**The economic and financial outlook of the euro area: halfway down "the long and winding road"**

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## The economic outlook

This conference comes at a difficult and uncertain juncture for the global economy, the euro area and Italy. After solid growth in 2017 and early 2018, world GDP decelerated significantly in the second half of last year. Although there are signs that the downward momentum might have stopped, in many countries economic activity remains weak. According to the IMF's latest forecasts, in 2019 the global economy will expand at the lowest rate since 2009, when it recorded a recession.

Trade tensions, mostly fuelled by the new protectionist strategy pursued by the United States, and their effects on confidence, especially of private enterprises, are contributing significantly to this poor performance of the world economy. International trade progressively slowed in 2018, falling by 1.0 per cent in the last quarter of the year, and recent data suggest that the economy remained weak in the early months of 2019. The progressive liberalisation of trade that has characterised the last few decades has come to a sudden halt and is being reversed in some important economies. The average tariff rate applied to imports by the United States, for example, more than doubled in 2018 (from 1.5 to 3.3 per cent). More generally, the system of supranational institutions and multilateral rules on international trade that supported the sustained global economic expansion after World War II is encountering serious difficulties.

Protectionism is a response – a wrong one – to the challenges of globalisation and technological change, which both have momentous consequences for the job prospects of workers with lower skills. In the OECD countries, for example, the rise of automation is estimated to cause a high probability that as much as one job out of seven will be lost, while three out of ten may undergo significant changes over the next fifteen to twenty years. Even though new jobs will be created, managing the transition will be no easy task. Not enough has been done up to now to make appropriate plans for an affordable, timely and adequate retraining of workers, to invest resources in education, and to combat poverty and inequality.

In the shorter term, global risks are still tilted to the downside. The economic outlook remains vulnerable to persistent trade tensions, to a greater-than-expected cyclical slowdown in China, and to the possibility that the United Kingdom exits the European Union without a deal.

GDP growth decreased markedly in the euro area as well, to 1.8 per cent in 2018 (from 2.4 per cent in the previous year). The euro area is much more open to foreign trade than the United States and Japan. For this reason its business cycle is highly correlated with the international one. Dependence on external demand is especially high in Germany, where the export-to-GDP ratio is close to a stunning 50 per cent, but it is also significant in France, Italy and Spain (where it is slightly above 30 per cent) due to their integration in the global value chains, including the European ones, commonly known as the "European factory".

In the euro area the negative impact on GDP growth of weaker exports has been amplified by a slowdown in domestic demand. Since mid-2018 the outlook for investment has progressively deteriorated due to the adverse effects of increased global uncertainty on firms' confidence and capital accumulation plans. The drop in production in the car sector following the introduction of a new international regulation on emissions from light-duty vehicles has also played an important role.

Against this background, the European Central Bank's monetary policy continues to be highly expansionary. The Governing Council expects official rates to remain at their current low levels at least until the end of 2019 and, in any case, for as long as necessary to ensure the convergence of inflation towards its target of a growth rate of consumer prices "below but close to 2 per cent" to be maintained over the medium term. Even after the first rate hike, the Eurosystem will continue for an extended period of time to reinvest in full the principal payments from maturing bonds purchased under the asset purchase programme (APP). Last March we also decided to launch a new series of targeted longer-term refinancing operations (TLTRO-III), the first of which will be conducted next September; these operations will help to preserve favourable bank lending conditions and ensure the smooth transmission of monetary policy.

Our stance does not endanger overall financial stability. In the current situation, the main risks come from the weak growth and inflation outlook. As is well known, the global crisis spurred a widespread debate on whether the mandate of central banks should be broadened to formally include the preservation of financial stability. Even though the latter is certainly a precondition for price stability, this change could raise potential conflicts between the two objectives, undermining the credibility of central banks and the effectiveness of their policies. Preserving financial stability should instead be the main task of macroprudential action. The same considerations apply to regulation and microprudential supervision: each policy can work well only if it has clear objectives and targeted intervention tools to achieve them.

The deterioration in the international outlook has also had a strong negative impact on the Italian economy: economic activity progressively weakened in 2018, recording a slight contraction – a so-called "technical recession" – in the second half of the year. Overall GDP growth was just 0.9 per cent last year, around half the level recorded in 2017; all the main international forecasters expect it to decelerate further this year.

The slowdown of activity in Germany, with which we share close economic ties, and the fall in business confidence, have been especially important factors in the weakness of aggregate demand and, especially, the marked deceleration in investment by Italian firms. Our surveys confirm that weak capital accumulation reflects greater cautiousness on the part of enterprises in the face of uncertainty about economic and political factors, and the persistent trade tensions.

Economic activity returned to slightly positive growth in the early months of this year: according to the preliminary estimate GDP increased by 0.2 per cent in the first quarter of 2019. This trend could continue, especially if the global rebound in investors' confidence observed since late 2018 proceeds and continues to exert its effects in Italy too. But to fully recover the path of sustainable growth, Italy must tackle its two main structural problems: the stagnation of productivity observed since the 1990s and the high level of public debt.

Italy has been growing on average by around 1 percentage point less than the rest of the euro area since 1999. This is the result of the country's delayed response to the big changes of our era: globalisation and the technological revolution. A short-lived relief provided by fiscal or monetary policy, albeit important, is not enough to solve this problem. To address it, Italy must quickly adopt a consistent growth strategy combining measures to support innovation, with those to improve the quality of human capital, and to create a more favourable environment for "doing business".

Following the double-dip recession associated with the two financial crises that erupted in the past decade (the global financial crisis of 2007-09 and the euro-area sovereign debt crisis of 2010-13), many Italian firms have introduced organisational changes that have enhanced their efficiency, making them more competitive on international markets. The restructuring process has been more intensive in the export sector and, as a result, domestic firms have been gaining market shares in many countries. It is a process that must continue and be extended to the rest of the economy, supported by appropriate public policies.

In recent years various measures have been introduced to support high-tech investments and innovative start-ups. In order to be effective, industrial policy needs stable and appropriate fiscal incentives, while the regulatory framework must be aligned with international best practices. The Italian economy has many strengths that can help support these recent positive developments: private sector net wealth is high by international standards, the debt-to-income ratio of Italian families is low, exports remain strong and the current account of the balance of payments is in surplus – it has been this way for many years now, so much so that the net foreign asset position is balanced.

A reduction in the risk premium on Italian public sector bonds is another crucial objective: at the beginning of this week the yield differential with respect to 10-year German bonds was over 270 basis points, more than twice the level prevailing in early 2018, before the latest general elections. The premia on credit default swaps suggest that the yield differential has risen as a result of the increase in both credit risk and the risk of redenomination of bonds in a different currency. The high public debt-to-GDP ratio exposes Italy to the volatility of financial markets, with the annual amount of bonds to be refinanced currently standing at around €400 billion. The average residual maturity of the public debt is above 7 years; therefore, the initial impact of higher interest rates on servicing costs is small but, if the increase in rates persists, it would inevitably weigh on expenditure. Reducing the differential between the interest burden on public debt and the nominal rate of growth of GDP – which is positive in Italy, compared with negative values in most advanced countries and throughout Europe, including in Greece – while maintaining an adequate primary surplus, is therefore of vital importance.

The transmission of higher rates from government bonds to the cost of loans for households and firms has been limited so far, thanks to banks' ample liquidity and improved balance sheets. But signs of tension are beginning to emerge. According to our surveys, credit conditions tightened somewhat, especially for small enterprises, following the increase in banks' funding costs and the deterioration in the economic outlook. In the longer run, a high risk premium on government bonds would inevitably end up affecting the real economy. A credible strategy to reduce the burden of Italy's high public debt in the medium term can no longer be postponed and the factors that lead investors to perceive higher risks, such as lax budgetary conditions and the prevalence of transfers and subsidies over growth-enhancing measures, should be tackled.

## The financial sector: progress and open issues

In the euro area banks' capital position has strengthened considerably. Between mid-2015 and end-2018 the capital (CET1) ratio of the so-called "significant institutions" – those under the direct supervision of the ECB, which account for around 80 per cent of the area's banking assets – increased from 12.7 to 14.3 per cent. For the entire Italian banking system it stands at 13.3 per cent.

In Italy the stronger capital position of banks has been accompanied by a substantial improvement in the quality of their assets, mainly thanks to large disposals of non-performing loans (NPLs). The deterioration in credit quality recorded during the global financial crisis and the European sovereign debt crisis was due for the most part (about 90 per cent according to our estimates) to the negative developments in the macroeconomic outlook. As of end-2018 the ratio of NPLs, net of provisions, to total loans had fallen to 4.3 per cent, more than halving with respect to mid-2015, when it had reached 10 per cent; in the same period, the value of net NPLs diminished from almost €200 billion to €90 billion. According to the plans requested from all banks by the supervisory authorities – the ECB for the significant institutions and the Bank of Italy for the others – the net NPL ratio should decline further, to around 3 per cent at the end of 2021.

Notwithstanding significant progress in Italy and in the rest of the euro area, much remains to be done. Four areas require special attention: banks' profitability, where intermediaries need to tackle the difficult challenges posed by technology; the appropriate treatment of risks on the asset side of banks' balance sheets; the management of higher funding costs (and the need to satisfy the new requirements on "bail-inable" liabilities); and the framework for managing banking crises, which has turned out to be rather complex in recent years.

Profitability. Despite recent improvements, the profitability of European banks remains weak: the average return on equity (around 6 per cent for the major intermediaries) is barely in line with the cost of equity in the euro area (and is somewhat lower in Germany and in Italy). The reasons are not only those related to the weak economic outlook. Indeed, in Europe the role of banks in financing the economy has been diminishing for over a decade, making it difficult to increase revenues by expanding credit volumes.

The transition towards a more market-based financial system is necessary in a modern economy. In this respect, in the euro area non-financial companies continue to be excessively dependent on bank credit. The ratio of bank loans to total financial debts is 36 per cent in the euro area (56 per cent in Italy), against 33 and 27 per cent in the United States and the United Kingdom. By contrast, the share of bonds is still about 10 percentage points lower than in the United Kingdom and 30 points less than in the United States. The market capitalisation of listed non-financial companies is also insufficient: at end-2017 it stood at 25 per cent of GDP in Italy and 60 per cent in Germany, against around 125 per cent in the United States.

In order to raise profitability banks must contain costs, diversify the sources of income, and find ways to significantly raise efficiency levels. The changes that are currently taking place in the financial sector pose novel challenges, but also provide fresh opportunities for well-managed financial intermediaries, among which banks can certainly be included. FinTech and Big Tech companies are offering new financial services and exploiting innovative technologies and massive amounts of data. Banks are responding by expanding the range of products provided through digital channels. It is a process that is bound to continue, as more intensive use of new technologies is necessary to compete effectively in the market and achieve adequate levels of profitability.

Risks on the assets side. We can draw a number of lessons from Italy's double-dip recession and the consequences for its banking system of both the global financial crisis and the sovereign debt crisis. The first lesson concerns the treatment of impaired assets, an area where Italy's experience has been especially important. Following the large-scale disposals of bad loans completed in recent years, in Italy more than half of banks' total NPLs currently consist in exposures to firms whose difficulties may prove to be temporary (loans defined as "unlikely to pay"). Their management should aim at maximising the probability that these loans become performing again. On the one hand, significant benefits could be obtained if non-financial firms, where necessary with the collaboration of banks, resorted to specialised operators such as "turnaround funds", able to provide the knowledge and resources to relaunch impaired enterprises. On the other hand, supervisory and regulatory authorities should consider how best to support these strategies, including through the adoption of new specific measures.

The current European regulation on minimum coverage of new NPLs, for instance, imposes increasing provisions on loans based only on the time that has elapsed since their classification as non-performing (known as "calendar provisioning") and distinguishes only between guaranteed and non-guaranteed loans. The difference between bad and unlikely-to-pay loans is instead overlooked. There is therefore the risk of creating perverse incentives for banks to hold fire sales or liquidate

NPLs, amplifying losses for both the banks and their customers and discouraging an active management of the credit relationship. This is an area in which regulation could be improved.

Another lesson regards the debate that has intensified in the aftermath of the sovereign debt crisis about the so-called "bank-sovereign nexus" (or "doom loop"). Some have proposed that the prudential treatment of banks' sovereign exposures be made more restrictive. These recommendations are built on the premise that a capital requirement or the assignment of a risk charge would break the link between banks and the State. But this link goes well beyond the holding of sovereign bonds. Indeed, it is the real economy that provides the most important connection: a restructuring of the public debt, for example, might be so disruptive that firms and households could be swept away by it, damaging the entire banking system regardless of its capitalisation or its holdings of government bonds. These proposals, moreover, overlook the stabilising role that banks, by acting as contrarian investors, can play on bond markets in periods of tension. For these reasons, after almost three years of work and intensive discussions, at end-2017 the Basel Committee decided to maintain the current regulation.

The reduction in sovereign risk must ultimately come from sound government policy, as it cannot be obtained by simply shifting sovereign bonds from the balance sheet of one economic sector to that of another. This requires not only balanced and prudent fiscal policies but, most importantly, structural reforms aimed at regaining sustained GDP growth. The latter, in turn, would help make loans to households and firms more attractive, and reduce the share of government debt in banks' balance sheets.

While there has been a heated debate about NPLs and sovereign bond holdings, much less attention has been paid on the risks deriving from the stock of illiquid and opaque assets in banks' balance sheets, including the instruments classified as Level 2 and Level 3 assets in the fair value hierarchy. These risks are not easy to measure, but available estimates put them broadly on a par with those associated with NPLs. The Single Supervisory Mechanism has recently adopted some initiatives aimed at defining the most appropriate interventions to take adequate account of these risks. These efforts must be intensified.

The increase in the cost of funding is the third area that should not be neglected. In the coming years all large banks will have to raise a significant amount of "bail-inable" liabilities in order to fulfil the new global and European regulation on total loss-absorbing capacity (TLAC) and the minimum requirement for own funds and eligible liabilities (MREL). Raising funds may indeed pose a difficult challenge. Regulators and supervisors have to strike the right balance between the need to set appropriate criteria in order to stop taxpayers bearing the cost of future banking crises, on the one hand, and, on the other hand, the need to be sufficiently rigorous, with the risk, in persistently adverse market conditions for many intermediaries, of ultimately increasing the probability of future banking crises. The principle of bailing-in creditors makes sense but its concrete application requires care, especially in the current circumstances.

<u>The management of banking crises</u>. Italy's experience has revealed serious drawbacks in the new European regulation governing small-and medium-size intermediaries which, under the new rules, cannot access the facilities embedded in the so-called "resolution" procedure. For these banks – the vast majority of the roughly 3,000 euro-area institutions – a piecemeal liquidation is the only option currently available in the absence of interested buyers. But liquidation threatens the continuity of the supply of financial services, may imply large losses for both creditors and debtors and, due to potential contagion effects, may pose serious risks to overall financial stability. More must be done in this field, and from this perspective the experience of the United States is especially important. The US Federal Deposit Insurance Corporation – a government entity whose reserves are made up of private funds, but which can activate a large line of credit with the US Treasury – has successfully managed the crisis of almost 500 financial intermediaries since 2007, minimising the harm for the economy at large. It is a lesson that merits careful consideration.

## Conclusion

Let me conclude. As the economic prospects for the euro area are currently dominated by uncertainty, many analysts fear that should the situation degenerate into a full-blown recession or lead to deflation, monetary policy would be disarmed. This is a mistake. Central banks can rely on a wide range of instruments to support economic activity and, if necessary, the Eurosystem is ready to use them all in order to fulfil its mandate. But monetary policy should not remain alone in sustaining the economy. In the absence of a common European budget, threats to the growth or inflation outlook require greater coordination of national fiscal policies, while structural reforms would provide essential help by boosting productivity dynamics.

On the financial front, the most serious difficulties posed by the global financial crisis and the European sovereign debt crisis are now being overcome. In Italy there has been significant progress: NPLs have been halved, provisions have increased considerably and banks' capitalisation has risen significantly, even though the legacy of the double-dip recession continues to weigh on some intermediaries. Further progress will depend not only on banks' continued efforts to improve their balance sheets and lending strategies, but, above all, on their ability to rise to the challenges posed by the digital revolution, adopt strategies based on higher investment in new technologies, reduce operating costs and restructure their distribution network.

Today there are also risks associated with the incompleteness of the European construction, as we have witnessed since at least 2010. The standstill in the reform of economic governance, due to a mutual lack of trust among countries that developed during the crisis, is particularly dangerous at this stage, as the constraints on national policies have been rapidly made more stringent but the introduction of their supranational counterparts has been delayed.

In the economic and financial domain, it is clear what the most immediate steps should be: completing the banking union, rethinking the management of banking crises, and establishing a well-functioning capital markets union. But, at the same time, the reasons for discontent and criticism of European institutions also require a response. We must work to restore mutual trust, enhance security, and to create a sense of belonging. Italy must play its part by working hard and consistently to improve its economic environment and to make a credible commitment to a path of gradual but significant debt reduction. The hope is that, after the forthcoming European elections, the conditions will be established for resuming the reform agenda and pushing it forward with renewed vigour. Otherwise, as the song says, "the long and winding road … will never disappear".