BANCA D'ITALIA
EUROSISTEMA

The Annual Report at a Glance

Rome, 29 May 2018

2017

THE 2017 ANNUAL REPORT AT A GLANCE

The international economy

[1] In 2017 the expansion of the world economy gained strength, reaching 3.8 per cent, which was a higher rate than expected. Driven by the recovery in investment, this growth encompassed the main advanced economies as well as the emerging and developing countries.

World trade made a marked recovery, growing once more at a rate that exceeded that of GDP. However, firms' assessments of foreign orders suggest a possible weakening in 2018, most likely attributable to fears prompted by escalating trade tensions between the United States and its primary trading partners.

Favourable cyclical conditions have driven up commodity prices. Agreements between major oil producing countries helped to reabsorb the excess supply that had persisted for three years. In May 2018 geopolitical tensions pushed oil prices up even further to reach their highest levels since 2014.

Rising commodity prices contributed to the slight uptick in global inflation, although the core component remained moderate. The US Federal Reserve continued with its plan to normalize monetary policy, pursued over the last two years, which had limited impact on the markets.

During 2017, conditions on world financial markets loosened. In early 2018, stock index volatility rose rapidly in connection with an upward revision in expected interest rates and the announcement of new protectionist measures by the United States.

BOXES:

The effects of the US tax reform

Developments in the Brexit negotiations

The debate on strengthening the lending capacity of multilateral development banks

The euro-area economy

[2] In the euro area, the expansionary phase of the business cycle that began in spring 2013 gained steam, spreading to all countries. In the first quarter of 2018, growth fell off slightly, returning to a level in line with the average for the last three years.

With fears of deflation having subsided in early 2017, inflation gradually rose, even though it is still far below the level consistent with the Eurosystem's definition of price stability, especially in its core component. The progressive pick up in inflation in the next few years will depend upon the reabsorption of spare labour capacity and the associated increase in the inflation expectations of households and firms.

The support to growth provided by economic policies and, in particular by the very favourable monetary conditions, continues to be important. According to European Commission estimates, the fiscal policy stance in the euro area is expected to become slightly expansionary this year.

In 2017 the Commission presented a number of initiatives to reform the governance of the Economic and Monetary Union, including proposals to complete the Banking Union and the Capital Markets Union and the plan to strengthen the European Stability Mechanism (ESM), which could serve as a kind of European monetary fund.

BOXES:

Low inflation in the euro area and the global economy

Wage growth in the euro area during the double-dip recession

Public debt in the euro area: some recent proposals

[3] The monetary policy stance was very gradually recalibrated in 2017. The economic growth outlook improved and the first signs emerged of inflation picking up, although there is still much uncertainty about the speed of convergence towards levels below, but close to, 2 per cent. There is also uncertainty about the actual size of the underutilized workforce, which continues to hold back wage recovery, and the rapidity with which inflation expectations will rise. As of yet, the upward trend observed for core inflation is still not sufficiently robust.

Monetary policy instruments were gradually scaled back without any repercussions on the financial markets or on long-term interest rates, as many observers had feared. The ECB's Governing Council has repeatedly emphasized the need for prudence, persistence and patience; looking forward, it contends that an ample degree of monetary accommodation is still necessary and any change to this stance will depend upon incoming information.

BOX:

Monetary policy recalibration

The Italian economy

[4] In 2017 the Italian economy consolidated its recovery, under way almost with no interruption since the second quarter of 2013. However it is proceeding at a slower pace than in previous recoveries and with a lower rate of growth than in the other main euro-area economies.

Growth exceeded the forecasts made at the start of the year by leading analysts and was observed in all the macro-areas, but especially in the northern regions. All components contributed: foreign trade, household consumption, the accumulation of capital goods and investments in construction, which are still far lower than they were prior to the crisis, in part owing to reduced investment by general government.

Exports accelerated more than imports, meaning that foreign trade made a positive contribution to GDP growth for the first time since 2013. The current account surplus reached its highest level since the mid-1990s.

Lending to the private non-financial sector expanded, though still modestly for businesses, as has been observed in the past when the economy was emerging from a deep recession or from recessions accompanied by financial crisis.

Fiscal policy continued to be moderately expansionary for the fourth year in a row, nevertheless general government net borrowing came down. The debt-to-GDP ratio also declined slightly; less favourable financial conditions should not have a significant impact on debt sustainability, as long as the fiscal stance remains prudent and the economy continues to grow at the current pace.

BOXES:

Economic cycles in Italy

The determinants of economic activity in 2017 according to the Bank of Italy's model

Regional trends

The normalization of financial conditions and the Italian economy

[5] Thanks primarily to the recovery in payroll employment, household disposable income continued to increase, driving the expansion in consumption under way since mid-2013. Consumer confidence also improved in the second half of the year, reflecting more favourable labour market expectations.

Income inequality rose slightly between 2014 and 2016. Over the last ten years the income gap has widened both between different age groups and within different geographical areas, reflecting a deterioration in the conditions of the poorest households. In 2016, the percentage of individuals living in absolute poverty reached a ten-year high.

Our estimates indicate that in 2017 the decline in household property wealth came to a halt, despite a further modest decline in real estate prices, which do not yet reflect the recovery in demand.

BOXES:

Inequality and poverty: comparison across age classes before and after the Great Recession

Income inequality between the Centre-North and the South

Uncertainty about economic policies and household consumption

[6] In 2017 economic activity strengthened in every sector except agriculture. Value added accelerated in manufacturing and in services and increased significantly in construction for the first time since 2006.

The demographic balance of firms improved thanks to a reduction in the business mortality rate. While the business birth rate remained lower than that prevailing before the crisis, for the third consecutive year there was an increase in young firms' ability to survive and in their contribution to both value added and capital accumulation, especially investment in intangible assets.

Investment accelerated, especially in plant, machinery and transport equipment, thanks to the tax incentives, the favourable monetary and financial conditions, the reduction in uncertainty and the increase in business confidence about demand prospects. However, as a share of GDP, investment remained below pre-crisis levels.

Innovation and the propensity to adopt new technologies, **though low by international comparison**, **also strengthened**, buoyed by the support measures introduced in recent years. Labour productivity in the private sector returned to growth, rising to pre-crisis levels: in industry the increase under way over the past ten years continued, albeit at a lower rate than the euro-area average, while in services it started to climb again.

BOXES:

Uncertainty indicators for Italian firms

Innovative start-ups in Italy: some findings on recent support measures

Patent development and the financial structure of innovative Italian firms

Growth potential and productivity according to firm-level data

The efficiency of production factor allocation in Italy and credit conditions

[7] Financial conditions improved overall for both households and firms.

Total household wealth grew, mostly on account of the increase in the value of financial assets, and a greater share of savings was allocated to asset management products, which help to diversify portfolio risks. Loans to households by banks and other financial intermediaries accelerated.

In 2017 firms' profits continued to grow. Leverage decreased again, largely on account of the increase in net equity. Corporate loans remained stable; signs of a recovery only emerged at the start of 2018. Recourse to the capital markets gathered pace, even on the part of medium-sized firms. The availability of external financing is an important factor for newly-established firms.

BOXES:

The economic recovery and business lending

Institutional investors and the Italian corporate bond market

The financial structure of new firms

[8] Employment continued to expand in all the main economic sectors in 2017. However, there were still ample margins of spare labour capacity: the number of hours worked per employee was still about 5 per cent lower than pre-crisis levels. The share of part-time workers that would prefer full-time work remained high.

Self-employment decreased and payroll employment increased: over the last three years, the number of self-employed workers (which includes para-subordinate workers) declined by about 160,000, while the number of payroll employees increased by more than 900,000, of which more than half with permanent contracts. In 2017 the growth in payroll employment was however wholly attributable to fixed-term contracts. Last year, permanent employment was affected by the end of the social contribution relief that was extended to new hires in 2015-16 and, in the last few months of the year, by the decision on the part of firms to wait for the new relief expected in 2018 for hiring young workers.

The participation rate increased further, especially among older workers, while it fell among the youngest age group, reflecting more time spent in education.

The unemployment rate fell but only slightly, remaining at historically high levels; **youth unemployment fell more markedly**, but it was still triple that for the population as a whole.

In 2017 the increase in contractual earnings was modest, as in the previous year. However, the collective contracts signed in the second half of 2017 and in the first few months of 2018 signal that wage growth might be strengthening as a result of a firmer anchoring to inflation expectations and the increase in those expectations.

BOXES:

Changes in the occupational structure in Italy in the last ten years

Changes in unemployment benefits in Italy

The mismatch between labour demand and educational level

[9] Consumer prices in Italy returned to growth in 2017, buoyed by the most volatile components. **Core inflation, though recovering gradually, remained low** by historical standards (more than in the euro area), mostly on account of the still ample margins of spare capacity. Inflation expectations showed signs of a still uncertain recovery.

Wage growth was also weak, hampered by the continuing slack in the labour market and by the fact that some agreements signed between the late months of 2015 and the early months of 2016 introduced pay rise indexation to the previous year's low inflation.

The price competitiveness of Italian firms was unaffected by the appreciation of the euro due to the fact that the increase in production prices was lower in Italy than it was for its main competitors. The gain vis-à-vis other euro-area countries offset the loss vis-à-vis non-euro-area competitors.

BOXES:

Labour market conditions and weak core inflation

The inflation expectations of Italian firms and the labour market

[10] The current account surplus increased further. Exports accelerated, driven by the growth in demand caused by the favourable international outlook. In the services sector, spending by foreign tourists in Italy continued to grow for the eighth year in a row. Italy's investment income returned to surplus.

Investment by non-residents in Italian government securities recovered, while Italian investors purchased foreign portfolio securities, mostly investment fund shares, for larger amounts than in the preceding three years. The Bank of Italy's negative balance in the TARGET2 payment system did not widen any futher in the second half of 2017.

In recent years Italy's net external debtor position diminished significantly thanks to the build-up of current account surpluses; after peaking at 24.6 per cent of GDP in March 2014, it shrank to 6.7 per cent at the end of 2017. Based on the IMF's forecasts on the current account balance, Italy's net external position should fall to nil by around 2020, while the imbalances of the other main euro-area countries are expected to remain large.

BOXES:

Spending by foreign tourists in Italy

Investments in foreign mutual fund shares and the asset composition of residents' portfolios

Recent trends in the Bank of Italy's TARGET2 balance

The improvement in the net international investment position

[11] In 2017, the fiscal policy stance remained moderately expansive, consistent with the goal of not hindering the strengthening economic recovery. The primary surplus, which remained unchanged at 1.5 per cent of GDP, according to the European Commission's estimates fell by 0.6 percentage points of GDP on a cyclically-adjusted basis. Thanks to the further reduction in interest expense, net borrowing continued to contract, declining from 2.5 to 2.3 per cent. The debt diminished marginally to 131.8 per cent.

The fiscal stance is expected to remain substantially neutral in 2018. According to the current legislation scenario in the Economic and Financial Document presented at the end of April, net borrowing is projected to fall to 1.6 per cent in 2018 and a balanced budget is expected in 2020. The debt-to-GDP ratio is projected to narrow by about 1 percentage point in 2018; the reduction should continue at a faster pace in subsequent years, reaching approximately 122 per cent in 2021.

In May, the European Commission judged that the public accounts were substantially consistent with European fiscal rules in 2017; for 2018 it noted the risk of a significant deviation which will be assessed in spring 2019 in light of final budget data.

BOXES:

The impact on the public accounts of the financial sector support measures

The effects on incentives and income redistribution of a recomposition of the taxes levied on households

General government commercial debts

[12] As regards competition, little progress was made. The limited achievements were mainly due to the first annual law on the market and competition (Law 124/2017) coming into force, but the situation worsened in some sectors.

An enabling law was approved to reform the regulation of business crises. The criteria leave space for a broad review of liquidation procedures in order to reduce the time and cost of debt recovery. The reform introduces procedures for business crisis early warning and settlement which could help to overcome debtor inertia. There is however the risk that the mechanisms that trigger the start of these proceedings may be excessively automatic, resulting in premature liquidations and causing an overload for the bodies responsible for managing them.

In the civil justice system the stock of pending court cases continued to decrease, mainly due to a lower propensity to litigate; progress in shortening the duration of proceedings was still limited, except in relation to foreclosures which take less time thanks to the measures introduced in 2015-16.

Many provisions of the new Public Procurement Code have still not come into effect, including those that require that contracting authorities be suitably qualified. These measures are needed to increase the efficiency of the system, especially because the new rules give public purchasers greater discretion.

BOXES:

The regulation of professional activities and intergenerational mobility

The effects of some recent reforms on the length of foreclosure proceedings

The regulation of tenders: the possible costs of discretion

[13] In 2017 banks strengthened their economic and financial situation. The stock of non-performing loans (NPLs) was considerably smaller, both as a result of numerous bad-loan sales and because there were fewer new defaults which, in relation to total loans, returned to the levels recorded before the global financial crisis.

Expansionary monetary conditions contributed to reducing funding costs, which fell to very low levels in historical terms. The increase in customer deposits almost completely offset the fall in retail bond issuance.

There was strong profit growth, thanks to the reduction in loan-loss provisions for NPLs and, to a lesser extent, cuts in operating costs. The return to profitability and the sizeable capital increases significantly narrowed capitalization gaps between the main Italian and European banks. Capital strengthening in 2017 was at a ten-year high.

During the year the crisis situations of some banking groups were resolved. Banca Monte dei Paschi di Siena was allowed to carry out a precautionary recapitalization; Veneto Banca and Banca Popolare di Vicenza went into liquidation. The sale of the bridge banks – established after the resolution of four local banks at the end of 2015 – was completed.

The flow of resources into investment funds increased thanks to the tax incentives introduced under the provisions on individual savings plans. Asset management companies' profits also grew.

BOXES:

The reform of cooperative banks

The complex financial instruments on the balance sheets of significant banks in the SSM

The changes in banking regulation and supervision, credit supply and the economy

The cost of investing in mutual funds

[14] Italian financial market conditons improved in 2017 as a result of the strongly expansionary monetary policy stance, strengthening economic recovery, favourable trends in company profits and the reabsorption of a large part of the systemic risks in the banking system. The general Italian stock market index benefited, in particular, from the rise in bank share prices.

The yields on Italian government securities gradually increased following the consolidation of the economic recovery in the euro area. Yield spreads between Italian ten-year government securities and the corresponding German government bonds remained stable, despite the ongoing international tensions. **Since mid-May 2018, the spread has risen again considerably on account of the re-emergence of uncertainties on the outlook for the Italian economy.** Low risk premiums on Italian government securities require credible prospects for consolidating the public finances and ongoing reform efforts aimed at raising the growth potential of the Italian economy over the long term.

BOX:

The relationship between share prices and the prices of government securities over the business cycle

SPECIAL FEATURES

Italian goods exports in the last twenty years: trends and determinants

[15] Italian goods exports at current prices have more than doubled since 1999. However, this growth has been lower than that for world trade and for the other euro-area economies overall. Since 2010 the performance of Italy's exports has improved markedly by international comparison, as confirmed by the end of a prolonged decline in Italy's market share of global imports.

Until 2010, across all the main sectors Italian exporters were exposed to structural difficulties, exacerbated by the loss of price and cost competitiveness. These difficulties stemmed from an industry specialization that made Italian firms particularly vulnerable to growing competition from countries with low labour costs and from a large number of small firms which were less able to adapt to globalization.

The improvement under way since 2010 was due to the recovery of competitiveness and the structural changes that had taken place over the previous ten years. Besides the depreciation of the euro and the reduction in relative terms of prices and labour costs, changes in the production structure have, over time, reduced exposure to competition from the emerging economies. Moreover, the largest gains in Italian exports have been made by medium-sized and large firms, which are better able to withstand external shocks and grasp new opportunities on the international markets.

BOXES:

Business strategies and trends in Italian goods exports

The invoicing currency and the effects of exchange rate fluctuations on business activity

Cyber risks for the Italian economy

[16] A growing number of business, finance and consumption activities rely on digital technologies and are therefore exposed to the risk of cyber attacks. Cyber security is not only a technology issue, as vulnerabilities often arise from underestimating risks or from organizational loopholes. The international, European and Italian regulatory framework is rapidly changing in order to strengthen the defenses of institutions, businesses and citizens, but limited knowledge of the spread of these attacks and of their impact stands as an obstacle to designing effective policies to counter the threat.

Recent Bank of Italy data show that larger firms and those that adopt advanced technologies are damaged by cyber attacks more often than others. They are particularly attractive to hackers because they make extensive use of connected devices and store valuable data. ICT firms are an exception, because they are more aware of the risks and invest more to protect themselves.

The Bank of Italy is called to contribute to the financial system's cyber security both directly, by managing critical infrastructures such as the payment system, and indirectly in its financial supervision activities, which increasingly involve aspects related to cyber security.

BOXES:

Measuring the economic impact of cyber attacks

International cyber-security initiatives in the financial sector

The Computer Emergency Response Teams (CERTs) in the Italian financial sector