

30<sup>th</sup> ASSIOM FOREX Congress

**Economic developments  
and monetary policy in the euro area**

Speech by the Governor of the Bank of Italy

Fabio Panetta

Genoa, 10 February 2024

## 1. Global economic trends and outlook

The global economy remains sluggish. World trade stagnated again in the fourth quarter of last year; it is expected to recover moderately this year, but at a much slower pace than in the two decades before the pandemic.<sup>1</sup>

The simultaneous tightening of monetary policy by the central banks of the leading economies is helping, along with the fall in energy prices, to bring inflation down significantly, but is dampening demand. The exception is the United States, where domestic demand and output continue to grow rapidly.

The global outlook is also vulnerable to the uncertainty fuelled by the conflicts in Ukraine and the Middle East, as well as by the economic difficulties in China, where the property crisis continues unabated.

Disruptions to the Red Sea shipping route, which handles around 12 per cent of world trade, are forcing vessels from Asia to seek alternative routes. This is delaying deliveries and increasing transport costs, especially for destinations in Europe (Figure A1).

In this weak economic context, geopolitical fragmentation is setting back economic integration between countries and regions across the globe.

The introduction of trade restrictions, under way for some time, accelerated after the pandemic and the invasion of Ukraine (Figure A2),<sup>2</sup> at times taking the form of embargoes on exports of technological products such as microprocessors. This could lead to a rebalancing of trade between countries, as has already occurred for energy products.

If this new scenario were to endure, it would have significant medium- and long-term consequences.

A decline in the international trade of goods, services, technologies and ideas would reduce productive efficiency and dampen the potential growth of the global

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<sup>1</sup> World trade is estimated to have grown by 0.6 per cent in 2023. This year, the anticipated trade growth rate is around 2.5 per cent.

<sup>2</sup> According to Global Trade Alert, countries have adopted more than 2,000 protectionist measures since 2022; see also WTO, *Reports on G20 trade and investment measures (May-October 2023)*, December 2023.

economy, which has been declining for years (Figure A3). Indeed, global value chains are vulnerable to disruptions in the supply of key inputs and have become a source of uncertainty for macroeconomic developments.<sup>3</sup> Barriers to capital movements, in turn, reduce investment opportunities and risk diversification across countries.

These trends could exacerbate the current downward pressure on the equilibrium interest rate,<sup>4</sup> as a result of population ageing, sluggish productivity<sup>5</sup> and an increase in the demand for risk-free assets which has outstripped supply.

More broadly, commercial and financial fragmentation risks fraying the multilateral order that has underpinned global economic development since the end of the Second World War and fostered peace among the leading powers. The effects of this would extend beyond economics and the financial sphere.

Given the openness of the European and Italian economies, geopolitical divisions pose significant risks. It is in our interest to vigorously defend the progress made so far in global integration and in multilateral dialogue.

At the same time, a far-sighted and pragmatic approach obliges us to find ways to operate effectively in a less open world, thereby reducing the vulnerabilities stemming from the new global situation.

There could be growth opportunities for the least-developed regions in Europe, if they are able to intercept the investment flows in search of market outlets to relocate some stages of the production process.

Analyses by the Bank of Italy and other central banks<sup>6</sup> suggest that European companies, especially those exposed to the Chinese economy, are reorganizing their production and their supply chains.

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<sup>3</sup> For Italy, a quantification of the potential losses from specific input shortages due to geopolitical fragmentation is discussed in A. Borin, G. Cariola, E. Gentili, A. Linarello, M. Mancini, T. Padellini, L. Panon and E. Sette, 'Inputs in geopolitical distress: a risk assessment based on micro data', Banca d'Italia, *Questioni di Economia e Finanza* (Occasional Papers), 819, 2023.

<sup>4</sup> In the language of economists, the long-run equilibrium interest rate is also referred to as 'natural interest rate'.

<sup>5</sup> A. Gerali and S. Neri 'Natural rates across the Atlantic', *Journal of Macroeconomics*, 62, 2019; also published in Banca d'Italia, *Temi di discussione* (Working Papers), 1140, 2017.

<sup>6</sup> M. Bottone, M. Mancini and T. Padellini, 'Navigating fragmentation risks: China exposure and supply chains reorganization among Italian firms', Banca d'Italia, mimeo, 2023; M.G. Attinasi, D. Ioannou, L. Lebastard and R. Morris, 'Global production and supply chain risks: insights from a survey of leading companies', ECB, *Economic Bulletin*, 7, 2023, 33-41; Deutsche Bundesbank, 'The significance of China as a supplier of critical intermediate inputs to German firms', *Monthly Report*, 75, 9, 2023, 21-25.

While some of the remote regions that have benefited from significant investment from advanced economies in the past are no longer as attractive to investors, countries that can take advantage of low-cost renewable energy and their proximity to European markets may become more so. In a context of tense international relations, being a member of the European Union and of a stable currency area, such as the euro area, as well as of the Atlantic Alliance, has become a competitive advantage.

This is a rare opportunity for the Italian Mezzogiorno.<sup>7</sup> However, turning opportunities into concrete growth prospects will require active policies to attract capital and to strengthen contextual factors, such as infrastructure, investment in human and social capital, and efficient general government.<sup>8</sup>

## 2. The euro-area economy

In the euro area, the economy has been stagnating for five quarters now, owing to weak foreign and domestic demand.<sup>9</sup>

The end of the post-pandemic upswing due to widespread reopenings, the ongoing tightening of monetary policy and the climate of uncertainty are slowing business investment and household spending.

Most of the euro-area's industrial sectors are in recession (Figure A4).<sup>10</sup> A country-level analysis shows a sharp decline in industrial production in Germany, hit harder than elsewhere by fewer purchases by China, and by the downturn in energy-intensive sectors and the fragmentation of global manufacturing supply chains. In Europe the cyclical weakness in manufacturing is beginning to affect the service sector. The construction sector has also stalled. The latest information does not point to a significant cyclical recovery in the short term (Figure A5).

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<sup>7</sup> 'The economic development of Southern Italy: a national priority', address by Fabio Panetta at the Foggia branch of the Italian Istituto Poligrafico e Zecca dello Stato (State Mint and Polygraphic Institute), 21 September 2019 (only in Italian).

<sup>8</sup> A. Accetturo, G. Albanese and R. Torrini (edited by), 'The North-South divide: economic development and public intervention', Banca d'Italia, Seminars and conferences, 25, 2022 (only in Italian); S. Galano, L. Sessa and S. Zuccolà, 'The quality of electricity supply: a comparison among Italian regions', Banca d'Italia, Questioni di economia e finanza (Occasional Papers), 737, 2022 (only in Italian).

<sup>9</sup> Total euro-area exports for the third quarter of 2023 were 3 per cent lower than the corresponding year-earlier period, based on national accounts.

<sup>10</sup> The pharmaceuticals and electronics sectors are the main exceptions having benefited from, respectively, the surge in vaccine and new drug production, and the strong demand for products needed for remote working.

One bright spot in this low-growth scenario is rising employment. Labour demand was initially supported by the post-pandemic surge in manufacturing and then by the shift towards labour intensive processes, made relatively cheaper by rising energy prices. In 2021 and for most of 2022, the number of job vacancies rose.

Labour shortages in recent years have spurred businesses to retain workers, even when this means exceeding their staffing needs.<sup>11</sup> This has supported employment and consumption.

If economic activity remains weak, firms may have to cut their workforce significantly.<sup>12</sup> We have already seen signs of a labour market slowdown: the number of vacancies has been falling since its peak in spring 2022 (Figure A6).

The fiscal policies of euro-area countries are expected to hold back the economy over the coming months. They are expected to become more restrictive, especially owing to the withdrawal of the stimulus measures introduced in response to the energy crisis.

Last December, the European Central Bank revised the 2024 growth projections downward, to 0.8 per cent, leaving those for 2025 unchanged at 1.5 per cent. These estimates are higher than those of private analysts<sup>13</sup> and, given the recent data, could prove to be optimistic. In any case, they all point to a modest pace of growth, slower than before the pandemic.

However, the problems facing the European economy are not only cyclical. There are structural issues that make the growth model followed by our continent particularly vulnerable to the changes in the world economy that I mentioned previously.

A production base integrated into long and complex international value chains, the concentration of exports in areas that are less economically dynamic than before, and the relatively high weight of the industrial sector – which is expanding less than the service sector – are all weaknesses in today's altered international context.

There is a risk that the slow growth of recent years will become rooted in firms' investment plans, in consumer expectations and, ultimately, in the entire

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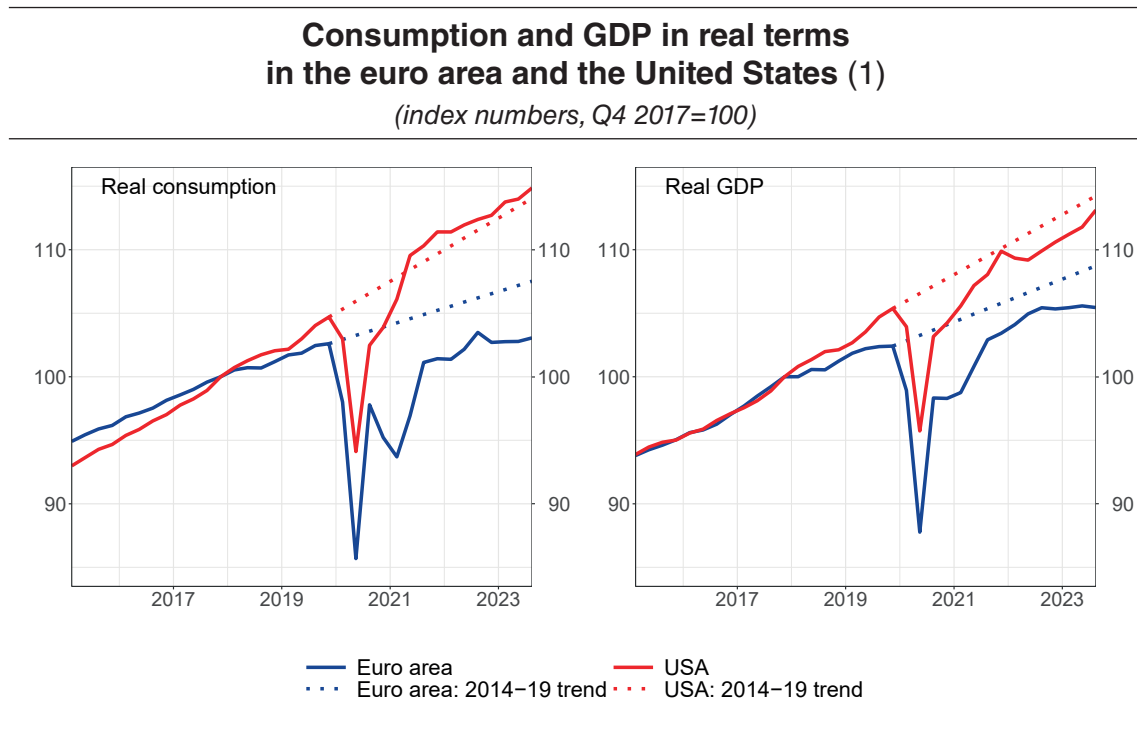
<sup>11</sup> Economists call this phenomenon 'labour hoarding'.

<sup>12</sup> A phenomenon known as 'labour shedding'.

<sup>13</sup> The analysts polled by Consensus Economics in January say that the economy will grow on average by 0.5 per cent in 2024 and by 1.3 per cent in 2025.

European production fabric, thereby thwarting future development opportunities and ambitions. In the United States, both GDP and consumption have returned to or even exceeded their pre-pandemic long-term growth paths, but this has not been the case in Europe (Figure 1).

Figure 1



Sources: Based on Bureau of Economic Analysis and Eurostat data.  
(1) Seasonally adjusted quarterly data.

The potential offered by the Single Market is enormous. In order to take advantage of it, we must regain our sense of common purpose, at both the financial and political level, that same sense which enabled us to respond swiftly to the pandemic shock.<sup>14</sup>

### 3. Monetary policy in the disinflation phase

Over the last two years, the ECB’s monetary policy has shifted sharply from a very expansionary to a very restrictive stance.

This change of pace was necessary in response to inflationary shocks of historic proportions caused by bottlenecks in global production chains and energy price increases.

<sup>14</sup> ‘Beyond money: the euro’s role in Europe’s strategic future’, address by F. Panetta at the ‘Ten years with the euro’ conference, Riga, 26 January 2024.

We could argue about the pace and intensity of monetary policy, but one thing is clear: inflation has not become self-sustaining or endemic. Medium-term inflation expectations have remained anchored at the 2 per cent target (Figure A7), a prerequisite for price stability. This has limited the cost of disinflation, which has so far unfolded without triggering a deep recession.

For this to be the end result, for inflation to be permanently eradicated and for the economy to return to a path of growth and stability, the next monetary policy decisions must be consistent with the current macroeconomic picture.

In this uncertain environment, any speculation on the exact timing of monetary easing would be a sterile exercise and disrespectful to the ECB Governing Council as a collegiate body. What should be discussed now are the conditions to start monetary easing, while avoiding risks to price stability and unnecessary damage to the real economy.

### ***The conditions for starting monetary policy normalization***

There are three conditions for starting monetary policy normalization.

First, the disinflation process must be well under way.

Recent data suggest that progress towards price stability has been greater than many were expecting just a few months ago. Inflation fell to 2.8 per cent in January, 8 percentage points below its peak in 2022 (Figure A8). Core inflation, which excludes food and energy, has also fallen rapidly.

While varying in intensity, this decline was broad-based across all countries (Figure A9) and across a very large proportion of items in the consumption basket (Figure A10), including products that typically show more persistent price changes.

Second, the fall in inflation needs to be sustained.

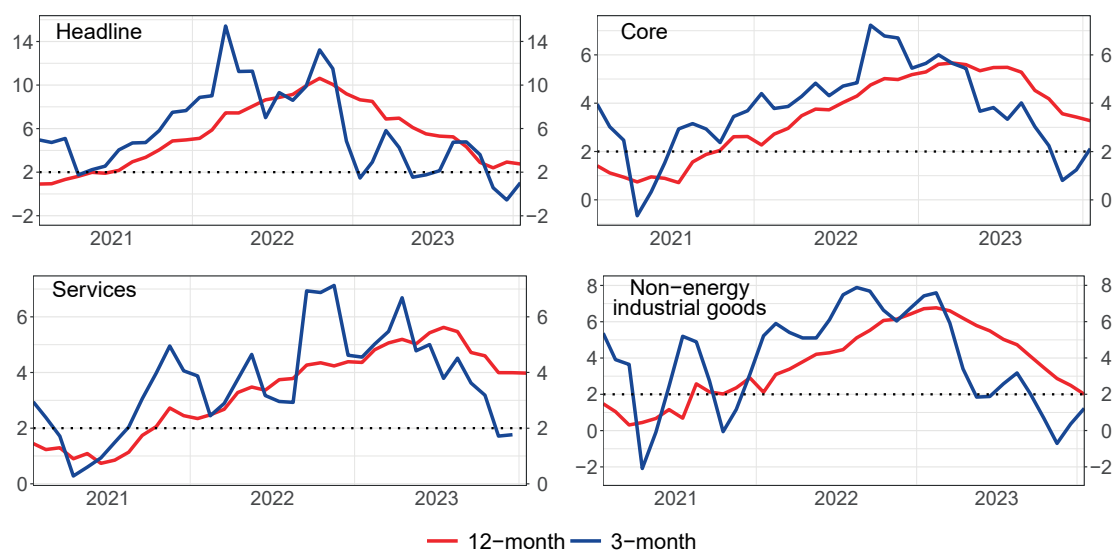
Indicators of short-term and underlying inflation clearly point to ongoing disinflation.

Measures of inflation momentum – which are less influenced by past trends and reflect current developments more accurately – are consistently below annual inflation. These are also at low levels for both headline and core inflation, with similar trends for services and industrial goods (Figure 2).

The decline in firms' and households' inflation expectations, as well as those of market participants, points in the same direction. The latter expect inflation

### Headline and core inflation in the euro area (1)

(12-month percentage changes and annualized 3-month percentage changes)



Sources: Based on ECB and Eurostat data.

(1) Monthly data. 12-month percentage changes and annualized 3-month percentage changes, calculated using seasonally adjusted data.

to return to around 2 per cent as early as this spring. Subsequent downward revisions in the Eurosystem's projections also signal that disinflation is under way (Figure A11).

Another key element is the unwinding of the energy shock. Specifically, gas prices are now close to their mid-2021 level and below the technical assumption used in the latest Eurosystem projections.

The third condition for monetary normalization to begin is that the achievement of the inflation target is not jeopardized by a potential interest rate cut.

This last requirement depends on several factors: the outlook for economic activity, the transmission of monetary policy to the financial and real sectors, and the risks to future inflation developments.

On the first point, I have already outlined the domestic and international factors that are holding back the economy.

As regards the transmission of monetary policy, the effects of tightening are proving to be stronger compared with both past experience and the ECB's previous



estimates.<sup>15</sup> Moreover, interest rate hikes and the reduction in liquidity supply will continue to weigh on the economy throughout 2024.<sup>16</sup>

The impact on the credit market has been particularly pronounced, with lending rates to households and firms rising (Figure A12) and real growth rates similar to or lower than during the crises of the past decade (Figure A13).

These developments reflect not only the decline in credit demand due to higher lending rates, but also the tightening of credit supply standards at a time when borrowers are expected to become riskier.<sup>17</sup> Looking ahead, this tightening may be exacerbated by banks' lower liquidity buffers (Figure A14) due to the reduction in the size of the Eurosystem's balance sheet.<sup>18</sup>

### ***The risks to inflation***

Turning to the risks to inflation, let me first emphasize that the main concerns raised in the past are proving to be unfounded.

I have already mentioned that there has been no upward de-anchoring of inflation expectations; if anything, downside risks are emerging.<sup>19</sup>

Concerns about the hypothesis of persistently high core inflation have also proven to be groundless: indeed, core inflation has declined in recent months, following the fall in headline inflation, in line with past empirical evidence<sup>20</sup> (Figures A15 and A16).

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<sup>15</sup> 'Everything everywhere all at once: responding to multiple global shocks', speech by F. Panetta at The ECB and its Watchers XXIII Conference, Frankfurt, 22 March 2023. 'The banking channel of monetary policy tightening in the euro area', speech by P. R. Lane at the NBER Summer Institute 2023 Macro, Money and Financial Frictions Workshop, Cambridge, Massachusetts, 12 July 2023.

<sup>16</sup> Empirical evidence suggests that the effects of monetary policy feed into production and price dynamics with an estimated lag of six to eight quarters. See, for example, M. Darracq-Paries, R. Motto, C. Montes-Galdón, A. Ristinemi, A. Saint Guilhem and S. Zimic, 'A model-based assessment of the macroeconomic impact of the ECB's monetary policy tightening since December 2021', in ECB, *Economic Bulletin*, 3, 2023, pp. 61-67.

<sup>17</sup> The Bank Lending Survey conducted by the Eurosystem suggests that banks' risk perception and risk aversion were the two key factors behind tighter credit standards for firms and households; see M. Bottero and A. M. Conti, 'In the thick of it: an interim assessment of monetary policy transmission to credit conditions', Banca d'Italia, *Questioni di Economia e Finanza* (Occasional Papers), 810, 2023.

<sup>18</sup> 'Disinflation in the euro area and opportunities for the Italian economy', speech by F. Panetta at the conference 'Cooperative Banking Group: opportunities and challenges of a new banking model', Rome, 30 November 2023.

<sup>19</sup> Over the past few weeks, inflation expectations five to ten years ahead based on price-indexed financial asset prices have fallen slightly below the 2 per cent target (Figure A7).

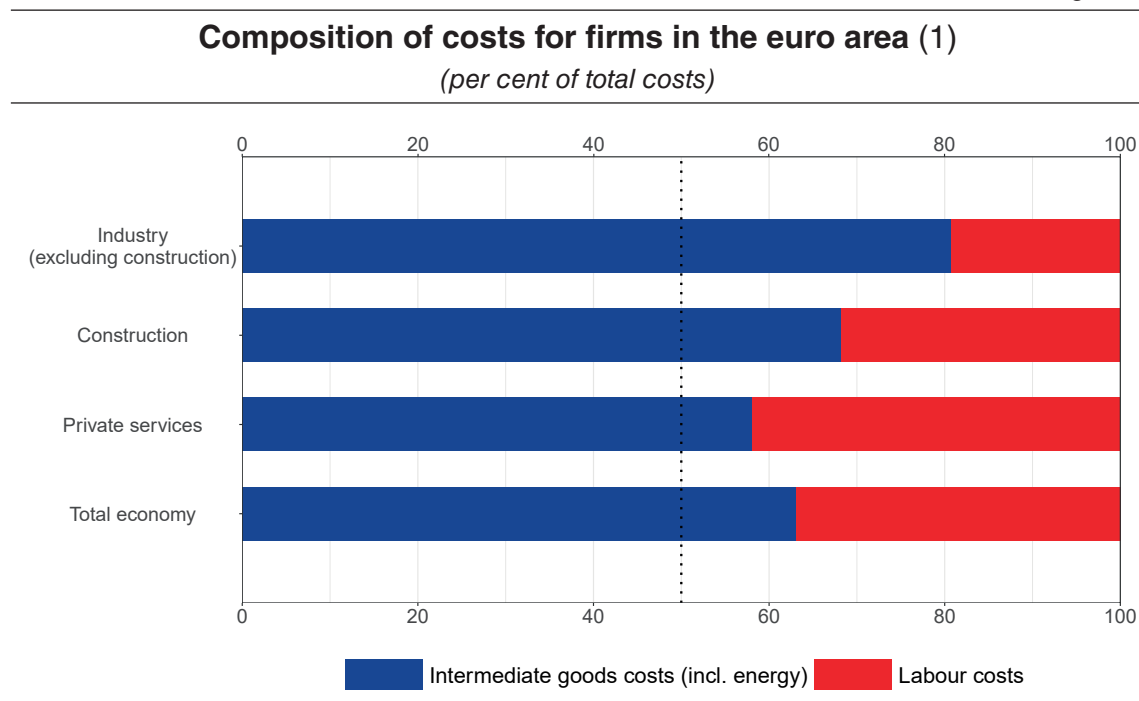
<sup>20</sup> 'Getting disinflation right', speech by F. Panetta, Bocconi University, Milan, 3 August 2023.

Similarly, fears that inflation would stop falling after the initial rapid decline – the ‘last mile problem’ – now appear unwarranted: inflation is falling at the same rate or faster than it has risen (Figure A17).

The risk remains that still strong nominal wage growth could reignite inflation. This possibility should not be underestimated, but a closer look at the data allays these concerns.

Labour is only one production factor, and its share of total costs for firms is much lower than that of intermediate goods and energy (Figure 3).<sup>21</sup> Current wage growth, while higher than in 2021 and 2022, is offset by the decline in other costs that has been ongoing for months.

Figure 3



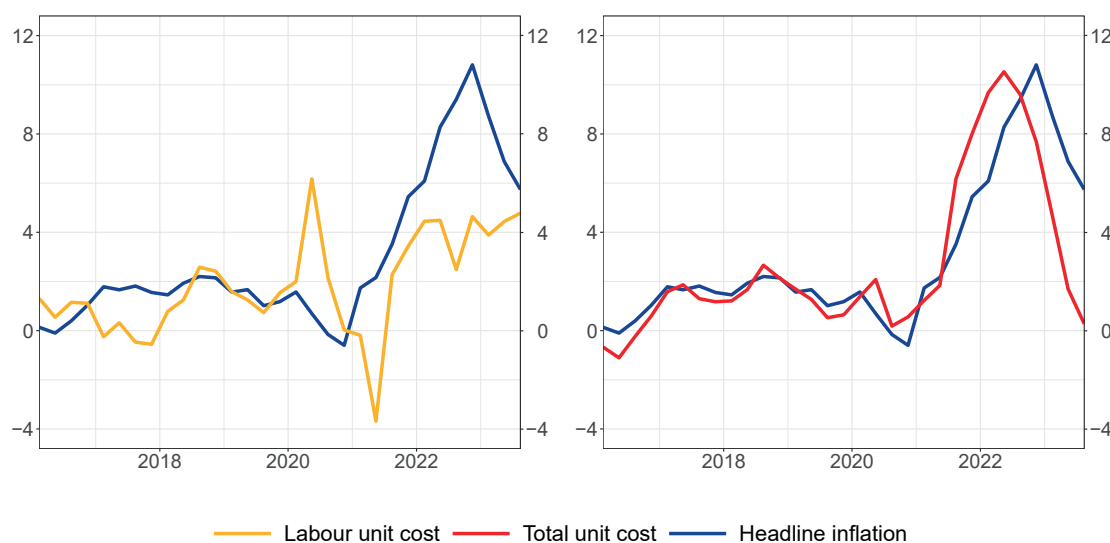
Sources: Based on data from Destatis, Eurostat, Insee and Istat.  
(1) Estimates based on the data for France, Germany and Italy.

The increase in firms’ total production costs – which is the main driver of inflation<sup>22</sup> (Figure 4) – has gradually fallen to zero, easing inflationary pressures. In line with these developments, firms do not expect total costs to accelerate in the coming months (Figure A18).

<sup>21</sup> Considering only labour and intermediate goods as inputs of production, labour costs account for around 40 per cent of total costs in the economy as a whole.

<sup>22</sup> In perfect competition, prices are equal to total marginal costs (see H. R. Varian, ‘Microeconomic analysis’, New York-London, Norton, 1992). In monopolistic competition, firms apply a mark-up to total marginal costs (see A. K. Dixit and J. E. Stiglitz, ‘Monopolistic competition and optimum product diversity’, *American Economic Review*, 67, 3, 1977, pp. 297-308).

**Total unit cost, labour unit cost  
and headline inflation in the euro area (1)**  
(percentage changes on year-earlier period)



Sources: Based on data from Destatis, Eurostat, Insee and Istat.

(1) Quarterly data. Percentage changes compared with the year-earlier period. Estimates based on the data for France, Germany and Italy. Unit costs are calculated as the ratio of total costs to total output in real terms.

The effects of stagnating total production costs are compounded by those of weak demand for goods and services, which makes firms less likely to pass on wage increases to prices, for fear of losing market share.

Therefore, a hypothetical increase in wage growth is currently highly unlikely to trigger a wage-price spiral.

Moreover, with inflationary pressures tilted to the downside and corporate profits high, some recovery in the purchasing power of wages, after the recent losses (Figure A19), is to be expected and will support consumption and the economic recovery.

Conflicts in the Middle East also pose risks to inflation. However, maritime transport only accounts for a small share of total production costs.<sup>23</sup> Here too, low demand and high inventories reduce the likelihood of higher transport costs being passed on to prices to a significant extent. Nonetheless, it cannot be ruled out that the situation will worsen and that tensions will escalate, affecting the supply and prices of energy products. These developments will need to be monitored closely.

<sup>23</sup> Transport costs account for around 1 per cent of the euro-area output.

## ***Implications for monetary policy***

Macroeconomic conditions suggest that disinflation is at an advanced stage, and progress towards the 2 per cent target continues to be rapid. The time for a reversal of the monetary policy stance is fast approaching.

The March ECB staff projections will provide useful elements for assessing the next monetary policy move. The first step, but also the various options on the way to monetary policy normalization must be carefully weighed. We need to consider the pros and cons of cutting interest rates quickly and gradually, as opposed to later and more aggressively, which could increase volatility in financial markets and economic activity.

### **4. The economic situation and the Italian banking system**

In Italy, GDP growth was 0.7 per cent in 2023<sup>24</sup> and is expected to remain around that level this year. Inflation, which was 0.9 per cent in January, is expected to remain below 2 per cent in 2024.

Industrial production is being affected by stagnation in Germany and by the lower contribution of demand from the other export markets for Italian goods. Growth in value added in services is modest. The exception is the construction sector, where activity is buoyed by incentives that are now being phased out.

Despite a generally weak economic environment, some areas of production are showing signs of dynamism.

The revision of the national accounts last September raised GDP growth in 2021 by over 1 percentage point, showing an economy that has recovered quickly and resolutely from the pandemic-induced recession. Italian GDP is now 3.6 percentage points higher than at the end of 2019, compared with increases of 1.8 percentage points in France and 0.1 percentage points in Germany.

The labour market has also returned to its pre-crisis levels. In 2023, employment increased by 1.9 per cent, reaching its highest point for many years, as did the participation rate. Stable forms of employment have become widespread.

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<sup>24</sup> The annual figure is based on quarterly data adjusted for seasonal and calendar effects. The forecasts for 2024 released last December, before the release of the figures for last year's fourth quarter, indicated a 0.6 per cent growth rate. Without factoring in the adjustment for calendar effects, expected GDP growth would be 0.8 per cent (see Banca d'Italia, 'Macroeconomic projections for the Italian economy – Eurosystem staff macroeconomic projections', 15 December 2023).

This positive employment trend is bolstering household incomes, especially for less well-off households.<sup>25</sup> Consumption grew by 1.4 per cent in the first three quarters of 2023 and we estimate that it will continue to support demand this year.

The positive trends that emerged after the pandemic must be consolidated.

In recent years, Italy has achieved sizeable trade surpluses and improved its net international creditor position. This testifies to the competitiveness of many Italian firms on the world market, but also signals untapped potential for growth: a positive trade balance is equivalent to a transfer of savings abroad, which in turn indicates that the volume of investment is lower than the capacity to save.<sup>26</sup>

The recovery in capital accumulation following the pandemic crisis marks a potential breakthrough in this regard. This trend now needs to be reinforced by stimulating investment and channelling it towards improving infrastructure and technology, and firms' capacity to innovate.

In the shorter term, we need to reap the full benefits of implementing the reforms and investment under the National Recovery and Resilience Plan (NRRP), which can boost Italy's potential growth and make the necessary rebalancing of its public accounts less arduous.

The information available for 2023 suggests that the fiscal deficit and public debt as a percentage of GDP have fallen. Over the next few years, despite the expected decline in the deficit, debt should remain broadly stable, largely due to the use of the sizeable building renovation tax credits that have accrued over the past few years.

We need to work on several fronts to speed up fiscal consolidation: prudent management of our public finances to achieve an adequate primary surplus has to go hand in hand with reforms and investments that can boost growth.

### ***Italian banks***

The main balance sheet indicators paint a positive picture of the Italian banking system.

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<sup>25</sup> G. Dachille, M. Paiella, A. Dalla Zuanna and E. Viviano 'L'impatto distributivo della crescita occupazionale e dell'inflazione: 2018-2021', Banca d'Italia, *Note Covid-19*, 31 May 2023 (only in Italian).

<sup>26</sup> At the end of September 2023, Italy's net international investment position stood at €122.7 billion, equal to 6.1 per cent of GDP. This improvement of €17.3 billion compared with late June 2023 can be chiefly attributed to the current account and capital account surplus.

Capital rose to 15.8 per cent of risk-weighted assets,<sup>27</sup> in line with the other euro-area banks. Non-performing loans as a share of total loans fell to 1.4 per cent,<sup>28</sup> completing the recovery process that began almost a decade ago.

Liquidity ratios are well above the regulatory requirements. Profitability has also improved: the return on equity is close to 13 per cent,<sup>29</sup> a figure not seen since the global financial crisis.

Part of this improvement reflects the efficiency gains in costs and in credit risk management, as well as the positive effects of the regulatory reforms and of rigorous supervision.

Yet it also reflects exceptional factors. In fact, banks have benefited from the macroeconomic policies adopted to counter the crisis and from the unusual market conditions of the last two years, with ample liquidity and rapidly rising interest rates.

The increase in market interest rates has been passed through swiftly to interest income on short-term and variable-rate loans, which account for a large share of total loans in Italy (Figure A20).<sup>30</sup> At the same time, abundant liquidity and low demand for credit have limited the increase in the cost of sight deposit funding, which accounts for 40 per cent of total bank funding.

The improvement in credit quality also reflects the sound profitability and financial conditions of firms (Figure A21). This in turn partly reflects both the surge in production following the pandemic and the ample liquidity buffers that firms have accumulated in recent years thanks to their access to State-guaranteed loans.

Looking ahead, it would be imprudent to rely on the unrealistic assumption that such a positive situation could arise again. And since it is in times of relative calm that the imbalances that emerge in cyclical downturns are built up, we should be thinking today about the risks we may face tomorrow.

We need to focus on three areas.

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<sup>27</sup> The figure refers to Common Equity Tier 1 capital.

<sup>28</sup> The ratio of non-performing loans to total loans, net of write-downs.

<sup>29</sup> The figure refers to the first nine months of 2023 and is on an annual basis.

<sup>30</sup> In Italy, around 80 per cent of the stock of loans to firms and about 35 per cent of loans to households have a variable rate. The corresponding shares in France and Germany are below 40 per cent for loans to firms and equal to around 5 and 15 per cent respectively for those to households.

## ***Liquidity and funding***

Maintaining a balanced maturity structure of assets and liabilities remains a priority.

At a time when the Eurosystem is mopping up excess liquidity, banks' funding plans should be realistic and promptly implemented. It is important to avoid the fallacy of composition: it is unlikely that all banks will be able to turn to the market at the same time and at low cost.

Aggregate liquidity will gradually decline, but the ability to raise funds in the market may fluctuate intermittently as banks' excess reserves diminish or in the event of market turbulence.

The US banking crises of March 2023 show that individual lenders' liquidity strains can rapidly turn into deposit runs, due to the speed with which customers can transfer funds using online banking and to the propagation of information through digital channels.

They also confirmed the importance of timely access to liquidity sources, including central bank refinancing. In this regard, the Bank of Italy's collateral valuation framework permits the rapid collateralization of a wide range of financial instruments, including less liquid ones.

Our supervisory function is assessing the accuracy and credibility of banks' funding plans. Particular attention is paid to banks that have less diversified funding sources and rely on deposit growth.

## ***Non-performing loans***

Past experience suggests that rising interest rates have positive effects on banks' balance sheets in the short term, but over longer horizons they often have a negative impact on households and firms' financial conditions, with spillback effects on credit.

Bank of Italy estimates suggest that the quality of loans may deteriorate over the next two years. Non-performing loan ratios are expected to remain well below the peaks reached after the sovereign debt crisis, but unexpected events could lead to more adverse scenarios.

Banks must be prudent when classifying loans and apply international accounting standards thoroughly, which require them to record expected losses and make appropriate provisions, even when losses have not yet materialized.

Where models fail to fully capture the effects of new risk factors on default probabilities, banks are required to make specific adjustments.<sup>31</sup> Several banks already do so, but their approaches vary, so the Bank of Italy is conducting research to identify and disseminate best practices in this area.

An ecosystem of companies specialized in the management and recovery of non-performing loans has emerged in the wake of the sovereign debt crisis. This activity, which has become an important part of the credit sector, has made considerable progress in recent years.<sup>32</sup>

But there is still room for improvement. The Bank of Italy is stepping up its supervision of debt collection companies, known as master servicers.<sup>33</sup> Some organizational shortcomings have been found, which call for stronger controls and improved risk management and recovery strategies, especially when these are outsourced.

The most difficult challenge, and the one with the greatest impact on the real economy, is the management of loans to customers who are struggling but may recover. In order to draw up effective recovery plans for borrowers, companies working in this area need to improve their management, financial and advisory capacities.

## ***Capital***

In light of the risks emerging to their activity, banks must safeguard the soundness of their capital base.

Since 2020, the increase in the capital ratios has been driven by the decline in risk-weighted exposures – the denominator of the ratio – mainly as a result of the State-guaranteed loans granted, which are gradually reaching maturity.<sup>34</sup> At the same time, the amount of capital has decreased.<sup>35</sup>

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<sup>31</sup> These are called overlays, whose use is encouraged by the supervisory authorities to take account of risks (such as geopolitical, inflation and climate risks), not always adequately captured by ordinary models.

<sup>32</sup> See FSB, 'Peer Review of Italy', 2024.

<sup>33</sup> All supervised servicers perform the guarantee tasks envisaged under Law 130/99 (master servicing tasks). The recovery of securitized loans is almost exclusively left to third-party agencies, which are licenced to do so under Article 115 of the Consolidated Law on Public Security (Testo unico delle leggi di pubblica sicurezza, TULPS) and are not subject to supervision (special servicers). Special servicers have usually already been involved by the investor when due diligence is performed on the securitized portfolios and are responsible for preparing and updating business plans; they are also directly accountable to investors for debt collection scenarios.

<sup>34</sup> Around 80 per cent of the State-guaranteed loans to Italian banks will expire by the end of next year.

<sup>35</sup> M.A. Aiello, C. Ciancaglioni and G. Manzelli, 'Risk-weighted assets dynamics for Italian and SSM banks over the last three years', Banca d'Italia, Notes on Financial Stability and Supervision, 34, 2023.



The trends in capital can be reversed by drawing on last year's exceptional profits, thereby strengthening the banks' ability to absorb future losses.

Aside from the microprudential perspective, macroprudential capital buffers are necessary to enable banks to support the economy in the event of external shocks to the financial system. These can be built up by financial intermediaries using capital in excess of minimum requirements, without raising new capital.

With the pandemic emergency behind us, many foreign authorities have increased capital buffers that can be released if adverse events occur. The Basel Committee has welcomed the accumulation of macroprudential reserves, including when cyclical growth is not strong. The ECB has also supported the build-up of such buffers, banks' capital positions and profitability permitting.

The Bank of Italy is examining the macroprudential policy stance in Italy. The results will be announced in the coming weeks.

## **5. Technology**

In recent years, the debate on the impact of technology on the financial system has focused on the risk that 'traditional' intermediaries could be disintermediated by FinTech companies – young and innovative companies specializing in the application of technology to finance.

This risk has not materialized. What can be seen, in Italy and internationally, is that banks have embraced the most promising innovations, adopting the new technologies and in some cases acquiring a controlling stake in FinTechs. These companies currently play a somewhat autonomous role in specific areas of the financial sector, such as retail payments, small loans and asset management.

It has become clear that the greatest challenges to the financial system come from global tech giants such as Google, Apple, Facebook, Amazon, Microsoft and several others.

These Big Techs enjoy formidable competitive advantages. Their vast financial resources and their position at the forefront of digital innovation are just two of them, and not necessarily the most important when it comes to financial intermediation.

The key strengths of Big Techs are their capacity to access and to exploit an impressive wealth of data on hundreds of millions of clients, partly thanks to their client-oriented, rather than product-oriented, business models.

Online platforms allow Big Techs to interact simultaneously and cheaply with a large number of intermediaries, firms and consumers via a single channel. For their operators, these platforms are a unique source of real-time data about a given firm's products, about specific goods and services, and about consumers' tastes and incomes, and may over time become the main channel for screening customers and for distributing financial and payment services.

Financial intermediaries will have to respond to these trends, making greater use of innovative techniques such as digital identity systems, big data and artificial intelligence, in order to realize efficiency gains and provide higher-quality services. Above all, they will have to prioritize customer relations.

In turn, legislators and supervisors will need to strike the right balance between the goal of stimulating innovation and competition and that of preventing regulatory arbitrage and distortions of competition. Fair competition must be ensured by applying the same rules and controls to the same activities and risks, minimizing the risks engendered by the new players without stifling the development of products that can improve consumer welfare.

Central banks are also directly involved as issuers of payment instruments. A central bank digital currency, be it retail or wholesale (in the euro area, respectively, the digital euro and TARGET infrastructure) can provide intermediaries with further instruments to meet the demand from individuals and financial operators for efficient, secure, and low-cost digital financial services.

At the same time, widespread access to digital finance raises broader issues, including the defence of monetary sovereignty, financial inclusion, the right to privacy, cyber security, the fight against money laundering and the financing of terrorism, and so on.

These matters are being examined by national and international authorities. They are on the Finance Track agenda of the G7, which is chaired by Italy this year. They are also being addressed by the G20, the Financial Stability Board (FSB) and the Committee on Payments and Market Infrastructures (CPMI) in the Bank for International Settlements (BIS).

In the coming years, the Bank of Italy will closely follow these issues, which are crucial for the future of the financial system in Italy and in Europe.

## **6. Conclusions**

The global economy is being held back by the ongoing monetary tightening in several countries and by the uncertainty raised by ongoing conflicts. Geopolitical fractures are emerging at global level that, if not addressed, could jeopardize development prospects, integration between countries and the multilateral architecture that has supported international relations since the Second World War.

In Europe, the economy has not experienced a deep recession so far, but has stagnated for many quarters and there are no signs of a marked acceleration. Inflation is falling rapidly and the risks to price stability have eased. If monetary policy were to take too long to accompany the ongoing disinflation, downside risks to inflation could emerge that would conflict with the symmetrical nature of the objective set by the ECB's Governing Council.

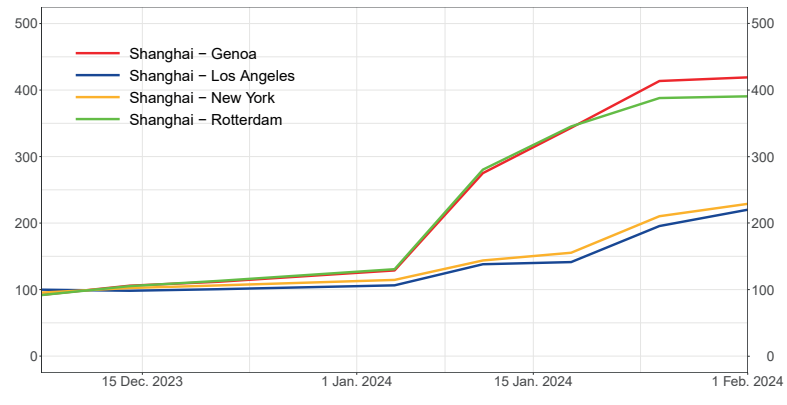
The weakness of the European economy is extending to Italy. To embark on a path of sustained growth, we must act on two fronts. We need to reassure investors about a downward trajectory for public debt; the reduction in the risk premiums that this may entail would make the path easier. We need to stimulate investment that can boost innovation and productivity.

Positive signs have emerged in recent years: greater capital accumulation, the strength of the labour market, the ability of many companies to compete in international markets, and the soundness of bank balance sheets. These are key elements that can play an important role in relaunching Italy's development.

## *APPENDIX*

Figure A1

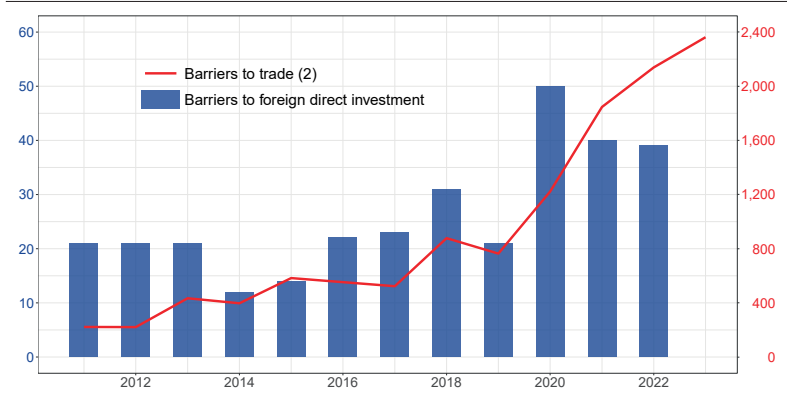
**Sea freight rates for container shipping on a number of different routes (1)**  
*(index numbers, December 2023 average=100)*



Source: Eikon, based on Freightos data.  
 (1) Weekly data.

Figure A2

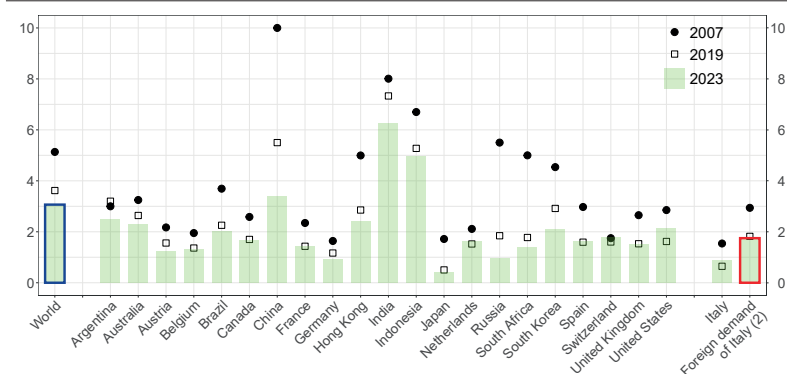
**New barriers to trade and foreign direct investment (1)**  
*(number of new restrictions)*



Source: Global Trade Alert and UNCTAD.  
 (1) Annual data. – (2) Right-hand scale.

Figure A3

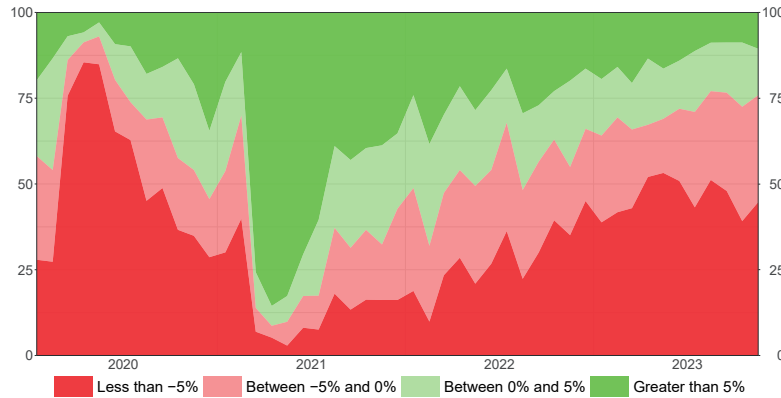
**Potential GDP growth (1)**  
*(per cent)*



Source: IMF, *World Economic Outlook* (October 2007, October 2019 and October 2023).  
 (1) Annual data. Forecasts published in the year indicated in the figure, relating to each country's long-term GDP growth (5 years forward). – (2) Long-term growth in Italy's foreign demand is calculated by weighting the long-term GDP growth of each country by the share of Italy's exports to these economies.

Figure A4

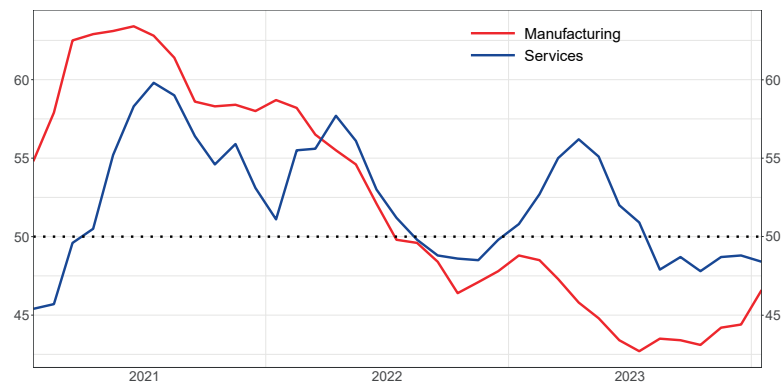
**Distribution of industrial production across sectors in the euro area based on changes in the indices (1)**  
*(as a percentage share of the total number of production sectors)*



Source: Based on Eurostat data.  
 (1) Monthly data; 12-month percentage changes.

Figure A5

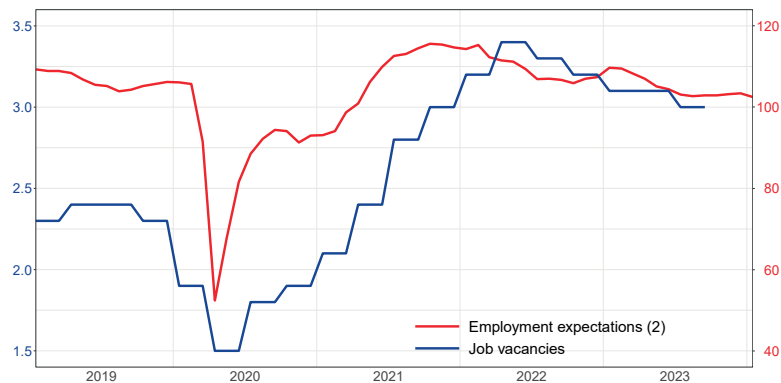
**Purchasing managers' indices (PMIs) in the euro area (1)**  
*(diffusion indices)*



Source: S&P Global Market Intelligence.  
 (1) Monthly data. Diffusion indices for economic activity in the manufacturing and service sectors. Values greater than 50 are compatible with expansion in the sector.

Figure A6

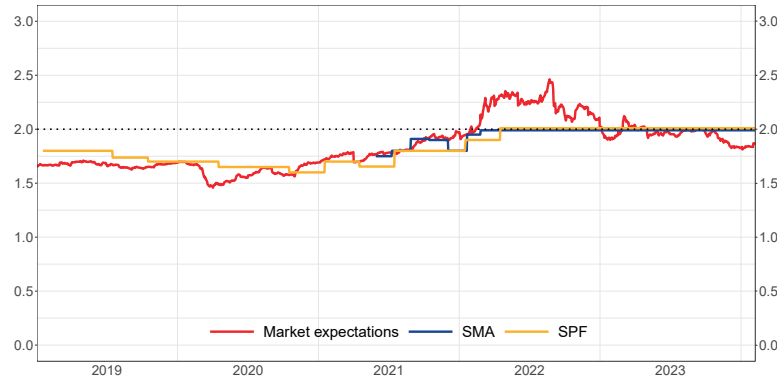
**Forward-looking employment indicators in the euro area (1)**  
*(per cent; index numbers, long-term averages = 100)*



Sources: European Commission and Eurostat.  
 (1) Quarterly and monthly data. Ratio of job vacancies to total jobs (sum of employment and job vacancies) for the non-farm private sector and employment expectation index.

Figure A7

**Long-term inflation expectations in the euro area (1)**  
(per cent)

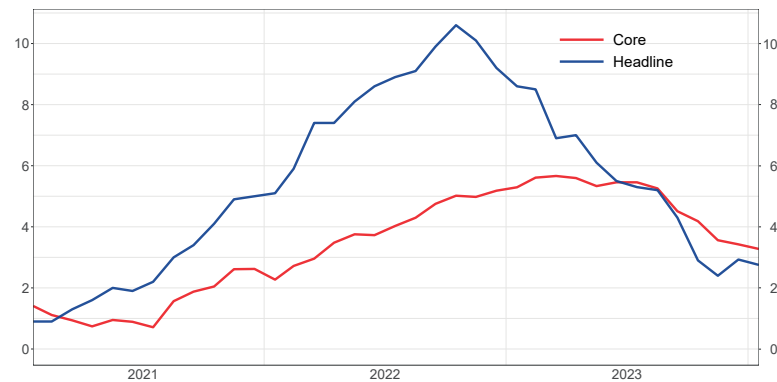


Sources: ECB and Bloomberg.

(1) Daily, quarterly and sporadic data. Median of the long-term inflation expectations reported by the experts interviewed as part of the Survey of Professional Forecasters (SPF), conducted at the beginning of each quarter, and of the Survey of Monetary Analysts (SMA), conducted around 2 weeks ahead of the ECB Governing Council's monetary policy meetings. 5-year, 5 years forward inflation-linked swap rates, net of the estimated inflation risk premium.

Figure A8

**Euro-area inflation (1)**  
(12-month percentage changes)

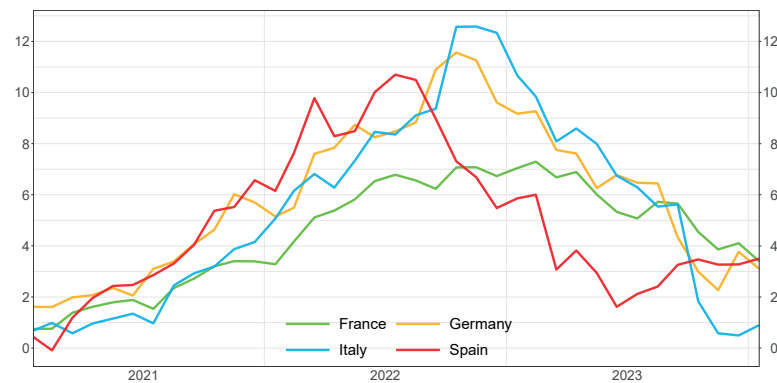


Source: Eurostat.

(1) Monthly data. For January 2024, preliminary data.

Figure A9

**Inflation in the main euro-area countries (1)**  
(12-month percentage changes)

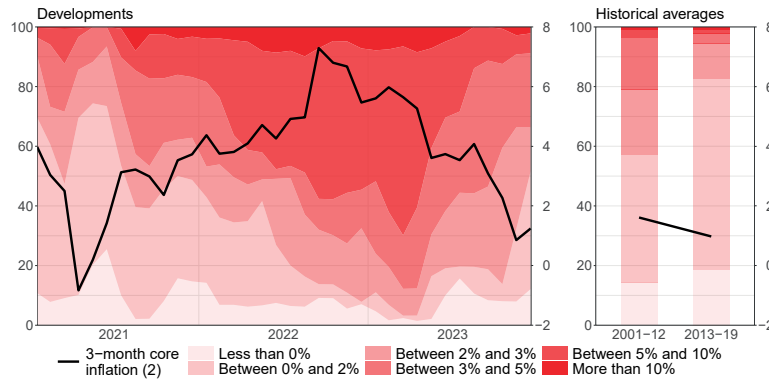


Source: Eurostat.

(1) Monthly data; For January 2024, preliminary data.

Figure A10

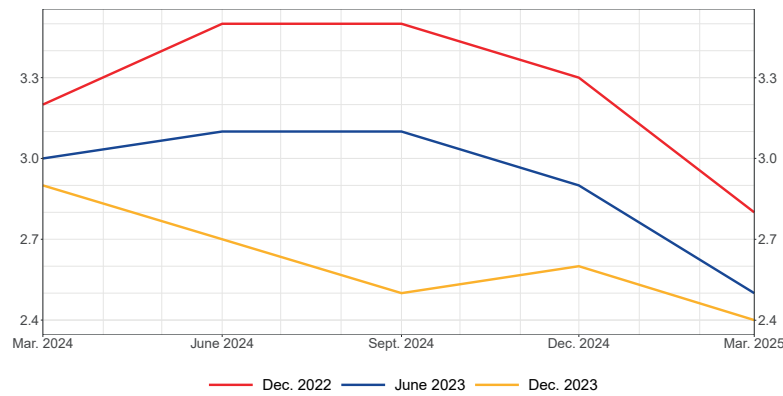
**Distribution of the components of core inflation in the euro area based on the 3-month annualized change in prices (1)**  
(per cent of total items in the core inflation basket)



Source: Based on Eurostat data.  
(1) Monthly data; 12-month changes and annualized changes in the average for the 3 months ending in the reference month compared with the previous 3 months (no overlapping), calculated using seasonally adjusted data for each item in the core inflation basket. – (2) Right-hand scale.

Figure A11

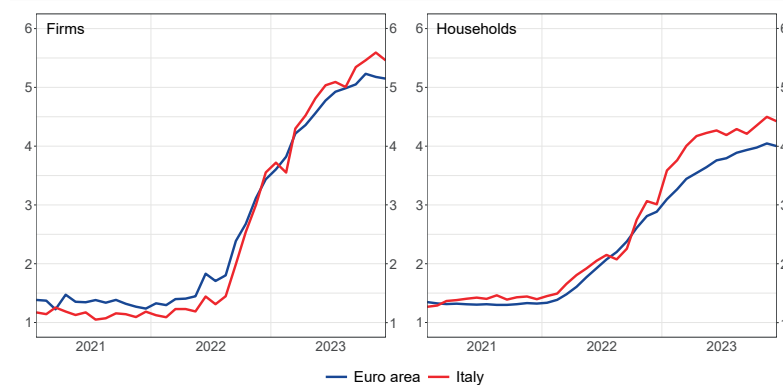
**Eurosystem inflation projections (1)**  
(per cent)



Source: ECB.  
(1) Quarterly data. The macroeconomic projections for the euro area are those prepared by experts from the Eurosystem national central banks in the projection exercises carried out in June and December of 2022 and 2023 (Eurosystem staff macroeconomic projections for the euro area).

Figure A12

**Interest rates on loans (1)**  
(per cent)

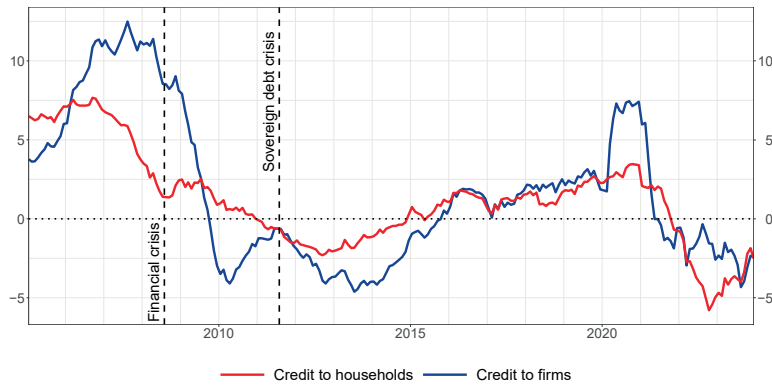


Source: ECB.  
(1) Monthly data. Interest rates on new loans to firms and on new mortgage loans to households for house purchase.



Figure A13

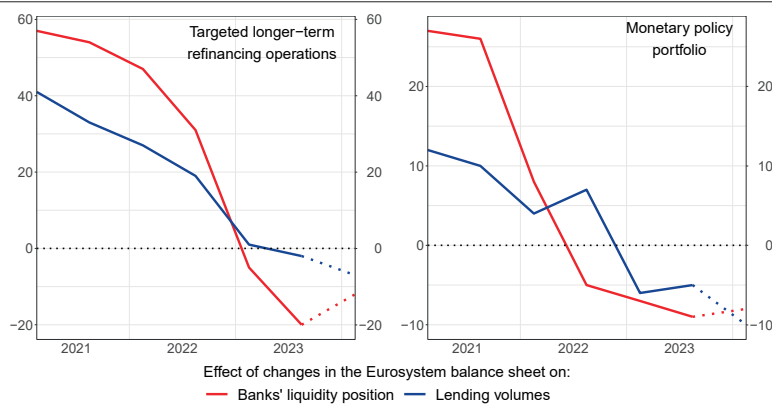
**Credit growth in real terms in the euro area (1)**  
(12-month percentage changes)



Sources: Based on ECB and Eurostat data.  
(1) Monthly data. Credit in real terms is calculated by deflating the nominal figures with the consumer price index.

Figure A14

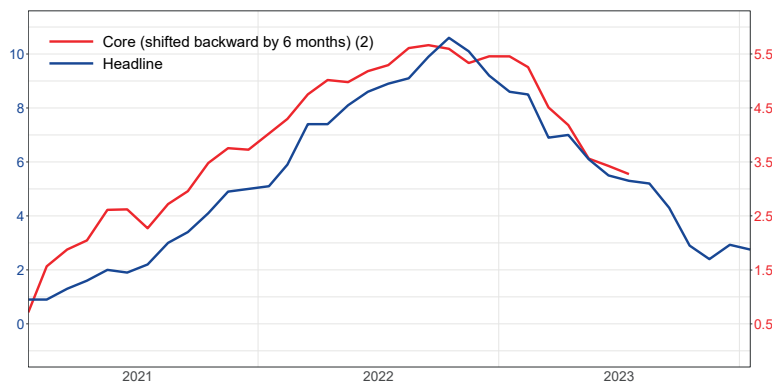
**Effects of changes in the Eurosystem balance sheet on banks' liquidity position and lending (1)**  
(net percentage shares)



Source: ECB, Bank Lending Survey.  
(1) Half-yearly data. A negative net percentage share indicates a negative effect in the reference six-month period. The latest observation refers to the October 2023 survey and incorporates banks' expectations for the next six-month period (dashed line).

Figure A15

**Core and headline inflation in the euro area (1)**  
(12-month percentage changes)

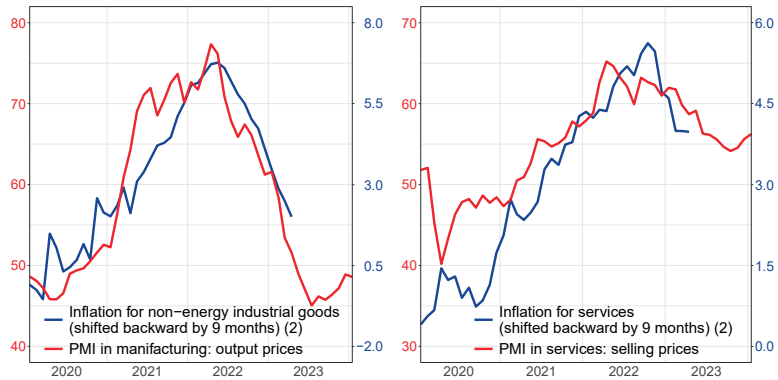


Source: Based on Eurostat data.  
(1) Monthly data. The core inflation series was shifted 6 months backward. – (2) Right-hand scale.

Figure A16

### Inflation for non-energy industrial goods and services and PMIs in the euro area (1)

(12-month percentage changes; diffusion indices)

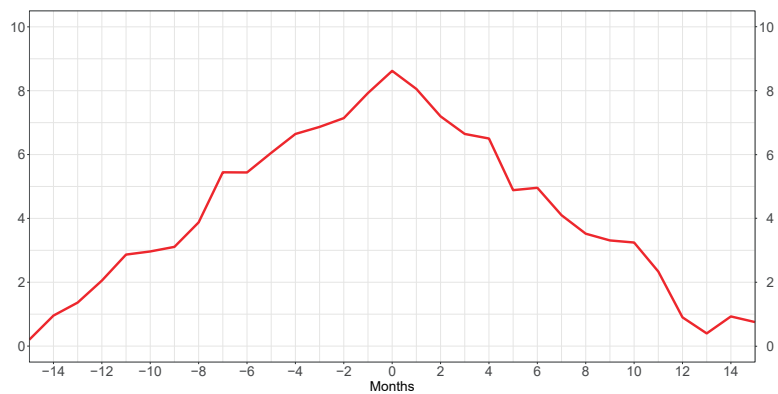


Sources: Based on Eurostat and S&P Global Market Intelligence data.  
 (1) Monthly data. The inflation series was shifted 9 months backward.

Figure A17

### The rise and fall of inflation in the euro area, 2021-24 (1)

(percentage points; deviation from the 2 per cent target)



Source: Based on Eurostat data.  
 (1) The peak month for inflation was October 2022 (10.6 per cent on a 12-month basis); the horizontal axis indicates the months before and after this date.

Figure A18

### Euro-area firms' expectations of intermediate goods costs and wages (1)

(index numbers: expectations of no change=0)

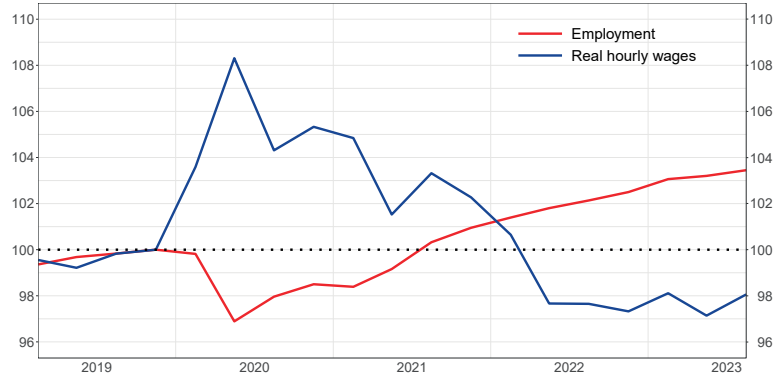


Source: Based on data from C. Elding, J. Gareis, F. Kuik and R. Morris, 'Main findings from the ECB's recent contacts with non-financial companies', in *ECB Economic Bulletin*, 5, 2023, pp. 46-48.  
 (1) Quarterly data. Expectations refer to the quarter following the one in which the survey is conducted and are converted into scores that, by construction, vary from -2 to 2. A score equal to zero corresponds to expectations of costs remaining stable; a score greater (lower) than zero signals expectations of an increase (decrease). The value of the score indicates the intensity of the expected change.

Figure A19

### Employment and hourly wages in real terms in the euro area (1)

(index numbers Q4 2019=100)

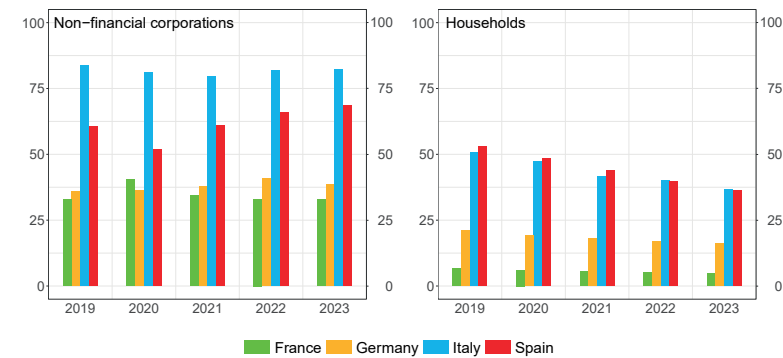


Source: Based on Eurostat data.  
 (1) Seasonally adjusted quarterly data. Real wages are calculated by deflating nominal wages using the consumer price index.

Figure A20

### Share of variable-rate bank loans (1)

(per cent)

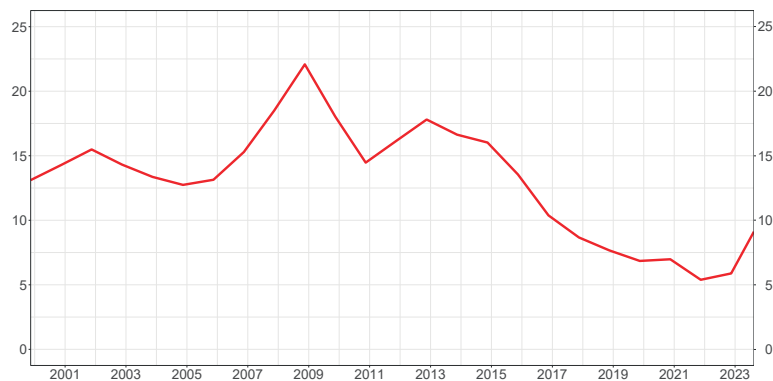


Sources: Bank of Italy and ECB.  
 (1) The data refer to the end of the year. The figure for firms includes current account overdrafts and excludes non-performing loans; the figure for 2023 refers to September. For households, the figures from countries other than Italy are calculated as 10-year averages of the shares of variable-rate loans in total lending.

Figure A21

### Ratio of net financial charges to gross operating income for Italian firms (1)

(per cent)



Sources: Bank of Italy (Financial Accounts) and Istat.  
 (1) The data refer to Q4 for every year up to 2022 and to Q3 for 2023 (latest figure available).

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