BANCA D'ITALIA
EUROSISTEMA

# The Annual Report at a Glance

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# THE ANNUAL REPORT AT A GLANCE

## The World Economy and the Euro Area

**[1] 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 the 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.

**BOX**

*The renminbi's new international role*

**[2] 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.

**Balance of payments disequilibria 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 current account balances of the emerging and advanced importing countries, on the other hand, registered a clear improvement.

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

**BOX**

*Adequacy and effectiveness of the global financial support network*

**[3] 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 nonethless 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 spare capacity and unemployment. Inflation expectations over longer horizons deduced from the financial markets are well below the ECB Governing Council's definition of price stability.

**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 lack of adequate common shock absorbers were compounded by those associated with increased geopolitical uncertainty and, particularly since last summer, the weakening external environment.

**After the consolidation of 2011-13, fiscal policy maintained a basically neutral stance in 2015; it is expected to become mildly expansionary in 2016**. The debt-to-GDP ratio, which had peaked in 2014, came down by 1.5 percentage points last year, initiating a process that is forecast to continue this year. The debate on creating a fiscal capacity for the euro area continued throughout 2015.

**BOX**

*Recent developments in macroeconomic imbalances in the European Union*

**[4] 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 fresh fall 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 make-up 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.

**BOXES**

*Misalignment of financial asset prices with their fundamental values*

*Distributive implications of a highly expansionary monetary policy*

*Anchoring of inflation expectations and macroeconomic effects*

## The Italian Economy

**[5] After three years of contraction the Italian economy returned to growth in 2015, although at a moderate pace (0.8 per cent)**. However, GDP still lagged some 8 percentage points below pre-crisis levels, which were instead overtaken in Germany and France and, very slightly, in the euro area as a whole.

**Domestic demand was the main driver of growth**. Household spending picked up, including on components other than durable goods; investments began to expand again. The recovery in demand is closely tied to the expansionary stimulus of monetary policy; it also benefited, though to a smaller degree, from the shift of focus of fiscal policy towards renewed support for growth following the inevitably restrictive effect of consolidation at the height of the sovereign debt crisis.

**Growth continues in early 2016**. Going forward, the strengthening of domestic demand will struggle against a persistently weak external environment that could take the steam out of the recovery even beyond its direct effects on trade, causing investment to slow. This is confirmed by Bank of Italy surveys, which show that the firms most exposed to geopolitical risk adopt more cautious spending programmes.

**BOX**

*The determinants of the recovery*

**[6] Industrial production returned to growth** but is still more than 20 percentage points lower than in the first quarter of 2008. Corporate 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.

**BOXES**

*Firm demographics during the crisis and the impact on growth*

*Taxation and corporate dynamics*

*Resource reallocation during the recession*

*Urban agglomeration and productivity*

*Recourse to the bond market by Italian firms*

*Public sector support for innovative start-ups: a preliminary evaluation*

**[7] 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 temporary income support measures introduced by the Government in 2014 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.

**BOXES**

*The tax bonus and household consumption*

*Trends in residential property prices in Italy and their determinants*

*Urban agglomeration and house prices*

*The effect of low interest rates on household debt*

**[8] 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, social security cushions, 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.

**BOXES**

*The Jobs Act: a preliminary evaluation*

*Immigration and refugees: initial assessment and possible impact*

**[9] 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.

**BOXES**

*Italian firms' price policies during the crisis*

*Wage dynamics and rigidities: firm heterogeneity and macroeconomic impact*

*The distribution of value added between labour income, profits and real-estate rents*

**[10] The current account surplus increased further**. The improvement was due to the contraction of the energy deficit caused by the fall in oil prices. Although exports of goods slowed in the final part of the year, they outstripped growth in potential demand from outlet markets, confirming the ability of Italian firms to compete in global markets. Imports began to increase again at a fast pace. Based on our estimates, the current account is running a small surplus, even when adjusted for the effects of the business cycle.

**Foreign investors continued to purchase Italian portfolio securities, primarily shares and public sector bonds**. Resident households also continued to weight their 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.

**BOXES**

*Holders of Italian government securities by sector and country*

*Undeclared foreign assets and international tax evasion*

**[11] Given a level of economic activity still well below its potential, Italy's budgetary policy was moderately expansionary in 2015**. While respecting the constraints imposed by Europe's fiscal rules, the Government significantly reduced the tax wedge on labour, which it partly financed by measures to combat evasion and by 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 with respect to the baseline projections, 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.

**BOXES**

*The taxation of income and female labour supply*

*General government commercial debts*

*Assessing the performance of local government enterprises*

**[12] 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 mortgage foreclosure procedures, which could speed up credit recovery and promote a swifter and less costly reinvestment of resources. The general government reform and the new Code for public contracts 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.

**BOXES**

*The contractual instruments for managing business crises: their use and outcomes*

*The uneven performance of court offices in Italy*

*Why people opt to work in the general government sector*

**[13] 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 with 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 (*Financial Stability Report*, No. 1, 2016). Investor uncertainty about 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 and the state guarantee scheme for securitized bad debts (Gacs). The recently created private investment fund, dubbed Atlante, could foster the development of a secondary market for NPLs.

**The funding activity of institutional investors remained intense**. Low interest rates prompted banks 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.

**BOXES**

*Lending-based crowdfunding*

*The measures on credit recovery procedures*

**[14] 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 prices 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 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 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 meet their capital needs mainly through self-financing, while investment, though recovering, is still modest.

**BOX**

*Monetary policy announcements and their effect on the financial markets*

**[15] The survey on household income and wealth, conducted by the Bank of Italy since the mid-1960s, is among the longest-running surveys in the world**. Granular data on important socio-demographic aspects of the country 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 wealth. 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 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 inter-generational 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.

**BOX**

*The real and financial wealth of Italian households according to the aggregate statistics*