Italian Banking Association
Annual Meeting

Banks and the economy: credit, regulation and growth

Speech by the Governor of the Bank of Italy
Fabio Panetta

Rome, 9 July 2024

1. The economic situation and monetary policy

After stagnating for more than a year, economic activity in the euro area edged up by 0.3 per cent in the first quarter of 2024. The biggest contribution came from foreign demand, while domestic demand remained weak: household consumption rose marginally and investment declined.[1] Activity remains sluggish above all in manufacturing.

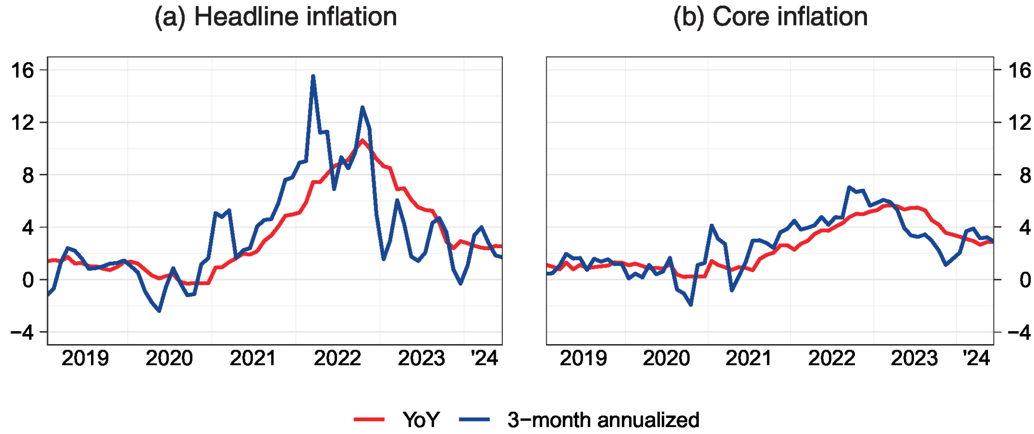
GDP is estimated to have grown moderately in the second quarter, supported by services; conversely, the latest business surveys confirm that industrial activity remains weak.

Inflation is continuing to fall, with fluctuations in the monthly data. In June it declined to 2.5 per cent, while its core component, which excludes the most volatile items, held stable at 2.9 per cent (Figure 1).

Figure 1

Euro-area consumer price inflation (1)

(per cent)



Sources: Calculations based on ECB and Eurostat data.
(1) The inflation rates for the Harmonized Index of Consumer Prices (HICP) are calculated as the year-on-year percentage change and the seasonally adjusted 3-month annualized changed. Core inflation excludes energy and food.

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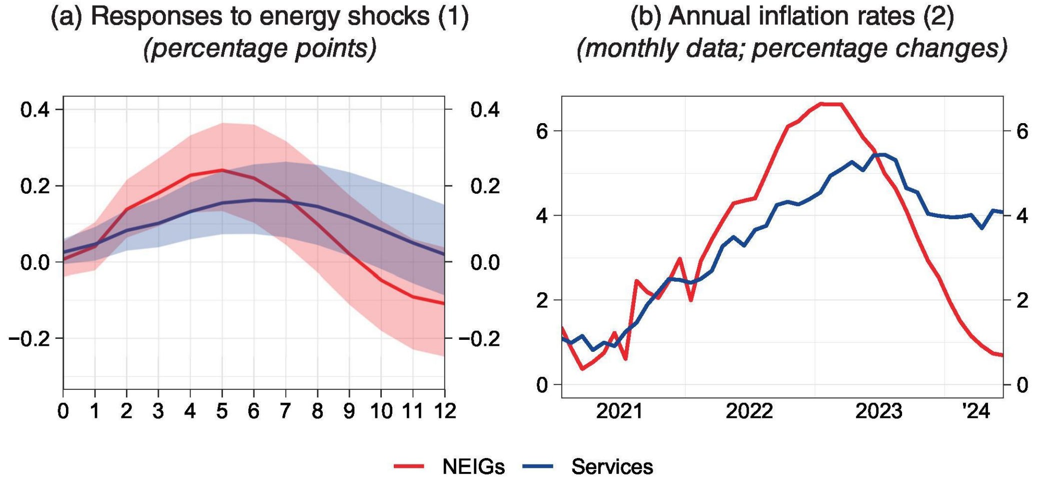
1 The decline in overall investment was mitigated by positive developments in the construction sector, which benefited from temporary factors, notably favourable weather conditions in Germany.

At the beginning of June, the ECB Governing Council lowered its key interest rates by 25 basis points, after keeping them unchanged at high levels for nine months. This decision reflects the gradual fall in inflation and the prospect of a further drop in the coming months.

Despite the current period of disinflation, some observers are concerned about price growth in services, which still stands at 4.1 per cent. These concerns are not unwarranted, but they need to be put into perspective, as service prices tend to move differently from those of goods. As was the case with past energy shocks, services inflation has been slow to react to energy price increases in the last few months, tardy in reaching its peak and is now falling more slowly than goods inflation (Figure 2).[2]

Figure 2

Inflation persistence, services versus non-energy industrial goods



Sources: Calculations based on ECB and Eurostat data.
(1) Impulse-response functions based on a quarterly VAR model over the sample period 1996-2023; the x-axis indicates the number of quarters after the energy shock. Model specification and identification of energy shocks are similar to those presented in S. Neri, F. Busetti, C. Conflitti, F. Corsello, D. Delle Monache and A. Tagliabracci, 2023, 'Energy price shocks and inflation in the euro area', Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), 792, 2023. – (2) Year-on-year percentage changes of the euro-area HICP of non-energy industrial goods (NEIGs) and services over the sample period 2021-2024.

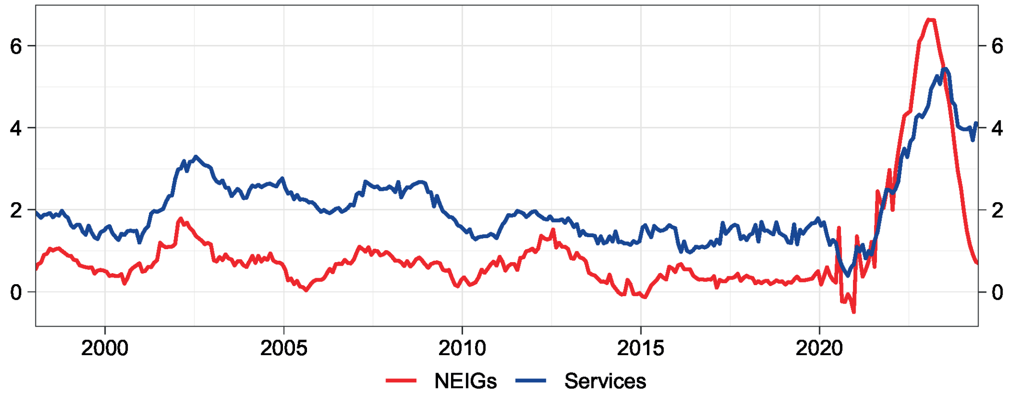
Furthermore, the fact that services inflation is higher than that of goods is nothing new. This has been the case in the euro area since the late 1990s, even when headline inflation was in line with or below the ECB's target (Figure 3).

2 For a more in-depth analysis of euro-area inflation dynamics and monetary policy prospects, see 'Monetary policy after a perfect storm: *festina lente*', speech by F. Panetta at the 3rd International Monetary Policy Conference held by the Bank of Finland, 'Monetary policy in low and high inflation environments', Helsinki, 26 June 2024.

Figure 3

Inflation levels, non-energy industrial goods versus services (1)

(monthly data; percentage changes)



Source: Calculations based on Eurostat data.
(1) Year-on-year percentage changes of the euro-area HICP of non-energy industrial goods (NEIGs) and services over the sample period 1998-2024.

There is also debate over the pace of wage growth, which continues to be robust. In this case too, careful analysis of the data can mitigate fears. Following the losses of previous years, the current increase in wages constitutes an inevitable recovery in purchasing power, and will lose steam as the loss to be recouped decreases. Moreover, the lower costs of intermediate inputs and the sizeable profits accumulated so far are allowing firms to absorb wage growth without passing it on to final prices. Finally, the increase in labour costs on the one hand, and the fall in energy prices and in the cost of capital[3] on the other, will foster an increase in the capital-labour ratio and in productivity, thereby also helping to contain inflationary pressures.

Two important factors will have to be taken into account in future monetary policy decisions. First, past key rate hikes are still squeezing demand, production and inflation, and will continue to do so in the coming months.[4] Second, the expansionary effects of the monetary easing envisaged in the coming months will be mitigated by the further contraction of the Eurosystem's balance sheet, which will continue to have a tightening effect on banks' funding costs and liquidity, and thus on the supply of credit to the economy.

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3 At this time, the cost of capital is decreasing as a result of the decline in both actual and expected interest rates, as well as by the fall in the prices of energy goods.

4 According to our estimates, the effect of monetary tightening on inflation will be even greater in 2024 than in 2023; see A.M. Conti, S. Neri and A. Notarpietro, 'Credit strikes back: the macroeconomic impact of the 2022-2023 ECB monetary tightening and the role of lending rates', Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), forthcoming.

From now on, the disinflation process can be completed by gradually adjusting the official interest rates to the actual and expected fall in inflation, if macroeconomic developments confirm the current forecasts. However, we must stand ready to react promptly to new shocks that could move us away from that trajectory, either upwards or downwards.

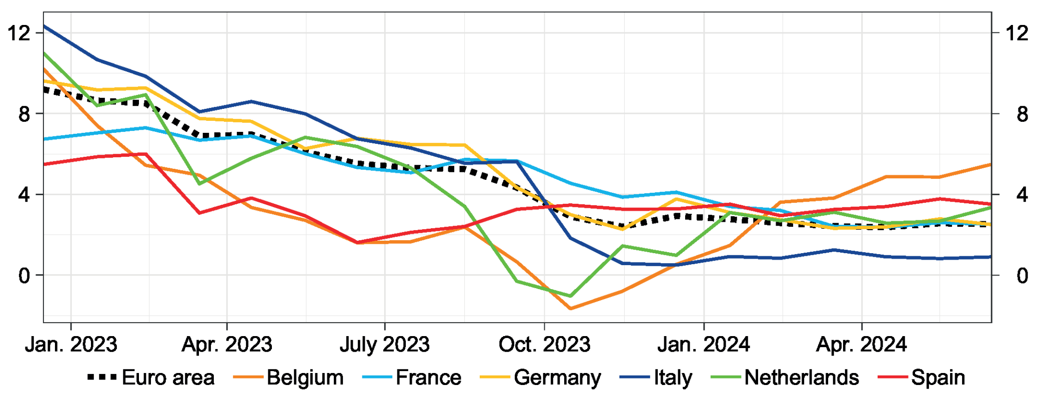
Cyclical developments in the Italian economy are closely following those in the euro area. Growth was also 0.3 per cent in Italy in the first quarter of this year, and appears to have remained at a similar level in the second. Services continue to expand, especially in tourism-related components, while manufacturing remains weak. The forecasts of Consensus Economics point to growth of 0.8 per cent for 2024 as a whole.[5]

Economic activity is mainly being driven by net foreign demand, while domestic demand is still weak. Investment in plant, machinery and intangible assets is falling, affected by tight financing conditions and by uncertainty over the global economic and political situation.

Figure 4

Inflation in the six main euro-area countries (1)

(percentage changes)



Source: Eurostat.
(1) Year-on-year percentage changes in the HICP. For June 2024, preliminary estimates.

Household consumption is growing moderately, buoyed by a positive labour market performance: in the first five months of 2024, there were almost half a

[5] The forecasts of Consensus Economics are in line with the projections published in June by Banca d'Italia; they pointed to growth of 0.6 per cent, adjusted for calendar effects, and of 0.8 per cent without the adjustment. Our projections were prepared in May, before Istat released its updated data for the quarterly national accounts. Incorporating these revisions would push the projections up by around 0.1 percentage points.

million more persons employed on average than in the same period in 2023. Wage growth remains moderate.

Inflation, which had been above the euro-area average until the summer of last year, fell rapidly to very low levels,[6] thereby contributing significantly to disinflation in the euro area as a whole (Figure 4).

I will not expand on these brief comments on recent economic developments in Italy, as our *Economic Bulletin*, to be published at the end of this week, will provide a detailed analysis.

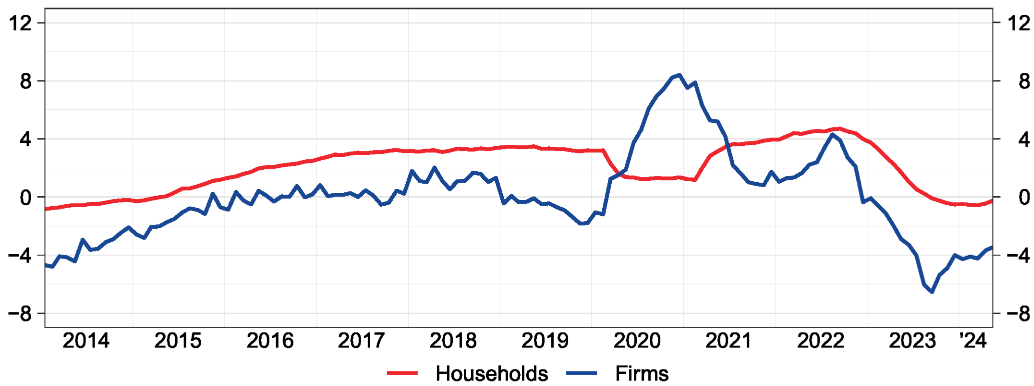
2. Credit, firms and banks

Credit growth has weakened considerably in Italy as a result of monetary tightening. There has been a significant contraction in the stock of business loans, which has only recently lessened. Lending to households has also slowed down sharply and has stagnated over the past year (Figure 5). Interest rates on new loans have risen considerably.

Figure 5

Bank loans in Italy (1)

(12-month percentage changes)



Source: Supervisory reports.
(1) The data for May 2024 are provisional. Includes repos and bad debts; excludes repos vis-à-vis central counterparties. The percentage changes are adjusted to reflect the accounting effect of securitizations, reclassifications, value adjustments, exchange rate variations and other variations not due to transactions. The data on firms refer to non-financial corporations and producer households.

The slowdown in lending is comparable to what occurred during the crisis episodes of the last 15 years. The effects on the real economy have, however, been much less severe.

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6 For further details, see Chapter 14: 'Inflation after the pandemic: developments, causes and consequences', *Annual Report for 2023*, 2024.

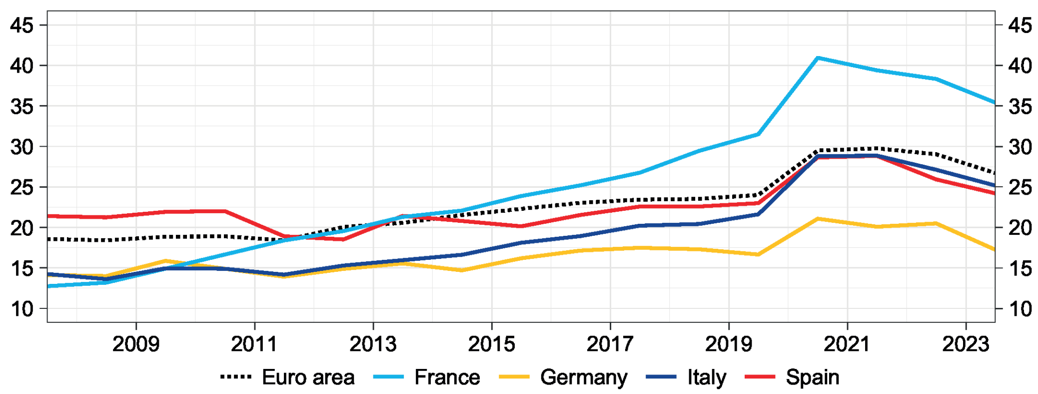
This is primarily due to a better macroeconomic situation as a result of the exceptional support measures adopted in response to the health and energy crises. Yet, it also reflects the sounder conditions of firms, households and banks, which not only benefited directly or indirectly from those measures but are now also on a more solid footing.

For firms, strong profitability has prevented higher interest expenses from undermining debt sustainability.[7] Part of the liquidity buffer accumulated during the pandemic years was used to repay, sometimes in advance, loans that had become more costly.[8] Despite these outlays, liquidity is still ample (Figure 6).

Figure 6

Firms' liquidity as a share of GDP (1)

(per cent)



Sources: Based on Banca d'Italia (Financial Accounts), ECB and Eurostat data.
(1) Liquidity is the sum of currency and deposits held by firms.

The sound position of households reflects high employment and low indebtedness: the ratio of financial debt to disposable income, which was already low by international standards, declined further to 58.6 per cent.

Finally, as I have mentioned on other occasions, the condition of banks has improved considerably in terms of profitability, asset quality and capitalization. The tightening in lending supply, which has emerged in the past few months, mainly reflects a heightened perception of borrower riskiness, rather than a worsening

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7 The ratio of interest expense to gross operating income is below 10 per cent, half the average value recorded in the period 2008-11. In the two years 2022-23, the gross operating income of firms grew by 13 per cent in real terms, reaching 8 per cent of assets, its highest level in 20 years. The boost in profits was associated to a 4 per cent rise in self-financing. According to Banca d'Italia's Survey of Industrial and Service Firms, the share of firms that reported a profit exceeded 80 per cent in 2023.

8 *Financial Stability Report*, 2, 2023. It is estimated that about 20 per cent of loans outstanding at the end of 2021 were repaid early during the two years 2022-23. The share of early repayments was higher for larger firms and especially for floating-rate loans not backed by public guarantees.

in the condition of banks. Supply constraints therefore remained within normal levels and did not force firms to cut back on investment or households to curtail consumption.[9]

Given that firms are stronger than before, the financial position of households is sound, and banks are healthy, we can look ahead with confidence. However, we should refrain from being over-optimistic.

The protraction in credit weakness would weigh on a situation that is, as in other countries, exposed to vulnerabilities. In the current environment, it would be difficult to conceive public intervention of the exceptionally generous kind adopted after the pandemic.

Moreover, a number of factors complicate the context within which banks are called to supply credit to the real economy.

The shrinking of the Eurosystem's balance sheet which I mentioned earlier could raise the cost of issuing bank bonds and intensify the rebalancing of savers' portfolios towards higher-yielding assets, thereby increasing competition and interest rates on bank deposits. The global geopolitical situation, as well as the domestic politics in some major countries, is keeping the underlying uncertainty high.

Furthermore, a protracted period of high interest rates could affect the ability of borrowers to repay their debts. We are seeing early signs of this: in the first quarter of 2024, the flow of non-performing loans rose to 2.1 per cent of total business loans, from 1.8 per cent in the previous quarter,[10] and is estimated to continue to grow moderately both this year and the next. The loan default rate for households is expected to remain lower, at around 1 per cent. These levels are nonetheless far from historical highs: at challenging times over the past decade, this indicator neared 10 per cent for firms and exceeded 3 per cent for households.

In such an environment, banks must temper the need to contain risks with that of supporting the real economy. Credit should continue to flow to borrowers that are capable of honouring their commitments. This will require banks to carefully

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9 Based on banks' responses in the Eurosystem's Bank Lending Survey, lending developments in recent years have reflected, in addition to weak demand, a tightening of credit standards largely due to an increased risk perception on the part of banks. Unlike in the past, bank balance sheet constraints have not been reported to have had a significant impact. 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 and S. Auer and A.M. Conti, 'Bank lending in an unprecedented monetary tightening cycle: evidence from the euro area', Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), 856, 2024.

10 The figure for Q4 2023 has been revised slightly upwards, based on previous reports.

select borrowers, constantly monitor their profitability and financial conditions and design an effective recovery strategy in the event of default.

Loan loss provisions must be made prudently. On average, banks under our direct supervision with traditional business models have a lower NPL coverage ratio than significant banking groups. We have already reminded the banks concerned to adjust their provisions; most of them have taken steps and we will assess their effectiveness in the coming months. A low number of banks have not fully heeded our plea; we will continue to push them to adopt the necessary measures.

Some banks, with balance sheet indicators less favourable than the system average have drawn up business plans that envisage a rapid expansion of activities. Such strategies need to be carefully considered. Efforts to restore profitability must build on efficiency gains and more refined customer selection criteria; it should be borne in mind that there are no shortcuts to achieving the goals that have been set.

3. Banking and financial regulation

An effective regulatory framework, together with careful supervision, is essential to provide the banking system with the efficiency and strength needed to fund the real economy under stable conditions.

We have seen this play out in recent years. The regulatory reforms introduced in the wake of the 2008-09 crisis have made the global banking system stronger and enabled it to overcome an unprecedented string of adverse events without excessive jolts: the pandemic, a war at the border with Europe, the return of inflation, and a monetary tightening of unparalleled intensity in recent history. In the United States, where the reform was less than stringent for part of the banking system, some banks failed, originating contagion effects that required heavy intervention by the authorities.

It is in the general interest, including of financial intermediaries, to continue to strengthen the regulatory framework for banks and financial players, with a view to managing both traditional risks and those arising from innovative activities.

The prudential regulation of banks

Next year, the final part of the prudential framework for banks drawn up by the Basel Committee will come into force in Europe. It will be followed by a phase-in period that will end in 2030.[11] Once completed, the regulatory review will have taken well over twenty years. This is too long when measured against the consequences of potential instability and the speed at which new risks emerge.

European lawmakers have transposed the Basel rules with no significant deviations from the original design and taken into account the specific features of our continent's economy, starting with the large share of small and medium-sized enterprises, which are granted preferential prudential treatment in the allocation of credit.[12]

The role of banks' internal models – whose use leads, in practice, to lower capital requirements – has been reduced, while the sensitivity to risk of standardized methodologies has increased.[13] The impact on requirements will therefore be greater for the Italian and European financial intermediaries that use internal models, which are typically the largest and most complex ones.

In keeping with the commitment of the Group of Central Bank Governors and Heads of Supervision not to impose excessive capital burdens, the new rules provide for capital increases that banks can easily achieve in the current period of high profits. For this reason too, any hesitation in the implementation would be counterproductive: it would expose the whole economy to risks in the immediate future and make implementation more difficult if it were pushed back to a less positive phase than the current one.

However, the transposition of the new rules is not proceeding at the same pace everywhere. It is particularly slow in the United States. This makes the reform incomplete and creates competitive disparities between financial intermediaries, as in the case of the new market risk rules. For this reason, to ensure a level playing field among intermediaries that operate at global level, the European Commission recently announced its intention to suspend the entry into force of this part of the reform in the EU for one year. It is certainly not the ideal outcome: competition in laxity among jurisdictions is not the appropriate response to the need for lower risks and for uniform rules at global level.

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11 The phase-in period is intended to avoid excessive discontinuity with the current rules and to gradually steer the system towards the new framework.

12 Loans to small and medium-sized enterprises involve less capital absorption than similar exposures to other borrowers.

13 The internal models recognized by regulation allow banks to estimate, on the basis of their own data and against a comprehensive set of quantitative and qualitative criteria, the main risk parameters, which in turn form the basis for calculating capital requirements. Conversely, in the standardized methodologies intended for less complex banks, the requirements are calculated using predefined formulas.

Parallel to the ongoing international reform, Italy is strengthening its macroprudential safeguards and finalizing the related supervisory system.

In order to increase protection against risks that may arise outside the financial system, Banca d'Italia introduced a systemic risk buffer in April 2024. The buffer, equal to 1.0 per cent of credit and counterparty risk-weighted exposures to residents in Italy, will be reached gradually: 0.5 per cent this year and the remaining 0.5 per cent by 30 June 2025.

Past crises have also shown that financial stability needs to be safeguarded by evaluating the system as a whole, and not only its constituent parts. To this end, Italy has recently designed a framework that complies with the best international guidelines in order to improve coordination and the exchange of information between authorities. On 5 July, the first meeting of the Italian Committee for Macroprudential Policies took place and brought together the authorities that contribute to strengthening the role of the financial system in supporting growth and development: Banca d'Italia, the Italian Companies and Stock Exchange Commission (Consob), the Italian Institute for the Supervision of Insurance (IVASS) and the Italian Pension Fund Supervisory Authority (Covip). Overall, while vulnerabilities exist, the Committee's assessment is that risks to financial stability in Italy are currently contained.[14]

Crypto-asset markets and MiCAR

The risks that today require attention are those stemming from crypto-assets, a category that encompasses many different instruments. The main distinction is between stablecoins and crypto-assets that are not backed by any underlying assets, which from now on I will simply call 'unbacked'.

Stablecoins – e.g. Tether or USD Coin – are digital instruments whose value is linked to that of a portfolio of assets, known as reserve assets, such as currencies, deposits, securities or other instruments.[15] Without appropriate and incisive regulation, stablecoins too would be particularly vulnerable to 'redemption runs', should their holders lose faith in them.

Unbacked crypto-assets – such as Bitcoin or Ethereum – are not issued by a specific entity, as a rule. They have no intrinsic value and do not generate income flows, such as coupons or dividends, and are created using computing technology.

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14 Banca d'Italia, Consob, IVASS and Covip, 'First meeting of the Committee for Macroprudential Policies', press release, 5 July 2024.

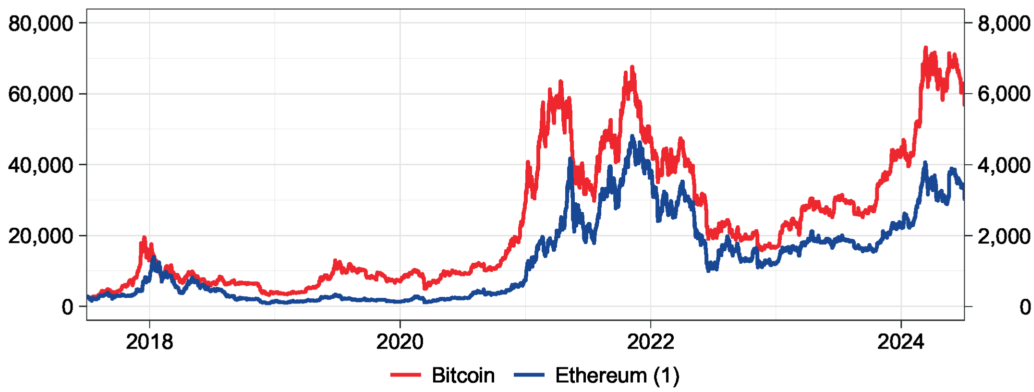
15 Stablecoins can be pegged to other crypto-assets.

Their value cannot be ensured by any party or by any real or financial asset. They are sometimes traded on informal and opaque circuits or on platforms that are not subject to adequate controls. Crypto-assets are held by operators whose main objective is to sell them on at a higher price and, in some cases, to dodge tax rules or the regulations in place to counter money laundering and terrorist financing. In many cases, these crypto-assets are in effect akin to a gamble, a speculative high-risk contract, whose value is not tied to fundamentals. For these reasons, their value fluctuates very sharply (Figure 7). Clearly, they do not possess the characteristics that make them suited to perform the three inherent functions of money: a means of payment, store of value and unit of account.

Figure 7

Price of Bitcoin and Ethereum

(US dollars; daily data)



Sources: Coinmarketcap and Yahoo Finance.
(1) Right-hand scale.

The share of unbacked crypto-assets held by investors who may be potentially unaware of the high risks they are facing is still low, but not negligible.[16] It could grow in the future, as it did during the pandemic, especially in emerging countries.

With the aim of monitoring the risks connected with crypto-assets, the European Union has recently adopted the Markets in Crypto Assets Regulation (MiCAR),[17] a specific set of rules that will be implemented in full over the course of this year. Banca d'Italia and Consob will be called upon, on the basis of the draft legislative decree approved a few days ago, to exercise the supervisory functions provided for under the new regulatory framework.

16 The Eurosystem's 2022 Study on the payment attitudes of consumers in the euro area (SPACE), published in December of that year, showed that crypto-assets were held by only 4 per cent of respondents, less than one third of whom also used them as a means of payment. According to Statista data, the share of holders of crypto-assets in the United States is about twice as high.

17 Regulation (EU) 2023/1114.

MiCAR identifies the different types of instruments in the form of digital tokens that it governs: electronic money tokens (EMTs), whose value is linked to that of a single official currency; asset-referenced tokens (ARTs), which are linked to one or more underlying assets; and a residual category that includes unsecured crypto-assets and utility tokens.[18] As they are pegged to underlying assets, only EMTs and ARTs are to be considered as stablecoins.

MiCAR treats these crypto-assets differently. For EMTs and ARTs, it sets out precise requirements that they must meet and specific obligations for the financial intermediaries that issue or distribute them, as well as for all the market players involved in any capacity.[19] Conversely, the rules governing unbacked crypto-assets and utility tokens are largely limited to prior notification obligations: therefore, in practice, these products remain outside the scope of the regulation.

The new rules help to bring some order to the crypto-asset market, although in some cases their effectiveness is hampered by the complexity and the ever-changing nature of the issues at hand. For example, the management of stablecoins on unreliable trading platforms, particularly outside Europe, could generate risks beyond the control of individual issuers.

All of this increases the responsibilities falling on the financial intermediaries, both traditional and non-traditional, operating in this market, which, under MiCAR, will need to pay due attention to both financial and operational risks.

They will also have to guarantee the robustness of the technology used from a technical and legal standpoint, in order to combat illicit or criminal transactions as well. In particular, they will need to ensure compliance with the rules in place to counter money laundering and terrorist financing and with the sanctions adopted at international level, by aligning their organizational structures with those rules. To meet these needs, crypto-asset operators must bring in people with adequate skills and establish effective control functions, right from the planning stage of new initiatives.

According to MiCAR, both EMTs and ARTs possess the characteristics that make them suitable as a means of payment and of exchange. However, in our assessments, the only instruments that can fully perform the means of payment function, while preserving the public's trust, are EMTs, which may be issued by banks and Electronic Money Institutions (EMIs). Only these instruments are, in fact, pegged to the value of a currency that is legal tender and are protected

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18 Utility tokens are crypto-assets that have the sole function of giving access to a good or service provided by their issuer. Examples of this are tokens to be used on gaming platforms.

19 These obligations mainly have to do with market access, prudential and transparency requirements.

by specific rules guaranteeing holders that the funds they invest in them can be redeemed at par value at any time.

The provision of ARTs as a means of exchange, which is governed by MiCAR with a number of safeguards and restrictions, must instead be considered by the financial intermediaries involved with the utmost care and attention, given the risks connected to the possible fluctuations in the value of these instruments and to the lack of redeemability at par value.

In the coming days, we will publish a communication to the market on this issue, aimed at facilitating an effective application of MiCAR, with a view to helping to preserve the smooth functioning of the markets and of the payment system and to protect the holders of these instruments.

4. Conclusions

After a long period of stagnation, the European economy has recorded moderate growth in the last few months. This is a positive development, but the future remains uncertain. There are as yet no signs of a clear improvement in domestic demand, weighed down by the still tight monetary conditions and the disquiet caused by geopolitical tensions and recent international political events.

The fall in inflation has made it possible to start easing monetary conditions. The reduction in key interest rates will continue at a gradual pace, accompanying the return of inflation to the target, if macroeconomic developments remain in line with the ECB Governing Council's expectations. Should unexpected events risk deviating us from this path, in one direction or another, we must be ready to promptly adapt our decisions.

Growth is proceeding at a moderate pace in Italy. The contraction in lending to the economy caused by monetary tightening has had no disruptive effects, unlike in the past. This also reflects banks' robust profitability and capital position, to which the legislative reforms launched after the financial crisis have contributed.

The soundness of banks is today a strength of our production system.

They now have the task of shoring up the recovery in demand, supporting households and firms, and thereby preventing lending from curbing consumption and investment. In this way, they can help relaunch the Italian economy.