BANCA D'ITALIA
EUROSISTEMA

Annual Report at a glance

Rome, 31 May 2021

2020

Links to the English translation of the boxes are added (as they become available).

THE 2020 ANNUAL REPORT AT A GLANCE

The international economy

[1] The COVID-19 pandemic has had an extremely severe impact at a human, social and economic level. More than 160 million people have been infected and more than 3 million have lost their lives. According to IMF estimates, global GDP fell by 3.3 per cent in 2020, the sharpest contraction since the Second World War; trade decreased by 8.9 per cent, also as a result of the restrictions on the movement of goods and people.

The spread of the virus swept through the whole global economy. With the successive epidemic waves, the economic effects played out differently across sectors and geographical areas, reflecting the severity of the pandemic at local level and the economic policy responses.

Monetary policies prevented the pandemic crisis from morphing into a financial crisis by guaranteeing liquidity to the markets and facilitating credit through various measures, including asset purchase programmes, which were also adopted by the central banks of some emerging economies for the first time. Fiscal policies played a key role in supporting the income of households and firms, especially in the advanced economies, thereby preventing the crisis from spiralling.

Financial market conditions eased progressively after the abrupt deterioration observed at the beginning of the pandemic. Since the final months of 2020, the improving growth outlook, fuelled by news about the availability of vaccines, have contributed to the reduction in investors' risk aversion and the rise in long-term interest rates, especially in the United States.

The crisis hit above all the most vulnerable population segments and countries, increasing the risk of a rise in inequality in the coming years. According to the World Bank, the pandemic brought the reduction in the number of people in extreme poverty to a halt for the first time in more than twenty years. In this context, the support of the global financial community to the most fragile economies and progress in the vaccination campaigns will be crucial to laying the foundations for overcoming the crisis, reducing economic uncertainty and accelerating the return to growth.

BOX:

The course of the COVID-19 pandemic and the progress in the vaccination campaign

The euro-area economy

[2] Euro-area GDP recorded the sharpest contraction since the inception of the Monetary Union. The dynamics of economic activity during the year reflected the course of the epidemic and of the resulting containment measures: the sharp drop in the first two quarters was followed by a marked recovery in the summer months, which, however, came to a halt in the autumn. Households' saving rate rose, owing to the lower spending induced by the restrictions on mobility and the strengthening of the precautionary motive.

The reduction in inflation, which declined to 0.3 per cent on average for the year, reflected the fall in global demand, in energy prices, and in domestic economic activity. The increase recorded in early 2021 influenced by the recovery of the energy component but also by a number of temporary factors, the impact of which is expected to be largely reabsorbed during the year. While pointing to a recovery, the outlook for prices remains weak over the medium term.

The fiscal policy response to the pandemic crisis was incisive and was carried out using multiple instruments, among which the activation of the general escape clause of the Stability and Growth Pact, the increased flexibility in the use of EU Cohesion Funds, and the adoption of a temporary framework concerning the rules on State aid. The agreement reached in July 2020 on the Next Generation EU (NGEU) programme for the common funding of individual countries' plans to support recovery is an innovation of historic importance.

The expansionary fiscal policy stance was common to all the Member States and responded to the severity of the crisis. According to the European Commission's latest estimates, the ratio of net borrowing to GDP rose by 6.6 percentage points on average in the euro area; the ratio of public debt to GDP increased by slightly more than 14 points.

BOX:

Financial flows in the euro-area countries during the pandemic

Monetary policy in the euro area

[3] In response to the risks to economic activity, price stability and monetary policy transmission arising from the pandemic, the ECB was decisive in adopting expansionary measures. In March 2020, its intervention countered the very strong turbulence in the financial markets and enabled them to stabilize; this subsequently made it possible to maintain accommodative financing conditions for households, firms and governments, which are crucial to deal with the contraction of the economy.

The terms of targeted longer-term refinancing operations were made more favourable; the asset purchase programme was strengthened; the new pandemic emergency purchase programme (PEPP), covering public and private sector securities, was launched and expanded on several occasions. Its flexible purchase approach distinguishes it from previous programmes; it has made it possible to intervene quickly when and where necessary, playing a vital role in countering tensions in the financial markets.

In December, the ECB Governing Council expanded the PEPP and decided that its purchases will aim at maintaining favourable financing conditions for a prolonged period of time, adjusting the amount of monthly purchases flexibly to take account of trends in sovereign yields and in other financial indicators, as well as of the inflation outlook. In March 2021, the Governing Council decided to increase the volume of monthly purchases under the PEPP significantly, until June. Large and persistent increases in yields do not appear to be justified by the current economic outlook, and will be countered.

The Governing Council remains committed, even once the crisis is over, to intervening with all the instruments at its disposal to support growth and ensure a sustained return of inflation, which is still too low, to levels consistent with the price stability objective.

At the beginning of 2020, the ECB launched its monetary policy strategy review. Work resumed last summer after being put on hold to address the pandemic emergency, and is scheduled to end in the second half of this year. The review will take account of the changes observed in the economy over the last two decades and will re-examine the main aspects of monetary policy conduct, including the quantitative definition of price stability, how to ensure that the objective is perceived as symmetric, and how to strengthen the capacity of monetary policy to stabilize the economy, countering the risks of deflation in a low interest rate environment and through the use of unconventional instruments.

BOX:

The PEPP and the stabilization of financial markets

The Italian economy

[4] Last year Italy's GDP recorded its largest drop since the Second World War (-8.9 per cent). The impact of the COVID-19 pandemic was transmitted through various channels: the decline in global economic activity, exports and inbound tourist flows; the reduction in mobility and consumption; and the impact of uncertainty on investment by firms.

The contraction in GDP was uneven, with industry seeing a quicker recovery and services weakening once again in the final months of the year. All geographical areas were affected, but the North, hit hardest by the first wave of infection, was impacted most markedly.

Consumption (down by 10.7 per cent) suffered due to the restrictions on economic activity. Firms put a brake on their investment plans, causing gross fixed investment to decrease by 9.1 per cent, especially in the non-construction component. The pandemic had a considerable, but temporary, impact on exports: after falling sharply in the first half of the year, foreign sales picked up pace, returning to pre-pandemic levels in the final quarter.

There was a decisive fiscal policy response to the pandemic, with the introduction of expansionary measures, for the most part temporary: net borrowing rose to 9.5 per cent of GDP, from 1.6 per cent in 2019. Saving as a ratio of gross national disposable income remained unchanged; the reduction in the general government current account balance was matched by the rise in private sector saving, due in part to the accumulation of liquidity for precautionary reasons by non-financial corporations, but above all to the contraction in consumption, including for those households that did not see their disposable income decline.

The consequences for the labour market were substantial, but the recourse to the existing social safety nets and the emergency scheme introduced during the crisis helped to mitigate them considerably. The steep decline in hours worked was associated with a much more modest decrease in the number of persons in employment. Job loss was concentrated among self-employed workers and those on fixed-term contracts, especially in the service sector, penalizing in particular young people and women.

The health emergency could also have an impact on the demographic trends of the population in the coming decades, affecting both birth rates and migration flows.

Price developments reflected above all the weakness in global and domestic demand. The decrease in consumer price inflation (down to -0.1 per cent) was due to the drop in energy prices and to the impact on the domestic component of the recession and of the wage stagnation that were sparked by the health emergency.

The new waves of infection continued to weaken economic activity in the first quarter of 2021; GDP declined by 0.4 per cent, rising in industry and falling in services. The high frequency data, summarized in the weekly GDP indicator prepared by the Bank of Italy, point to signs of a recovery. Rising vaccination rates and the marked improvement in the global economy have bolstered expectations of a robust recovery in the second half of the year. The outlook is, however, still subject to risks; it will depend on the success of the vaccination campaign in containing the epidemic, on monetary policies remaining expansionary and on the roll-out of the National Recovery and Resilience Plan (NRRP).

Fiscal policy continues to be expansionary, even into this year, in order to address the health emergency and prolong the support measures for the production system. Under the Government's budget, the general government deficit will amount to 11.8 per cent of GDP in 2021; the debt-to-GDP ratio will reach 159.8 per cent, to then fall starting in 2022. The speed of convergence towards pre-crisis levels will also depend on whether the reforms and the investments set out in the NRRP will translate into actual productivity and growth gains.

The NRRP envisages a wide variety of interventions, which pursue an overall strategy for modernizing the country. In particular, it provides a strong stimulus to the digital and environmental transition of firms and general government and sets out a detailed programme of reforms to resolve some of Italy's structural weaknesses. Gender equality, support for young people and the rebalancing of regional gaps are the three priorities that cut across all the measures proposed.

BOXES:

The transmission of the pandemic to the Italian economy

Regional trends

The possible long-term demographic effects of the pandemic

The National Recovery and Resilience Plan

Households

[5] The reduction in disposable income caused by the health emergency was widespread and varied greatly across households. However, the decline was much smaller overall than that in GDP, thanks to the support measures, most of which are one-off and temporary; these have also helped to stem the rise in unequal labour income distribution, which would otherwise have been significantly greater than that observed over the entire course of the two previous recessions, between 2009 and 2014. Despite the piecemeal nature of the various support measures, the temporary social safety net created during the pandemic performed a significant redistributive function; nonetheless, the ordinary social safety nets must be extensively redesigned in order to make them more coherent in the future.

The decline in consumption reflected the drop in disposable income, but also a very significant increase in the propensity to save. Contributory factors were both the cutback in household spending prompted by fears of infection and by the restrictions on retail trade imposed to combat the spread of COVID-19, and economic precautionary motives in a context of considerable uncertainty about the income and employment outlooks. In 2020 on average, the propensity to save reached a twenty-year high. Only one third of households expect to spend in 2021 the savings they set aside in 2020.

The pandemic accelerated the widespread use of payment instruments other than cash and modified the preferences of households in the real estate market, increasing demand for larger homes, with terraces or gardens.

Based on the Bank of Italy's most recent surveys, households' expectations have become slightly more optimistic. Most expect that their income will not fall in 2021 as a whole, though households that even prior to the pandemic found themselves in financial difficulty were more pessimistic.

According to the available indicators, consumption stabilized in the first few months of 2021 at levels still below those observed prior to the pandemic, with a marked recovery for goods, while the demand for services remains weak, especially in the hotels and catering segment.

BOXES:

The impact on inequality of the COVID-19 crisis and of the income support measures in the first half of 2020

Consumption and saving behaviour during the pandemic

The impact of the pandemic on households' payment habits

The pandemic and households' preferences: indications from the real estate market

Firms

[6] In 2020, firms' activity contracted significantly: industry staged a rapid recovery, while services were more severely affected by fears of infection and restrictions, with a high degree of variability between segments. Overall, the trends this year have demonstrated the economy's considerable ability to recover, but developments in the number of cases have continued to be the main obstacle to growth.

As occurred during the global financial crisis and the sovereign debt crisis, firms made substantial cuts in their investments owing to the uncertainty created by the pandemic. However, according to the surveys conducted by the Bank of Italy, unlike in the previous recessions, a large swathe of firms appears to be ready to resume investing once the health situation has improved solidly, thanks in part to very favourable financing conditions.

In the most recent surveys, firms' opinions on the demand for their own products is less pessimistic; however, most report a level of activity that is still lower than that prior to the health emergency and expect recovery times of more than one year on average.

The epidemiological situation weighed on firm demographics, translating into a sharp drop in the birth of new firms, associated with a significant decline in job creation, as well as in the number of exits from the market, temporarily limited by public support measures and the freeze on liquidation proceedings.

Nevertheless, the pandemic also accelerated the digital transformation of the production system: recourse to smart working and the use of new digital technologies increased considerably; half of the firms expect to continue to use them in the future.

Our surveys indicate that the interruption or the postponement of changes to some production processes, caused by the health crisis, delayed firms' ecological transition plans. Looking ahead, the full implementation of the investments envisaged in the NRRP and the related reforms should, however, provide a boost to the process of transitioning towards a digitalized and more sustainable economy.

BOX:

Firm demographics during the pandemic

The financial situation of households and firms

[7] The impact of the pandemic on households' financial wealth was highly diversified: those most affected by the measures introduced to curtail contagion had to dip into their savings to cope with the drop in income; those least affected instead increased their portfolio holdings, in part owing to the reduction in non-essential consumption. After declining markedly at the onset of the pandemic in connection with the fall in securities prices, financial wealth increased overall during the year, following the return to normality of the financial markets and the sharp increase in savings.

The effects of the crisis on the financial conditions of households were mitigated by the Government's income support measures, accommodative monetary policy and debt moratoriums. According to the latest data, repayment of instalments has returned to normal for the majority of mortgages for which moratoriums have ended.

The decline in economic activity hit firms' profitability very hard, but the public interventions succeeded in alleviating the repercussions on liquidity. The increase in financial leverage was very uneven; while it was offset by the rise in liquid assets for firms as a whole, it was especially marked in the sectors hit hardest by the pandemic.

Looking forward, public support for the productive sector must aim to promote the revival of investment, facilitate recourse to debt restructuring instruments and incentivize the resumption of the process to rebalance finances, especially through capital strengthening.

BOXES:

Trends in the financial leverage of Italian firms and the economic cycle

Financial support measures and lending to firms during the pandemic

The labour market

[8] The pandemic crisis dealt a severe blow to the labour market, but the decline in the number of people in employment was much smaller than that in the number of hours worked, which reached its lowest level in the last four decades. Although more than half a million people were laid off, the measures introduced by the Government helped to stem the losses; according to our estimates, around 440,000 jobs were protected by these policies.

To combat the exceptional magnitude and nature of the pandemic's impact, it was necessary to adopt a broad range of new social security measures and incentives to stimulate labour demand; despite the reform efforts of recent years, the pandemic laid bare the shortcomings of pre-existing instruments.

The job losses differed among categories of worker: fixed-term employment declined markedly, as did self-employment; the service sector also recorded losses, especially in tourism. The reduction in employment opportunities was especially severe for young, often fixed-term, workers, and for women, whose presence in the sectors hardest hit is greater than average. The number of employees working remotely increased rapidly.

The restrictions on mobility and fewer job openings during the recession prompted some cohorts of the population to stop looking for work. Ample spare capacity and uncertainty about economic developments slowed down collective wage bargaining.

BOXES:

The prospects for reallocating workers in the sectors hit hardest by the pandemic

Agile work in the private sector

Prices and costs

[9] The public health emergency translated into a significant drop in inflation, which was slightly negative on average in 2020. The sharp fall in energy prices, which reflected global economic conditions, and the repercussions on domestic prices of the recession and of wage stagnation, were among the contributory factors. Food prices were an exception, driven up by greater demand for these goods, especially during the first lockdown.

Inflation turned positive at the start of 2021, following the recovery of the energy component and the improvement in the global economic outlook, but also owing to temporary factors. Some costs affecting the initial phases of price formation increased in the early months of 2021, but wage growth is likely to remain moderate in the rest of the year as well.

Based on the results of Bank of Italy surveys, the great majority of firms believe that the pandemic crisis was primarily transmitted to their businesses and product prices through the contraction in demand, rather than because of supply constraints. The findings also indicate that the longer firms believe the impact of the crisis on production will last, the lower their planned list prices will be.

BOX:

The pandemic and firms' price strategies

Foreign trade, competitiveness and the balance of payments

[10] As in the other euro-area countries, Italian exports were affected by the marked contraction in world trade, temporary halts in production, and the appreciation of the euro: following the decline in the initial phase of the pandemic, sales of goods nonetheless rapidly returned to the levels recorded in the previous year. Unlike the loss observed during the collapse in trade during the global financial crisis, Italy's share of world goods trade remained virtually unchanged, reflecting the increased competitive capacity of our exporting firms.

Lower expenditure on energy products helped to keep the current account surplus high, offsetting the drop in tourism revenues and the lower surplus in non-energy goods. Thanks to the continuous current account surpluses recorded in recent years, Italy's net international investment position turned positive for the first time in more than thirty years.

Tourism was among the sectors hit hardest by the pandemic, with revenues down by close to 90 per cent in the period from March to May, followed by an upturn during the summer months and then another downturn. To relaunch this sector, effective curbs on infection are indispensable.

Foreign portfolio investments recorded large outflows in the first half of the year, in concomitance with the tensions on the financial markets, which then gradually turned into inflows as the markets became more optimistic. In the second half of 2020, purchases of Italian securities by foreign investors increased; the widening of the negative balance on TARGET2 in the first half of the year was gradually reabsorbed.

BOXES:

Italy's sectoral exports in the last decade and the effects of the pandemic

International tourism in Italy during the pandemic

The public finances

[11] The health and economic emergency has had a profound impact on the public finances for 2020 and on the outlook for the years to come. In 2020, general government net borrowing rose to 9.5 per cent of GDP, from 1.6 per cent in 2019. The primary balance recorded a deficit (6 per cent of GDP) for the first time since 2009. The ratio of debt to GDP rose by more than 21 percentage points, to 155.8 per cent; around half of this increase is attributable to the contraction of the GDP denominator. Based on the assessments of the European Commission, the change in the cyclically-adjusted primary surplus – a measure of the fiscal policy stance – was equal to 2.8 per cent of GDP.

According to the plans presented in last April's 2021 Economic and Financial Document – which also take account of the measures included in the NRRP – net borrowing will reach 11.8 per cent of GDP this year. It will decline gradually in the subsequent three years (to 3.4 per cent in 2024). The debt-to-GDP ratio will rise to 159.8 per cent; it will decline starting in 2022, notwithstanding persistent primary deficits, thanks to continued accommodative financial conditions and to the robust expansion of the economy.

The Government aims to bring the ratio of debt to GDP back to pre-crisis levels by the end of the decade, including by making the necessary budgetary adjustments. The simulations reported in the 2021 Economic and Financial Document show that attaining this objective will depend on the capacity of economic policy to ensure a return to consistently higher growth and a sufficient improvement in the primary balance when macroeconomic conditions permit it.

The NRRP, recently submitted to the European Commission, mobilizes European and national resources worth more than €235 billion between 2021 and 2026; around 70 per cent of these funds are for new projects. Infrastructural capital is among the economic policy priorities identified in the recovery plan for the European Union.

BOX:

Territorial gaps in infrastructure endowment

Business activity regulation and the institutional environment

[12] Since the early 1990s, competition in Italy's markets for goods and services has increased, helping to support productivity and economic activity. However, the liberalization of regulated sectors has slowed in recent years, also owing to the crisis connected with the COVID-19 epidemic. The NRRP envisages the adoption, over the next five years, of a package of measures to open up these sectors to competition.

The support measures and the moratoriums on bankruptcy proceedings have contributed to keeping down the number of bankruptcies that have occurred due to the repercussions of the health emergency. However, it is likely that the number will increase in the near future; the extent of this will depend on the economic recovery. This scenario could exacerbate the problems facing the system for managing business crises – already characterized by lengthy proceedings and limited recourse to restructuring tools by smaller firms – and thereby hinder the reallocation of production factors.

The partial interruption in the activity of the courts during the spring of last year slowed the process begun in recent years of improving the functioning of the civil justice system. The NRRP envisages organizational reform and a simplification of procedures in order to speed up judicial proceedings, as well as an expansion of alternative dispute resolution schemes.

The pandemic emergency has also highlighted that the public administration is lagging behind in the adoption of digital technologies. The NRRP has allocated about €7.5 billion to this area for the creation of digital infrastructures and for upgrading employees' skills through targeted recruitment and investment in training; it also envisages measures to streamline and simplify administrative procedures and to reform career paths.

BOX:

The impact of the reforms on productivity and growth: the evidence for Italy

Banks and institutional investors

[13] Italian financial intermediaries' activity in 2020 was strongly affected by the consequences of the pandemic.

Banks met the increase in firms' demand for funding, which was fuelled by the liquidity needs that emerged following the suspension of production activities and by the propensity to accumulate precautionary reserves. The availability of credit was favoured by the possibility of taking advantage of public guarantees on loans and ample recourse to Eurosystem refinancing.

The improvement in capital adequacy was significant; the public guarantees on loans and supervisory authorities' recommendations to limit dividend distribution were contributory factors. The gap between the capital level of Italian significant banking groups and the average level of the other banks that are supervised by the Single Supervisory Mechanism (SSM) has essentially closed. Capital strengthening enables Italian banks to address the likely deterioration of credit quality from a more solid position.

The pandemic has not slowed down the plans to dispose of non-performing exposures, which have continued to decline. The flow of new non-performing loans decreased over the course of 2020, despite the contraction in economic activity, but recorded a moderate increase in the last quarter of the year; banks considerably increased the share of performing loans classified as Stage 2, i.e. whose credit risk rose.

The growth in expected losses has led to a marked increase in loan loss provisions, which affected profitability; the effects stemming from the cyclical downturn added to the structural challenges that existed even before the pandemic. The profitability outlook will depend on the speed and intensity of the economic recovery; the current uncertainty calls for a careful evaluation of the adequacy of loan loss reserves, especially on the part of less significant banks.

Banks, especially the large ones, have continued to reorganize the distribution network by cutting the number of branches and employees. The restrictions on mobility favoured a greater use of digital distribution channels, encouraging investment in the development of projects connected to financial innovations applied to the provision of financial services.

The outflows from Italian open-ended investment funds recorded last spring were partly offset in the second half of the year, when the prices of financial assets picked up. As in the past, a sizeable share of the premium income of insurance companies was obtained through the banking credit channel.

BOXES:

Public guarantees and the growth in lending to firms

Commercial agreements and shareholdings between banks and insurance companies in Italy

The money and financial markets

[14] In 2020, following their marked deterioration between the end of February and mid-March, the conditions in Italy's financial markets improved progressively thanks to the Eurosystem's interventions and the favourable expectations created by the

measures taken by the national and EU fiscal authorities, in particular the agreement on the NGEU programme. Despite the new rise in the number of COVID-19 cases, the improvement continued during the autumn, favoured by reports on the effectiveness of the vaccines and the end to the uncertainty concerning the outcome of the US presidential elections.

Net issues of Italian government securities, which nearly tripled compared with the previous year, were easily absorbed by the ample demand at auction. Purchases in the secondary market conducted by the Eurosystem for monetary policy purposes were significant: at end-2020, the share of Italian public sector securities held by the Bank of Italy rose to 25.8 per cent of the total. Despite the abrupt and temporary rise recorded in the spring, the sovereign risk premium and the yields on Italian government securities decreased during the year as a whole; the financing costs of banks and firms decreased.

Share prices recouped most of the losses that had marked the most acute phase of the health emergency. However, the dynamics were very diverse across segments owing to the heterogeneous impact of the pandemic on the different economic sectors. In the early months of 2021, the conditions in Italian financial markets continued to benefit from the measures adopted by the ECB and the expansionary fiscal policy; the favourable expectations created by the roll-out of the vaccination campaigns offset the negative effects of the increase in the number of cases. The outlook, as in the rest of the euro area, continues to be highly dependent on the course of the pandemic.

BOX:

Share prices across the various segments during the pandemic

Special focus: Central banks, climate risks and sustainable finance

[15] Climate change is wide-ranging and poses risks to the economic and the financial systems. The growing concern over these risks has intensified the interest in environmental, social and governance (ESG) factors within the financial sector. This has led to the rapid spread of sustainable finance, which takes into account such considerations in making investment decisions.

The primary responsibility in the fight against climate change falls upon governments, which can intervene to facilitate the transition towards a sustainable economic development model by introducing incentives for ‘green’ investments, the institution of greenhouse gas emissions pricing schemes, and the adoption of regulations to limit the activities that have the greatest environmental impact.

Climate risks are also relevant for central banks and their ability to meet their institutional objectives. The analyses that they conducted to quantify and manage the economic risks connected with climate change and evaluate the policies necessary to address these risks can be put at the service of the public at large. In their capacity as investors, central banks act as a benchmark for other institutions in risk analysis and management, in the adoption of investment decisions that are consistent with the decarbonization objectives, and in increasing savers' awareness.

The Bank of Italy plays an active role in this domain and takes part in international forums such as the Network for Greening the Financial System (NGFS), set up in 2017 by a number of the world's central banks and supervisory authorities to coordinate analyses, based on common objectives and lines of action, to strengthen the role of the financial system in managing climate risks and redirect financial flows towards sustainable investment. Under the Italian G20 Presidency, the Bank of Italy has promoted, together with the Ministry of Economy and Finance, the creation of the Sustainable Finance Working Group, with the objective of incentivizing best practices in sustainable finance and fostering the transition towards greener and more resilient and inclusive economies and societies.

The ECB has included the issue of climate change in its monetary policy strategy review, which is currently underway.