archivio Uniemens data.
(1) Firms with at least one employee in the non-farm private sector, excluding household services. Size class as at 2007. – (2) Data for 2005-2013. Payroll employment, annual average. – (3) Data for 2005-2014. Random sample of workers born on the 1st and 9th day of every month, excluding those on wage supplementation. Average daily earnings, corresponding to taxable income for social security contribution purposes.

Between 2008 and 2013 aggregate earnings growth was also determined by diverse company strategies for curbing labour costs. The larger firms limited the rise in average per capita wages, while smaller ones more frequently reduced their work force (see the figure). Small and medium-sized enterprises pay lower wages, near the minimums set by national collective bargaining agreements, and often with no supplementary components, such as bonuses, that can be cut in case of recession. These firms accordingly responded both by shedding staff and by adjusting the composition of the work force. In particular, they resorted to

[1] E. Adamopoulou, E. Bobbio, M. De Philippis and F. Giorgi, 'Allocative efficiency and aggregate wage dynamics in Italy, 1990-2013,' Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), forthcoming.

fixed-term contracts, whose provisions, including wage levels, must necessarily be renegotiated each time.[2]

In recent years the impact of labour market conditions and inflation expectations on nominal wage growth has intensified. We estimate that since 2008 the correlation between wage changes and inflation expectations has tightened.[3] At the same time, the negative correlation between wage growth and the unemployment rate has also strengthened, confirming earlier analyses.[4] This finding, which according to these estimates holds not only for Italy but for France and Spain as well, can be traced to the spread of variable wage components and recourse to fixed-term contracts, which has enabled firms to negotiate wages more closely in line with the cyclical conditions prevailing when new contracts are signed.

---

2 E. Adamopoulou, E. Bobbio, M. De Philippis and F. Giorgi, 'Wage rigidities and business cycle fluctuations: a linked employer-employee analysis,' Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), forthcoming.

3 G. Bulligan and E. Viviano, 'Has the wage Phillips curve changed in the euro area?' Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), forthcoming.

4 M. Riggi and F. Venditti, 'Surprise! Euro area inflation has fallen,' Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), 237, 2014.

Wage growth eased further at the end of the year, reflecting the non-renewal of many of the contracts that lapsed during the year and in the first few months of 2016; in March the industries whose contracts had expired accounted for about 50 per cent of the total wage bill (see Chapter 8, 'The labour market'). In the absence of additional renewals, contractual wage growth would be halved in 2016 to an all-time low of 0.8 per cent.

The few contracts that were renewed in the second half of 2015 do not call for significant increments this year, reflecting low inflation expectations. In chemicals and pharmaceuticals and in rubber and plastics, the agreements provide for future adjustments of wages where actual inflation diverges significantly from the contractual reference rate, which could intensify the downward pressure on prices if inflation continues to be worse than projected in the contracts (see *Economic Bulletin*, 2, 2016, and Chapter 8, 'The labour market').

The variation in hourly labour costs in the private sector was broadly unchanged, with an increase of about 1 per cent in 2015, thanks in part to the negative effect, estimated at 0.5 percentage points, of social security contribution relief for new open-ended hirings under the 2015 Stability Law (Law 190/2014). Firms also benefited from the exemption from the regional tax on productive activities (IRAP) of labour costs relating to permanent contracts (see Chapter 11, 'Public finance').

The productivity gain in industry, due to a significantly smaller increase in hours worked than in value added, resulted in a sharp slowdown in unit labour costs from growth of 2.2 to 0.5 per cent. For the private sector as a whole, however, there was a slight acceleration because of the poor performance of productivity in services, where employment increased more than value added (see Chapter 8, 'The labour market'). This affected the share of value added going to profits, which slipped further in the private sector (see the box 'The distribution of value added between labour income, profits and real-estate rents').

THE DISTRIBUTION OF VALUE ADDED BETWEEN LABOUR INCOME, PROFITS AND REAL ESTATE RENTS

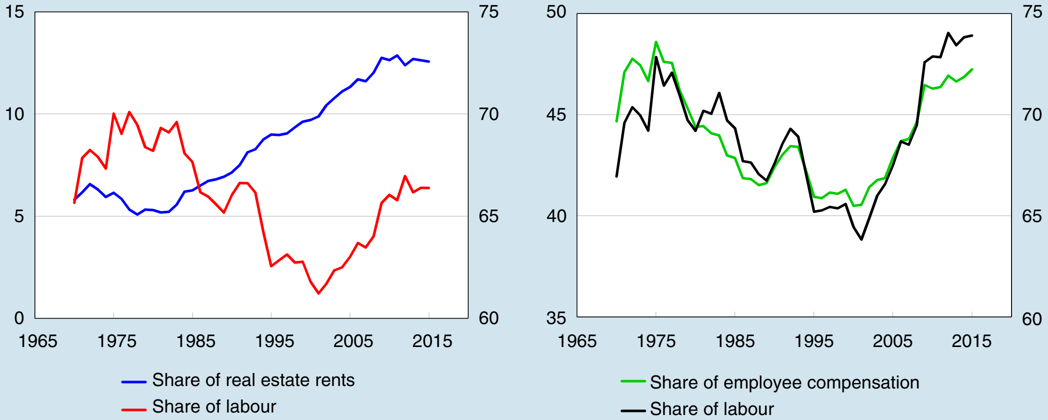
The share of value added that goes to labour income depends on a series of factors, such as the relative prices of productive factors, firms' market power, technology, and the sectoral make-up of the economy. The longer the lag in the adjustment of production inputs to variations in output, the more labour's share will tend to be negatively correlated with the economic cycle.

In Italy, labour's share peaked in the mid-1970s, declined steadily to a low point in the early 2000s, and has risen again in the last fifteen years (see the figure, panel a).[1]

The share of labour and real estate rents in value added at factor costs (1)
(per cent)

(a) Share of labour (2) (3) and real estate rents (4) in value added, total economy

(b) Share of labour (2) (3) and employee compensation (5) in value added, private sector (6), net of real estate rents



Source: Based on Istat data.
(1) For the years prior to 1995, shares calculated according to ESA 95 series have been reconciled with those according to ESA 2010. – (2) Right-hand scale. – (3) The labour income of self-employed workers is obtained by imputing to them the average employee compensation in the relevant sector, sectors A-T in the NACE 2007 classification. – (4) Real estate rents are defined as value added net of labour income of sector L, real estate activities. – (5) The share of employee compensation is the ratio of domestic employee compensation to value added. – (6) The private sector is defined as the total economy net of NACE 2007 sectors O, P and Q.

The drop between 1975 and 2000 was due only in part to a corresponding recovery in the share of profits. A contributing factor was the progressive increase in the incidence of real estate rents, about two thirds of which consist in the imputed value of housing services to owner-occupiers. This rise was driven by the increase in rental costs, which in turn was consistent with the rise in house prices. The share of real estate rents rose still further in the 2000s, stabilizing in the last three years at 12.6 per cent of value added, compared with 5 per cent in 1985 and about 10 per cent in 2001.

[1] R. Torrini, 'Labour, profit and housing rent shares in Italian GDP: long-run trends and recent patterns,' Politica economica, 3, 2015, pp. 275-314; also published in Banca d'IItalia, Questioni di Economia e Finanza (Occasional Papers), 318, 2016.

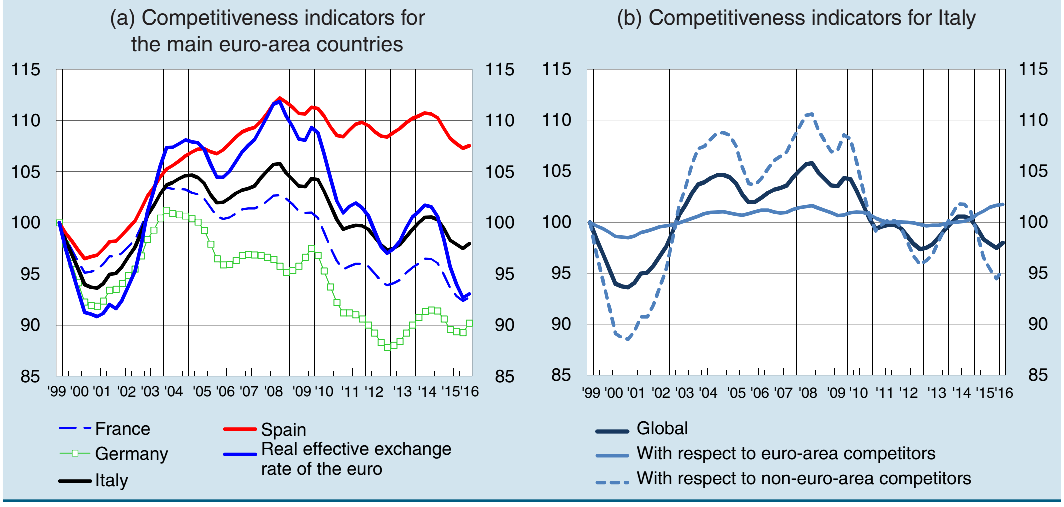
In the private sector alone (see the figure, panel b), labour's share of value added net of real estate rents has regained the peak levels of the mid-1970s. It rose by nearly 5 percentage points between 2001 and 2007, from 63.8 to 68.5 per cent, as a consequence of declining profit margins accompanied by a sharp slowdown in productivity and simultaneous increases in the ratios to value added of capital, employment, and real per capita labour costs. Then, during the recession, labour's share rose by a further 5 points, to 73.9 per cent in 2015, following cyclical developments and reflecting the slow adjustment of wage dynamics to the fall in inflation over the last three years. The share of employee compensation alone showed a similar pattern (see the figure, panel b); in the same way, during the recession the share of profits shrank to historically low levels.

Price competitiveness

Italian firms' price competitiveness, measured by the producer prices of manufactures, improved by nearly 3 percentage points on average for the year (Figure 9.2.a) thanks entirely to the nominal depreciation of the euro. A loss of competitiveness with respect to euro-area competitors owing to a smaller decline in prices than the area-wide average was more than offset by the gain with respect to non-area countries (Figure 9.2.b).

Figure 9.2

Competitiveness indicators for the main euro-area countries and real effective exchange rate of the euro (1)
(indices, Q4 1999=100; 4-quarter moving average)



Sources: Bank of Italy and, for the real effective exchange rate of the euro, ECB.
(1) Based on producer prices of manufactures. An increase indicates a loss of competitiveness. The competitiveness indicators are calculated with respect to 61 competitor countries (including the members of the euro area). The figure for the last quarter is partly estimated. The real effective exchange rate of the euro is calculated by the ECB with respect to 20 competitor countries outside the euro area.

French and Spanish manufacturers posted fairly similar competitiveness gains last year, 3.9 and 2.7 percentage points respectively, while German firms saw less improvement, with a gain of just over 2 points.

The appreciation of the euro in the first three months of 2016 was reflected in a worsening of the competitiveness indicator by comparison with the end of 2015.

10. FOREIGN DEMAND AND THE BALANCE OF PAYMENTS

Italy's current account surplus increased again in 2015. The improvement was due to the contraction of the energy deficit thanks to the fall in oil prices. Although exports of goods slowed in the final part of the year, they outstripped the growth in potential demand from outlet markets, confirming the ability of Italian firms to compete in global markets. Imports returned to rapid growth. According to our estimates, on a cyclically adjusted basis the current account was still slightly in surplus.

Foreign investors continued to purchase Italian portfolio securities, primarily shares and government securities. There was further reallocation of resident households' portfolios towards foreign securities, and investment funds in particular. The Bank of Italy's negative balance in the TARGET2 settlement system gradually widened, in tandem with the increased liquidity injected under the Eurosystem's Asset Purchase Programme.

Exports and imports

Exports. – Exports of goods and services grew by 4.3 per cent in volume in 2015, though they were affected by the weakening of world trade in the second half of the year.

Goods exports, led by the rapid expansion in those to euro-area countries, outpaced the growth in potential demand from outlet markets (Figure 10.1). Despite faltering demand in the emerging economies and the commodity producing countries, exports to non-EU markets again expanded strongly, benefiting from the gain in price competitiveness (see Chapter 9, 'Prices, costs and competitiveness').

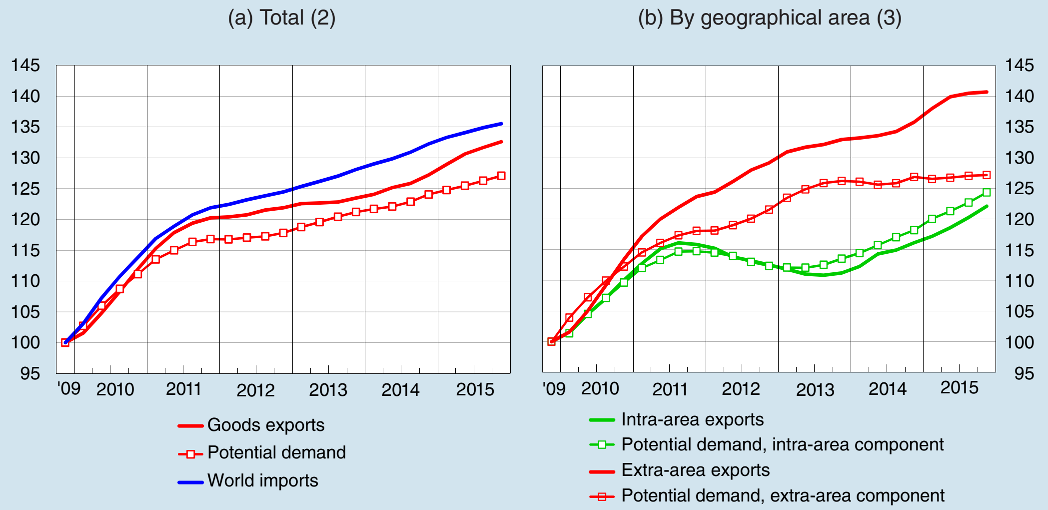
Italy's share of world trade, which had been practically stable since 2010, rose slightly, to 3.1 per cent at constant exchange rates and prices.

According to the findings of the Bank of Italy's survey of industrial and service firms, since the recovery of trade following the global crisis of 2008-09 Italian manufacturing firms have turned increasingly to foreign markets in a phase of persistently weak domestic demand. The propensity to export has increased especially among large and medium-sized companies, which in 2015 got about half of their sales revenue from exports; for small firms, exports' share of total turnover rose to about 35 per cent.

The growth in goods exports in 2015 (4.4 per cent in volume on the basis of the national accounts) came chiefly from transport equipment; sales of motor vehicles were especially strong, gaining 32 per cent compared with 2014. Exports of chemical and pharmaceutical products recorded further rapid growth, while those of machinery and equipment weakened. Exports of electronic and refined petroleum products turned upwards after two years or more of decline.

Figure 10.1

Goods export volumes, potential foreign demand and world goods imports (1)
(4-quarter moving averages; indices, Q4 2009=100)

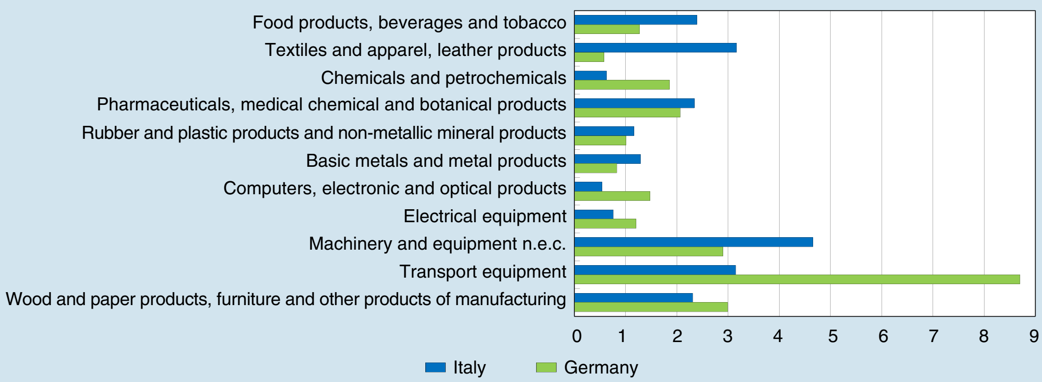


Sources: Based on data from Istat, IMF and CPB Netherlands Bureau for Economic Policy Analysis.
(1) Seasonally adjusted. – (2) Goods exports, national accounts. Potential demand is calculated as the weighted average of the imports by volume of Italy's trading partners, weighted by their shares of Italian exports by value. – (3) The breakdown of goods exports into intra- and extra-euro-area is estimated, beginning with the aggregate national accounts figure, on the basis of foreign trade data and the prices of industrial products sold abroad.

Since 2010, with the recovery of world trade following the blow dealt by the Lehman Brothers failure in 2008, Italian goods exports have increased overall by 23 per cent in value, in line with the euro-area average. This is about 3 percentage points less than Germany's gain, all of the difference being ascribable to sales of motor vehicles which account for a third of Germany's export expansion (Figure 10.2). In Italy, by contrast, significant gains were recorded in several sectors of specialization: machinery and equipment, clothing and footwear, and food products. According to Eurostat data, the transport equipment sector was also the leading contributor to Spain's strong export expansion of 33 per cent over the same period.

Figure 10.2

Sectoral contributions to the growth of goods exports in value between 2010 and 2015 (1)
(per cent)



Sources: Based on Istat and Destatis foreign trade data.
(1) The overall growth in goods exports in the period was equal to 22.7 per cent for Italy and 25.6 per cent for Germany.

Exports of goods to European Union countries continued to grow in 2015, rising by 5.3 per cent. Among non-EU markets, exports to the United States turned in a strong performance, while those to Russia contracted for the second consecutive year (down by 34 per cent with respect to 2013) and those to several Asian countries, notably China, also declined.

Imports. – The rate of growth in the volume of imports of goods and services picked up to 6 per cent in 2015. The expansion in the goods sector was even more robust (8.1 per cent) as a consequence of the growth in exports and inventory accumulation (the most import-intensive demand components) together with the upturn, after the long recession, in household spending on consumer durables and business investment in transport equipment. Along with imports of transport equipment, those of pharmaceuticals, electronic products, electrical machinery and raw materials, including energy commodities, also grew.

The current and capital accounts

The current account surplus increased again in 2015 to 2.2 per cent of GDP (Table 10.1). The improvement was due entirely to the contraction in the energy deficit, which benefited from the decline in oil prices; the balances on services and primary income, instead, worsened slightly (Figure 10.3). Despite the steep drop in outlays for energy commodities, the total value of imports rose.

The cumulative improvement in the current account balance, which amounts to 5.6 percentage points with respect to the 2010 low, is ascribable mainly to goods. Our

Table 10.1

Balance of payments
(balances in billions of euros, except as indicated)

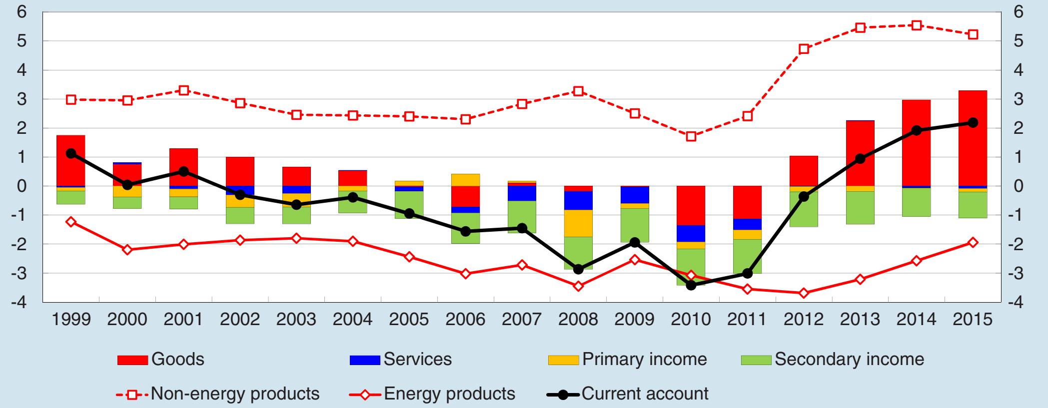
	2011	2012	2013	2014	2015
Current account	**-49.3**	**-5.8**	**15.2**	**30.9**	**36.0**
per cent of GDP	-3.0	-0.4	0.9	1.9	2.2
Goods	-18.6	16.8	36.1	47.9	52.7
Non-energy products (1)	39.5	76.3	87.6	89.3	84.5
Energy products (1)	-58.1	-59.5	-51.5	-41.5	-31.9
Services	-6.2	-0.1	0.3	-0.8	-1.2
of which: Transport	-8.7	-8.2	-7.9	-8.2	-8.4
Travel	10.3	11.5	12.8	12.5	13.5
Primary income	-5.3	-3.0	-3.1	-0.3	-0.9
Secondary income	-19.3	-19.5	-18.1	-15.8	-14.6
Capital account	**1.0**	**4.0**	**0.2**	**3.4**	**2.6**
Financial account (2)	**-64.4**	**-10.2**	**12.8**	**50.3**	**33.1**
Direct investment	12.4	5.3	0.6	2.5	6.6
Portfolio investment	11.4	-24.4	-13.2	1.0	89.6
Financial derivatives	-7.3	5.8	3.0	-3.6	3.4
Other investment	-81.9	1.6	20.7	51.3	-67.0
Change in official reserves	0.9	1.5	1.5	-1.0	0.5
Errors and omissions	**-16.1**	**-8.3**	**-2.6**	**16.0**	**-5.5**

Source: For GDP, Istat.
(1) Based on Istat foreign trade data. – (2) According to the sign convention for the financial account adopted by BPM6, positive values for assets indicate an increase and negative values a reduction; therefore, a positive balance indicates a net increase in assets, a negative balance a net increase in liabilities.

estimates, based on a model that considers the size of the output gap of Italy and its trading partners and the elasticity of exports and imports to the various components of demand, indicate that the improvement was considerable also on a cyclically adjusted basis, chiefly by virtue of the increase in exports. Taking account of the margins of uncertainty of the estimates, in 2015 the structural balance appears to have shown a slight surplus of around 0.5 per cent of GDP (Figure 10.4).[1]

Figure 10.3

The balance on current account and its components
(per cent of GDP)

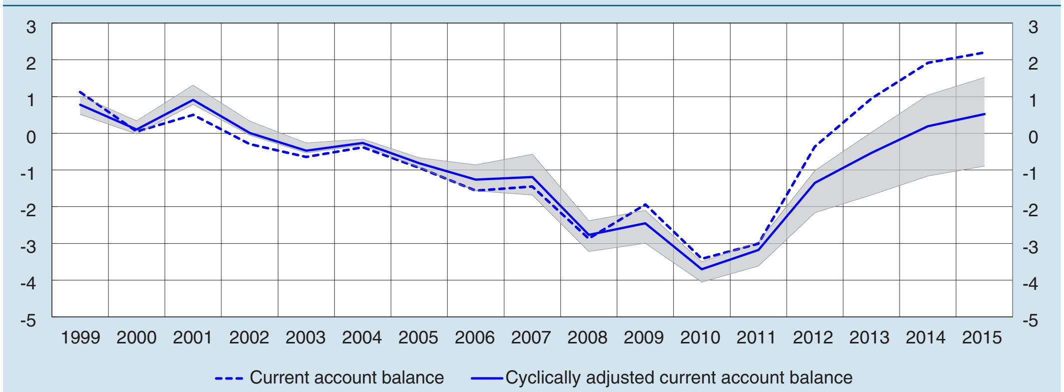


Sources: For GDP, Istat; for the breakdown between energy and non-energy products, based on Istat foreign trade data.

In 2015 a substantial boost to the increase in the surplus on merchandise trade came from the non-EU component, which reflected the growth in exports to the United States and the reduction in the value of imports from Russia and the OPEC countries owing to the decline in the prices of energy products. The surplus with the EU, instead, shrank slightly.

Figure 10.4

The cyclically adjusted current account balance (1)
(per cent of GDP)



Sources: Based on data from Banca d'Italia, European Commission, IMF, Istat and OECD.
(1) The grey area indicates the range of values obtained by alternative estimation methods.

[1] S. Fabiani, S. Federico and A. Felettigh, 'Adjusting the external adjustment: cyclical factors and the Italian current account', Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), forthcoming.

On the services account, spending by foreign visitors to Italy again expanded strongly, thanks in good part to the Milan Expo which also had beneficial effects on tourism in the surrounding area and in Italy's main tourist cities (Florence, Rome and Venice), while spending on foreign travel by Italians slowed. The result was an increase in the surplus on travel.

The deficit on primary income rose slightly to almost €1 billion. By contrast, that on secondary income declined, reflecting the smaller deficit on public transfers with EU institutions. The level of workers' remittances was practically unchanged with respect to 2014 (€5.3 billion).

The financial account

Non-residents invested about €23 billion in Italian portfolio securities, of which €21 billion in government securities. Demand, which was concentrated in the medium- and long-term component, came largely from countries outside the euro area (see the box 'Holders of Italian government securities by sector and country'). Foreign investors also purchased shares.

According to provisional data, inward direct investment totalled €7.2 billion, compared with €12.9 billion in 2014; inflows relating to mergers and acquisitions (€16.5 billion, down slightly from the previous year) were largely offset by intra-group loan repayments (€9.4 billion).

Total direct investment inflows to Italy remained modest by European standards.

HOLDERS OF ITALIAN GOVERNMENT SECURITIES BY SECTOR AND COUNTRY

The expansion of the Eurosystem's Asset Purchase Programme (APP) to include public sector securities in March 2015 partly altered the allocation of Italian general government securities among the different categories of Italian and foreign holders (Figure A). Between March and December of last year, the Bank of Italy purchased around €73 billion worth of Italian public sector securities under the APP, bringing the share of these assets held at the end of the year to 9.1 per cent of the total (up 3.4 percentage points on December 2014). The share held by non-resident investors, who continue to show interest in Italian securities, remained stable. Of the other Italian investors, only insurance companies increased their share of holdings of general government securities (by 0.7 percentage points, to 16.0 per cent); by contrast there was a decline in the share held by households (2.4 points, to 6.3 per cent), as they gradually shifted their portfolios towards the asset management industry, and in that held by domestic banks (1.2 points, to 18.7 per cent).

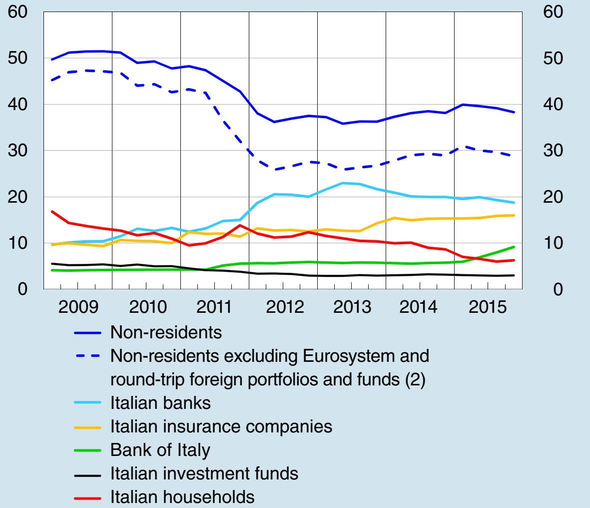
From a backward-looking perspective, between the summers of 2008 and 2013 the share of Italian government securities held by Italy's banks had risen sharply, as it had in other countries, due to protracted financial market instability; this share subsequently began to fall again. Since the global financial crisis, the percentage of government securities held in the portfolios of Italian insurance companies has risen considerably. During the same period, the shares held by households and investment funds have instead fallen by roughly half (to 6.3 and 3.0 per cent, respectively).

At the end of 2015 foreign investors held 38.3 per cent of Italian government securities. Net of Eurosystem holdings (excluding the Bank of Italy) and foreign individually managed portfolios and investment funds attributable to Italian investors, our estimates based on Assogestioni and ECB data put the non-residents' share at 28.8 per cent, essentially the same as in 2014 and much lower than the share held prior to the sovereign debt crisis.

Figure A

Italian general government securities by holder (1)

(per cent)



Sources: Bank of Italy, Financial Accounts and estimates based on Assogestioni and ECB data.
(1) Calculated at market prices, net of securities held by Italian general government entities. Data for a subset of holders. – (2) Securities held by foreign investors net of those held by the Eurosystem (excluding the Bank of Italy) and of foreign individually-managed portfolios and investment funds attributable to Italian investors.

A clearer picture of the composition of foreign holders of Italian general government securities by sector and geographical area can be gleaned from the Eurosystem's recent securities holdings statistics (SHS) data and from the IMF's Coordinated Portfolio Investment Survey (CPIS) data. We estimate that euro-area investors held more than 60 per cent of the Italian general government securities held by non-residents at the end of 2015 (see the table).[1] The main sector represented in the euro area was 'other financial intermediaries' (accounting for 23.0 per cent of the total securities attributable to non-residents), predominantly non-

Foreign holders of Italian general government securities by area and sector

(per cent)

HOLDERS	2013	2014	2015
Euro area	**62.8**	**63.5**	**61.6**
Banks (1)	15.1	15.0	13.9
Insurance companies and pension funds	10.5	11.7	11.5
Other financial intermediaries	21.5	22.8	23.0
Other sectors (2)	15.7	14.0	13.2
Non-euro area	**37.2**	**36.5**	**38.4**
Total foreign holders	**100.0**	**100.0**	**100.0**

Sources: Estimates based on ECB and IMF data.
(1) Including money market funds. – (2) Includes the following sectors: non-financial corporations, households, general government entities, the Eurosystem (excluding the Bank of Italy).

[1] V. Della Corte and S. Federico, 'Foreign holders of Italian government debt securities: new evidence', Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), forthcoming.

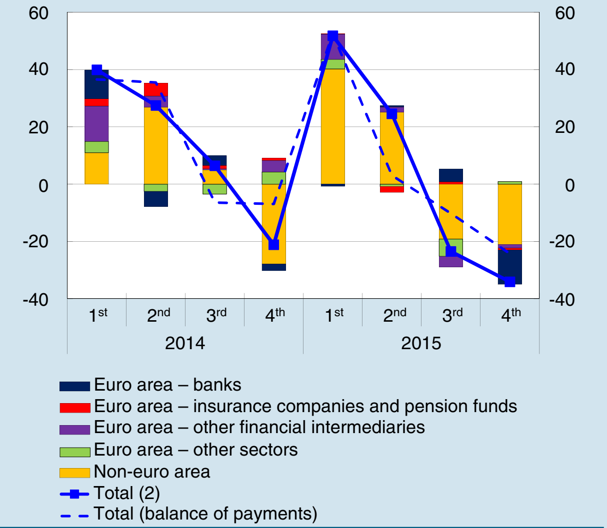
money market funds, followed by banks (13.9 per cent) and the insurance industry and pension funds (11.5 per cent). Among non-euro area investors, large shares were held by the private sector and public sector institutions (central banks and general government). By country, the main euro-area holders of Italian government securities are France and Luxembourg, followed by Germany and Spain; outside the euro area, they are the United States, the United Kingdom, China and Japan.

In 2015 foreign demand for Italian general government securities, which in 2014 was buoyed mainly by other euro-area countries, mostly reflected purchases made by non-euro area investors; these purchases were concentrated in the first part of the year, coinciding with the announcement and first few months of operation of the APP (Figure B). In the euro area, the share attributable to other financial intermediaries increased slightly, while that of banks fell; the share held by insurance companies and pension funds remained virtually unchanged.

Figure B

Foreign investment in Italian general government securities by area and sector (1)

(billions of euros)



Sources: Estimates based on Bank of Italy, ECB and IMF data.
(1) See notes to the table. – (2) Our estimates, based on ECB (SHS) and IMF (CPIS) data, do not cover the entire universe of non-resident holders of Italian general government securities; this explains the difference as compared with balance of payments data.

Italian residents' portfolio investment in foreign assets came to €112.1 billion, with an increase in the exposure to both debt and equity instruments. As in 2014, purchases of foreign investment fund units were again very substantial (about €70 billion). To some extent this reflects portfolio reallocation by households who, presumably partly in response to the Asset Purchase Programme (see Chapter 4, 'Monetary policy in the euro area'), reduced the portion invested in government securities and bank bonds and continued to increase the portion – traditionally small by international standards – invested in asset management products (see Chapter 7, 'Households'). Direct investment abroad amounted to €13.8 billion, somewhat less than in 2014.

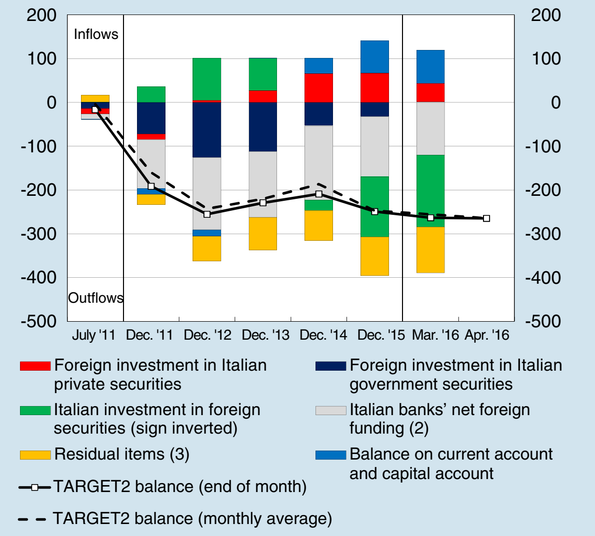
After declining in 2014, last year Italian banks' net external liabilities in respect of loans, deposits and other investments, including funding intermediated by resident central counterparties, rose by €31 billion.

A significant part of the deficit on 'other investment' was due to the increase of about €40 billion in the Bank of Italy's debtor position in the TARGET2 European settlement system. A similar development was observed for the debtor balance of Spain's central bank. In Italy, in terms of the balance of payments the increase reflected residents' net purchases of foreign assets, only partially offset by foreign investment in Italian government securities, by the increase in resident banks' net funding on international markets and by the current account surplus (Figure 10.5). From the standpoint of monetary base creation, the worsening of the balance reflects the uneven distribution within the euro-area countries' banking systems of the excess reserves created by the Asset Purchase Programme. So far, the excess liquidity has tended to flow out of Italy and Spain towards the banking systems of several central and northern European countries (such as Germany, France and the Netherlands), presumably in response to differences in the related opportunity cost.

Figure 10.5

TARGET2 balance and cumulative balance of payments flows (1)

(billions of euros; cumulative flows from July 2011)



(1) Breakdown of the balance based on the accounting identity of the balance of payments. – (2) Including funds intermediated by resident central counterparties. – (3) Direct investment, financial derivatives, other investment, errors and omissions.

The TARGET2 debtor balance continued to increase in the first few months of 2016, rising from an average of €247 billion in December to €264 billion in April.

The net international investment position

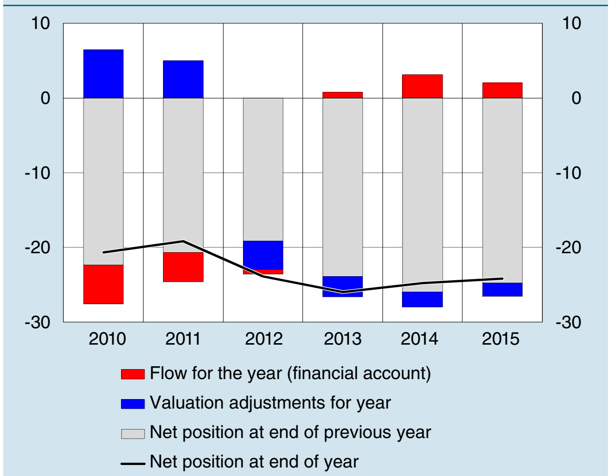
The statistics on Italy's net international investment position were recently revised to incorporate the assets held illegally abroad and now reported under the voluntary disclosure procedure (see the box 'Undeclared foreign assets and international tax evasion'). With the revision, Italy's net position at the end of 2015 improved by just under 3 percentage points of GDP.

At the end of 2015 Italy's debtor position stood at €395.6 billion, or 24.2 per cent of GDP. The slight reduction with respect to the end of 2014 (equal to 0.6 points of GDP) was due to the significant current account surplus (€36 billion), offset by valuation adjustments (Figure 10.6); the latter had a negative overall impact of about €30 billion as a result of the increase in the value of liabilities and, to a lesser extent,

Figure 10.6

Net international investment position

(per cent of GDP)



Source: For GDP, Istat.

the decrease in that of assets. The upward revaluation of liabilities was caused by the increase in the market value of shares issued in Italy by the private sector and held by non-residents, while the value of assets was reduced by negative price adjustments, which more than offset the effects of opposite sign connected with the depreciation of the euro.

UNDECLARED FOREIGN ASSETS AND INTERNATIONAL TAX EVASION

In the absence of direct evidence, the stock of undeclared wealth held abroad by residents can be derived from external statistics.

These data demonstrate the extent of undeclared capital transfers and asset holdings abroad, particularly in tax havens: the distribution by counterparty country of foreign direct investment and international trade in services reveals the high weight of offshore financial centres; BIS data on cross-border bank deposits of non-bank customers report very large capital stocks held in the names of residents of offshore financial centres or directly in such centres; on a global scale, statistics on portfolio securities held by non-residents show that liabilities systematically exceed assets, while in theory the two aggregates should balance out. This discrepancy offers a convenient starting point from which to estimate the underdeclaration of assets.

Table A sets out the most recent estimates[1] of undeclared financial assets held abroad, based on a comparison of the bilateral statistics published by the IMF and incorporated with data from other sources (BIS data on deposits). We estimate that, worldwide, portfolio assets were underdeclared by a total of almost $5,000 billion at the end of 2013, approximately 7 per cent of global GDP; this amount relates especially to units in investment funds established in financial centres (particularly Luxembourg) and offshore destinations (especially the Cayman Islands). If we add to this the estimate of cross-border bank deposits undeclared by investors, the total stock amounts to between $6,000 billion and $7,000 billion.

Table A

Undeclared external assets (portfolio securities and bank deposits)
(trillions of dollars)

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Equity and investment fund shares	1.1	1.2	1.5	1.8	2.1	2.5	3.4	2.4	2.6	2.7	2.6	2.9	3.0
Debt securities	0.9	1.1	0.9	1.1	1.0	0.9	1.1	1.3	1.1	0.5	1.6	2.0	1.9
Deposits (min.)	0.5	0.6	0.7	0.8	0.8	1.0	1.3	1.3	1.2	1.2	1.1	1.1	1.2
Deposits (max.)	1.0	1.2	1.4	1.6	1.6	2.0	2.5	2.5	2.4	2.3	2.2	2.3	2.3
Total (min)	**2.6**	**2.8**	**3.1**	**3.7**	**3.9**	**4.4**	**5.8**	**5.0**	**4.8**	**4.3**	**5.2**	**6.0**	**6.1**
Total (max)	**3.1**	**3.4**	**3.8**	**4.5**	**4.7**	**5.4**	**7.1**	**6.2**	**6.0**	**5.5**	**6.3**	**7.1**	**7.2**

Sources: Based on IMF, BIS and national statistics.

[1] V. Pellegrini, A. Sanelli and E. Tosti, 'What do external statistics tell us about undeclared assets held abroad and tax evasion?', presentation at the conference 'The Bank of Italy's analysis of household finances. Fifty years of the Survey on Household Income and Wealth and the Financial Accounts', Rome, Banca d'Italia, 3-4 December 2015.

In addition to undeclared foreign assets, there is the problem of evasion of capital income taxation and, especially, personal income taxes, given that underdeclaration statistics refer mainly to households. At the global level, we estimate capital income tax evasion of between €16 billion and €33 billion per year. With regard to personal income taxes – assuming that the entire stock of undeclared assets at end-2013 arose from income that had previously evaded domestic taxation – global evasion is estimated to be between €1,500 billion and €2,100 billion (Table B). The figures indicate the scale of potential lost tax revenues, accumulated over time, associated with undeclared foreign capital.

Table B

Estimated international tax evasion (portfolio securities and bank deposits)
(billions of euros)

	Capital income tax evasion (annual average)			Personal income tax evasion (on 2013 stock)		
	Minimum	Maximum	Average	Minimum	Maximum	Average
World	**16**	**33**	**24**	**1,551**	**2,063**	**1,788**
Italy	**0.4**	**1.4**	**0.8**	**49**	**99**	**72**

Sources: Based on IMF, BIS and national statistics.

Although it is difficult to break down the global estimate geographically, undeclared assets can be attributed to individual holder countries using economic variables (GDP and measures of financial wealth). Italy's share is estimated at between €150 billion and €200 billion at the end of 2013, with almost €1 billion per year in capital income tax evasion and around €70 billion in personal income tax evasion.[2]

Through the voluntary disclosure programme, introduced by Law 186/2014, almost €62 billion in previously undisclosed assets have been declared (generating around €4 billion in tax revenue, according to provisional Revenue Agency data). Since it is estimated that just over €51 billion relate to portfolio securities and bank deposits, these assets account for about 30 per cent of the estimated average stock evaded. This estimate appears plausible, given that the actual cost of participating in the programme varied and in many cases could have exceeded the benefits of becoming compliant.

Italy's net international investment position does not usually incorporate estimated undisclosed foreign assets held by Italian residents; however in cases in which these assets are subsequently declared, as occurred under the recent voluntary disclosure programme or through past tax amnesties, the official statistics have been revised to take them into account (see the section 'The net international investment position').

[2] Most of the undeclared amounts would in any event be difficult to recover, especially owing to the statute of limitations on tax assessments.

11. THE PUBLIC FINANCES

With a level of economic activity still well below its potential, Italy's budgetary policy was moderately expansionary in 2015. Taking into account the constraints imposed by Europe's fiscal rules, the Government significantly reduced the tax wedge on labour, partly financing this cut with measures to combat evasion and spending cuts. The general government deficit narrowed from 3.0 to 2.6 per cent of output, reflecting the fall in interest payments. The ratio of debt to GDP, though curtailed by the reduction in the Treasury's account with the Bank of Italy, rose slightly.

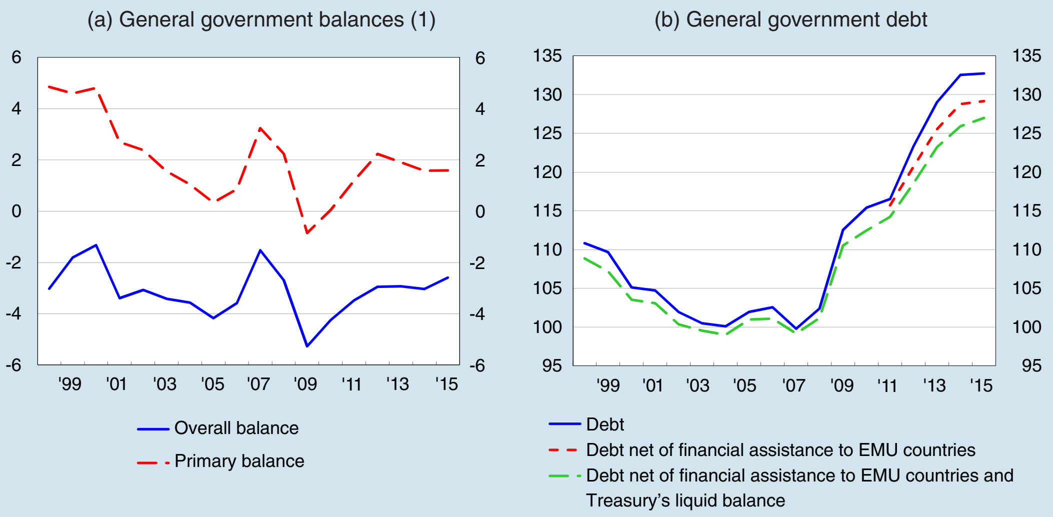
In 2016 the fiscal policy stance is expected to remain expansionary. This year's budget widens the deficit on a current legislation basis, in particular by deferring to 2017 the triggering of the safeguard clauses, which envisage a VAT rate hike, and by abolishing the property tax on primary residences. In the Government's projections the debt-to-GDP ratio will contract by 0.3 percentage points.

Public finances in 2015

Net borrowing fell by 0.4 percentage points to 2.6 per cent of GDP (Figure 11.1), reflecting the fall in interest expenditure from 4.6 to 4.2 per cent of GDP, while the primary surplus remained stable at 1.6 per cent. The ratios of both revenue and

Figure 11.1

Public finance indicators
(per cent of GDP)



Source: For net borrowing and primary surplus, Istat.
(1) A negative balance indicates a deficit (net borrowing); a positive balance indicates a surplus (net saving).

primary spending to GDP shrank by 0.3 percentage points to 47.9 and 46.3 per cent respectively (Table 11.1; see the sections 'Revenue' and 'Expenditure').

Table 11.1

Consolidated accounts of general government (1)
(billions of euros and per cent of GDP)

	2010	2011	2012	2013	2014	2015
Current revenue	726.2	737.1	765.7	762.7	769.5	778.7
Capital revenue	6.2	10.7	5.9	9.3	7.1	5.4
Total revenue	**732.4**	**747.8**	**771.7**	**772.0**	**776.6**	**784.0**
per cent of GDP	45.6	45.7	47.8	48.1	48.2	47.9
Current primary expenditure	665.0	666.4	671.4	683.7	690.9	691.2
Interest payments	68.8	76.4	83.6	77.6	74.3	68.4
Capital account expenditure (2)	66.7	61.9	64.2	57.7	60.3	66.7
Total expenditure	**800.5**	**804.7**	**819.2**	**819.0**	**825.5**	**826.4**
per cent of GDP	49.9	49.1	50.8	51.0	51.2	50.5
Primary balance	**0.7**	**19.5**	**36.0**	**30.6**	**25.4**	**26.1**
per cent of GDP	0.0	1.2	2.2	1.9	1.6	1.6
Net borrowing	**68.1**	**57.0**	**47.5**	**47.0**	**48.9**	**42.4**
per cent of GDP	4.2	3.5	2.9	2.9	3.0	2.6

Source: Istat.
(1) Based on the methodological criteria in Regulation (EU) 549/2013 (ESA 2010). – (2) This item includes (with a negative sign) the proceeds deriving from property disposals.

For the second consecutive year local governments turned in slightly positive balances. Net of transfers from other public entities, their revenue fell by 1.6 per cent (to 8.9 per cent of GDP; see the section 'Revenue'), while expenditure contracted by 1.3 per cent (to 14 per cent of GDP).

With a level of economic activity still well below its potential, Italy's budgetary policy was moderately expansionary. According to the European Commission's most recent estimates, in 2015 the output gap was negative by nearly 3 percentage points and the cyclically-adjusted primary surplus shrank by 0.6 percentage points of GDP.

Part of the expansion is due to temporary measures: the structural primary surplus – which excludes both cyclical effects and the effects of these measures – contracted by only 0.3 percentage points (in 2014 it fell by 0.5 points, after increasing 2.5 points in the two years 2012-13). Taking into account interest expenditure, the structural balance improved by 0.15 percentage points, slightly less than the amount requested of Italy by the Commission last summer (0.25 points).

After the increase of 16 percentage points observed in the three years 2012-14, the public-debt-to-GDP ratio increased marginally, by 0.2 points, to 132.7 per cent (see the section 'General government debt').

Budgetary policy in 2015. – In the Economic and Financial Document (EFD) update of September 2014 the Government planned to increase net borrowing on a current legislation basis by 0.7 points in 2015, to 2.9 per cent (Table 11.2). Nevertheless, as a consequence of earlier measures the structural budget deficit would have improved over 2014 albeit only by 0.1 percentage points, less than the minimum required by European rules at that time (at least 0.5 points).

Table 11.2

Public finance objectives, estimates and outturns for the year 2015
(billions of euros and per cent of GDP)

	General government				Memorandum items:			
	Net borrowing	Primary surplus	Change in structural balance	Debt	Real GDP growth rate (%) 2015	Privatization receipts 2015	Net borrowing 2014	Structural deficit 2014
Objectives								
September 2014 (1)	….	….	….	2,196.9	….	….	….	….
per cent of GDP	2.9	1.6	0.1	133.4	0.6	0.7	3.0	0.9
October 2014 (2)	….	….		….	….	….	….	….
per cent of GDP	2.6	1.9	0.3	133.1	0.6	0.7	3.0	0.9
April 2015 (3)	….	….	….	2,172.2	….	….	49.1	….
per cent of GDP	2.6	1.6	0.2	132.5	0.7	0.4	3.0	0.7
September 2015 (4)	….	….	….	2,172.3	….	….	49.1	….
per cent of GDP	2.6	1.7	0.3	132.8	0.9	0.4	3.0	0.7
Estimates								
September 2014 (1)	36.8	37.5	….	….	….	….	49.2	….
per cent of GDP	2.2	2.3	0.7	133.7	0.5	….	3.0	1.2
April 2015 (3)	41.2	28.2	….	….	….	….	49.1	….
per cent of GDP	2.5	1.7	0.3	132.4	0.7	….	3.0	0.8
September 2015 (4)	42.8	27.2	….	….	….	….	49.1	….
per cent of GDP	2.6	1.7	0.3	132.8	0.9	….	3.0	0.7
Outturn (5)	**42.4**	**26.1**	**….**	**2,171.7**	**….**	**6.6**	**48.9**	**….**
per cent of GDP	2.6	1.6	0.15	132.7	0.8	0.4	3.0	1.1

(1) Economic and Financial Document (EFD) *update 2014*. – (2) Italy's Draft Budgetary Plan 2015 (updated tables). – (3) EFD 2015. – (4) EFD update 2015. – (5) Net borrowing, primary surplus and GDP growth based on Istat data; the change in structural balance in 2015 and structural deficit in 2014 are from the European Commission, Spring forecasts, May 2016.

In October 2014, after a discussion with the European Commission, the Government revised its plans on the occasion of the draft budgetary plan for 2015, trying to strike a balance between the need to strengthen the recovery, finance the reforms and continue fiscal consolidation in accordance with European rules. The structural adjustment for 2015 was increased to 0.3 percentage points of GDP. The goal for the deficit was set at 2.6 per cent.

The Stability Law for 2015 enacted the Government's programmes, increasing net borrowing for 2015 by 0.4 per cent of GDP with respect to current legislation. The budget included a significant reduction in the tax wedge on labour (more than €11 billion), financed in part by measures to combat evasion and by spending cuts. In particular, the tax credit for low- and middle-income workers introduced in May 2014 was made permanent and labour costs were excluded from the tax base for IRAP. Apart from these permanent measures, a three-year social security contribution relief was introduced for private sector employers on new permanent employment contracts stipulated in 2015. Additional resources were directed towards financing the school reform ('La Buona Scuola') and the social buffers envisioned by the Jobs Act (see the box 'The Jobs Act: a preliminary assessment' in Chapter 8).

In January 2015 the European Commission clarified the margins of flexibility allowed by the Stability and Growth Pact, also indicating the size of the fiscal adjustments requested of countries according to their economic situation and level of public debt.[1] In the case of Italy the minimum fiscal adjustment requested for 2015 was reduced from 0.5 percentage points to 0.25, therefore in line with the 0.3 point improvement estimated by both the Government and the Commission.

In April 2015, with the publication of the EFD, the Government confirmed its net borrowing objective: the improvement in the budget balance deriving from a more favourable macroeconomic outlook was to be directed towards the financing of additional expansionary measures, for about 0.1 percentage points of GDP. These resources were then used to finance application of the ruling of the Italian Constitutional Court which, at the end of April, declared illegitimate the freezing of inflation-linked increases for pensions greater than three times the minimum in 2012 and 2013.[2]

Budget plans and outturns. – Net borrowing in 2015 was in line with the plans made in October 2014. Notwithstanding the fact that economic growth was slightly better than expected, the primary surplus was 0.3 percentage points below the objective. The gap was offset by the decline in interest expenditure which was greater than forecast. The structural balance improved by 0.15 points of GDP, instead of the 0.3 points projected in October.

Revenue

General government revenue grew by 1.0 per cent in 2015 to €784 billion or 47.9 per cent of GDP. If both the tax credit for low- and middle-income employees and that for firms against deferred tax assets[3] are reclassified as tax cuts, revenue grew by 0.7 per cent.

The ratio of taxes and social security contributions to GDP remained stable at 43.5 per cent; taking into account the reclassification of the tax credits mentioned above it decreased by 0.2 percentage points, to 42.6 per cent.

Social security contributions increased by 2 per cent to €218.5 billion, in line with the growth in gross wages for the economy as a whole.[4] Tax revenue rose by 1.0 per cent, driven by central government tax revenue (1.9 per cent). Notwithstanding a further increase in the main local tax rates (Figure 11.2), local government tax revenue fell by 2.1 per cent to 6.4 per cent of GDP owing to the reduction in IRAP receipts.

---

1 European Commission communication, 'Making the best use of the flexibility within the rules of the Stability and Growth Pact', COM(2015), 12 final, 2015.

2 In May, the Government passed an ad hoc decree law to approve partial indexing for pensions up to six times the minimum pension, decreasing with the amount of the pension itself. The decree will eventually increase net borrowing by €500 million per year; for 2015 back payments have entailed an outlay of about €2 billion.

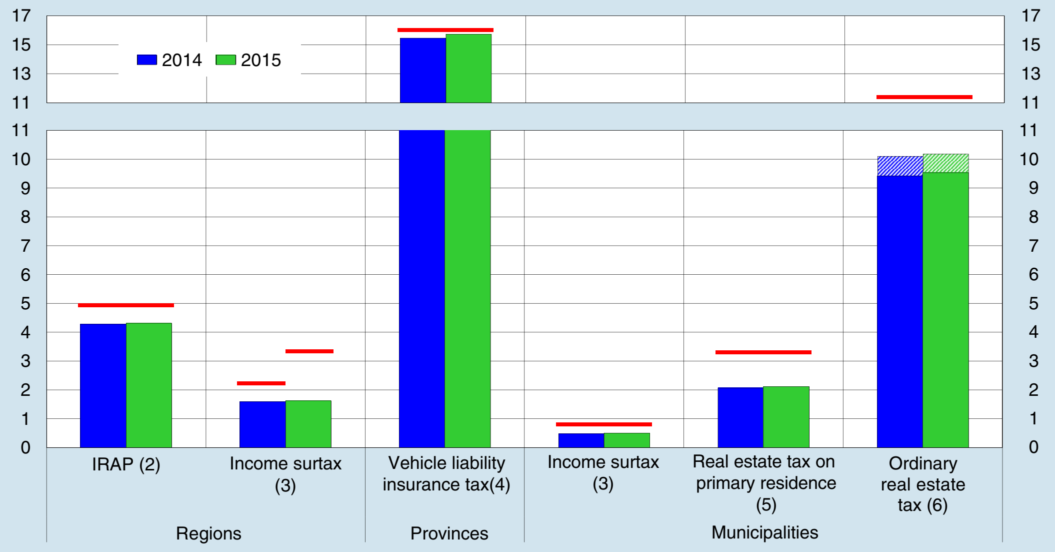
3 According to existing accounting rules (ESA 2010), these credits are entered entirely as increased expenditure. They are hybrid in nature, however. As a rule they result in a decrease in tax revenue because they reduce the taxpayer's liability; only if the liability is smaller than the credit do they give rise to a transfer to the taxpayer (and therefore an expense for general government).

4 The tax relief introduced by the 2015 Stability Law is responsible for a €1.7 billion loss in net revenue according to official assessments.

Figure 11.2

Main local tax rates (1)

(per cent; for municipal taxes, per mille)



Sources: Based on data from Ministry of Economy and Finance (MEF), local government acts, and Ivass.
(1) The red line represents the legal ceiling for each tax; the IRAP rate and the regional IRPEF income surtax rate can exceed the ceiling in the case of high healthcare deficits. – (2) Average of the sectoral rates, weighted by each sector's share of the total tax base of private sector parties based on tax returns. – (3) Average of the rates applied by each region, weighted by each region's share of the tax base according to income tax returns. – (4) Average of the rates applied by each province, weighted by each province's share of motor vehicle liability insurance premiums. – (5) Non-luxury primary residences; average of the rates applied by more than 6,000 municipalities, weighted by tax base. – (6) Taxes on real estate other than the primary residence; sum of IMU and TASI (the cross-hatched area), both calculated as averages of the rates applied by more than 6,000 municipalities, weighted by tax base.

Revenue from direct taxes levied by the general government grew by 1.9 per cent, principally driven by personal income tax receipts, IRPEF, (up 2.7 per cent to €166 billion) and corporate tax receipts, IRES (up 3.2 per cent to €32 billion; the increase was partly due to the end of the transitory effects of the large frontloaded payment required at the end of 2013). Even revenue from taxation of income from financial assets increased sharply (6.4 per cent to €16.1 billion) as a result of the rise in tax rates enacted by Decree Law 66/2014 and the Stability Law for 2015. An opposite effect derived from the lapsing of the one-off tax on the revaluation of equity in the Bank of Italy (€1.8 billion in 2014).

There was a more moderate increase in indirect tax revenue (0.5 per cent, to €249.3 billion), which was particularly affected by the fall in IRAP receipts (-7.5 per cent, to €28.1 billion) due to the exclusion of labour costs from the tax base, and the fall in natural gas tax receipts (-33.1 per cent, to €3.2 billion). Revenue from VAT increased by 4.2 per cent, to €101.2 billion, partly owing to the recovery in consumption and the new tax payment methods provided for in the Stability Law for 2015 (split payments and reverse charges). In 2015 indirect taxes benefited from the contributions paid by banks into the National Resolution Fund (€2.3 billion).[5] Overall, real estate tax receipts (TASI and IMU) grew slightly (1.1 per cent to €24.5 billion).

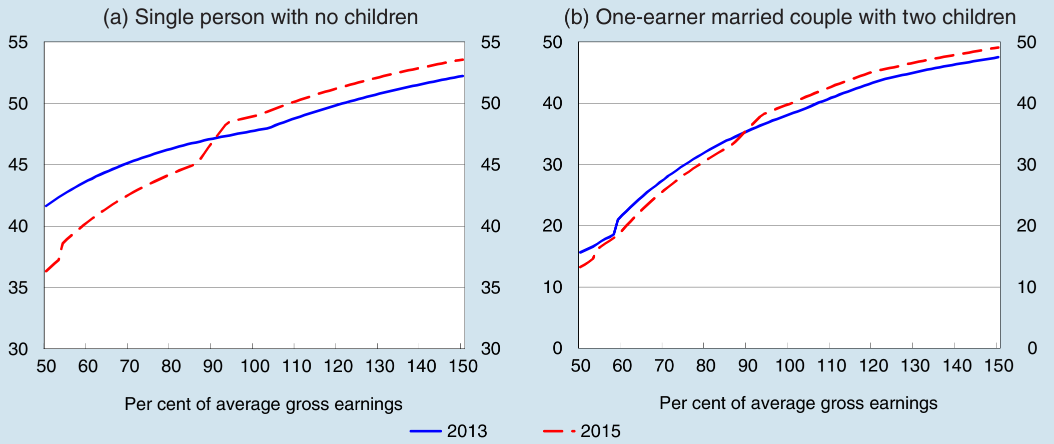
[5] The Fund is classified as part of the general government sector in compliance with European rules.

Italy's tax and social contribution burden in the international context. – Italy's overall tax and social contribution burden is still high: the difference with respect to the euro-area average, while diminishing by 1 percentage point over the last three years, was 2.4 per cent in 2015.[6] Even reclassifying the tax credits mentioned above as decreases in revenue, there remains a difference of 1.6 percentage points.

Based on the OECD's most recent estimates,[7] in the period 2014-15 the tax wedge for Italian workers with gross earnings up to 90 per cent of the average – close to the highest income level eligible for the tax credit introduced in May 2014 – fell on average by about 2 percentage points (Figure 11.3).[8] Estimates indicate that for the same period the average tax wedge with respect to the euro-area countries remained constant. The large tax wedge particularly discourages potential second-income earners within a household from entering employment (see the box 'The taxation of income and female labour supply').

Figure 11.3

Tax wedge on labour in Italy (1)
(per cent)



Source: Based on OECD data, Taxing Wages, various years.
(1) Average gross earnings amounted to €29,704 in 2013 and €30,710 in 2015.

The OECD's estimates are based on existing labour contracts and therefore do not take into account the effects of the temporary social contribution relief applied to new permanent contracts stipulated in 2015. For those benefiting from this relief, if the contributions paid by the employer are less than the maximum exemption under the law (€8,060), the tax wedge is estimated to be halved for three years.

6 Based on European Commission data (Spring forecasts, May 2016).

7 OECD, *Taxing Wages*, various years. The OECD dataset does not include Cyprus, Latvia, Lithuania and Malta, and for Italy it excludes IRAP

8 The OECD does not provide estimates of the tax wedge for workers earning less than half the average wage. For the workers in this category who have benefited from the tax credit for low- to medium-incomes, the reduction in the tax wedge is estimated to be higher than the average; for the others it is virtually nil. For an estimate of the local tax burden, the OECD uses regional and local personal income surtaxes for residents in Rome; the estimate therefore reflects the fact that between 2013 and 2015 there was a significant increase in the regional surtax in Lazio, much higher than in the rest of Italy.

THE TAXATION OF INCOME AND FEMALE LABOUR SUPPLY

Italy has a low level of female labour supply: in 2015, the employment rate of women between the ages of 25 and 54 was more than 14 percentage points less than the European Union average (57.9 per cent against 72.3 per cent).[1] While the employment rate for single women (76.1 per cent in 2014) is broadly in line with the European average, the rate for married women living in a couple is markedly lower (59.4 per cent against 73.2 per cent in 2014).

A recent study looks at the effects of the structure of labour taxes and family allowances on the labour supply of Italian married women.[2] The study is based on a life-cycle model of labour supply, consumption, and fertility, estimated using data from the Survey on Household Income and Wealth relative to the 2004-12 period and constructed to include the structure of the tax and welfare systems in place in Italy at the time.[3]

The occupational choices made in each period also take into account the positive impact of work experience on potential future salary and on the possibility of accumulating savings to cover the risk of unpredictable adverse future events. The model is used to study the effects of various different policies to support lower-income families (increases in family allowances, child-related tax credits, work-related tax credits, and the introduction of different types of subsidies for lower labour incomes). These policies are made comparable by structuring them in such a way as to guarantee a similar impact on the public finances (a reduction of about 4 per cent of the net revenue simulated by the model, taking into account also behavioural reactions).

In the simulations, all the measures reduce the incidence of poverty in the population, but with varying effects on the female labour supply. At one end of the spectrum, the increase in family allowances – a benefit that decreases as overall household income increases – discourages female labour supply. At the other end, work-related subsidies for lower individual incomes which directly affect the economic return from paid labour encourage an increase in the number of hours worked by married women (up to about 3 per cent).

1 For men in the same age group the difference between the Italian figure (78.6 per cent) and the European Union average is much smaller, at about 5 percentage points.

2 M.R. Marino, M. Romanelli, and M.Tasso, 'Women at work: the impact of welfare and fiscal policies in a dynamic labor supply model', Banca d'Italia, Temi di Discussione (Working Papers), forthcoming.

3 In the model, each couple decides whether and how much the wife works, the saving rate and whether to have another child, considering the work opportunities and salaries available. The households differ according to several characteristics, such as the age and education level of the spouses, the wife's work experience, the number of children, wealth, and preferences regarding whether to work or to raise the children. In the empirical section, all the model's parameters are estimated simultaneously, using the method of simulated moments.

According to the latest Eurostat data,[9] in Italy, Germany and France the statutory rate on business income remained stable in 2015 (31.4 per cent, 30.2 per cent and 38.0 per cent respectively) while it fell in Spain (from 30.0 to 28.0 per cent).

9 Eurostat, *Taxation Trends in the European Union*, 2015.

Expenditure

In 2015 general government outlays grew by 0.1 per cent, to 50.5 per cent of GDP or €826.4 billion. Reclassifying the tax credits as discussed above (see the section 'Revenue'), total expenditure is estimated to have fallen slightly and primary expenditure by 0.5 per cent, after five years of particularly slow growth (1.0 per cent per year on average in nominal terms, practically unchanged in real terms).

Primary expenditure. – Social benefits in cash – net of the tax credit for low- to middle-incomes – increased by 0.8 per cent compared with 0.4 per cent in 2014. The pension segment, which represents almost 90 per cent of the total, also increased by 0.8 per cent, as in 2014, largely because the average new pension was higher than the average pension terminated during the year and as a result of cost-of-living adjustments.

Compensation of employees decreased for the fifth consecutive year. Contributing to the 1.1 per cent decrease in nearly equal parts were the reduction in the number of employees – largely caused by the measures limiting employee turnover – and the decrease in average wages, both because of the prolonged wage freeze and as a result of their composition (the salaries of the new hires are on average lower than those of employees that have left their jobs).

Intermediate consumption and social benefits in kind both grew by a total of 0.5 per cent to €133.0 billion. About 90 per cent of the latter and a third of the former relate to healthcare spending, administered by the regional governments, which increased by 1.0 per cent overall, remaining at 6.9 per cent of GDP.

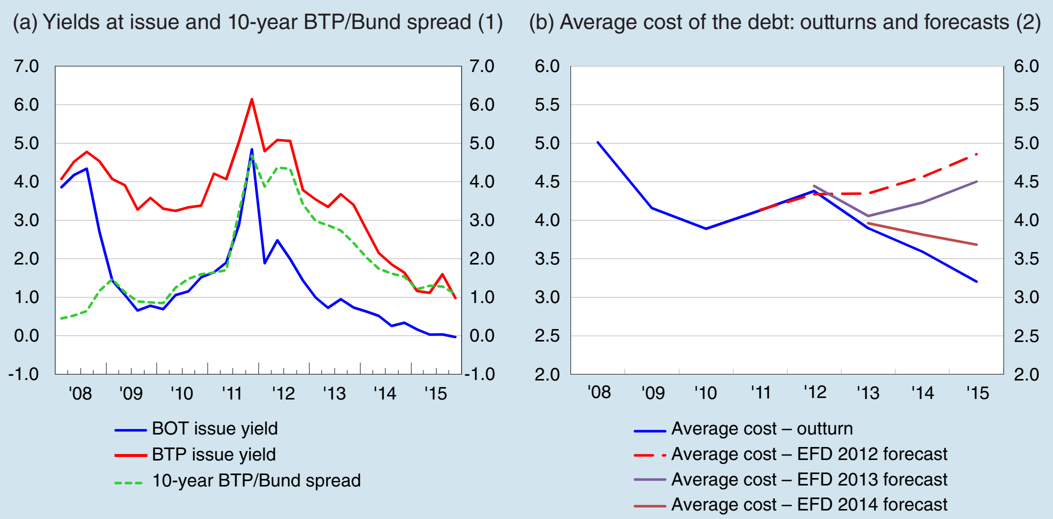
Gross fixed investment – excluding property disposals – remained largely stable, halting the sharp contraction under way since 2010. Capital expenditure grew by 10.7 per cent (4.4 per cent in 2014). The increase reflects the inclusion in the capital account of back payments to pensioners following the Constitutional Court's decision (see the section 'Public finances in 2015') and of the funds disbursed by the National Resolution Fund to cover the losses of the four banks placed under resolution last November (see the section 'Capital and profitability' in Chapter 13). Net of these items and the aforementioned tax credits against deferred tax assets for firms, capital expenditure rose by 7.2 per cent (compared with a 2.5 per cent contraction in 2014).

Interest expenditure. – Interest expenditure fell for the third consecutive year (-7.9 per cent): the increase in debt was more than offset by the decline from 3.6 to 3.2 per cent in its average cost (see the section 'The government securities market' in Chapter 14).

Compared with the level reached in 2012 (5.2 per cent of GDP), over the last three years the ratio of interest expenditure to GDP has fallen by 1 percentage point, for a total saving of €30 billion. The reduction reflects the fall in issue yields on both short-term and medium- to long-term bonds, which were close to 5 and 6 per cent respectively at the end of 2011 (Figure 11.4.a). Mostly as a result of monetary policy and budget measures approved in 2011, at the end of 2015 short-term yields turned negative and yields on medium- to long-term bonds fell by 500 basis points.

Figure 11.4

Yields at issue and average cost of the debt
(per cent)



(1) Average quarterly figures. – (2) The cost of the debt forecast in the EFDs is calculated excluding interest flows in connection with derivatives.

Interest expenditure has been consistently lower than estimated in the Government's programmes (Figure 11.4.b). Compared with the projections in the 2012 EFD, which envisaged an increase of more than half a point in the average cost of debt over the three years 2013-15, interest expenditure for 2015 was lower by about €27 billion, with a total saving over the three-year period of more than €50 billion. In the 2013 EFD both the expenditure and the average cost were still expected to rise; in the 2014 EFD the average cost was expected to ease slightly.

Primary expenditure was largely in line with the 2012 programme (see the box 'The balanced budget target in the 2012 programme and the dynamics of expenditure', Chapter 11, *Annual Report,* 2014), while the unexpected reduction in interest expenditure for the three years 2013-15 has in part offset the reduction in tax revenue caused by the worse than expected cyclical outlook and the tax breaks implemented over the three-year period.

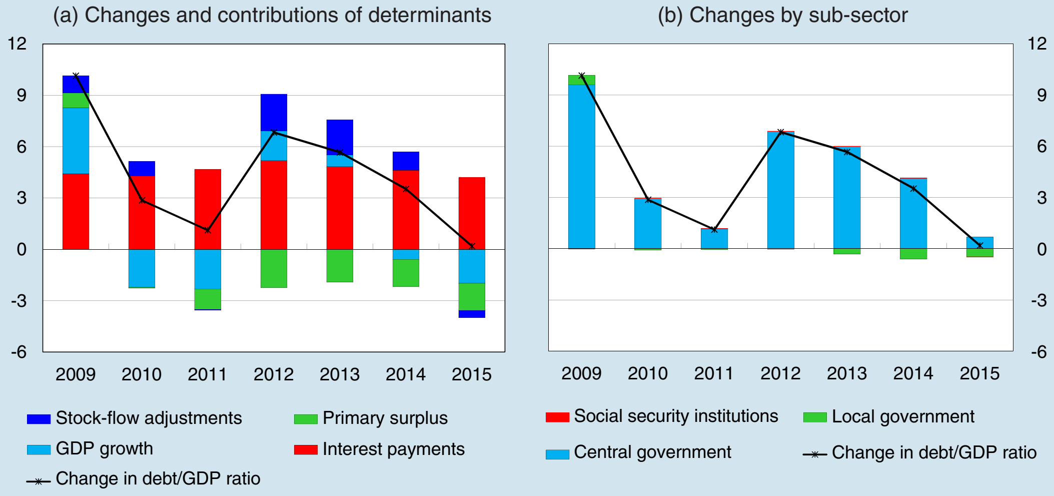
Compared with 2012, the primary surplus in 2015 was lower by about half a percentage point (2.2 per cent of GDP); nonetheless, net borrowing improved by 4 percentage points to 2.6 per cent.

General government debt

In 2015, the ratio of general government debt to GDP rose by 0.2 percentage points to 132.7 per cent (Figure 11.5); the inclusion of the Nation Resolution Fund in the general government increased the debt by 0.1 percentage points. The gap between the average cost of debt and nominal GDP growth increased the ratio by 2.2 points; an opposite effect derived from the primary surplus (1.6 points) and other factors that affect the debt but not net borrowing (0.4 points).

Figure 11.5

General government debt
(per cent of GDP)



The most important of these other factors were the decrease in the Treasury's liquid balance, which resulted in a reduction in gross debt, and the placement of new bond issues at above-par prices on average; these factors held the debt down by 0.7 and 0.3 percentage points of GDP respectively. By contrast, the debt grew as a result of the flows generated by financial derivatives (0.2 points); the reclassification as loans – in accordance with European statistical rules – of the market value of five interest rate swaps resulting from the exercise of five swaptions (0.2 points); and the payments for the reduction of the stock of commercial debt (0.2 points).

Central government debt increased by 0.7 points to 127.1 per cent of GDP, owing in part to loans by the Ministry of Economy and Finance to local governments for the payment of overdue commercial debts and to finance the buy-back of some regional bonds last December (for a total of 0.3 per cent of GDP).

The ratio of local government debt to GDP decreased by 0.5 percentage points to 5.6 per cent. Including financial liabilities to other general government bodies (which are consolidated in calculating general government debt), local government debt amounted to 8.2 per cent of GDP at the end of 2015, a reduction of 0.4 percentage points compared with 2014. Over the last three years the composition of local government debt has changed: in 2012 liabilities towards other general government bodies amounted to 12.7 per cent while at the end of 2015 they came to approximately one third of the total.

The average residual maturity of the debt, in decline since 2011, returned to growth in 2015 (from 6.8 years in 2014 to 7.1) owing in part to the restructuring by Cassa Depositi e Prestiti of loans to local government. The share of debt held by non-residents grew for the second consecutive year, to 34.1 per cent.

Other liabilities and guarantees. – Calculated according to European rules, the public debt does not include some types of liability, such as commercial payables (except those transferred to financial intermediaries without recourse), derivatives and – in that they represent contingent liabilities – general government guarantees in favour of third parties.

Commercial debts fell for the third consecutive year as a consequence of both closer monitoring and more stringent regulatory limits on payment times (see the box 'General government commercial debts'). Net liabilities in derivatives, at market values, decreased from 2.5 to 1.9 per cent of GDP; the decrease is partly due to the reclassification in the public debt of certain derivative transactions in accordance with European statistical rules. In 2015 general government guarantees in favour of third parties fell for the third consecutive year, from 2.7 to 2.3 per cent of GDP, owing above all to the reduction in guarantees in favour of the financial sector.

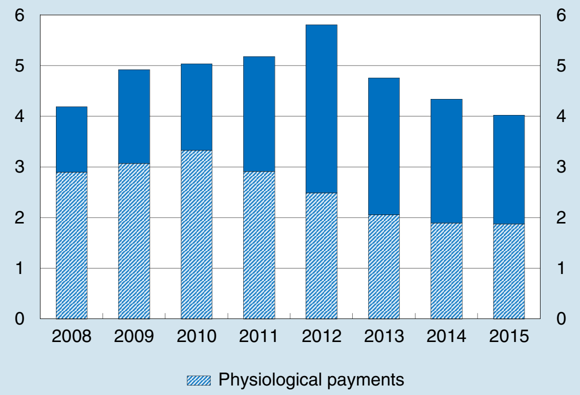
GENERAL GOVERNMENT COMMERCIAL DEBTS

By international comparison, the Italian general government's average payment times are longer and its level of commercial debt is higher.[1] This phenomenon, which was more pronounced during the crisis, has abated over the last few years, mostly due to the measures taken in 2013-14.

In the absence of official data on the overall amount of commercial debt and payment times, reported below are the estimates made by the Bank of Italy based on its own business surveys and on supervisory reports. Due to the survey nature of some data, the estimates are marked by a fair degree of uncertainty.

Estimated commercial debt. – Our estimates show that between 2008 and 2012 total general government commercial debt increased from 4.2 to 5.8 per cent of GDP (figure).[2] In subsequent years the amount fell, primarily due to the large amount of resources made available to

Estimate of general government commercial debts (1)
(per cent of GDP)



(1) Physiological payments are those made within the times fixed by the parties in the contract.

[1] Based on data provided to Eurostat as part of the excessive deficit procedure, the commercial debt-to-GDP ratio is higher in Italy than in any other euro-area country. This data does not take into account commercial debts assigned without recourse to financial intermediaries and, for Italy, nearly all debts against capital expenditure. Even with regard to payment time, based on data from the survey conducted by Intrum Justitia published in the European Payment Report 2016, there is a significant gap between Italy and the average for the other European countries considered.

[2] See L. D'Aurizio, D. Depalo, S. Momigliano and E. Vadalà, 'Trade debts of Italian general government: an unsolved problem', *Politica economica - Journal of Economic Policy,* vol. 31, 3, pp. 421-458; also published in Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), 295, 2015.

the local governments (almost €50 billion in the two-year period 2013-14, about 70 per cent of which was utilized) as part of a special plan for the payment of overdue debts. At the end of 2014, the year in which the plan neared an end, commercial debts amounted to 4.3 per cent of GDP (about €70 billion).

In 2015 local governments paid their commercial debts primarily from ordinary funds in their budget: the amount of commercial debts decreased slightly, to 4.0 per cent of GDP (€65 billion). This level nonetheless remains significantly higher than physiological, i.e. the level consistent with contractual payment periods.[3] The physiological stock has fallen in the last three years, partly as a result of the transposition of the European late payment directive that requires normal payment times to be between 30 and 60 days.

Estimated average payment times. – According to our estimates, average payment times continued to decrease in 2015, falling to about 115 days; it was more than 120 in 2014 and peaked at almost 200 days in 2010. The reduction in the average payment times with respect to 2014 is mainly due to a reduction in the delay, while contractual payment times remained virtually unchanged.

[3] Estimated using responses from firms in the sample survey conducted by the Bank of Italy, which distinguishes between contractual times and delays in payment.

The outlook

In the 2015 EFD the net borrowing objective for 2016 was 1.8 per cent, 0.4 points above the baseline projections. The Government wanted to avoid activation of the safeguard clauses, which would have implied a €16 billion tax hike, only partly offsetting the effects of this decision with resources gained from the spending review. The planned reduction of the structural deficit was 0.1 per cent of GDP (Figure 11.6); the Government sought application of the flexibility provided for by the Stability and Growth Pact in relation to its structural reforms; without it the necessary adjustment – given the cyclical position and the level of public debt – would have been equal to half a percentage point. In July, at the close of the European semester, the Council of the European Union conceded to Italy the flexibility requested and concurred that the programmed structural improvements were consistent with European regulations.

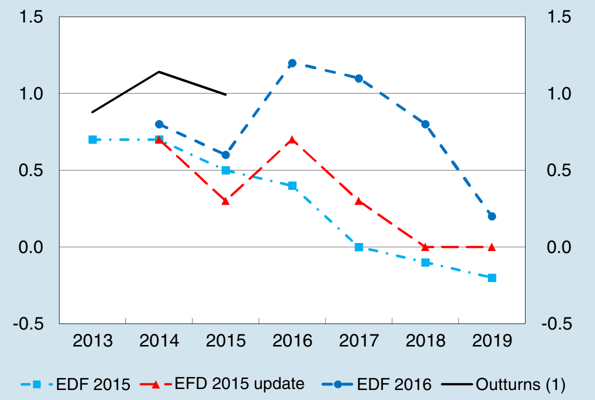
In September, in the 2015 EFD update, the Government emphasized its expansionary fiscal policy stance for 2016 even though the economic outlook had improved slightly. Although the estimate of net borrowing on a current legislation basis was not changed, the projected deficit was raised to 2.2 per cent of GDP, 0.4 points above the level set in April (with the possibility of a further 0.2 point increase, largely to move to 2016 the reduction of the IRES rate planned for 2017).[10] In the new planning framework, the structural balance, rather than

[10] The increase was conditional upon the European Commission's consent to the request for greater margins of flexibility for refugee-related additional expenditure.

improving slightly, worsened by 0.4 points compared with 2015; the achievement of structural budget balance was postponed from 2017 to 2018.

Figure 11.6

General government structural deficit: objectives and outturns
(per cent of GDP)



(1) European Commission, Spring forecasts, May 2016.

According to the Government the increase in the deficit was consistent with European regulations, on the basis of the margins of flexibility conceded in respect of investments and the additional room for manoeuvre allowed for structural reforms. In November the European Commission signalled the risk of non-compliance with the rules, though it recognized that conditions might exist for providing greater flexibility than granted in July; it also announced that Italy's position would be assessed in the spring. The Eurogroup concurred with the Commission's opinion.

The expansionary measures programmed by the Government were implemented via the Stability Law for 2016 which, apart from postponing the triggering of the safeguard clauses (and modifying their scope), also provided for the virtual elimination of the tax on the primary residence.[11] By incorporating an amendment of the Government to the initial bill, the package approved by Parliament allocated the additional increase in the deficit (0.2 per cent of GDP) to various measures, mostly temporary in nature and relating to security and culture. According to official estimates the measures increase the deficit by 1.1 points compared with the baseline, bringing it to 2.4 per cent of GDP.

In the April 2016 EFD, the Government presented the new baseline projections and the public finance programmes for 2016-19. For the current year, the deficit is estimated at 2.3 per cent with a moderate decline in the debt-to-GDP ratio (0.3 percentage points). For the coming three-year period net borrowing on a current legislation basis is expected to gradually decrease and in 2019 a budget surplus of 0.4 per cent of GDP is projected. The Government is planning to widen the deficit by about 0.4 per cent per year on average, reflecting its intention to not apply the safeguard clauses and to only partly offset the effects through a spending review (see the box 'Assessing the performance of local government enterprises'), a revision of tax expenditure and by strengthening measures to combat tax evasion and avoidance. In structural terms, after worsening by 0.7 percentage points of GDP in the current year, the balance is expected to improve by 0.1 points in 2017.

[11] *Audizione preliminare all'esame della Nota di aggiornamento del Documento di economia e finanza 2005*, testimony of the Deputy Governor of the Bank of Italy L.F. Signorini, Senate of the Republic, Rome, 29 September 2015 (only in Italian).

ASSESSING THE PERFORMANCE OF LOCAL GOVERNMENT ENTERPRISES

According to estimates by the Ministry of Economy and Finance, there are nearly 8,000[1] local government enterprises in Italy (entities part-owned by local governments), much more than in France or Germany. In recent years – as part of the spending review – the Government has intervened numerous times to streamline the use of these enterprises and to reduce their numbers.

Empirical evidence on the efficiency of private and public enterprises is not conclusive, partly because it is influenced by the fact that public enterprises often operate in sectors with a low level of competition. A recent study[2] compared the performance of local government enterprises with that of a comparable sample of private enterprises, similar in terms of business sector, size, geographical location and ownership structure. The study found that government enterprises have lower total factor productivity. The performance gap with respect to private enterprises, which averages about 8 per cent, increases as the share held by the public sector increases, reaching 15 per cent for fully publicly owned enterprises. Regarding the level of competitiveness in the market,[3] the performance gap is smaller and statistically significant only when the share held by the public sector exceeds 30 per cent.

1 Ministry of Economy and Finance, *Rapporto sulle partecipazioni detenute dalle Amministrazioni Pubbliche al 31 dicembre 2013*, December 2015.

2 N. Curci, D. Depalo and E. Vadalà, 'Municipal socialism or municipal capitalism? Performances of local public enterprises in Italy', mimeo. The econometric analysis is robust against the possibility that the ownership structure of firms is determined endogenously.

3 The classification of sectors by degree of competitiveness is found in Table II.3 of the 'Programma di razionalizzazione delle participate locali', prepared by the working group headed by C. Cottarelli, Special Commissioner for the Spending Review.

In May, the European Commission decided not to open the excessive deficit procedure despite Italy's failure to meet the debt rule, in the light of some relevant factors. In particular, the Commission took into account the still unfavourable macroeconomic context, Italy's structural reforms and its broad compliance with the preventive arm of the Stability and Growth Pact. Regarding the latter, however, the Commission has indicated, based on its projections, that there is a risk of significant non-compliance with the objectives established by the rules. To avoid this deviation it will be necessary to step up the Government's consolidation plan starting next year. In particular, the concession of a margin of flexibility totalling 0.85 percentage points of GDP for 2016[12] allows a significant deviation to be avoided and, as already indicated in November, is conditional upon the resumption in 2017 of a credible convergence path towards the medium-term objective. For next year, the Commission's estimates indicate that, in order to avoid a significant deviation, the structural correction should be increased by 0.15 to 0.2 percentage points of GDP with respect to what had been programmed. The Commission has announced an additional assessment of the debt criterion in autumn in the light of the draft Stability Law for 2017. The Government has confirmed its commitment to comply with European rules and its belief that its programmes are consistent with them.

12 Of these, 0.5 points relate to the structural reform clause and 0.25 to the investment clause; the other 0.1 points relate to expenditures for exceptional events beyond the Government's control, in connection with the flow of migrants and the threat of terrorism.

12. BUSINESS ACTIVITY REGULATION AND THE INSTITUTIONAL ENVIRONMENT

Reforms designed to improve firms' operating conditions proceeded. In addition to intervention in the labour market, the Government has amended Italy's bankruptcy law and enforcement procedures, which could speed up credit recovery and promote a swifter and less costly reinvestment of resources. The general government reform and the new Public Procurement Code have been approved. These measures can gradually raise quality and probity in government action. Their full effectiveness is conditional on their proper implementation; they may necessitate further organizational changes and the investment of additional resources.

There are signs of improvement in the civil justice system, above all thanks to the measures adopted in recent years to reduce the number of cases that go to trial; nonetheless, proceedings continue to be very drawn out, especially in some courts. Little progress has been made in removing the obstacles to competition that persist in several service sectors.

Competition and market regulation

Following the liberalization measures adopted in 2011 and 2012, there has been limited progress in opening markets to competition. The annual draft law on competition, presented to Parliament in February 2015, has yet to be passed. In the text, which originally incorporated only some of the proposals contained in the Italian Competition Authority's last official opinion to the Government published in July 2014, several provisions on the exclusive rights enjoyed by certain professional categories and the fuel distribution system have been watered down.

The legislative decree on the reordering of local public services, which implements Law 124/2015 (known as the 'Madia Law' after the Minister who proposed it), will help rationalize the current regulatory framework by harmonizing the sector's rules. However, the possibility of resorting without distinction to either competitive procurement procedures or in-house service providers, which has been enshrined as a general and inviolable principle, inhibits further intervention at the sector level to encourage the award of contracts through competitive procedures.

In the motorway sector recourse to competitive procedures for the renewal of existing concessions, envisaged under the new Public Procurement Code (Legislative Decree 50/2016), can help obviate the problem of multiple contract extensions.[1]

---

[1] *Indagine conoscitiva in materia di concessioni autostradali*, testimony of the Head of the Bank of Italy's Structural Economic Analysis Directorate, P. Sestito, before the Chamber of Deputies, Rome, 11 June 2015.

The regulation of business activity

Bankruptcy law. – Decree Law 83/2015, converted into Law 132/2015, made numerous amendments to Italy's insolvency law. Additional measures were introduced by the recent Decree Law 59/2016. In order to shorten the length of bankruptcy procedures, deadlines have been set for judicial commissioners to prepare and implement liquidation plans; failure to comply with these deadlines can lead to the revocation of the commissioner's appointment. Bankruptcy procedures can now be concluded even pending the outcome of litigation, and measures have been taken to ensure the prompt distribution of the proceeds of sales. A digital registry has been created containing detailed information on enforcement and insolvency procedures, accessible to parties operating in various capacities on the NPL market. The availability of this data will ensure greater transparency, and so not only foster the development of an NPL market by making it easier to assess the value of bad loans, but also facilitate restructuring operations.

A series of new measures have been adopted to promote the use and increase the effectiveness of crisis resolution tools (see the box 'The contractual instruments for managing business crises: recourse and results'). A new restructuring agreement for firms with the greatest exposure to banks and financial intermediaries has also been introduced, and its effects can now be extended to non-participating creditors; alternative composition plans to those proposed by debtors can also be presented by creditors.

NEGOTIATION TOOLS FOR MANAGING BUSINESS CRISES: THEIR USE AND OUTCOMES

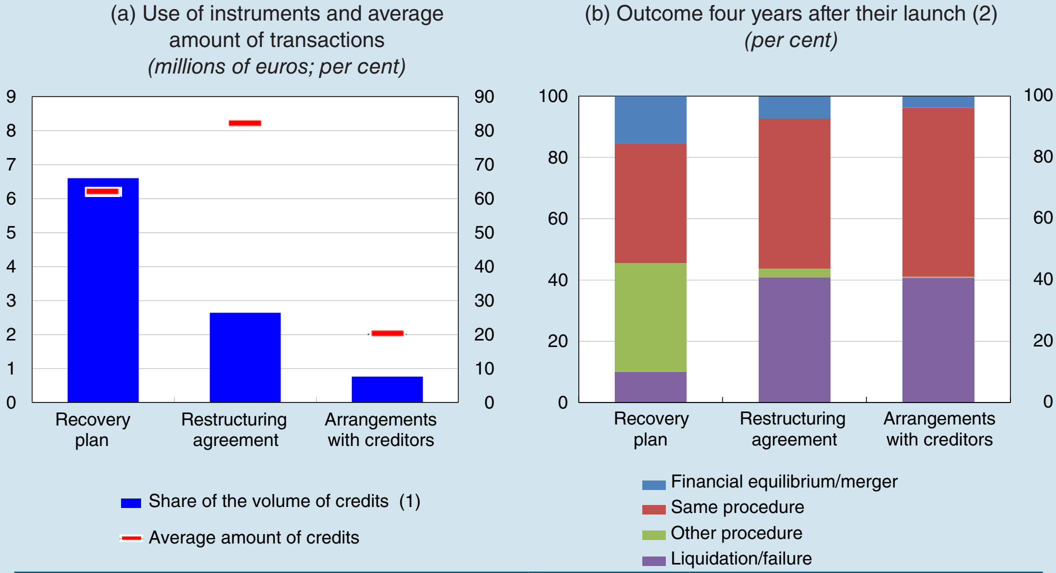
Italy's bankruptcy law contains a number of debt restructuring tools based on contractual agreements between debtors and creditors, designed to enable companies in financial distress to remain viable: recovery plans, restructuring agreements and arrangements with creditors. These instruments differ mainly in relation to the extent of the courts' involvement – the greater this is, the more complex the procedure – and the applicability of the content of agreements to non-participating creditors. Judges have little or no involvement in recovery plans, and increasing involvement in restructuring and arrangements with creditors. Only for both of the latter is it possible, with the judge's intervention, to extend the content of the agreement to non-participating creditors.

The survey conducted by the Bank of Italy in 2015 among Italy's main banking groups on the procedures for managing NPLs to firms provides a series of indications on the frequency with which the various instruments are used and the outcomes of debt restructurings.[1] By volume of the loans involved, the recovery plan is the most frequently utilized tool (66 per cent), followed by restructuring agreements, used in little more than 25 per cent of cases, and pre-bankruptcy arrangements with creditors. The average amount of these credits is higher in restructuring agreements (figure, panel A).

[1] L. Carpinelli, G. Cascarino, S. Giacomelli and V. Vacca, 'The management of non-performing loans: a survey among the main Italian banks', Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), 311, 2016.

Four years after the debt restructurings began, 75 per cent of those involving recovery plans are still under way or another procedure has been opened; this share is 41 per cent for restructuring and arrangements with creditors (three years since they began). Compared to the other instruments used, the recovery plan is more frequently associated with positive outcomes: in just over 15 per cent of cases firms' financial equilibrium is restored or they merge with other businesses, compared with 7 per cent for debt restructuring agreements and 4 per cent for arrangements with creditors (figure, panel B). All in all, the survey found a preference for less procedurally complex and burdensome instruments, which nonetheless are less frequently brought to conclusion.

The use of restructuring instruments, average amounts and outcomes



(1) Right-hand scale. – (2) Data for arrangements with creditors refer to outcomes 3 years after their launch.

In a partial reversal of these developments, changes have been made to the rules on pre-bankruptcy arrangements with creditors regarding voting modalities and the content of the proposals, which could limit their use. Although their objective is to safeguard unsecured creditors, these measures risk hindering the conclusion of negotiated agreements capable of delivering for all parties, creditors included, better results with respect to the liquidation.

Arrangements with creditors are widely used for the purposes of liquidation. Based on the data provided by Italy's main banks, at the end of 2014 almost 25 per cent of total credits involved in liquidation procedures were attributable to compositions with creditors (54 per cent to bankruptcies, and 21 per cent to home foreclosures). The average value of the credits involved in arrangements with creditors was higher than for bankruptcies (almost €1 million compared with €450,000).[2] Composition plans were used more frequently in areas of Italy where bankruptcy procedures take longer.[3]

[2] L. Carpinelli, G. Cascarino, S. Giacomelli and V. Vacca, 'The management of non-performing loans: a survey among the main Italian banks', Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), 311, 2016.

[3] C. Castelli, G. Micucci, G. Rodano and G. Romano, 'The "concordato preventivo" in Italian corporate bankruptcy law: a policy evaluation', Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), 316, 2016.

Home foreclosures. – Swifter credit recovery times may be among the effects of the measures envisaged by Decree Law 83/2015, designed to speed up enforcement proceedings. The use of public auctions has become marginal. Instead, the use of irrevocable written offers to secure sales is being encouraged, as well as flexibility in determining the property price, thereby reducing the number of attempts at sale necessary to assign the asset. It has become obligatory for judges to delegate sales transactions to professional vendors. Finally, Decree Law 59/2016 has introduced a time limit within which the debtor can oppose the proceeding and has made it obligatory for judges to use electronic instruments for sales transactions.

Security interests. – International comparisons highlight the ample room that exists in Italy for modernizing the rules on liens, pledges and mortgages.[4]

Decree Law 59/2016 introduces a form of non-possessory security interest over movables (where previously debtors were required to transfer possession of the asset), thereby facilitating the granting of security interests. The new arrangements mean that, if debtors default, creditors can claim the asset directly, requesting that it be assigned to them without recourse to any legal proceeding. This mechanism, which is not retroactive, will speed up the satisfaction of claims in the event of default, and will also have positive effects on deliverable recovery rates.

Also for loans to firms secured by real estate, an out-of-court mechanism has been introduced to assign the asset to the creditor. Subject to the agreement of all parties, this mechanism can also be used for existing loans, including those classified as non-performing in the balance sheets of credit intermediaries provided no insolvency procedure is already under way. If opposed, the out-of-court examination of the security interest can enable the debt to be extinguished within a few months, compared with an estimated duration of in-court examinations of over three years (see the box 'The measures on credit recovery procedures' in Chapter 13). With the new recovery procedures creditors' claims are satisfied by acquiring an illiquid asset, whereas in enforcement procedures creditors receive the sale price.

The rules on liens, i.e. those governing the pre-emptive rights granted by law according to the nature of the credit, remain a critical area. They are often anachronistic and opaque, rendering uncertain the satisfaction that competing creditors can obtain from the security interest.[5]

The institutional environment

Civil justice. – The number of cases pending in the courts of first and second instance continued to decline, confirming the trend under way since 2010. Overall, from the end of 2009 to 30 June 2015 the reduction came to 23 per cent. The improvements were

---

4 The 'strength of legal rights' indicator in the World Bank report titled *Doing Business 2016. Measuring Regulatory Quality and Efficiency*, which measures the degree of protection that the rules on security interests and some bankruptcy law arrangements grant to creditors and debtors, ranked Italy second last among the OECD countries.

5 E. Brodi, 'Il Sistema delle garanzie in Italia: una lettura economica delle disposizioni in materia di privilegio, pegno e ipoteca', Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), forthcoming.

most marked for the workload of justices of the peace (down by 39 per cent), followed by first instance courts (15 per cent) and appellate courts (21 per cent).

These trends are mostly attributable to the fall in the number of new cases owing to the measures adopted in recent years to reduce the number that go to trial. In the offices of the justices of the peace and first instance courts, this decline was accompanied, however, by a fall in definitive sentences. Only the appellate courts are functioning more efficiently, as confirmed by the growing number of cases closed, apparent since 2005.

At national level the number of pending cases has diminished in all judicial offices to varying degrees. Significant differences remain, however, suggesting room for improvement in how the work of the courts is organized (see the box 'The uneven performance of court offices in Italy'). Efficiency gains could stem from enabling law 57/2016 for the reform of the honorary magistracy, which envisages their use in a supportive capacity alongside stipendiary magistrates.

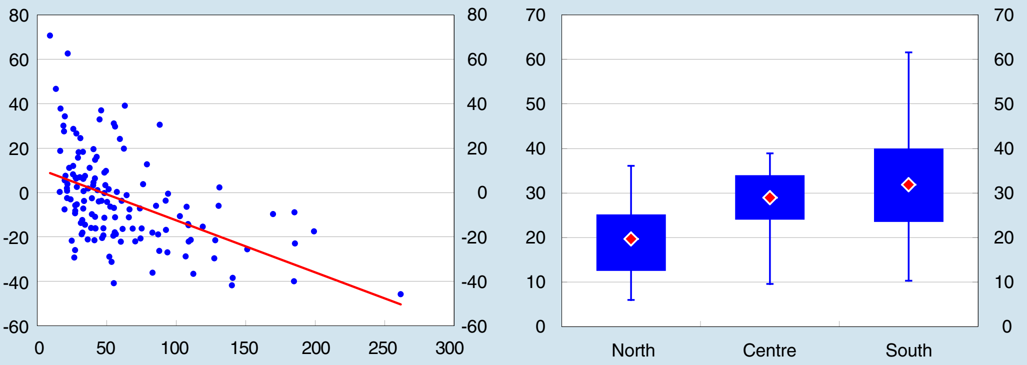
THE UNEVEN PERFORMANCE OF COURT OFFICES IN ITALY

In 60 per cent of first instance courts the number of cases pending has declined (to varying degrees and by up to 46 per cent), while in the remaining 40 per cent this number has gone up. The reductions have been largest in courts with the highest initial levels of pending cases (figure, panel A). The trends, however, are correlated above all with the variations that have occurred in case inflows.

Differences in courts' performance in Italy

(a) Proceedings pending: starting level in 2009 and change from 2009-14 (1)
(number of proceedings; per cent)

(b) Proceedings pending for more than 3 years as a share of the total by geographical area in 2014 (2)
(per cent)



Source: Based on Ministry of Justice data.
(1) The horizontal axis shows the number of proceedings pending (per 1,000 inhabitants) in 2009; the vertical axis shows the percentage change in the number of proceedings pending in the period 2009-2014; the red line shows the linear interpolation. – (2) The graph shows the number of proceedings pending for more than 3 years as a share of the total; the lower and upper extremes indicate the lowest and highest values, the rhombus the average, and the rectangle the interquartile range.

The picture is very uneven, with marked differences throughout Italy. On average the share of cases pending for more than three years is 20 per cent in the North and 30 per cent in the Centre and South. There are also considerable variations within areas, especially in the South (figure, panel B). In the appellate courts the number of pending cases began to diminish from 2012 onwards. The decline has occurred in all the courts, though not to the same degree. For appellate courts too, significant differences remain, which – unlike for the first instance courts – are unrelated to geographical location. At the end of 2014 the share of cases pending for more than three years varied from 2 per cent in Trieste to 51 per cent in Potenza.

The data for the Court of Cassation run counter to these trends. During 2015 pending appeals increased by almost 4 per cent. At the end of 2015 the number of appeals had exceeded 100,000, almost double the figure for 2000. In 2015 some 30,000 appeals were lodged, of which 38 per cent relating to taxation. Of the total cases registered 15 per cent had a declared economic value of less than €5,200; over half involved the State or local government authorities.

The efficiency of the Public Administration. – With the approval of enabling law 124/2015, last summer marked the beginning of a wide-ranging and ambitious general government reform. Among the main measures adopted, the law rationalizes organizational arrangements, simplifies administrative procedures to speed up the launch of new businesses, and increases the use of ICT technologies. Important changes have also been made at managerial level, to promote greater transparency and competition in appointments, and in public sector employment, through a review of selection and staff assessment mechanisms.

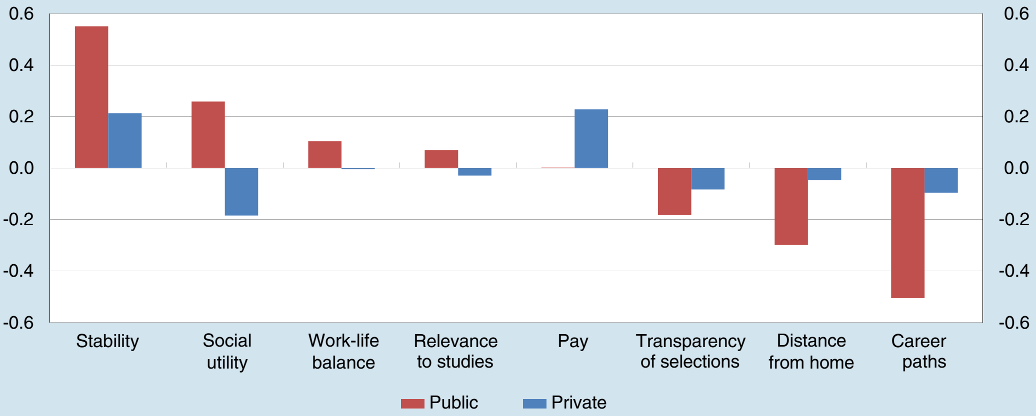
The implementation of these measures can improve the quality of government action over time; their full efficacy may require the investment of additional resources. To ensure more effective change in how general government works, phenomena such as the fragmentation of duties and duplication of functions must be eradicated.

WHY PEOPLE OPT TO WORK IN THE PUBLIC SECTOR

The 2014 Survey of Household Income and Wealth posed a series of questions to public and private sector employees about what had led them to choose their respective sector of employment. Their responses reveal a marked preference for the public sector over the private one: 82 per cent of public sector workers said they had deliberately opted for the public sector, against 40 per cent of workers who chose the private sector. Most of the factors driving their choices were non-financial: the prospect of a stable employment contract, a healthy work-life balance, the work itself both in terms of social utility and of its relevance to academic qualifications (see the figure).

The scores attributed to eight factors by workers with different characteristics highlight the main strengths and weaknesses of the public sector in attracting the best-educated and most capable workers. The estimates show that public sector employment is significantly less attractive than the private sector for career prospects, but more attractive for the relevance of jobs to academic qualifications and that these differences are greater among more highly-educated and high-ability workers (defined as those who earn their degree fastest). For the most highly educated, moreover, the public sector scored significantly less well than the private sector when it came to the transparency of selection procedures and pay, while it fared better relative to the desire to carry out socially useful work and to achieve a healthy work-life balance.[1]

Influence of the various factors on the decision to work in the public and private sectors (1)



Source: Based on data from the 2014 Survey of Household Income and Wealth.
(1) Average deviation from individual mean score (ranging from 1 to 5), by sector and motivation. The eight factors examined were: the stability of the employment contract ('stability'), the desire to carry out socially useful work ('social utility'), the working hours that most respond to personal needs ('work-life balance'), the matching of job specs to skillsets ('relevance to studies'), salaries and pay scales ('pay'), transparency of selection procedures ('transparency of selections'), distance from the worker's place of residence ('distance from home'), more dynamic career paths ('career paths').

[1] L. Rizzica, 'Why go public? A study of the individual determinants of public sector employment choice', Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), forthcoming.

The focus on public sector employment is a welcome development, above all with a view to making the sector more attractive to motivated and skilled workers (see the box 'Why people opt to work in the public sector').

In Italy the public sector's ability to attract these workers has suffered as a result of wage and career structures that place little value on education and workers' skills. According to estimates based on data from the European Union Statistics on Income and Living Conditions (EU-SILC) survey conducted by Eurostat, Italy trails other countries (Spain, UK, France and Germany) by around 2 percentage points in returns on schooling. This gap is more pronounced in the public sector (2.6 percentage points) than in the private sector (1.9 points). Estimates based on data from the OECD's Programme for the International Assessment of Adult Competencies (PIAAC) show qualitatively similar results for certified cognitive (numerical and linguistic) skills.

The difficulties of attracting the most well-educated and capable workers have been exacerbated by the widespread recourse in the past fifteen years to flexible working contracts, usually drawn up following rather opaque selection processes, and by the permanent hirings that ensued, which bypassed the rules on public competitions (see Chapter 15, 'The public administration' in last year's *Annual Report*).

Traditional selection procedures, primarily oriented towards recruiting workers with a broad-based education by verifying the possession of purely factual notions, can raise barriers to the entry of the right people for the job. Estimates based on the Bank of Italy's 2014 Survey of Household Income and Wealth indicate that the likelihood of success in a competition depends more on the efforts candidates make to pass a specific entrance exam than on indicators of intrinsic ability. The costs for candidates of preparing for competitive exams were also reported to be high: those hired following a public competition studied five months on average to prepare for the exam; over 45 per cent of candidates did not work during that period.[6] The irregular scheduling of exams and long reserve lists of those deemed qualified for the job but not among the first wave hired (with waiting times to entry averaging seven years for every successful candidate) pose further problems.

The reform limits recourse to reserve lists of qualified candidates and centralizes competition management, which should help ensure greater transparency and the comparability of selection processes and enable competitions to be held more regularly. The centralization of the competitions should not preclude other, more flexible, channels for the recruitment of specialists. Selection processes would be more efficient if competition procedures were flanked by genuinely selective trial periods, designed to verify candidates' aptitudes and motivations.

The phenomenon of temporary work is being combated by culling the forms of flexible contracts that can be used in general government; to lower the risk of persons being hired on a permanent basis without due attention to merit, their permanency must be conditional upon participation in authentically selective procedures.

The criteria for assessing public employees' performance and incentives, vital for motivational purposes, have not been clearly defined in the enabling law. The margins for recognizing and awarding individual merit could be increased through more flexible career paths and by granting additional administrative powers to managers.[7]

Public contracts. – Improvements in the efficiency of government action should also come about as a result of the new Public Procurement Code (Legislative Decree 50/2016), which plots the transition from rigid and complex rules to less burdensome and more flexible arrangements. Greater discretion is attributed to the contracting authorities, through further centralization and by introducing a special qualification system. This increased discretion has been counterbalanced by stronger regulatory powers for Italy's National Anti-Corruption Authority, the erection of important barriers to corruption and the special attention given to the executive phase of contracts. Especially welcome is the decision to introduce reputational requirements for firms, enabling their previous track records to be taken into account.

6 C. Giorgiantonio, T. Orlando, G. Palumbo and L. Rizzica, 'Incentivi e selezione nel pubblico impiego', Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), forthcoming.

7 R. Occhilupo and L. Rizzica, 'Incentivi e valutazione dei dirigenti pubblici in Italia', Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), 310, 2016.

If promptly followed by suitable implementation measures, in particular the adoption of flexible regulatory instruments (guidelines and standard documents) by Italy's National Anti-Corruption Authority, the new Code could ensure a more stable regulatory framework and make operators responsible for the results achieved. The success of the reform will also depend on the availability of financial and human resources, crucial for ensuring the correct exercise of the discretionary elements introduced by the new instruments.

13. BANKS AND INSTITUTIONAL INVESTORS

In 2015 the improvement in the short-term economic outlook was reflected in the activity of Italy's banks.

Bank lending stabilized at the end of 2015 and, for the first time in four years, rose slightly in the early months of 2016. Supply policies became more expansionary, but continue to vary widely depending on the perceived risk and size of clients. Funding diminished slightly, as did its average cost, mirroring trends in money market rates. Funding conditions held stable overall, even following the resolution of four banks holding a total market share of around 1 per cent of system-wide deposits.

The improvement in the short-term outlook had a positive impact on the quality of credit; the loan default rate diminished markedly; the stock of NPLs stabilized. Earnings turned positive again for bank and non-bank intermediaries: nonetheless, difficulties remain for most small banks, several medium-sized ones, and for mutual guarantee institutions. Capital ratios increased.

At the end of 2015 and in the early months of this year the slide in banks' share prices throughout the euro area – chiefly due to an increase in risk premiums – and the spike in their volatility were more pronounced for Italian banks, which are weighed down by a large volume of NPLs (see *Financial Stability Report*, No. 1, 2016). Investor uncertainty surrounding the outcome of a number of previously scheduled capital strengthening operations also played a part.

The high incidence of NPLs, a legacy of the long recession, has dented banks' earnings and, accordingly, their ability to raise capital and extend credit. The necessarily gradual reduction of these loans could benefit from the measures introduced last year, including those to speed up credit recovery (see Chapter 12, 'Business activity regulation and the institutional environment') and the state guarantee scheme for securitized bad debts (Gacs). The recently created private investment fund Atlante could foster the development of a secondary market in NPLs (see the box 'The launch of the Atlante fund', *Financial Stability Report*, No. 1, 2016).

The funding activity of institutional investors remained intense. Low interest rates prompted institutional investors to reduce their holdings of Italian public securities and increase those of private sector securities. The growth in funding continued to boost the profitability of the main segments.

BANKS

The structure of the Italian banking industry

At the end of 2015 Italy had 139 banks belonging to 75 banking groups, 424 stand-alone banks, and 80 branches of foreign banks.[1] Last year the number of banks decreased by 20: there were 16 new licences and 36 terminations, of which 26 were due to bank consolidation, 8 to liquidation and 2 to voluntary termination of the banking licence.

As a result of the reform of Italy's cooperative (*popolari*) banks,[2] two of the main parent banks became joint stock companies in 2015, and another one followed suit at the beginning of 2016.

Last April the mutual bank reform (*banche di credito cooperativo*) was enacted;[3] it will impact on 365 banks and provides for the creation of mutual banking groups as a means to encourage consolidation in the sector, economies of scale, and capital strengthening (see the box 'The recent reform of Italian mutual banks', *Financial Stability Report*, 1, 2016).

In November 2015 a solution was found to the crisis of four banks under special administration, holding around 1 per cent of system-wide deposits. The solution was based on the new rules introduced in the Italian legal system in transposing Directive 2014/59/EU on the recovery and resolution of credit institutions and investment firms (BRRD).[4]

The Italian banking groups classified as 'significant' under the Single Supervisory Mechanism (SSM) and supervised directly by the ECB in close cooperation with the Bank of Italy, numbered 13 in 2015; their combined assets came to 73 per cent of Italy's banking system total. Three groups featured among the 37 European banks with total assets of at least €200 billion.[5] These intermediaries were identified by the Bank of Italy at the beginning of 2016 as 'other systemically important institutions' (O-SIIs);[6] the largest one was included among the global systemically important institutions (G-SIIs) by the Financial Stability Board, along with 12 other European banks, and subsequently designated as a G-SII by the Bank of Italy. Compared with a sample of European significant banking groups, on average Italy's banking groups have a higher share of assets invested in loans to firms and less diversified credit risk exposure by country; both these traits could be a vulnerability during a recession.[7]

---

1 Data as at 31 December 2015.

2 Decree Law 3/2015, converted by Law 33/2015.

3 Decree Law 18/2016, converted by Law 49/2016.

4 See the Bank of Italy's website: 'Questions and answers on the solution of the crises at the four banks under resolution'.

5 Banks with exposures of at least €200 billion at the end of 2014 according to data published on the European Banking Authority's website.

6 See the Bank of Italy's website: 'Identification of UniCredit, Intesa Sanpaolo and Monte dei Paschi di Siena banking groups as other systemically important institutions(O-SIIs) authorized to operate in Italy'.

7 E. Bonaccorsi di Patti, R. Felici and F.M. Signoretti, *Euro area significant banks: main differences and recent performance*, Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), 306, 2016.

Last year the number of bank branches fell by 1.5 per cent compared with the previous year, down to 30,258, and by 11.4 per cent compared with 2008. The decline was greatest for larger banks, which had begun to downsize their branch network in 2008. The number of branches per 10,000 inhabitants was 5.1 in 2014, higher than the euro-area average (4.7) but lower than in Spain (6.9) and France (5.7).[8]

Online banking is becoming more widespread: some 57 per cent of households with a deposit account can access it remotely, 50 per cent can use home banking services (compared with 53 and 47 per cent, respectively, in 2014). The share of transfers made online increased by two percentage points from 2014, reaching 20 per cent. Banks also expanded the range of services they offer. Their responses to the regional bank lending survey conducted by the Bank of Italy's branches at the beginning of 2016 indicated that in the early years of online banking mainly payment services were offered; gradually this situation evolved until almost half of the providers were also offering remote savings management services. In the last five years the share of investment funds placed online rose from 20 per cent to 35 per cent. The number of banks that grant loans online is still low but increasing, and almost exclusively focused on households.

Information technology is reducing the cost of entering the market in financial services. In some countries there is a large number of operators specializing in lending-based crowdfunding; their presence in Italy is negligible (see the box 'Lending-based crowdfunding').

LENDING-BASED CROWDFUNDING

Lending-based crowdfunding is a source of financing alternative to banks: households and small firms are directly funded by a multitude of investors.[1] Borrowers and lenders, be they private individuals or institutional investors, are matched via an online platform that assesses the creditworthiness of potential debtors and manages the flow of payments between them and lenders, at times through third party companies. The lenders assume a large part of, if not all, the credit risk. The use of new technologies makes the process fast, simple, and inexpensive.

Loans issued through this platform still represent only a small share of total loans, but their numbers are growing rapidly, especially in China, the United States and the United Kingdom. In the UK in 2015, estimates indicate that lending-based crowdfunding to small firms has doubled compared to 2014, and now accounts for 14 per cent of new loans issued by banks to small firms, net of repayments.[2] In continental Europe and in Italy this type of funding is much less common: in 2015

[1] Lending-based crowdfunding is different from the other forms of collective funding such as donation-based crowdfunding, where contributors make donations without expecting anything in exchange; reward-based crowdfunding, where contributors receive a non-financial reward; and equity-based crowdfunding, where contributors receive equity in the business.

[2] B. Zhang, P. Baeck, T. Ziegler, J. Bone and K. Garvey, *Pushing boundaries. The 2015 UK Alternative Finance Industry Report*, 2016.

[8] Based on ECB data, *Report on Financial Structures*, 2015.

the three main platforms active in Italy (two for loans to households and one for loans to firms) generated less than €10 million in loans.

Lending-based crowdfunding allows borrowers who could previously only borrow from traditional financial intermediaries to diversify their funding sources and obtain small loans rarely granted by banks because they are insufficiently profitable or considered excessively risky; moreover, it offers additional investment opportunities to private individuals and institutional investors. By making efficient use of big data, lending platforms mitigate the information asymmetry between debtors and lenders otherwise reduced solely through direct contact. Numerous governments, central banks and supranational institutions[3] recognize the potential benefits of the increased use of these loans, especially for small firms. The positive effects could be greater in countries like Italy, where microenterprises carry significant weight and continue to face difficulty in accessing credit (see Chapter 6, 'Firms').

Lending-based crowdfunding may also stimulate competition in the financial sector, incentivizing traditional intermediaries to invest more in new technology. Moreover, there is ample room for collaboration with banks, which in the US and UK have on numerous occasions used lending platforms to underwrite all or part of some types of loans, taking advantage of their efficiency.

With the benefits come risks. It is not yet possible to assess whether the models used by the platforms to measure creditworthiness, which have never been validated by the supervisory authorities, are reliable even in an unfavourable economic situation. An increase in interest rates or the start of a recession could cause credit losses to increase more than expected. At the very least, supervisory authorities should be tasked with ensuring compliance with anti-money-laundering regulations, the proper management of payment flows and consumer protection.

Finally, the growing involvement of institutional investors[4] also needs to be monitored as, if it becomes excessive, it could pose a risk to financial stability.[5] The regulations should also strike a balance between the need to adequately manage risks with that of not obstructing the development of a rapidly changing business. The European Commission does not consider it necessary at this stage to propose a regulation, but it is closely following developments in this sector, especially with regard to the efficacy of national laws and their degree of convergence.

Italy does not have specific laws relating to crowdfunding, as do some European countries (France, Portugal, the UK and Spain). The parties involved (platforms, lenders and debtors) must comply with the laws that apply to the various activities undertaken (among which, soliciting investors, banking activities, lending to the

---

3 European Commission, 'Crowdfunding in the EU Capital Markets Union', SWD (2016) 154 final, 2016; moreover, the European Investment Bank has recently approved a pilot project for the funding of loans via a platform operated in the UK.

4 An ever growing number of crowdfunding loans are financed by hedge funds and banks, especially in the US and UK (in the UK they are estimated to account for just under 30 per cent). Securitized loans are also on the rise.

5 FSB, *Global Shadow Banking Monitoring Report 2014*, 2014.

public, credit mediation and providing payment services). The Bank of Italy has recently submitted for public consultation an amendment to the regulation on fund-raising by non-bank entities, clarifying the boundaries that must be respected to ensure that lending-based crowdfunding activities are consistent with the regulations governing fund-raising on a public basis.[6]

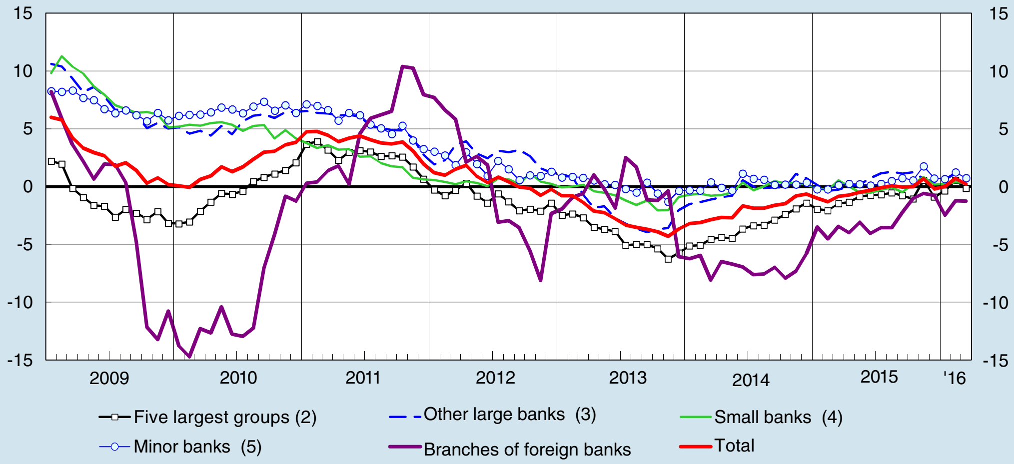
[6] *Disposizioni di vigilanza. Raccolta del risparmio dei soggetti diversi dalle banche,* Bank of Italy website (Italian only).

Assets

Lending. – The contraction in loans under way since 2012 progressively eased and eventually halted. In December the twelve-month change in the loans disbursed by banks active in Italy was -0.2 per cent (Figure 13.1). In the early months of 2016 the rate of growth turned barely positive again (0.2 per cent in March); the increase is attributable to lending to households, which picked up again for the five largest banking groups and accelerated for the other intermediaries.

Figure 13.1

Lending by bank size (1)
(monthly data; 12-month percentage changes)



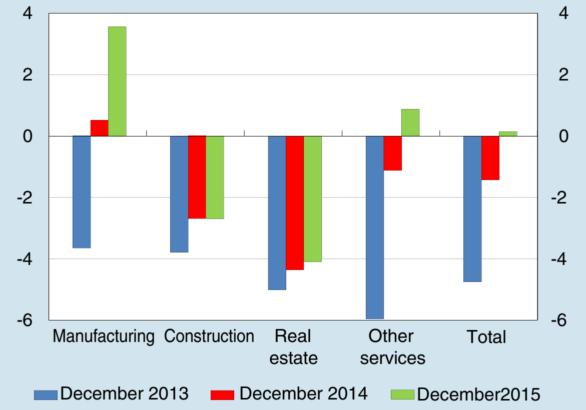
Source: Supervisory reports.
(1) The data for March 2016 are provisional. Loans include repos and bad debts. Banks are classified according to the composition of banking groups as at March 2016 and to unconsolidated total assets as at December 2008. Percentage changes are calculated net of the effects of securitizations, reclassifications, value adjustments and other variations not due to transactions. – (2) Banks belonging to the groups Banco Popolare, Intesa Sanpaolo, Monte dei Paschi di Siena, Unione di Banche Italiane and UniCredit. – (3) Groups and stand-alone banks with total assets of between €21,532 million and €182,052 million. – (4) Groups and stand-alone banks with total assets of between €3,626 million and €21,531 million. – (5) Groups and stand-alone banks with total assets of less than €3,626 million.

Banks maintained a prudent stance in their supply policies, expanding their lending to less risky borrowers. The Italian component of the euro-area bank lending survey reported, especially in the second half of 2015, a moderate recovery in demand which should continue in the second quarter of 2016, based on the answers given by the banks participating in the survey.

Lending to households increased by 1.2 per cent in 2015. The rise in new mortgage lending exceeded that of 2014 (38.3 per cent, compared with 11.7 per cent). Consumer credit granted by banks increased by 5.1 per cent (in 2014 it had declined by 0.7 per cent; see Chapter 7, 'Households').

Figure 13.2

Bank lending to firms without non-performing loans (1)
(percentage changes in the 12 months ending in the reference month)



Source: Central Credit Register.
(1) Loans by banks and financial companies reporting to the Central Credit Register disbursed to firms that in the 12 months considered had no non-performing loans. The sectors are classified according to NACE 2007.

Business lending decreased by 0.7 per cent, less than in 2014 (-1.9 per cent). Considering firms without non-performing loans only, growth was slightly positive for all the sectors combined (0.3 per cent) and in rapid acceleration for the manufacturing sector (Figure 13.2).

Credit continued to fall at a fast pace for firms with fewer than 20 employees (-2.5 per cent; see Chapter 6, 'Firms'). The gap with respect to other firms reflects the greater vulnerabilities in smaller businesses' balance sheets – which tend to limit the credit banks are willing to grant – and other factors on both the supply and demand side. Regarding demand, so far larger companies have reaped greater benefits from the economic recovery, have stepped up their investment and have consequently seen a rise in their borrowing needs. On the supply side, the fixed costs of loans for small amounts make them less profitable when interest rates are low; furthermore, small and medium-sized banks – the natural counterparties for small and medium-sized firms – are less able to disburse loans owing to their low profitability and the rapid growth in NPLs.

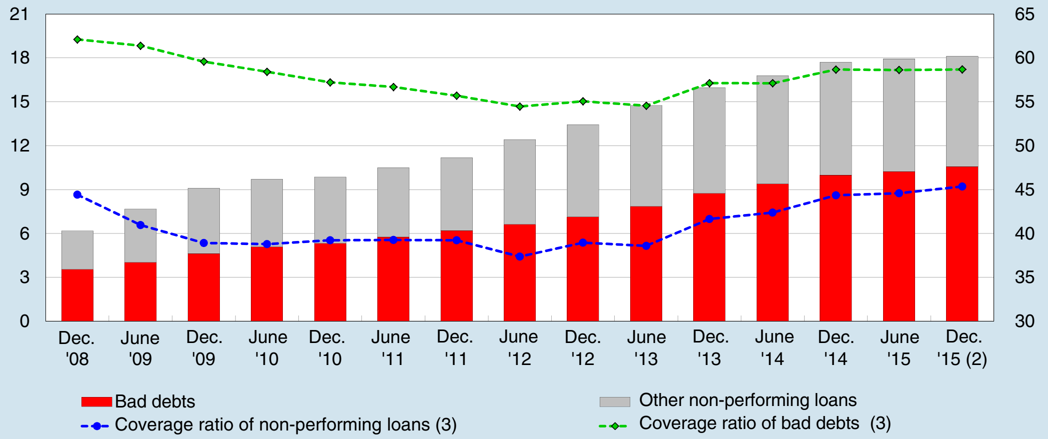
Credit quality. – The economic recovery has an impact on credit quality. In 2015 the flow of new NPLs decreased markedly in relation to total loans; on average for the year the ratio fell to 3.7 per cent, from 4.8 per cent in 2014, regaining the levels of the second half of 2008. The new bad debt rate (2.6 per cent on average) held stable compared with the previous year; the flow of new bad debts is still being fuelled by the inclusion of loans previously classified as non-performing in this category. In the first quarter of 2016 the annualized and seasonally adjusted flow of new NPLs decelerated further, to 2.9 per cent.

In the course of 2015 the stock of NPLs stabilized: at the end of the year, gross of write-downs it amounted to approximately €360 billion or 18.1 per cent of total outstanding loans (Figure 13.3), of which €210 billion classified as bad debts; net of write-downs the amounts recorded in the balance sheets came to €197 billion and €87 billion respectively. The share of gross NPLs for the main Italian banking groups was 16.8 per cent, compared with a European average of 5.8 per cent.[9]

[9] In international rankings the indicator includes exposures to central banks and banks (see EBA, *Risk Dashboard. Data as of Q4 2015,* 2016).

Figure 13.3

Credit quality of Italian banks and groups: shares and coverage ratios of non-performing loans and bad debts (1)
(per cent)



Sources: Consolidated supervisory reports for groups, individual reports for stand-alone banks.
(1) Loans to customers. Includes groups and banks owned by foreign intermediaries. Excludes branches of foreign banks. The shares and ratios are calculated based on banks' exposures gross of write-downs. The coverage ratio is the ratio of write-downs to the corresponding gross exposures. – (2) Provisional data. – (3) Right-hand scale.

Some 78.7 per cent of gross NPLs were to firms. For these, collateral securities came to 47.8 per cent of total gross exposures.[10] For loans to households the share of collateral securities was higher (77.8 per cent; see *Financial Stability Report*, No. 1, 2016).

Over the last three years write-downs made by banks entailed an increase of about 8 percentage points in the NPL coverage ratio (i.e. write-downs in relation to corresponding gross exposures), which was 45.4 per cent at the end of 2015 (58.7 per cent for bad debts), in line with the average for the main European banks. For smaller banks, the coverage ratio rose by more than 15 percentage points, to 40.9 per cent. The gap with the banking system average is largely due to the greater share of NPLs backed by collateral or personal guarantees (79.2 per cent compared with 67.0 per cent) and the ratio of bad debts as a proportion of NPLs.

The ratio of gross NPLs to the sum of common equity tier 1 capital and write-downs (i.e. the Texas ratio), while ranking high in international comparisons, is only slightly more than 100 per cent (see *Financial Stability Report*, No. 1, 2016).

The measures adopted in 2015 and in the second quarter of 2016 to speed up credit recovery will have a positive effect on the market valuation of NPLs and will facilitate their sale (see the box 'The measures on credit recovery procedures').

THE MEASURES ON CREDIT RECOVERY PROCEDURES

One of the reasons the secondary market for non-performing loans is undeveloped in Italy is the persistence of a significant gap between the book value of these assets

[10] The data are taken from the non-consolidated financial statements, which do not include loans disbursed by financial companies belonging to banking groups and by foreign subsidiaries. Moreover, the amount of collateral does not necessarily correspond to its value, but rather to the amount of credit backed by collateral; for example, in the case of a loan backed by collateral worth more than the loan itself, the amount recorded is that of the actual loan.

and the price offered by investors; weighing heavily on this gap is the length of recovery times, which are high by international standards. At the start of May the Government introduced Decree Law 59/2016 that contains measures for reducing credit recovery times, strengthening the effects of the laws passed last summer (see Chapter 12, 'Business activity regulation and the institutional environment').[1]

For commercial loans secured by real estate, an out-of-court remedy was introduced whereby the property is assigned to the creditor (Marcian Pact); subject to both parties' consent, it can also be applied to existing exposures, including those classified as bad loans on the books of banks, provided no bankruptcy proceedings have begun. The mechanism can also be used for exposures already subject to foreclosure.

With the out-of-court forfeiture clause, debts are extinguished in a span of 7 to 8 months, compared with an estimated 4 years for judicial foreclosure before the measures taken last summer, and more than 3 years before the recent decree. This option, by reducing the court system's workload, could further accelerate in-court recovery proceedings.

When fully operational, the effect of the new procedure on the market price of bad commercial loans secured by real estate for which the out-of-court forfeiture clause is in place could be considerable. Simulations suggest that, in certain scenarios, the price that a market operator would be willing to pay for a bad loan with an initial gross value of 100, with a book value of 60, could reach as high as the book value.[2]

In the transition phase, the quantification of the effect on the average price of the stock of existing bad loans (which includes both the part for which the Marcian Pact is used and the remainder) depends on (a) the number of commercial bad debts potentially eligible for the out-of-court procedure and (b) the percentage of these loans which will actually be renegotiated.

With regard to point (a), we can assume that the positions that could potentially be eligible for the mechanism are those recently classified as bad loans for which judicial recovery proceedings have not begun or are still in the early stages; taking into account those classified as bad debts for less than 2 years, the amount would be equal to a third of commercial bad loans secured by real property. With regard to point (b), assessing the percentage of these loans which will actually be renegotiated is not simple: the renegotiation of a loan depends on the incentives of banks and firms, which in turn are influenced by the specific characteristics of each credit

1 M. Marcucci, A. Pischedda and V. Profeta, 'The changes of the Italian insolvency and foreclosure regulation adopted in 2015', Banca d'Italia, *Notes on Financial Stability and Supervision*, 2, 2015.

2 For the methodology, see L.G. Ciavoliello, F. Ciocchetta, F.M. Conti, I. Guida, A. Rendina and G. Santini, 'What's the value of NPLs?', *Notes on Financial Stability and Supervision*, 3, 2016. The exercise reported in this box makes reference to the case of a bad loan secured by real property, which on average is assessed at 60 per cent of its initial gross value (hence the estimated 60). The calculations reported in the cited work are instead in reference to a bad debt only partly secured by collateral which on average is valued at 40 per cent of its real value (with an initial gross value of 100 and a book value of 40). As in the example in the box, the paper demonstrates that, if the credit is recovered in a few months, the amount that a market operator would be willing to pay is closer to the book value.

facility. If this percentage were 50 per cent, the average difference between the book value and the price offered by investors for the entire stock of commercial bad loans secured by real estate would fall by about 15 per cent. This would correspond to an increase in the average price offered by investors for these bad loans, expressed as a proportion of the initial gross value, near 5 percentage points.

In January 2015 a new harmonized scheme to classify loan exposures at the European level came into effect, introducing the new category of 'forborne exposure', i.e., debt contracts that are modified in view of debtors' financial difficulties or totally or partially refinanced for the same reason. Forborne exposures include both performing and non-performing loans; in particular, performing loans indicate the share of lending to financially weak customers that does not warrant inclusion among non-performing exposures. In June 2015 forborne performing loans for Italy's main banking groups came to 1.8 per cent of gross loans, slightly above the European average of 1.5 per cent, but below the levels recorded in Ireland, Portugal and Spain.[11]

Holdings of securities. – In 2015 Italian banks reduced their holdings of non-bank debt securities by 3.3 per cent (net of those that were securitized but not removed from the balance sheet), consisting almost entirely of sovereign securities. Purchases of securities issued by other euro-area countries (mainly France and Spain, and to a lesser extent Germany) did not offset the drop recorded for Italian government securities, including those issued by regional and local governments. Net sales of Italian public sector securities by Italian banks amounted to €21 billion; in the first three months of 2016 total net sales were practically nil.

The share of Italian public sector securities in total assets decreased moderately compared with the end of 2014 (it was 10.2 per cent in March) owing to the rise in the value of banks' portfolios. The share varies significantly with size: almost 23 per cent for small and minor banks and a little more than 7 per cent for the five largest banking groups.

Funding

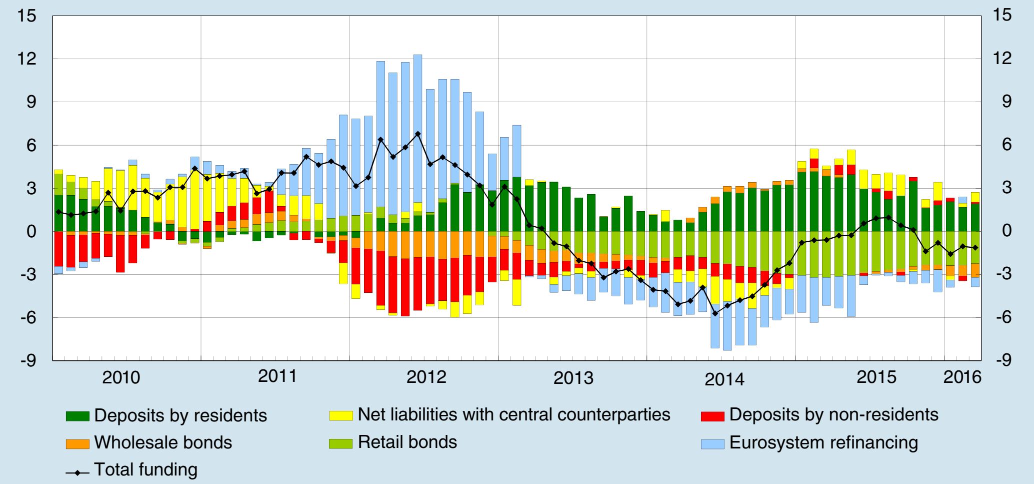
In 2015 Italian banks' total funding was down slightly (-0.8 per cent; Figure 13.4); net of Eurosystem refinancing, it increased by 0.8 per cent. The cost of funding declined, benefiting from the effects on market yields of the expansionary monetary policy measures and from the shift towards cheaper forms of funding.

Between the end of 2015 and the beginning of 2016 the prices of European bank securities suffered from the tensions on the financial markets; there was an increase in the risk premiums demanded by investors of intermediaries with lower-quality assets or with portfolios containing a sizeable share of financial instruments that are difficult to value (see *Financial Stability Report*, No. 1, 2016). Even during this period, funding conditions for Italian banks remained generally favourable.

[11] EBA, *2015 EU-wide Transparency Exercise,* 2015.

Figure 13.4

The growth of funding in Italy: contributions of the main components (1)
(monthly data; percentage points; 12-month changes)



Source: Supervisory reports.
(1) The sum of the contributions is equal to the twelve-month change in total funding. The percentage changes of the individual components are calculated net of the effects of reclassifications, changes in exchange rates, value adjustments and other changes not due to transactions. Excludes liabilities with resident Monetary Financial Institutions. Net liabilities with central counterparties represent repo funding with non-residents carried out through central counterparties. The twelve-month change in deposits by residents, ending in November 2015, could reflect the impact of the new deadline for filing self-assessment tax returns, which was 30 November in 2015 and 1 December in 2014.

In 2015 retail funding decreased by 0.7 per cent, less than in 2014: the 3.2 per cent increase in deposits of residents did not fully offset the further drop in bonds held by households (-20.6 per cent). Factors contributing to this trend, under way since the beginning of 2012, included the cancellation of the more favourable tax treatment of bonds compared with deposits and to banks' placement of financial and insurance products in an effort to support revenues from services. At the end of 2015 bonds held by households accounted for 13.2 per cent of Italian banks' retail funding (25.1 per cent at the end of 2011), of which one eighth were subordinated bonds.[12]

Italian banks' funding gap, i.e. the share of loans not covered by retail funding, narrowed, reflecting the continued weakness of credit growth; in December 2015 it stood at 9.5 per cent, against 10.7 per cent in 2014.

Wholesale funding grew by 5.5 per cent. Net liabilities with central counterparties and deposits of non-residents increased while bonds placed with banks and institutional investors decreased, with net issues down by €4.2 billion in 2015. Banks substituted a portion of their unsecured bonds nearing maturity with new issues of less costly guaranteed instruments.

In 2015 Eurosystem refinancing fell by 18.6 per cent. Italian banks only partially replaced the funds obtained through three-year refinancing operations with those available through targeted longer-term refinancing operations (TLTROs; see *Financial Stability Report*, No. 1, 2016).

[12] For a breakdown of the amount and holders of subordinated bonds issued by banks, see the Bank of Italy's website: 'Informazioni sui detentori di obbligazioni subordinate' (only in Italian).

The average cost of funding fell to 0.61 per cent in December 2015, down by 27 percentage points on the previous year. The average interest rate on deposits fell from 0.58 per cent to 0.37 per cent; the average cost of interbank funding has been negative since the second half of last year.

Banks' total funding contracted by 1.1 per cent in the twelve months ending in March 2016. Retail funding fell by 0.5 per cent: the further reduction in bonds was largely offset by the expansion in deposits. Wholesale funding decreased by 0.7 per cent owing to the drop in bond issues; liabilities with central counterparties increased. Eurosystem refinancing continued to decline.

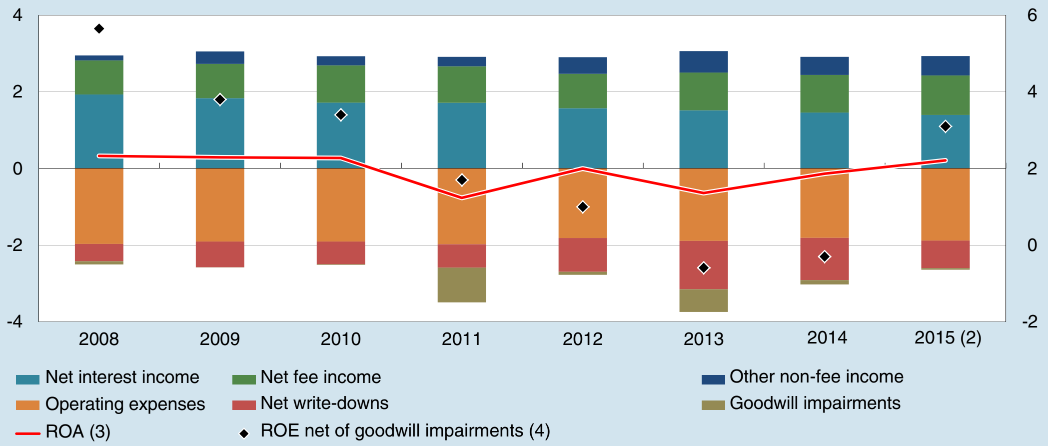
Capital and profitability

Profitability. – The profitability of Italian banks and banking groups turned positive again. The reduction in net interest income was more than offset by the rise in fee income and lower write-downs favoured by the improvement in economic activity and in firms' financial conditions. ROE net of goodwill impairments was 3.1 per cent (up from -0.3 per cent in 2014; Figure 13.5).

Figure 13.5

Main profit and loss items of Italian banks and groups (1)

(percentage points)



Sources: Consolidated supervisory reports for banking groups, individual reports for stand-alone banks.
(1) Relative to assets as at the end of the year (except for ROE). – (2) Provisional data. – (3) Net income over end-of-year assets (4) – Right-hand scale.

Net interest income fell by 3.5 per cent; compared with 2014, the average interest income declined by 0.4 percentage points, more than the contraction in the average cost of funding; slightly less than two-thirds of the reduction can be attributed to interest rates on loans, and 30 per cent of it to the interest earned on investment in bonds. Gross income increased by 1.7 per cent owing to the rise in fee income (6.1 per cent) – mostly in connection with asset management – and proceeds from trading activity, which nearly doubled compared with 2014.

Operating expenses grew by 4.8 per cent, mainly owing to contributions of around €2.3 billion to the National Resolution Fund in connection with the crisis of the four banks subject to the resolution procedure last November (see the box 'The financing of the Single Resolution Fund', *Financial Stability Report*, No. 1, 2016). Net of the contributions, costs went up by 0.5 per cent. Write-downs fell by 34.1 per cent; their share of the operating profit dropped by more than 30 percentage points to 68.2 per cent, still high compared with pre-crisis level (it was around 20 per cent in 2006-07).

The ROE of the five largest banking groups net of goodwill impairments, which is higher than that of the other banks, returned to the level of 2009 at 4.6 per cent. The profitability of the other large banks was just positive overall at 0.8 per cent despite the heavy losses suffered by some of them; for minor banks it was 0.9 per cent, mainly as a result of the negative figure for mutual banks (-0.4 per cent), for which net interest income declined more sharply compared with the other banks and write-downs were unchanged, absorbing almost all of the operating profit.

The profitability of the main Italian banking groups is still lower than that of their European counterparts but the gap narrowed significantly. The ROE of the Italian banking groups included in a sample of large European banks was 1.6 percentage points below the average for the sample in 2015, and 7.1 points lower in 2014.[13] The difference stems mainly from the greater write-downs necessitated by the deterioration in credit quality reflecting Italy's worsening economic performance compared with the main European countries. The ratio of costs to gross income for Italian banks was 65 per cent, two percentage points higher than the sample average but lower than for French and German banks (68 and 79 per cent, respectively).

Capital. – Capital strengthening in the banking system proceeded in 2015. At the end of the year common equity tier 1 (CET1) amounted to 12.3 per cent of risk-weighted assets; tier 1 and total supervisory capital came to 12.8 per cent and 15.1 per cent respectively. The three indicators went up by half a percentage point compared with the end of 2014.

The uptick is the result of capital strengthening and, to a lesser extent, the reduction in risk-weighted assets. The capital increases underwritten by two banking groups (worth approximately €4 billion) and the return to profitability both contributed to capital strengthening.

Among significant banks, in the first part of 2016 one banking group completed a capital increase of €1.5 billion, underwritten in its entirety by Atlante, a recently established private fund that will support banks' future capital increases and invest in NPLs. Two other banking groups announced capital increases totalling €2 billion; in one case the purpose is to comply with requests by the ECB following the Supervisory Review and Evaluation Process (SREP) completed at the end of last year. The capital adequacy of the other Italian significant banks met the requirements set by the ECB in the SREP.

[13] EBA, *Risk Dashboard. Data as of Q4 2015*, 2016

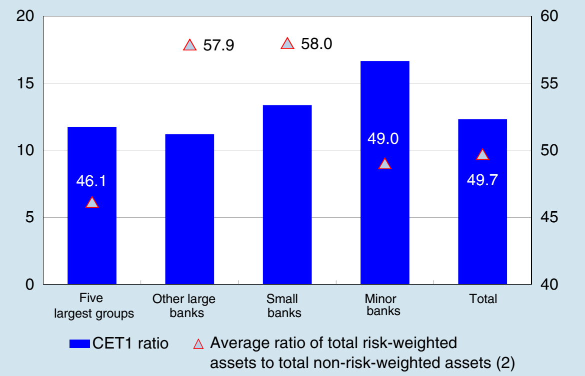
Minor banks' CET1 ratios were higher than the system-wide average (16.7 per cent versus 12.3 per cent; Figure 13.6). The gap was wider before the crisis (about seven percentage points).

The CET1 ratio for the main banking groups is about 2 percentage points lower than that for a sample of large European banks.[14] Conversely, the leverage ratio is higher for Italian banks; in June 2015 it was 5.0 per cent for the two largest Italian banking groups compared with 4.2 per cent for the main European banks.[15]

Figure 13.6

CET1 ratio and average ratio of total risk-weighted assets to total non-risk-weighted assets for Italian banks and groups (1)

(per cent; December 2015)



Sources: Consolidated supervisory reports for banking groups, individual reports for stand-alone banks.
(1) For the breakdown of banks into size classes, see the footnotes to Figure 13.1. – (2) Right-hand scale.

Non-bank credit intermediaries and loan guarantee consortiums

The contraction in loans by non-bank intermediaries accelerated (-5.0 per cent, compared with -2.9 per cent in 2014). The credit quality of the intermediaries entered in the special register maintained by the Bank of Italy improved slightly: NPLs as a share of total loans fell to 17.2 per cent (-0.2 points compared with 2014).

Profitability rose: financial companies posted operating profits of €246 billion after reporting a loss in 2014. In 2015 the number of companies recording a negative operating profit was 59, down from 70 a year earlier, and their losses more than halved. Their total capital ratio increased by one percentage point to 12.5 per cent, twice the minimum requirement. This was due both to the increase in supervisory capital (3.3 per cent) and the drop in risk-weighted assets (-6.0 per cent).

The guarantees extended by mutual loan guarantee consortiums entered in the special register, which came to €13 billion, were down by 10.5 per cent in 2015 compared with 2014. This was due in part to banks' direct access to the second-level guarantees provided by the Guarantee Fund for Small and Medium-sized Enterprises and was accompanied by a rise in riskiness. At the end of last year non-performing exposures accounted for 35.6 per cent of the guarantees extended, while bad debts amounted to 24.7 per cent, compared with 31.6 per cent and 20.3 per cent respectively in 2014. Profitability was affected by lower fee income (-8.8 per cent compared with 2014) and higher operating expenses (2.0 per cent compared with 2014), which absorbed almost 90 per cent of gross income. Loan guarantee consortiums reported total losses of €102 million in 2015 (€88 billion in 2014). Supervisory capital, almost entirely of the highest quality, amounted to 16.3 per cent of risk-weighted assets.

---

[14] EBA, *Risk Dashboard. Data as of Q4 2015*, 2016

[15] EBA, CRD IV – *CRR/Basel III Monitoring Exercise. Results based on data as of 30 June 2015*, 2016.

INSTITUTIONAL INVESTORS

Funding. – Italian institutional investors raised €113 billion in 2015, slightly more than in the previous year (Table 13.1 and Figure 13.7.a).[16] The inflow of new funds was still high across all the economic sectors.

Table 13.1

Italian institutional investors: net funding and assets under management
(millions of euros and per cent)

	Net flows		End-of-period stocks			
	2014	2015 (1)	2014	2015 (1)	Percentage composition	
					2014	2015 (1)
Investment funds (2)	40,043	30,187	250,578	280,402	15.2	15.4
Insurance companies (3)	57,540	54,372	576,637	646,440	35.0	35.5
Pension funds (4)	4,731	3,781	83,620	93,619	5.1	5.1
Individually managed portfolios	25,312	43,533	737,192	800,795	44.7	44.0
Total	**127,626**	**131,873**	**1,648,027**	**1,821,256**	**100.0**	**100.0**
Consolidated total (5)	**110,705**	**112,881**	**1,256,645**	**1,405,592**	**–**	**–**
per cent of GDP	6.9	6.9	77.9	85.9	–	–
Memo						
Foreign investment funds (6)	59,227	68,459	477,550	615,779	–	–
of which: operated by Italian intermediaries (7)	30,721	44,929	277,543	325,414	–	–

Sources: Based on data from the Bank of Italy, Ivass, Covip and Assogestioni.
(1) Provisional. – (2) Italian investment funds. – (3) Net insurance flows are premiums less surrenders and benefits. For end-of-period stocks, technical provisions net of reinsurance reserves. Excludes Italian branches of EU insurance companies and includes Italian branches of non-EU insurance companies. – (4) For end-of-period stocks, balance-sheet assets. Excludes insurance mathematical reserves relating to pre-existing funds. – (5) Net of investments in Italian collective investment undertakings by the various categories of intermediaries, investments of insurance companies and pension funds in portfolios managed on an individual basis by asset management companies, and the technical provisions of insurance companies deriving from the management of open pension funds. – (6) Foreign open-end investment funds. Stocks and net funding refer to the value of the units respectively held and subscribed by Italian investors. – (7) Investment funds operated by management companies established in Luxembourg or Ireland.

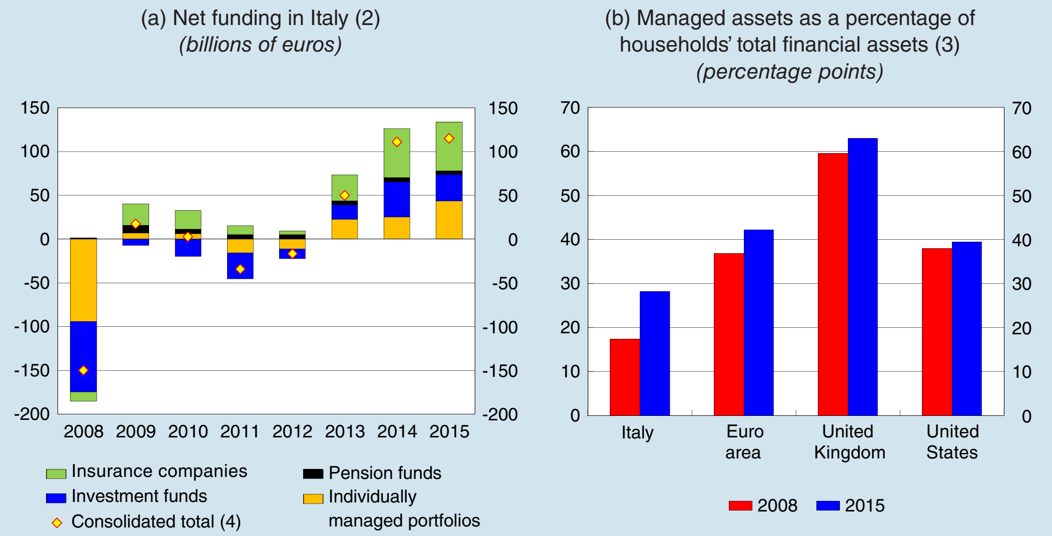
Net subscriptions of investment fund units, while decreasing compared with the previous year, nearly doubled from the levels of 2013. The uncertain outlook for growth and low returns in the bond market favoured flows into open-end funds with limited constraints as to asset allocation. Funding through flexible and balanced funds increased while bond funds yielded negative net inflows.

Funding obtained through individual portfolio management services rose significantly, from €25 billion to €43 billion, mainly owing to greater inflows from insurance companies and households. As for funding raised by asset management companies, which accounted for three quarters of the flows to individual portfolio management services, that from insurance companies rose from €10 billion to €17 billion while that for households increased from €4 billion to €8 billion.

[16] The funding figures by sector given in Table 13.1 include flows from other institutional investors.

Figure 13.7

Institutional investors: net funding and assets (1)



Sources: For panel (a), Bank of Italy, Ivass and Covip; for panel (b), Bank of Italy, ECB, OECD, Bureau of Economic Analysis and Federal Reserve.
(1) For 2015, provisional data. – (2) The flows for each sector are gross of funds raised from other institutional investors; for investment funds, only Italian funds. – (3) For the euro area, 19 member countries. For the United States, the pension fund aggregate refers to private, state and local funds and excludes federal retirement plans. Includes foreign funds held by residents. Excludes money market funds. – (4) See the notes to Table 13.1.

Low interest rates and the new capital requirements introduced by Solvency II prompted insurance companies to widen the range of variable-yield products they offer. In 2015 subscriptions decreased for policies offering minimum guaranteed returns but increased for unit-linked and multiline policies (see *Financial Stability Report*, No. 1, 2016).

Net contributions to pension funds decreased owing to an increase in pay-outs.

Funding through managed portfolios was fuelled by the shift in households' portfolios away from government securities and bank bonds (see Chapter 7, 'Households'). In the first part of the year the positive performance of the main market indexes drove investors to buy units of equity or flexible investment funds; in the months that followed the high volatility of the markets prompted a portfolio reallocation to more prudent forms of investment, e.g. balanced funds.

The share of the asset management industry in households' total assets remains small by international standards, although the gap has narrowed in recent years (Figure 13.7.b).

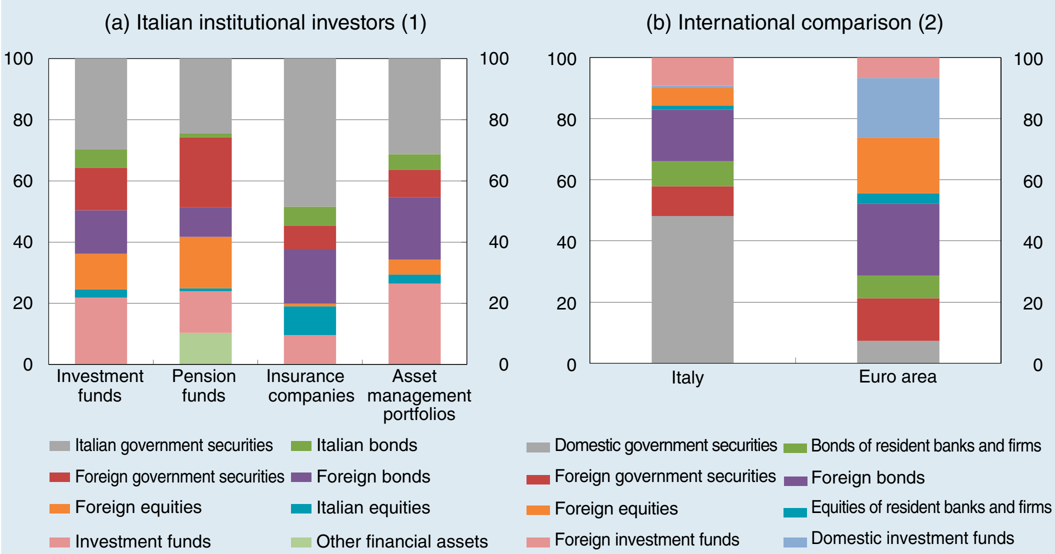
Investment. – At the end of 2015 institutional investors managed total assets amounting to €1.4 trillion, or 86 per cent of GDP, surpassing the all-time highs recorded at the end of the 1990s.

Low interest rates led investors to reduce their share of government securities and raise that of private-sector bonds and investment funds. From 2011 to 2015 the share of Italian government securities in investment fund and asset management portfolios dropped from 60 per cent to 45 per cent and from 43 per cent to 30 per cent respectively. Changes in the insurance and pension fund portfolios were less marked but followed the same trend.

There was an increase in the securities issued by foreign and, to a lesser extent, Italian private-sector companies. In the last five years investment by open-end investment funds in securities issued by Italian firms rose from 7 per cent to 12 per cent. At the end of 2015 the share of securities held by non-residents and of foreign investment fund units in institutional investors' portfolio ranged from 30 per cent for insurance companies to 59 per cent for open-end investment funds and asset management portfolios (Figure 13.8).

Figure 13.8

Main financial assets of institutional investors in 2015
(percentage shares)



Sources: Bank of Italy, ECB, Ivass and Covip.
(1) Assets at book value. Investments made to cover technical reserves in the non-life branch and traditional life insurance products (class C); managed investment funds, asset management portfolios and pension funds. Italian UCITS. Among pension funds instituted prior to the 1993 reform, the data include occupational, open and independent funds for which data on asset composition are available. Data for 2015 are provisional. – (2) Excludes asset management portfolios and unlisted shares.

The relatively subdued growth of investment in securities issued by Italian firms is partly a consequence of the low level of diversification in the asset management industry and the still relatively underdeveloped specialized agents industry to which institutional investors could delegate the selection and assessment of investments.

In recent years, following the development of the minibond market, some 30 private-debt closed-end funds became operational, of which half are Italian and have an overall funding target of €5 billion. At the end of 2015 there were also 158 closed-end funds active in private equity with a funding target of €9 billion. On the whole the amounts managed by the funds are still limited compared with the industry's total assets.

The growth of new sub-markets in stock exchanges tailored for smaller firms, such as ExtraMOT PRO and Italia-Mercato alternativo del capitale, can spur both the supply and demand for securities issued by these companies.

Profitability. – Low interest rates continue to have a limited impact on the profitability of Italian insurance companies owing to their good matching of duration and yields between assets and liabilities (see *Financial Stability Report*, No. 1, 2016).

Asset management companies posted an operating profit in all sectors, with a 41 per cent increase compared with 2014. The rise was particularly sharp for the companies managing open-end funds and individual portfolios, which benefited from the brisk flow of net funding. Firms specializing in the management of private equity, which in the past were affected by difficulties in acquiring new capital, saw their profitability improve owing to the reduction of operational costs, while those specializing in real estate benefited from a lower tax burden. The ratio of supervisory capital to the overall capital requirement rose from 5.2 per cent to 7.0 per cent owing to regulatory changes that eased the minimum requirements for certain market players based on size and on field of specialization.

European initiatives. – In the second half of 2015 the European Fund for Strategic Investments (EFSI) was launched as part of the broader Juncker plan. The EFSI's goal is to revamp investment in Europe by encouraging the inflow of private capital to the real economy. In March 2016 Italy had 29 projects approved for a total value of €1.7 billion, comparable to the amounts for France and the United Kingdom and twice that of Germany and Spain.

The European Commission eased the capital requirements for insurance companies investing in long-term infrastructure projects, in the EFSI and in the shares of private companies traded on multilateral dealing platforms.

The plan for a capital markets union envisions a comprehensive reform programme that will benefit, among others, Italian institutional investors. The following measures are being considered: (a) tax incentives to support venture capital and business angels; (b) development of a pan-European regulatory framework for borrowed funds; (c) possible revision to the capital requirements set by Solvency II for privately placed investment in debt securities.

14. THE MONEY AND FINANCIAL MARKETS

In 2015 conditions on Italy's financial markets improved further, thanks to the start of the economic recovery and the highly expansionary stance of monetary policy. Share and corporate bond prices rallied while the yields on government bonds and spreads with respect to Germany narrowed. At the beginning of 2016, however, share prices, in particular those of banks, fell sharply both in Italy and in other euro-area countries owing to fears about global growth and uncertainty over the direction of banking regulations in Europe.

The Eurosystem's Asset Purchase Programme (APP) helped maintain generally relaxed conditions on the government securities market; there have been no negative effects to date either on the availability of securities or on the secondary market's overall liquidity.

The gap between the lending conditions applied to Italian firms and banks on equity and bond markets and those applied, on average, to the companies of other euro-area countries narrowed steadily until it all but disappeared.

Notwithstanding the advantageous lending conditions, overall non-financial firms raised less capital than they did in 2014. Italian firms tended to reduce borrowing and to meet their capital needs mainly through self-financing, while investment, though recovering, is still modest.

The money market

Trading in the Italian money market was checked by the abundant liquidity in the banking system, which the Eurosystem's securities purchases increased further, reducing banks' need to tap interbank funding markets.

The bulk of trading in interbank funds continued to be made through repos concluded on the MTS general collateral and special repo segments while the volume of trading in unsecured interbank deposits was still very thin on both the e-MID electronic and over-the-counter markets (Figure 14.1).

Italy's overnight money market rates, in negative territory since the end of 2014, fell further, reaching a low of -0.35 per cent last March on the heels of cuts in the official rates in December 2015 and March 2016; they remain in line with the average rates recorded in the other euro-area money markets.

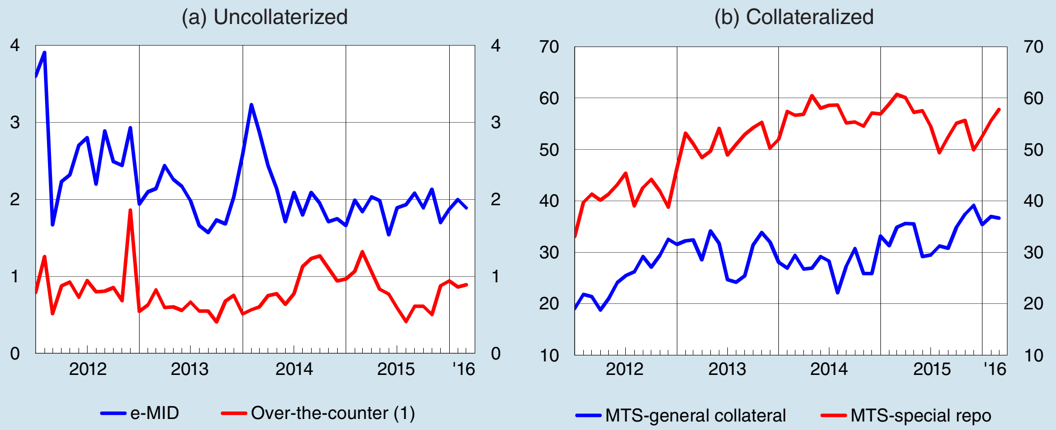
Public sector securities

Supply and demand. – In 2015 net issues of Italian public sector securities more than halved compared with 2014 (down from €67 billion to €25 billion) following

Figure 14.1

Money market trades

(monthly averages of daily data; billions of euros)



Sources: Based on data from e-MID SIM SpA, MTS SpA and TARGET2-Banca d'Italia data.
(1) Uncollateralized money market trades with maturities of up to one week between Italian banks belonging to different groups; estimates based on TARGET2-Banca d'Italia data.

the reduction in the borrowing requirement and the partial use of liquid resources by the Treasury; the stock of public sector securities was virtually unchanged at 111.4 per cent of GDP.

The share of Italian general government securities held by the Bank of Italy rose considerably because of the purchases made under the Eurosytem's expanded Asset Purchase Programme, reaching 9.1 per cent at the end of 2015, compared with 5.7 per cent a year earlier (see the box 'Holders of Italian government securities by sector and country'). The securities acquired by the Bank of Italy were mostly sold by households and Italian banks, while the portion held by non-residents remained basically unchanged at about 29 per cent.[1]

Yields. – Italian government securities have benefited from the Eurosystem's expanded APP, as have the securities of other euro-area countries (see Chapter 3, 'Macroeconomic developments and fiscal policies in the euro area'). The programme's anticipated effects – which market operators had to some extent already priced in at the end of 2014, before its launch – resulted in a marked drop in yields at all maturities in the first quarter of 2015.

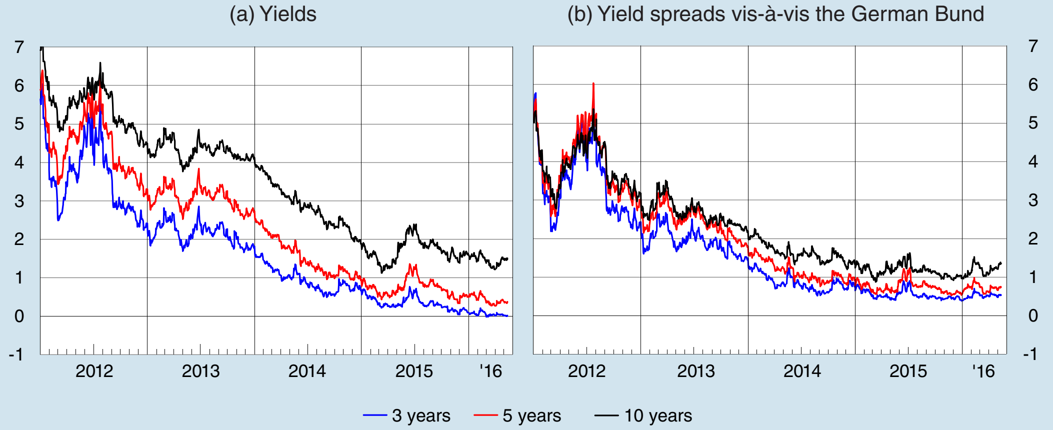
From mid-April onwards the rates on Italian government securities rose briefly, as did those of the other euro-area countries, first owing to technical factors and to improved inflation and growth expectations in the area, and later to the increase in sovereign risk premiums connected with the Greek crisis. Yields began to fall again in the summer after an agreement was brokered on a new financial assistance programme for Greece (see Chapter 3, 'Macroeconomic developments and fiscal policies in the euro area') and continued to decline in the autumn thanks

[1] Excluding the securities held by the Eurosystem (except for the Bank of Italy) as part of the Securities Markets Programme (SMP) and the Public Sector Purchase Programme (PSPP), as well as securities held in investment funds and individually managed portfolios registered abroad but attributable to Italian investors.

to mounting expectations that the purchase programme would be intensified. In 2015 the interest rate on ten-year government bonds fell by about 30 basis points overall (to 1.6 per cent last December; Figure 14.2.a) and the spread with respect to the corresponding German Bund narrowed from 135 to 97 basis points (Figure 14.2.b).

Figure 14.2

Yields and yield spreads on BTPs at different maturities
(daily data; percentage points)



Source: Based on Bloomberg data.

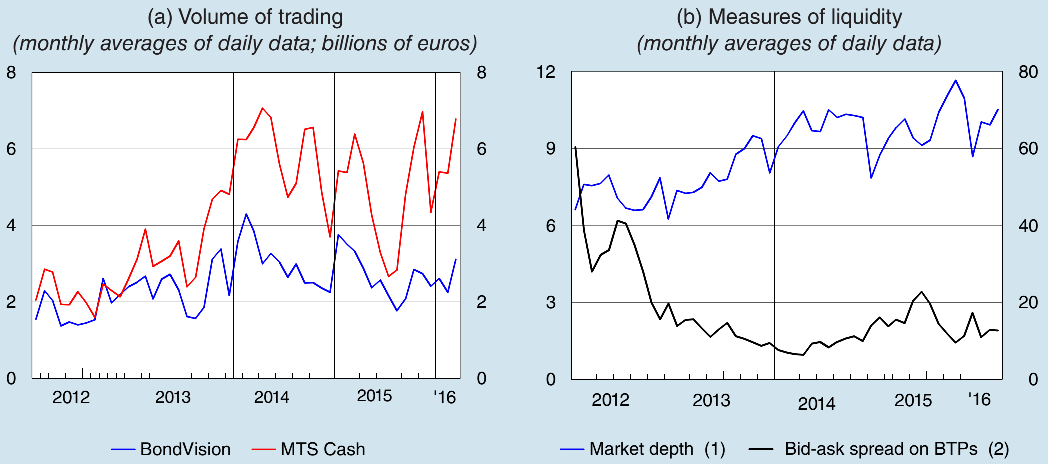
In early 2016 the turmoil on the financial markets triggered by the darkening global macroeconomic outlook and fears about the quality of European banks' assets had a limited impact on the yields of Italian government securities, in part owing to the stabilizing effect of the Eurosystem purchases. From mid-February yields began to decline again, also owing to expectations of further monetary stimulus; in the first four months as a whole, the yield on ten-year government bonds fell by about ten basis points. In the same period the ten-year interest rate differential with Germany rose slightly, against a backdrop of high volatility, reflecting the shift in investors' portfolios towards the reputedly safest assets such as German Bunds.

Trading in the secondary market. – Liquidity conditions on the secondary market in Italian government securities continued to be relaxed, despite faltering at times in concomitance with spikes in volatility on the global financial markets and, in particular towards mid-2015, the most critical phases of the Greek crisis. The heightened sensitivity of liquidity conditions to external shocks was partly attributable to a number of structural changes in the way the market in fixed income securities functions, such as the rise in high-frequency trading and banks' lower propensity to hold large stocks of securities; these developments appeared to impair the market's ability to absorb large orders without triggering significant changes in prices (see the box 'Recent trend in the liquidity of euro-area government bonds', *Financial Stability Report*, No. 2, 2015).

Overall last year the volume of average daily trading was below that recorded in 2014, both on the MTS Cash market and in the market in government securities for institutional investors - BondVision (Figure 14.3.a); while still very low, bid-ask spreads on Treasury bonds recorded an increase (Figure 14.3.b). By contrast, the quantity of securities offered for purchase or sale by market makers rose slightly.

Figure 14.3

Trading in the secondary market in government securities



Source: Based on MTS SpA data.
(1) Calculated as the daily average of the semi-sum of pending orders on both the buy and sell side proposed by the market maker in the first 5 best share listings. – (2) Right-hand scale.

The volume of special repo trading on the MTS Cash market remained high (Figure 14.3.b). Its average relative cost, measured by the difference between the rates on general collateral repos and special repos (specialness), declined to very low levels; this indicates that abundant securities remain available for repo transactions notwithstanding the purchases of public sector securities by the Eurosystem.

Corporate bonds and bank bonds

Issuance. – In 2015 non-financial Italian corporations continued to make gross bond placements on the international markets involving substantial amounts (€23 billion based on Dealogic data, against €21 billion in 2014). The overall balance between bond issues and redemptions was nonetheless slightly negative (Table 14.1), reflecting the recent tendency of firms to reduce borrowing (see Chapter 6, 'Firms').

Last year both Italian banks and those in other euro-area countries continued to replace bonds with less costly sources of funding, such as customer deposits (see Chapter 13, 'Banks and institutional investors'). This resulted in considerable net redemptions by Italy's banking groups, which they also made by reducing wholesale placements on international markets (to €28 billion from €36 billion in 2014, based on Dealogic data; Table 14.1).

Yields. – Firms' funding conditions on bond markets continued to converge towards those to which issuers are accustomed in the other euro-area countries, suggesting a gradual easing of financial market fragmentation along national lines which had instead marked the height of the sovereign debt crisis in 2011-12. Contributory factors included the first signs of economic recovery in Italy and the highly expansionary stance of monetary policy.

Table 14.1

Medium- and long-term bonds of Italian banks and firms (1)
(nominal values; millions of euros)

	Net issues (2)			Stocks			% of GDP
	2013	2014	2015	2013	2014	2015	2015
Banks	-80,297	-152,993	-105,663	875,792	724,310	619,531	38
Other financial corporations	-16,987	-17,198	-16,291	216,178	199,131	182,979	11
Non-financial corporations	22,730	3,876	-1,773	124,778	131,134	129,855	8
Total	**-74,555**	**-166,315**	**-123,727**	**1,216,748**	**1,054,575**	**932,365**	**58**

(1) The nationality and sector refer to the issuer and not to its parent company. Refers only to securities with a maturity at issue of more than one year. The data differ from those previously published owing to the adoption of the new SEC2010 accounting standards – (2) Difference between the nominal values of issues and redemptions.

During 2015 the gap between the average yield of bonds issued by Italian banks (which fell by 0.3 percentage points, to 1.1 per cent) and that on securities issued by banks in other euro-area countries was wiped out. The strains in the banking sector at the end of 2015 and early 2016 temporarily drove yields and risk premiums up, for junior debt in particular.

The yields on bonds issued by non-financial corporations also fell during 2015 (by 0.1 percentage point, to 1.1 per cent), settling slightly below the euro-area average.

The effects of the addition of the CSPP. – In March 2016 the ECB decided to expand the APP to include investment-grade euro-denominated bonds issued by non-bank corporations established in the euro area. Following its announcement bond spreads, including those on securities excluded from the purchases, such as high-yield securities, declined sharply; this confirmed the ability of monetary policy decisions to influence market expectations, with an immediate and significant impact on financial asset prices, and to encourage portfolio shifts towards a very broad range of assets (see the box 'Monetary policy announcements and their effect on the financial market'). Moreover, bond placements by non-financial corporations in the euro area greatly intensified in the weeks following the announcement. Based on provisional data, the total nominal value of bonds issued by Italian firms and eligible for purchase under the programme[2] is estimated at around €70 billion, some 11 per cent of all eligible bonds issued by euro-area firms.

[2] For the main characteristics of the eligible securities see 'ECB announces details of the corporate sector purchase programme (CSPP)', Press Release, 21 April 2016.

MONETARY POLICY ANNOUNCEMENTS AND THEIR EFFECT ON THE FINANCIAL MARKETS

The analysis of the response of the main financial markets to the 'surprise' component of central bank announcements – in press releases, speeches, interviews and hearings of bank executives – can provide some useful indications for assessing the impact and channels of transmission of monetary policy measures.[1]

Between 2000 and 2007, both in the euro area and in the United States, surprise announcements regarding traditional monetary policy instruments (official rates) had the greatest influence on short- and medium-term interest rates and share prices.

Between the end of 2008 and the spring of 2013, the ECB and the Federal Reserve adopted a series of unconventional measures to support monetary policy. During that time unexpected monetary policy announcements by the ECB had a stronger impact on long-term interest rates in the euro area, on the euro/dollar exchange rate and on private and sovereign risk premiums. In the United States the effects of the unexpected component of announcements by the Federal Reserve were seen mainly on long-term interest rates and the dollar exchange rate.

From mid-2013 surprise moves by the ECB continued to influence the prices of a broad range of financial assets, including public sector securities, shares and the euro exchange rate. The impact of central bank decisions on long-term interest rates and risk premiums on corporate and bank bonds also strengthened. In the United States, the greatest impact of the surprise announcements was on yields on government and corporate bonds.

1 M. Pericoli and G. Veronese, 'Monetary policy surprises and channels of transmission', Banca d'Italia, Temi di Discussione (Working Papers), forthcoming.

The equity market

Share prices and trading. – By the end of 2015 the Italian stock exchange index had gained 17 per cent on a year earlier (Figure 14.4.a), more than the 10 per cent jump in that of the main listed euro-area corporations.

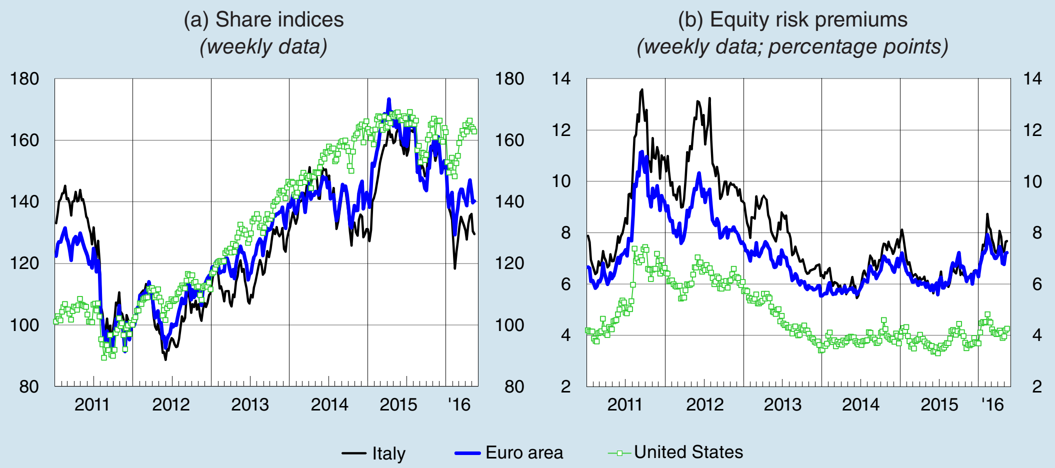
The stock prices of Italy's firms benefited above all from the reduced risk premiums demanded by investors (Figure 14.4.b), which more than offset the small dip in expected earnings (4 per cent over a 1-year horizon). The differential between the risk premiums on shares of Italian corporations and those on shares of corporations in other euro-area countries, which had climbed to very high levels during the sovereign debt crisis, narrowed further, staying close to zero throughout the year. Growing confidence in Italy's economic recovery was one contributory factor.

In the first four months of 2016 share prices slumped both in Italy and in the other euro-area countries: concerns over the possible repercussions of a slowdown in the emerging economies and falling oil prices, coupled with lasting tensions in the banking sector, drove up risk premiums; listed companies' expected earnings were again revised downwards. From the start of the year to end-April the Italian stock market index lost

11 per cent. Bank shares were among the worst hit (26 per cent in Italy and 24 per cent in Germany), in part because market operators began to pay closer attention to the large stock of non-performing loans (see the box 'Recent developments in banks' share prices in the euro area') and in part owing to uncertainty over the direction of banking regulations in Europe.

Figure 14.4

Equity markets

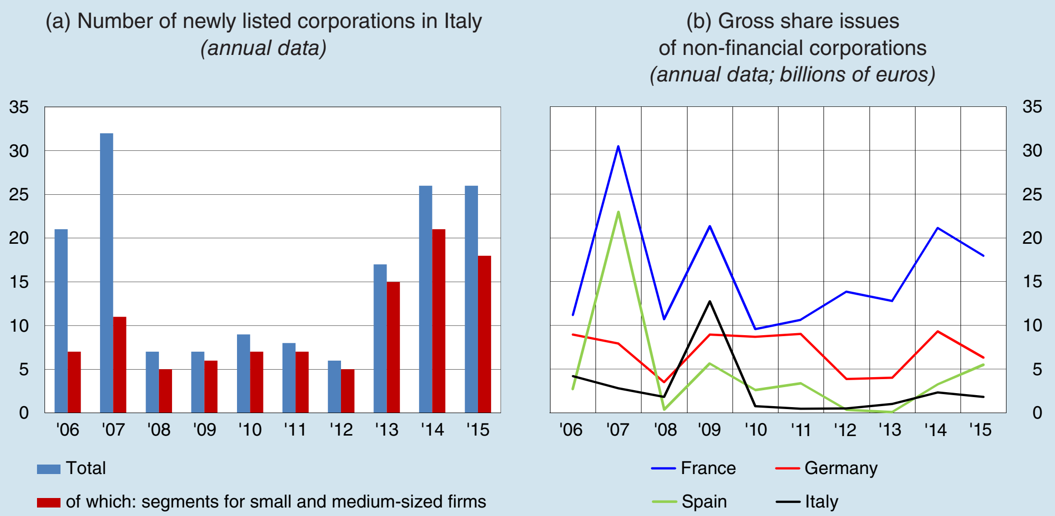


Source: Based on Datastream data.

Supply. – In 2015 the number of initial public offerings on the Italian stock market was unchanged from the previous year at 26 (Figure 14.5.a) but the value of the shares placed rose to €5.4 billion, against €2.9 billion in 2014. Again, most IPOs were in the segment for small and medium-sized firms (the AIM Italia-MAC alternative capital market). In 2015 this segment expanded significantly: 17 more companies joined, bringing the total to 74.

Figure 14.5

IPOs and gross share issues of non-financial corporations



Sources: Based on Borsa Italiana and ECB data.

Last year capital increases by listed companies – almost exclusively made in connection with a number of bank recapitalizations – declined to €4 billion, from €11 billion in 2014. The total value of gross share issues by non-financial corporations fell both in Italy and in the main euro-area countries (Figure 14.5.b).

Market infrastructure

The new European platform for the settlement of securities transactions, TARGET-2 Securities (T2S), became operational last summer, enabling intermediaries to settle securities transactions concluded in European markets with central bank money, with clear benefits in terms of costs, simplification of processes, and market integration. Through its central depositary Monte Titoli SpA, Italy, along with Greece, Malta, Romania and Switzerland, was among the first group of countries to migrate to T2S. After the transition to the new system at the end of August, the volume of transactions settled remained high and the share of those not settled owing to non-delivery of the securities or non-settlement of the cash leg (fails) initially rose briefly but then returned to normal (Figure 14.6.a).

With the adherence in March 2016 of the central depositaries of Portugal and Belgium and, towards the end of the year, of those of other countries, the volume of transactions on T2S is expected to increase significantly, delivering additional efficiency gains.

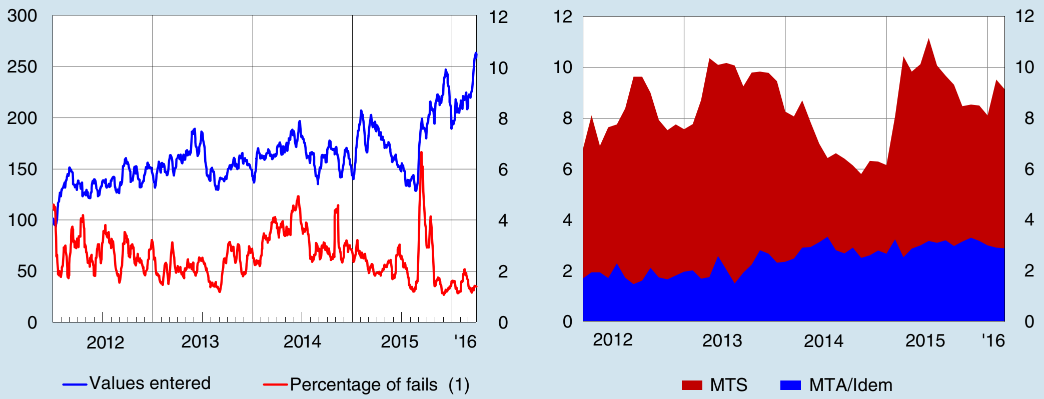
In 2015 the fresh improvement in financial market conditions also had positive effects on the activities of the central counterparty Cassa di Compensazione e Garanzia (CC&G). The overall amount of guarantees demanded of members by the CC&G increased both for the equity (repos and derivatives) and government securities markets (Figure 14.6.b). This increase mostly reflected the high volume of trading in these markets, while CC&G's particularly prudent approach enabled them to keep the margins applied unchanged even when the markets were at their most volatile.

Figure 14.6

Market infrastructures

(a) Monte Titoli: value of the orders entered and percentage of fails
(10-day moving averages; billions of euros and percentage points)

(b) Cassa di Compensazione e Garanzia: value of the initial margins deposited
(monthly averages of daily data; billions of euros)



Source: Based on data from Cassa di Compensazione e Garanzia SpA and Monte Titoli SpA.
(1) Right-hand scale.

15. ITALIAN HOUSEHOLDS' INCOME AND WEALTH: A LONG-TERM VIEW

The survey on household income and wealth (SHIW), conducted by the Bank of Italy since the mid-1960s, is among the longest-running surveys in the world.[1] Micro data on important socio-demographic aspects and on the main items in households' budgets are available from 1977. This allows the economic conditions of Italian households over the past forty years to be analysed in depth against the backdrop of the macroeconomic and demographic changes that have shaped the country.

There have been far-reaching changes along the way: Italians' life expectancy has increased, as have their level of education, female labour force participation rates, the number of foreigners in Italy and overall well-being. Inequalities, which had declined in the previous decades, increased again in the early 1990s and subsequently flattened out.

The economic slowdown that began in Italy in the 1990s has impacted on household income, especially that of payroll workers already in the labour market and, more markedly, of those who entered it in subsequent years. The worst affected are the young, who have put off leaving the family home and whose earning prospects over their entire life cycle are lower than those of previous generations. Households' limited need to save owing to easier access to credit has, however, softened the repercussions on consumption.

The smaller build-up of own wealth has magnified the importance of intergenerational transfers, strengthening the role of the family of origin in defining an individual's socio-economic status while entrenching inequalities that bear no relation to a person's intrinsic merit or ability.

Demographics, and Italian households' income and wealth

Italian society has changed profoundly over the last forty years. The number of people aged 65 and over is now equal to one third of those aged 20-64, about double the figure for the 1970s; life expectancy at 65 has risen from 13 to 19 years for men and from 17 to 22 years for women.

The gradual ageing of the population, common to all advanced countries, has gone hand in hand with a considerable increase in average education levels in Italy, which has partly closed the gap with the other advanced countries (see *Annual Report,* 2013, Chapter 11, 'Education and training in the productive economy'). The

[1] The Bank of Italy recently organized a scientific conference to mark the fiftieth anniversary of the survey. See the conference proceedings on the website: '*The Bank of Italy's analysis of household finances. Fifty years of the Survey on household income and wealth and the Financial accounts*', Banca d'Italia, Rome, 3-4 December 2015.

number of people at least 30 years old with a high school diploma or a degree has increased fivefold to almost 50 per cent; this figure rose to 70 per cent for 30 to 40 year olds, with a 10-point difference in favour of women.

Female labour force participation has risen sharply, though it remains low by international standards (see *Annual Report*, 2011, Chapter 11, 'The role of women in the Italian economy'). This is due to cultural factors, higher levels of education, greater scope for combining family and working life made possible by new kinds of contracts (e.g. part-time work) and the expansion in the supply of personal care services also thanks to the contribution of the foreign population in Italy (see *Annual Report*, 2008, Chapter 11, 'Immigration'). Foreigners accounted for over 8 per cent of Italy's resident population in 2015, a tenfold increase compared with the mid-1990s.

Though available human resources have increased, Italy's capacity to use them efficiently has gradually ceased to expand. The Italian economy has struggled to adapt to the changes wrought by globalization and the technological revolution.[2] Total factor productivity, which approximates the overall efficiency of the productive system, has slowed from average annual growth of 1.4 per cent between 1974 and 1993 to 0.3 per cent in the following twenty years.[3]

The main components of households' disposable income (employment and self-employment income, pensions and property) have been affected by these macroeconomic and demographic trends in different ways.

Average annual per capita employment income (net of taxes and social security contributions), which rose almost without interruption until 1989, contracted sharply during the early 1990s recession; it had grown by barely 10 per cent in 2006 compared with 1977. Since the mid-1990s, the modest growth in per capita employment income and the marked increase in the number of wage-earners have both reflected the rise in less stable forms of employment, whose introduction was facilitated by regulatory changes to the labour market (Figure 15.1.a).[4] By contrast, the average annual per capita income from self-employment, which is generally higher, rose by about 40 per cent in the same period (1977-2006; Figure 15.1.b).

The unfolding of the global economic crisis, which began in 2008 and continued in Europe with the sovereign debt crisis, brought 2014 income levels back to those recorded at the end of the 1970s for both employment categories; the parallel contraction in employment compounded the consequences for households, especially for those comprising employees.

---

2 A. Brandolini and M. Bugamelli (eds.) '*Rapporto sulle tendenze nel sistema produttivo italiano*,' Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), 45, 2009; A. Accetturo, A. Bassanetti, M. Bugamelli, I. Faiella, P. Finaldi Russo, D. Franco, S. Giacomelli and M. Omiccioli, '*Il sistema industriale italiano tra globalizzazione e crisi*,' Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), 193, 2013.

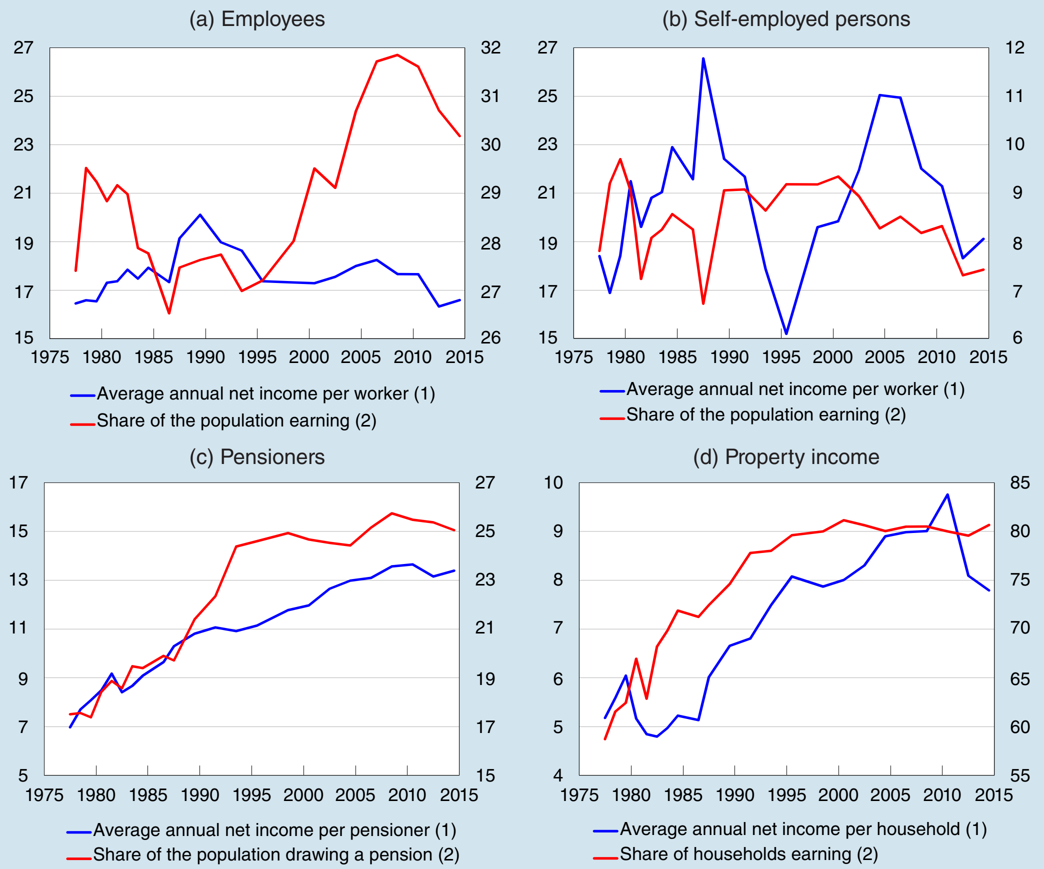
3 S.N. Broadberry, C. Giordano and F. Zollino, 'La produttività', in G. Toniolo (ed.), *L'Italia e l'economia mondiale. Dall'Unità a oggi*, Venice, Marsilio, 2013, pp. 257-311.

4 A. Brandolini, P. Casadio, P. Cipollone, M. Magnani, A. Rosolia and R. Torrini, 'Employment growth in Italy in the 1990s: institutional arrangements and market forces', in N. Acocella and R. Leoni (eds.), *Social Pacts, Employment and Growth. A Reappraisal of Ezio Tarantelli's Thought*, Heidelberg, Physica-Verlag, 2007, pp. 31-68. A. Rosolia, 'L'evoluzione delle retribuzioni in Italia tra il 1986 e il 2004 secondo i dati dell'archivio WHIP', *Politica economica*, 26, 2, 2010, pp.179-201.

Figure 15.1

Italian household income

(thousands of euros at 2014 prices and per cent)



Source: Based on data from the Survey on Household Income and Wealth, historical database (version 9.0).
(1) Thousands of euros at 2014 prices. – (2) Per cent, right-hand scale.

The reform of the pension system that started in the early 1990s, aimed at ensuring its long-term sustainability, has gradually prolonged the labour market participation of older workers and has interrupted the spike in the share of pensioners in the population recorded in the previous twenty years (Figure 15.1.c). Households have, however, continued to benefit from the growth in average per capita pension incomes, which have doubled over the forty years in question: in 2014 average annual pension income (net of taxes) came to 80 per cent of employment income.

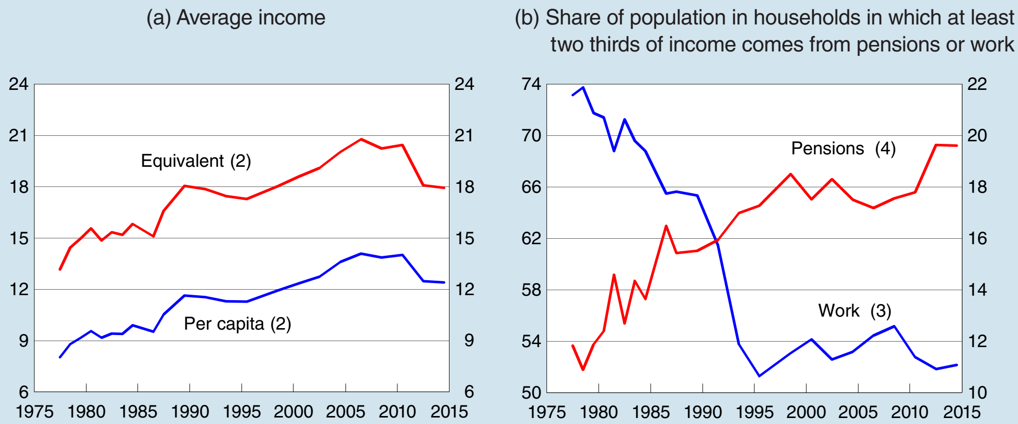
The positive trend in property income, attributable to the increase in house prices, has considerably boosted households' well-being through earned and imputed rental incomes (Figure 15.1.d).

According to the SHIW, the cumulative result of these trends was a 75 per cent increase in real terms of per capita net disposable annual income between 1977 and 2006. However, the two recessions that have buffeted the Italian economy since 2008 and the still modest recovery rates have wiped out roughly one quarter of this increase (Figure 15.2.a); between 1977 and 2014 per capita income grew by 54 per cent. The main aggregates of Italy's National Accounts by institutional sector, compiled by Istat, show that gross disposable income in the household sector, in per capita terms and at constant prices, followed a similar qualitative trend, growing by over 50 per cent between 1977 and 2006 and losing about one quarter of this increase during the subsequent crisis.[5] Average real equivalent income, a conventional measure of individual well-being inferred from the SHIW taking into account the economies of scale from households' size and composition, expanded by 58 per cent until 2006, then contracted by 14 per cent until 2014, and rose by 36 per cent over the forty-year period as a whole.[6]

Figure 15.2

Average income and main sources of income for Italian households (1)

(housands of euros at 2014 prices and per cent)



Source: Based on data from the Survey on Household Income and Wealth, historical database (version 9.0).
(1) Income net of income from financial assets; equivalent income calculated using the modified OECD scale. – (2) Thousands of euros at 2014 prices. – (3) Per cent. – (4) Per cent, right-hand scale.

Before the 1992-93 recession, 65 per cent of Italians lived in households in which at least two-thirds of income came from employment; in 1995 this share had fallen to just one half. With the recovery in employment this figure increased again, albeit modestly, reaching 55 per cent in 2008, then falling back as a result of the double-dip recession in Italy. By contrast, the number of persons in households in which pension incomes came to two-thirds of the total rose constantly, from 12 per cent in 1977 to 18 per cent in the second half of the 1990s; following a period of stagnation, it expanded again during the global financial crisis, helping to attenuate its effects on households' living standards (Figure 15.2.b).[7]

These developments have led to profound changes in the relative positions of specific population groups. Since the mid-1990s the gap between the equivalent

[5] In line with what is observed for sample surveys on household budgets conducted in Italy and abroad, the aggregates estimated from SHIW data are not directly comparable with the corresponding items in the National Accounts, owing to the many differences in definitions and methodologies. See *Methodological Note*, in *Supplements to the Statistical Bulletin,* 5, 2014.

[6] Unless otherwise specified, the definition of income adopted in this chapter excludes financial incomes, which have only been estimated since 1987 when financial assets were first measured. From 1987 to 2014, average equivalent income grew, at constant prices, by about 7 per cent including interest and dividends, by 8 per cent excluding them. Equivalent values are calculated using the OECD-modified equivalence scale.

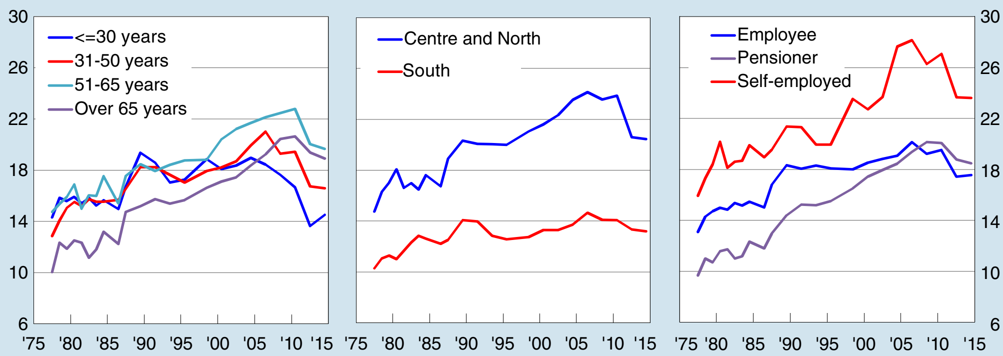
[7] A. Brandolini, F. D'Amuri and I. Faiella, *Country case study – Italy*, in S.P. Jenkins, A. Brandolini, J. Micklewright and B. Nolan (eds.), *The Great Recession and the Distribution of Household Income*, Oxford, Oxford University Press, 2013, pp. 130-152.

income of family members with a self-employed head of household and that of family members with an employee as head of household has widened appreciably; it was only partially filled during the most recent recessionary phase, though the average well-being of the second group was lower than that of households headed by pensioners. On average, the deterioration in living conditions during these years of crisis has been particularly intense for younger households; it has also been more marked in the Centre and North than in the South, almost closing the widening gap that had formed between the two areas in the period 1995-2006 (Figure 15.3).

Figure 15.3

Average equivalent income by head of household's characteristics (1)

(thousands of euros at 2014 prices)



Source: Based on data from the Survey on Household Income and Wealth, historical database (version 9.0).
(1) Income net of income from financial assets; equivalent income calculated using the modified OECD scale.

Despite modest overall growth in income, household wealth grew steadily over the entire period of the survey (see the box, 'The real and financial wealth of Italian households according to the aggregate statistics'). The SHIW has been recording the value of real assets (property, businesses and valuables) and the debt overhang from the purchase or renovation of real estate since 1977, that of financial assets since 1987 and that of other financial liabilities since 1991.

THE REAL AND FINANCIAL WEALTH OF ITALIAN HOUSEHOLDS ACCORDING TO THE AGGREGATE STATISTICS

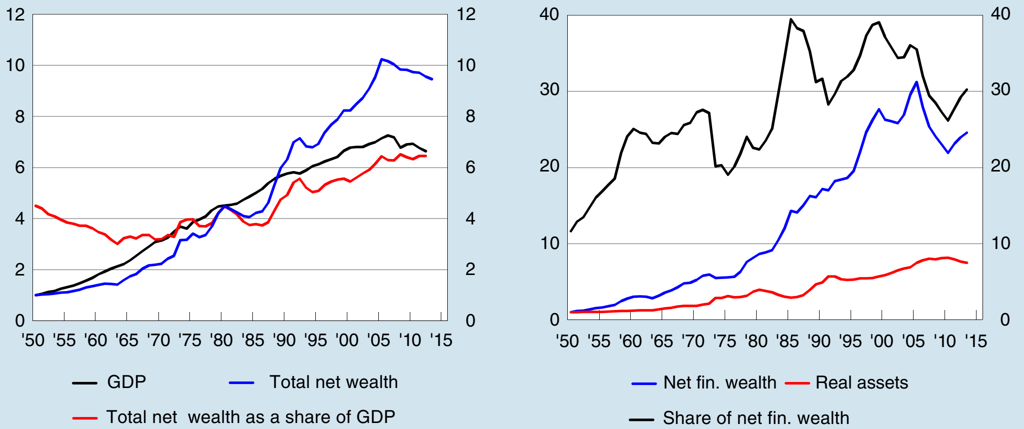
According to the official statistics, in 2014 households' net wealth was about six times gross domestic product (GDP), barely higher than the figure prevailing in the years immediately preceding the global financial crisis; over two thirds of this amount comprised real assets.[1] Italian household wealth is high by international standards, both in per capita terms and in proportion to GDP.[2]

[1] Net household wealth is given by the sum of real and financial assets net of financial liabilities. The real items have been estimated by Istat since 2005 while financial items have been estimated by the Bank of Italy since 1995. See Household wealth in Italy 2014, in *Supplements to the Statistical Bulletin*, 69, 2015.

[2] L. Bartiloro, M. Coletta, R. De Bonis and A. Mercatanti, 'Household wealth in a cross-country perspective', in R. De Bonis and A.F. Pozzolo (eds.), The Financial Systems of Industrial Countries. Evidence from Financial Accounts, Berlin-Heidelberg, Springer-Verlag, 2012.

Data for the entire post-unification period show that in the last ten years the ratio of net household assets to GDP has returned to levels comparable to those recorded at the beginning of the last century, after it had hit a record low in the mid-1960s, when it fell by half.[3] Between the 1950s and the mid-1960s the decline in the ratio mirrored the exceptional growth in GDP (see the figure); the rise in wealth, which expanded at a rate equal to one fifth of GDP growth, depended in equal measure on the rise in real estate components, as unit prices held basically stable, and on the increase in net financial wealth. In the following 15 years these trends were inverted: households' net wealth galloped ahead of GDP and, net of the change in consumer prices, had more than tripled by the beginning of the 1980s. Around four fifths of this growth was supported by that of real assets, in part driven by highly favourable property price cycles.[4] Almost two thirds of the expansion in wealth during the 1980s and 1990s is instead attributable to the growth in net financial wealth, which tripled notwithstanding the increase in household indebtedness.[5] The accumulation of real wealth was almost exclusively due to the expansion of home ownership, also facilitated by easier access to credit; despite the considerable price fluctuations throughout the entire period, at the end of the 1990s unit prices had not deviated greatly from those of twenty years previously. Property prices once again sustained the growth in net wealth from the turn of the century until the onset of the global financial crisis, when they stalled; this was accompanied by an increase in net financial wealth which had stagnated at the beginning of the decade as a result of the downward adjustment linked to the

GDP, total net wealth, real assets and net financial wealth
(constant 2010 prices; 1951=1)



Sources: L. Cannari, G. D'Alessio and G. Vecchi, 'Wealth', in G. Vecchi (ed.), Measuring Wellbeing. A History of Italian Living Standards, Oxford, Oxford University Press, forthcoming; A. Baffigi, Il PIL e la storia d'Italia. Istruzioni per l'uso, Venice, Marsilio, 2015.

---

[3] L. Cannari, G. D'Alessio and G. Vecchi, 'Wealth', in G. Vecchi (ed.), Measuring Wellbeing. A History of Italian Living Standards, Oxford, Oxford University Press, forthcoming; R. Bonci and M. Coletta, 'I conti finanziari dell'Italia dal 1950 a oggi', Banca d'Italia, proceedings of the conference 'Financial Accounts: History, Methods, the Case of Italy and International Comparisons' Perugia, 1-2 December 2005.

[4] F. Zollino, S. Muzzicato and R. Sabbatini, 'Prices of residential property in Italy: constructing a new indicator', Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), 17, 2008.

[5] R. De Bonis, D. Fano and T. Sbano, 'Household aggregate wealth in the main OECD countries from 1980 to 2011: what do the data tell us?', Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), 160, 2013.

bursting of the technological bubble. During the global financial crisis and the European sovereign debt crisis, net wealth shrank, albeit to a lesser degree than GDP, as a result of the decline in the value of net financial assets, which had already begun in 2007, and in that of real assets since 2011.

On the whole, since the mid-1960s when the ratio of household wealth to GDP turned upward again in almost all the advanced countries, the growth in Italian household wealth has stemmed above all from that in real estate assets, largely due to the increase in property ownership.

Real assets account for a significant share of most households' gross wealth; financial assets, mainly bank deposits, account for the bulk of total assets of less affluent households only.

Between 1977 and 2010 the average value of households' real assets, net of the growth of the private consumption deflator, almost tripled, while their median value quadrupled. The growth in the value of real estate assets reflected both the increase in prices, which almost doubled, and that of property ownership. The latter was boosted by the growth and ageing of the population and benefited from easier access to credit.[8] The home-ownership rate rose from just over 50 per cent in 1977 to 72 per cent in 2010, recording especially fast growth until 2000; the overall increase was greater for older households, from 60 to 80 per cent (see 'Italian Household Budgets in 2014', in *Supplements to the Statistical Bulletin*, 64, 2015).

Again, between 1977 and 2010, the number of households that took out loans to purchase or renovate real estate rose from 4 to 11 per cent; since the end of the 1990s this has been accompanied by an increase in the ratio of outstanding debt to real estate assets: while the latter has more or less doubled, total indebtedness has more than tripled.

Between 1991 – when the survey first measured all liabilities – and 2014, the share of indebted households fluctuated at around one quarter, which is low by international standards.[9] Slightly more than half were indebted for reasons other than the purchase and renovation of real estate, while only about one third of those with these types of debt had other debts too.

The distribution of income and wealth

The Gini index of equivalent income, a measure of inequality that synthesizes how distribution differs from an egalitarian one on a scale of 0 to 100, has been on a downward, if bumpy, path since the first half of the 1980s, continuing the trend under

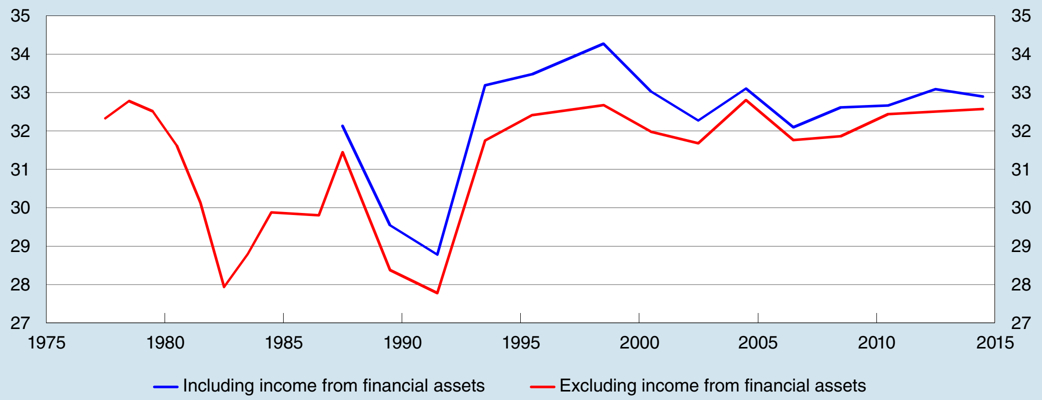
[8] A. Nobili and F. Zollino, '*A structural model for the housing and credit markets in Italy*,' Banca d'Italia, Temi di Discussione (Working Papers), 887, 2012.

[9] R. Gambacorta, G. Ilardi, A. Locatelli, R. Pico and C. Rampazzi, '*Principali risultati dell'Household finance and consumption survey: l'Italia nel confronto internazionale*,' Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), 161, 2013.

way since Italian unification (Figure 15.4).[10] This trend was interrupted in the second half of the 1980s and then inverted during the recession that hit Italy in 1992-93 when the European exchange rate mechanism was thrown into turmoil: during this period inequality grew rapidly while per capita disposable income declined only slightly.

Figure 15.4

Gini index of equivalent income (1)
(per cent)



Source: Based on data from the Survey on Household Income and Wealth, historical database (version 9.0).
(1) Equivalent income is calculated using the modified OECD scale.

By contrast, since the outbreak of the global financial crisis in 2008 and the subsequent recession caused by the sovereign debt crisis, and notwithstanding a broader contraction in income, there have been no discernible changes in inequality. Overall, it has stabilized at figures close to those recorded at the end of the 1970s and remains relatively high by international standards; however, it has risen less than in many other advanced countries since the 1980s.[11]

The two main contractions in the Italian economy since World War II, coinciding with the early 1990s and the double-dip of the global financial crisis and the European sovereign debt crisis, have affected inequality in varying ways, in part because of the different composition of the population at the onset of each: income distribution polarized during the first, while it shifted downwards overall during the second.

In the early 1990s recession, the proportion of the population belonging to the middle class shrank by six percentage points and this class's share of equivalent income, including financial returns, fell by five points (Figure 15.5).[12] In the most recent recession the middle class lost less ground and increased its share of income. The growth in the number of low-wage earners was much greater in the first recession (from 16 to 21 per cent), when the proportion of people in this category was nonetheless lower. At that

[10] A. Brandolini and G. Vecchi, 'Il benessere degli italiani', in G. Toniolo (ed.), *L'Italia e l'economia mondiale. Dall'Unità a oggi*, Venice, Marsilio, 2013, pp. 313-341.

[11] See Luxembourg Income Study (LIS), *Inequality and Poverty Key Figures*.

[12] According to the definition used here, the middle class includes people with equivalent incomes of between 60 per cent of the median income (the threshold usually used to identify low-income groups), and three times that figure. See A.B. Atkinson and A. Brandolini, 'On the identification of the middle class', in J.C. Gornick and M. Jäntti (eds.), *Income Inequality. Economic Disparities and Middle Class in Affluent Countries*, Stanford (CA), Stanford University Press, 2013, pp. 77-100.

time the share of income for the richest rose (from 6 to 10 per cent), the opposite of what happened during the recent recession.

This is probably due to the fact that at the end of the 1980s four-fifths of the middle class belonged to households headed by employed or self-employed workers, who are more vulnerable to cyclical fluctuations; halfway through the 2000s this figure fell to below 70 per cent, but rose by 10 points (to 30 per cent) for households with pensioners, who are more protected from the effects of the economic cycle.

Between the end of the 1980s and 2014, the increase in the share of low-wage earners went hand in hand with a substantial change in its composition, more than halving for pensioner households (from 40 to 15 per cent), rising for households headed by employees (from 14 to 20 per cent) and, though less so, for self-employed households (from 12 to 15 per cent).

The limitations of social buffers against poverty are confirmed by the fact that almost all households whose head was unemployed for most of the year, nearly 4 per cent of the population in 2014, were in the low-income bracket, more than double the figure recorded at the peak of the early 1990s recession.[13]

Figure 15.5

Equivalent income and population share by class of equivalent income (1)
(per cent)

Source: Based on data from the Survey on Household Income and Wealth, historical database (version 9.0).
(1) Income including income from financial assets; equivalent income calculated using the modified OECD scale. 'Low income': equivalent income less than 60 per cent of the median income; 'middle class': equivalent income of between 60 per cent and three times the median equivalent income; 'the rich': equivalent income higher than three times the median income.

13 *Preliminary testimony on the enabling act containing measures to combat poverty and reorganize the social security benefits and social services systems (in connection with the 2016 Stability Law),* testimony of Paolo Sestito, Head of the Bank of Italy's Structural Economic Analysis Directorate, Chamber of Deputies, Rome, 4 April 2016.

Economic hardship is greater for members of younger households. Among those with household heads aged 30 or under, more than one in three are in a low-income class (against just one in ten at the end of the 1980s); those with heads aged 31 to 50 found themselves in similar though less difficult circumstances. The share of low-income households fell slightly in the South, to 33 per cent from almost 40 per cent in 1995, though it remains three times higher than in the Centre and North.

Households, especially those in difficulty, can draw on their assets to soften the blow of income shocks on their living conditions. In 2014 low-income households nonetheless held less than 4 per cent of overall net wealth, three points less than in the two-year period 1993-95. Almost half of these households would not be able to leave the low-income class for a whole year – not even if they liquidated all their assets; during the 1990s recession this figure was considerably lower, not reaching 30 per cent. These particularly vulnerable households are more common in the South, among smaller households and those headed by employees. The wealth of other low-income households is on average about six times that of vulnerable households, a similar level to that of the mid-1990s.

Generation gaps

The weakening of the Italian economy since the 1990s has disproportionately affected young people: opportunities for entering the job market have increased, but working careers have become more discontinuous and starting salaries have decreased compared with previous generations, despite the higher levels of education.[14]

According to INPS data, entry-level weekly wages fell by about one fifth in real terms between the end of the 1980s and the beginning of the last decade, but were not offset by more rapid wage growth.[15] The double-dip recession between 2008 and 2013 weighed most heavily on those trying to enter the labour market, cancelling most of the increase in job opportunities for young people recorded in previous years.

The younger generations have reacted to this reduced earning capacity by putting off leaving the family home. Between the end of the 1980s and the beginning of the 2000s the proportion of young people aged 25-34 still living at home doubled, from just over 25 per cent to roughly 50 per cent; the slight decrease up to 2008 was interrupted by the global financial crisis and in 2014 the share neared 50 per cent again (30 per cent for those aged 30-34). These young people benefited from their parents' better economic conditions: their equivalent income was higher on average than that of their peers who had established a new household.

It is estimated that permanent income net of pension transfers, or rather how much people can expect to earn in their lifetime, will no longer increase and compared

[14] F. Giorgi, A. Rosolia, R. Torrini and U. Trivellato, *Mutamenti tra generazioni nelle condizioni lavorative giovanili*, in Schizzerotto, U. Trivellato and N. Sartor (eds.), *Generazioni disuguali. Le condizioni di vita dei giovani di ieri e di oggi: un confronto*, Bologna, il Mulino, 2011, pp. 111-144.

[15] A. Rosolia and R. Torrini, 'The generation gap: a cohort-level analysis of earnings levels, dispersion and the role of initial labour market conditions in Italy, 1974-2014', Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), forthcoming.

with previous generations may even fall for the younger generations that have established a household.[16] The intergenerational gap in well-being may be even wider if one considers that pension incomes for younger generations, being determined on the basis of a defined contribution method, will depend more than in the past on their often erratic career progression.[17]

While permanent income is lower, these generations have nonetheless benefited from the development of the Italian credit market and the improvement in borrowing conditions between the mid-1990s and the onset of the global financial crisis, including among population segments that traditionally found it more difficult to access credit;[18] the resulting lesser need to accumulate wealth has made it possible to curb the fall in consumption by squeezing savings.

The younger generations can also expect to inherit more wealth owing to the lower average number of children per family. In 2014 about one third of households said they had received an inheritance; the inherited wealth of these households, which amounts to 60 per cent on average of their net assets, is more than double that of households that have received no transfers or gifts. At the beginning of the 1990s, when only about one fifth of households had received an inheritance, the assets of beneficiary households were only about 70 per cent higher than those of households with no inheritance or gifts.[19]

The net wealth of the richest households depends less on intergenerational transfers than less well-off households, thanks to their greater ability to build up resources of their own accord. Yet overall income, the main reason for this independence, is more closely linked to that of the family of origin than in other advanced countries, indicating a lower degree of social mobility; it also reflects educational and occupational persistence between generations. There is evidence that the role of the family of origin in determining young people's income has become increasingly important.[20]

The increased value of inherited wealth and the growing role of the family of origin in explaining the uneven distribution of income among young people are entrenching inequalities in well-being for future generations.

---

16 A. Brandolini and A. Rosolia, 'Consumi, redditi, risparmi e benessere', in A. Golini and A. Rosina (eds.), *Il secolo degli anziani. Come cambierà l'Italia*, Bologna, Il Mulino, 2011, pp. 137-158; A. Brandolini and G. D'Alessio, 'Disparità intergenerazionali nei redditi familiari', in A. Schizzerotto, U. Trivellato and N. Sartor (eds.), *Generazioni disuguali. Le condizioni di vita dei giovani di ieri e di oggi: un confronto*, Bologna, il Mulino, 2011, pp. 145-173.

17 D. Franco, M.R. Marino and P. Tommasino, 'Pension policy and poverty in Italy: recent developments and new priorities', *Giornale degli economisti e annali di economia*, 67, 2, 2008, pp. 119-159.

18 S. Magri and R. Pico, '*L'indebitamento delle famiglie italiane dopo la crisi del 2008*,' Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), 134, 2012.

19 L. Cannari and G. D'Alessio, 'Intergenerational transfers in Italy', in *Household Wealth in Italy. Papers Presented at the Conference held in Perugia, 16-17 October 2007*, Banca d'Italia, 2008, pp. 255-285.

20 S. Mocetti, 'Intergenerational earnings mobility in Italy', *The B.E. Journal of Economic Analysis & Policy,* 7, 2, 2007; A. Rosolia, 'Intergenerational relations: the importance of the family', in Società italiana di statistica, *Conference proceedings from the 44th scientific meeting*, Università della Calabria, 25-27 June 2008, Padua, CLEUP, 2008, pp. 329-336.

ADMINISTRATION OF THE BANK OF ITALY
AT 31 MAY 2016

GOVERNING BOARD - DIRECTORATE

Ignazio VISCO	Governor
Salvatore ROSSI	Senior Deputy Governor
Fabio PANETTA	Deputy Governor
Luigi Federico SIGNORINI	Deputy Governor
Valeria SANNUCCI	Deputy Governor

BOARD OF DIRECTORS

Franca Maria ALACEVICH
Francesco ARGIOLAS
Nicola CACUCCI
Carlo CASTELLANO
Paolo DE FEO
Giovanni FINAZZO
Andrea ILLY
Cesare MIRABELLI
Ignazio MUSU
Lodovico PASSERIN D'ENTREVES
Stefano POSSATI
Donatella SCIUTO
Orietta Maria VARNELLI

BOARD OF AUDITORS

Dario VELO - Chairman
Lorenzo DE ANGELIS
Gian Domenico MOSCO
Angelo RICCABONI
Sandro SANDRI

ALTERNATE AUDITORS

Giuliana BIRINDELLI
Anna Lucia MUSERRA

HEAD OFFICE
MANAGING DIRECTORS

Paolo MARULLO REEDTZ	- accountant general
Ebe BULTRINI	- director general for it resources and statistics
Umberto PROIA	- director general for human resources and organization
Eugenio GAIOTTI	- director general for economics, statistics and research
Marino Ottavio PERASSI	- general counsel
Luigi DONATO	- director general for property and tenders
Emerico Antonio ZAUTZIK	- director general for markets and payment systems
Carmelo BARBAGALLO	- director general for financial supervision and regulation
Letizia RADONI	- director general for currency circulation
Daniele FRANCO	- state accountant general
Giuseppe SOPRANZETTI	- managing director with special duties and manager of the milan branch

* * *

Claudio CLEMENTE	- director of the financial intelligence unit