BANCA D'ITALIA
EUROSISTEMA

The Annual Report at a Glance

Rome, 31 May 2019

2018

THE 2018 ANNUAL REPORT AT A GLANCE

The international economy

[1] World economic growth weakened (reaching 3.6 per cent), falling short of expectations. The outlook deteriorated progressively over the course of the year, initially in the emerging countries, then in many advanced economies as well. In the United States, however, GDP rose, in part owing to the expansionary effects of the tax reform enacted in December 2017.

Temporary factors interacted with a high degree of uncertainty at global level, largely attributable to trade tensions between the United States and China. Overall, protectionist pressures sparked a reversal in the trend towards liberalizing world trade. This had an impact on investment expenditure and on international trade, which slowed sharply in the second half of the year.

The increase in US interest rates and the consequent appreciation of the dollar led to episodes of turbulence in the financial markets. During the summer, the currencies of the emerging economies depreciated, risk premiums rose and capital inflows declined, especially in the countries most reliant on external sources of funding. In the last part of the year, heightened fears of a global slowdown led to a sharp rise in volatility on the markets, a correction in the prices of the riskiest assets in the advanced countries and a drop in oil prices.

At the start of 2019 the monetary policy stance of the United States became more accommodative, leading to an easing on financial markets: the decline in long-term yields was coupled with a rise in stock prices.

The risk of the United Kingdom's exit from the European Union without an agreement persists, although it is no longer immediate.

The G20 has taken new steps to restart the multilateral dialogue on a wide range of issues relating to the reform of global governance in order to promote stable and sustainable growth.

BOXES:

Recent trade tensions and their implications

The reform of global governance: the proposals of the Eminent Persons Group to the G20

The euro-area economy

[2] There was a slowdown in GDP in the euro area and in the main member states, reflecting a deterioration in world trade and, in the last quarter of the year, in domestic demand. Growth resumed at a stronger rate in the first quarter of 2019, but the confidence of firms and households is still weak.

Inflation remained moderate, particularly in the core component, reflecting the still uncertain outlook for the economy, which also dampened the pass-through of wage acceleration to prices.

The labour market continues to improve, though with differences between countries. The share of citizens residing in a country other than their native one is on the rise.

According to the European Commission's estimates, the euro area's fiscal policy was broadly neutral in 2018 and is expected to be slightly expansionary this year; however, the fiscal stance varied from country to country. Based on the most recent demographic projections and assessments of the underlying trends of the public accounts, the Commission points out that the risks to the long-term sustainability of the public finances are higher than in the past for the main euro-area economies, with the exception of Germany.

BOXES:

Labour mobility and shock absorption in the euro area

Why has wage growth not passed through to prices yet?

[3] The Governing Council of the European Central Bank (ECB) gradually recalibrated the monetary policy instruments. This was done in response, on the one hand, to the disappearance of the deflation risk that had emerged in years past and, on the other, to the persistent uncertainty about the development of economic activity and the speed with which inflation will rise towards rates that are below, but close to, 2 per cent in the medium term.

The Council progressively reduced the net purchases under the expanded asset purchase programme (APP), terminating it at the end of 2018. At the same time it maintained an ample degree of monetary accommodation, communicating that it intended to keep the key interest rates unchanged for an extended period of time and reiterated that it would continue reinvesting the principal payments from maturing securities under the APP for an extended time past the date when it starts raising interest rates. The persistent historically loose monetary conditions have not as yet been accompanied by an increase in the credit risk tolerance of banks.

Towards the end of last year and the start of this one, global tensions led to weakening growth prospects and diminishing actual and expected inflation. In March the Governing Council announced a set of decisions, including the decision to launch a new series of targeted longer-term refinancing operations, in order to continue to maintain an expansionary monetary stance and to ensure that it is fully transmitted to the real economy. The Council also reiterated that it stands ready to use all instruments available within its mandate to ensure that inflation continues to move towards its target in a sustained manner.

BOXES:

Expansionary monetary policy and the risk tolerance of banks

The effects of TLTRO II on the credit market

The Italian economy

[4] **The growth of the Italian economy lost momentum, falling far short of the main forecasters' initial expectations;** it was slightly negative in the second half of the year. The economic weakening mirrored the slowdown in exports following the slump in world trade and the deterioration in the other European economies, particularly Germany. It also reflected the downward revision of investment plans, caused by the uncertainty fuelled by protectionist pressures at global level and by the economic policy stance.

In the first quarter of 2019, GDP growth turned slightly positive. However, cyclical indicators are still weak and, in April, the Ita-coin indicator fell to its lowest level since the summer of 2013. GDP remains far below its potential.

In 2018, moderate growth was common across all the main areas of the country, but was driven by the North, where it was almost double that of the Centre and the South.

The external current account balance remained broadly positive, as in the preceding two years. The net external debt position, which had been declining since 2014, fell to 3.9 per cent of GDP.

The fiscal policy stance remained substantially neutral. Net borrowing fell to 2.1 per cent of GDP, while the debt-to-GDP ratio began to rise again, reaching 132.2 per cent.

Bank loans to households continued to increase considerably. Lending to firms rose substantially in the first half of the year: the expansion in lending then steadily lessened as a result of the drop in demand and the tightening in supply conditions. Banks' strong capital positions, the rebalancing of funding towards less costly financing sources and high liquidity levels slowed the pass-through of the rise in government bond yields to the cost of credit, though it could strengthen in the future if government bond yields remain high.

BOXES:

Determinants of economic activity in 2018 according to the Bank of Italy's model

Italy's output gap

Regional trends

[5] The growth in households' disposable income strengthened, buoyed by the expansion in employment, higher wages and the increase in social security benefits. After rising significantly between 2009 and 2014, the inequality of equivalized labour income for individuals who live in households headed by someone between 15 and 64 years of age and with no retirees fell slightly, mainly as an effect of higher employment.

The increase in private consumption, under way since the spring of 2014, slackened. The propensity to save of consumer households began to rise once more, plausibly for precautionary reasons linked to greater uncertainty. The confidence indicators, which nonetheless remain high, began to fall in the latter part of 2018. For some types of households, particularly the most indebted ones, consumption may also have been affected by still weak inflation expectations.

Despite the further rise in housing sales, prices continued to fall, broadly in line with the trend under way for 7 years. This led to a decrease in the real component of household wealth. There have been signs in recent years of an increase in rental prices.

BOXES:

Labour income inequality across households

An analysis of the redistributive effects of recent anti-poverty measures

The role of inflation expectations in Italian households' consumption decisions

The rental market in Italian cities

[6] Activity weakened in all sectors except for agriculture and construction. Value added slowed in industry excluding construction and in services, reflecting the weakness of the international cycle and, in the second half of the year, the uncertainty that held down national demand; it instead accelerated in the construction sector, thanks to a relatively robust increase in residential investment, and returned to growth in agriculture.

The number of active firms continued to rise, but at a slower pace than in 2017, owing to the decline in the birth rate, which has been falling since 2010, and a slight increase in the death rate, spread across almost all sectors. Rising emigration among young and educated members of the workforce has contributed to curbing the establishment of new firms in recent years.

Investment continued to increase at a significant pace, but less so than in the year before. The recovery that began at the end of 2014 came to a standstill in the second half of the year as a result of the weakening economic cycle and the loss of business confidence. Investment in intellectual property decelerated for the second year in a row. By international standards, it is clear that Italy lags behind in the adoption and use of digital technologies.

Based on the surveys conducted by the Bank of Italy's branches, just over half of the firms took advantage of at least one investment incentive, which according to one third of the beneficiary companies prompted them to increase investment. On the whole, firms' plans for the current year envisage a slight expansion in investment, despite prevailing expectations of a reduction in manufacturing.

Labour productivity in the private sector stagnated; the performance varied greatly from firm to firm, proving to be especially favourable for those that were larger and more innovative. The trend in productivity was also positively correlated with the quality of managers and directors.

BOXES:

Financial crisis and technological change: the role of start-ups

Italy's digital lag

The characteristics of highly productive Italian firms

Directors and firm performance

[7] **The financial situation of households was affected by the cyclical slowdown and by the tensions in the financial markets in the second half of the year.** During these months the growth in disposable income weakened and the value of portfolio assets decreased considerably. Borrowing from banks and financial companies continued to increase, supported by low interest rates.

Tensions in the financial markets were accompanied by prudent behaviour on the part of households. Sight deposits and purchases of insurance policies with guaranteed minimum returns remained high, while subscriptions of investment fund units dropped sharply. Nonetheless, asset management instruments account for a much larger share of households' portfolios than they did in the past; they allow investors to better diversify their risks, including by taking advantage of a wider range of investments on international markets. Innovations in banks' distribution channels have made it easier to hold a variety of financial instruments other than deposits.

The deterioration in the economic outlook interrupted the recovery in the profitability of non-financial companies that had been under way since 2012. In the first half of the year, the increase in firms' indebtedness to banks reached its highest level since the sovereign debt crisis; it then declined as a result of the drop in demand and the adoption of more prudent supply policies. The smallest firms appear to be more financially vulnerable than larger ones to the cyclical slowdown owing to their limited ability to self-finance and to less favourable credit access conditions.

Despite negative developments in the stock market in 2018, the number of newly listed non-financial companies was slightly higher than in 2017. Over the last five years there has been an increase in IPOs compared with the past, mainly by small and medium-sized enterprises; however, the size of the Italian stock market continues to be much smaller than that of the main European countries.

BOXES:

Household investments through Italian asset management products

Online banking and portfolio choices

The listing of non-financial corporations: a comparison between the main European countries

[8] Employment rose on average in the year, but growth halted in the second half, reflecting the weakening economy. Some signs of a recovery appeared in the first quarter of 2019.

In particular, there was an increase in payroll employees hired with permanent contracts. A variety of factors contributed to the conversion of fixed-term contracts into permanent ones: the large number of fixed-term jobs inherited from 2017, the introduction of social security relief for persons under age 35 and, in the final months of the year, new restrictions on temporary contracts under the 'Dignity Decree'. For workers hired with fixed-term contracts, these restrictions nonetheless contributed to slightly reducing the probability of remaining employed at the end of the contract term. The share of professions demanding a high level of skill rose considerably.

The unemployment rate fell on average in the year (to 10.6 per cent, from 11.2 per cent in 2017). Labour market participation continued to rise, especially because the retirement age for the older categories of workers was postponed under reforms introduced in the last ten years. This effect is bound to diminish as a result of recent regulatory measures that have temporarily relaxed the requirements for accessing pension benefits.

Actual earnings returned to growth after two years of virtual stagnation, driven by contract renewals that occurred between the end of 2017 and the start of 2018. In the second half of the year, with the deterioration in cyclical conditions, the share of employees with expired, unrenewed contracts began to rise again, causing slower growth in contractual earnings that has continued into the current year.

BOXES:

The impact of broadband internet on Italian firms

The role of public employment services in the labour market

Italy's risk of a brain drain after the Great Recession

[9] Growth in consumer prices in Italy was weak, owing to the still ample margins of spare capacity and, in the second half of the year, the worsening in cyclical conditions; accordingly, core inflation remained very low.

Nominal wages returned to growth, without translating into stronger price dynamics. In addition, since the second half of 2018 wage growth has slowed due to the non-renewal of expired contracts.

The appreciation of the effective exchange rate of the euro hampered Italian firms' price competitiveness in relation to non euro-area competitors; in contrast, lower price growth improved competitiveness compared with euro-area partners.

BOXES:

Italian firms' inflation expectations and price strategies

Labour market mobility and wage pressures

[10] Like in other euro-area countries, the appreciation of the nominal exchange rate and the slowdown in global trade restrained exports. However, after the weak performance recorded at the start of the year, their growth helped to maintain the ample current account surplus, as did the lower deficit on services, which was largely due to the increase in tourism revenue, and the larger surplus on investment income, offsetting the decline in the energy balance.

Foreign portfolio investments by Italian residents fell to half the average level recorded in the previous four years, during which time households diversified their portfolios in response to the low government bond yields and the limited supply of bank bonds. Foreign investors reduced their holdings of Italian securities, especially between May and August, largely coinciding with bouts of high tension on the Italian financial markets. The capital outflow was accompanied by a widening of the Bank of Italy's negative balance on the TARGET2 payment system, which then stabilized between the end of 2018 and the start of 2019.

The current account surplus reflects the improvement, under way over the past several years, in the competitiveness of Italian exporters, which has further reduced Italy's net external debt position.

BOXES:

Euro-area trade and new competitors

Italy's exports of services

An analysis of the portfolio of the foreign investment funds held by Italian households

Foreign capital flows in Italy in 2018

[11] In 2018 the fiscal policy stance was substantially neutral. Net borrowing continued to decline, falling to 2.1 per cent of GDP, while the debt-to-GDP ratio returned to growth, reaching 132.2 per cent.

Since the spring of 2018, uncertainty concerning the new government's plans has helped to increase yields at issue for Italian government bonds. Following an agreement reached with the European Commission on the 2019 budgetary objectives, financial market tensions partially abated in the last part of the year. The long average residual maturity of the public debt slows the transmission of the higher yields at issue to the average cost of the debt, but it is estimated that a permanent 1 percentage-point rise in rates would result in an increase of just under 0.5 points in the cost of the debt after three years.

In 2019 the fiscal stance is expected to be slightly expansionary. According to the most recent official estimates, net borrowing will increase to 2.4 per cent of GDP. Instead, for the three years 2020-22, the Government plans to steadily reduce the deficit to 1.5 per cent of GDP, including by means of the indirect tax increases provided for by the safeguard clauses over the next two years and the corrective measures in 2022. Excluding these measures, average net borrowing would be just below 3.5 per cent of GDP over the three-year period.

The last Fiscal Sustainability Report of the European Commission signals an increase in risks to the sustainability of the public finances, largely on account of the deterioration recorded in recent years in the primary structural balance and, to a lesser extent, the expected increase in spending related to the ageing population.

BOXES:

The spread between the average cost of the debt and nominal GDP growth: recent trends and outlook

Looking beyond the public debt: commercial liabilities and liabilities in derivatives

The budget cycle within the context of the European Semester

An analysis of the macroeconomic and redistributive effects of the safeguard clauses on VAT

[12] The recent market regulation measures outline a stance that, as a whole, does not encourage competition, albeit with differences between sectors, some of which have benefited from the liberalization measures introduced in the past.

The Business Crisis and Insolvency Code was enacted at the start of 2019 with the goal of improving the efficacy of the insolvency laws and making them more uniform and comprehensive. The main features concern the introduction of alert and resolution procedures, encouraging the early detection and the management of crisis situations; the manner in which these features are implemented will have to be calibrated in order to avoid the risk of premature liquidations.

In the civil justice sector, the number of pending cases continued to decline, especially those pending for more than three years, albeit to a lesser extent than in the previous four-year period. The average duration of proceedings remained high, though it declined slightly.

To increase the efficacy of the fight against corruption, measures have been adopted to strengthen detection and prosecution tools. The reform of the statute of limitations, while containing the risk that a case gets dismissed for having exceeded the time limit, introduces uncertainty concerning the duration of criminal proceedings.

BOXES:

The effects of the deregulation of shop opening hours

Family firms: numbers, operating environment and performance

[13] **The growth in bank lending, though still contained, reached the highest level recorded since the start of the sovereign debt crisis.** However, in the second part of the year, the deterioration of the macroeconomic and financial outlook was rapidly reflected in business lending, which again started to contract in the first few months of 2019.

The non-performing loan rate fell below the levels recorded in the two years 2006-07. The stock of non-performing loans declined considerably, both in absolute terms and in relation to total loans, thanks to large sales transactions. The recovery times for bad loans also gradually decreased.

The reduction in loan loss provisions and, to a lesser extent, the lowering of operating costs contributed to the increase in profitability, which, for the main Italian banks, was just under that of the major European banks. Services relating to the placement of corporate securities provided a small contribution to income.

The downsizing of branch networks continued: the number of employees and branches declined, helping to contain operating costs. The process mainly regarded the five leading banking groups. In the first few months of 2019, the structure of the banking sector changed significantly following the reform of the cooperative credit banks: the number of banks not belonging to a group fell by more than two thirds.

Banks increased their investments in Italian government securities in the first half of the year. The fall in government bond prices was reflected in a decrease in the value of capital; the effect was mitigated by an increase in the share of securities valued at amortized cost.

Institutional investors' funding was lower than that of the previous year, largely on account of the decline in investment fund subscriptions. The reduction also concerned individual savings plans (*piani individuali di risparmio*, or PIRs).

BOXES:

The effect of taxation on the total cost of credit over the period 1998-2017

Closure times for bad business loans

Banks and the placement of corporate securities

[14] Since the spring of 2018, conditions on the Italian financial markets have reflected the heightened uncertainty surrounding economic and fiscal policies; in the last part of the year, they were also affected by the lower growth outlook at global level.

The sovereign risk premium, measured by the yield spread between Italian and German ten-year bonds, rose markedly; this increase was transmitted to the cost of bond funding for Italian firms and banks, which grew significantly. Tensions on the government securities market eased in the last quarter of 2018, after the Italian government reached a budget agreement with the European Commission. Share prices fell considerably during the year, especially bank shares, consistently with the euro-area trend.

In the first few months of 2019, conditions improved on the Italian financial markets, as they did in the other main advanced countries, benefiting from the Federal Reserve's less restrictive stance and the ECB's intention to maintain highly expansionary monetary conditions for longer.

However, share and bond prices started to decline significantly in May, affected by the increase in investors' risk aversion.

As a result of the uncertainty surrounding the macroeconomic outlook and future economic policies, in the first few months of 2019 the sovereign risk premium remained above the level recorded at the start of 2018; volatility stayed high on the government securities market.

BOXES:

The trend in Italian government bond spreads

The Italian stock market's performance in recent years

The venture capital market in Italy

Special focus: Tourism in Italy: numbers and development potential

[15] In Italy, the tourism sector contributes significantly to GDP, more than in France and Germany and similarly to Spain. Compared with the first half of the 1990s, against a backdrop of a significant expansion in the sector at global level, Italy has seen its market share decline more markedly compared with the other main international destinations. However, since 2010 there have been promising signs of a recovery in foreign inflows, which further strengthened over the past two years.

Tourism spending is not evenly distributed across tourism resources: accordingly, some areas are under-visited while others risk over-crowding. The regions in the North-East and in the Centre receive most of the international inflows; the largest share of Italian tourists are concentrated in the regions in the North-East. The tourism sector is less developed in the South, where the number of tourists remains limited, especially foreign tourists.

Tourism demand is becoming increasingly complex and elaborate. However, the key drivers remain cultural in nature, strengthening Italy's competitive advantage by virtue of its extensive artistic heritage and rich history. Whether the sector is able to grow further will largely depend on Italy's ability to capitalize on these resources.

The supply of tourist accommodation, which is more fragmented than in other countries, is starting to evolve, also thanks to the appearance of online reservation channels, which help to increase the number of non-hotel accommodations and accelerate the process of improving the quality of hotel structures.

To fully realize its tourism potential, Italy must overcome its development gaps, especially in relation to employee skills and transportation infrastructure; the low priority attributed to the sector by national policies must also be addressed.

BOX:

Innovations in state-owned museums: findings from a survey by the Bank of Italy

Special focus: Public investment

[16] According to the available estimates, an increase in public investment expenditure is capable of having a significant macroeconomic impact, the size of which depends on how efficiently the resources are used. The impact is higher in the presence of favourable monetary conditions and in the absence of negative repercussions on the sovereign risk premium.

In Italy, public investment expenditure has decreased markedly since the start of the crisis; in proportion to GDP, it has fallen below the levels recorded in the main European countries. This is due to the decline in resource allocation and to expenditure-related operational difficulties. The available indicators point to a lag in Italy's infrastructural endowment that is partly caused by poor spending decisions and inefficiency in the performance of public works, especially in the South. This reflects the inadequate regulatory framework and weak technical skills on the part of the public entities in planning and carrying out public projects.

In recent years, wide-ranging reforms have been passed to improve the efficiency of investment expenditure. However, many measures (such as those concerning the qualification of contracting authorities, the technical and financial plans, and the quality of proposed projects) have still not come into effect or have yet to be fully implemented. Measures aimed at accelerating the completion of public works, if not accompanied by greater transparency in the administrative process and suitable levels of professionalism on the part of the contracting authorities, may increase the risk of corruption and the inefficient allocation of resources.

BOX:

The macroeconomic effects of public investment expenditure: a comparative analysis of the estimate