FOR INFORMATION

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March 13, 2020

To: Members of the Executive Board

From: The Secretary

Subject: **Italy—Statement by the European Central Bank Representative**

Board Action:	Executive Directors' **information**
Additional Information:	For the Executive Board discussion on Italy to be held on Monday, March 16, 2020.

12 March 2020

Statement by Rasmus Rüffer (ECB Representative) and Kleopatra Nikolaou (Advisor) on Italy - 2019 Article IV and FSAP Consultation

(Preliminary)

IMF Executive Board Meeting

16 March 2020

We would like to thank Mr. Fanizza for his Buff statement and Staff for their report. We associate ourselves with the statement by Mr De Lannoy. Notably, would like to also express our deepest condolences to the Italian people for the loss of life in the wake of the outbreak of COVID-19 pandemic and wish the authorities and the people of Italy a fast recovery. We would like to further highlight a few issues.

In terms of context, it is important to acknowledge that the situation in Italy and globally is currently rapidly evolving. As a consequence, the current Article IV and FSSA reports cannot possibly make predictions on the societal and economic impact of the coronavirus crisis. The pandemic reflects a major adverse supply shock (disruptions in global supply chains; negative implications for labour supply) that is also leading to lower demand for specific goods and services (such as tourism). Moreover, it is hitting an economy already dealing with long-term structural imbalances (low productivity and potential growth and high unemployment and public debt), which, even before the outbreak of the virus, posed substantial downside risks to economic activity.

In the near term, Italy should focus its efforts on addressing the pandemic and its consequences on public health and the economy but should resume efforts to achieve fiscal consolidation in the medium term. The Covid-19 epidemic creates urgent spending needs, especially in the health care sector, while the actual supply shock and the endogenous demand reaction are likely to lead to a perceptible increase in the debt ratio. Several factors complicate these challenges further: the absence of fiscal buffers, the lack of decisive reforms and the fact that debt has not been on a clear downward path over recent years. Over the medium term, a reduction in the debt ratio through a credible and coherent fiscal policy strategy (not only in terms of structural balance but also in terms of better structural policies and budgetary composition aimed at strengthening potential growth) is essential to dispel concerns about debt sustainability that in turn weigh on confidence, investment and economic outcomes.

Together with high public debt, low productivity remains a core vulnerability of the Italian economy, while structural policies appear to face political economy challenges. Overall, we concur with Staff that in many areas, the implementation of structural policies has been lacking. More recently, the implementation of certain reforms such as the Citizenship Income and the partially undoing of the 2012 pension reform (Quota 100) are likely to have negative long-term effects on labour force participation and potential growth.

Turning to the FSSA report, we would first like to acknowledge the report as a good example of how euro area and national FSAP exercise can usefully complement each other. The national exercise provides additional value added, while avoiding unnecessary duplications. We also commend IMF staff for the high degree of integration of FSAP findings in the Art. IV consultation which could set a standard for bilateral IMF surveillance in other countries.

The COVID-19 pandemic can intensify the headwinds faced by the Italian financial system, alleviated however by the recent measures taken by the ECB for the euro area. The headwinds are likely to provide an obstacle to addressing some of the challenges highlighted in the FSSA. Having said that, the actions taken by the ECB on 12 March, both on the monetary policy and supervisory side, will provide support to the financial system in these challenging times. This relates, in particular, to the further easing of funding conditions for Italian banks stemming from the considerably more favorable terms for the TLTRO operations, and the temporary capital and operational relief for banks so that they can continue to fulfil their role in funding the real economy as the economic effects of the coronavirus become apparent.

We broadly concur with Staff's assessment of the financial stability developments and challenges in Italy. We welcome the substantial progress made in strengthening bank balance sheets in recent years, including by reducing the gross NPL ratio from around 16% at end-2016 to below 8% at September 2019. Further progress is important to resolve remaining NPLs, address the structurally low profitability and high operating costs, and strengthen bank capital buffers, in particular in those banks that face the most significant challenges in these respects. We also broadly concur with the findings of the FSAP solvency stress test results.

The analysis of the profitability effect of the TLTRO is based on assumptions which do not adequately reflect the objectives of this monetary policy measure. The TLTRO is structured in a way to incentivise banks to pass on the favourable funding conditions to borrowers, thereby contributing to a credit expansion. As the conditions of the operations depend on the evolution of banks' loan portfolio there is an embedded incentive to pass on the funding conditions to their customers. Staff's assumption of no pass-through to lending rates basically ignores this fundamental and intrinsic mechanism, thereby overstating the impact of profitability.

As regards banking supervision, the ECB concurs with the recommendations to address gaps in governance regulations and to escalate corrective supervisory measures for weak banks. In particular, we welcome IMF's recommendation that gaps in governance regulations of banks should be remedied as soon as possible. This is a key step to ensure a full transposition of Article 91 of CRD.

We would also like to draw Staff's attention to the fact that the ECB has already implemented measures that address some of the Staff recommendations. Namely the recommendations to 'Enhance banks capital levels, as appropriate, to ensure all banks maintain adequate capital ratios under stress scenarios' and to 'Continue scrutinizing banks credit risk and loan classification and provisioning practices, particularly of UTP portfolios, and to challenge progress and ambition of banks' NPL reduction plans' have already been implemented in the direct supervision of Significant Institutions.

As regards macroprudential policy, the ECB concurs with the IMF recommendation regarding the establishment of a national macroprudential authority and the enhancement of the legal basis for certain tools. Should the macroprudential authority be set up in a way that other Italian authorities are involved, assigning the leading role to the national central bank is paramount and in line with international best practice. Moreover, we support the IMF recommendations to enhance the national legal basis for macroprudential tools (for the systemic risk buffer and for borrower-based measures) and their implementation. At present, BdI has broad legal powers to issue regulation to contain risks in the banking sector, yet there is no precedent that these powers could be used to implement borrower-based measures similar to countries that have a well-defined toolkit in national laws. Experience from other countries suggests that it can take significant time to create an appropriate legal basis, calibrate measures and apply them, if needed, which supports the case for establishing a legal basis early on to support the ability to act in a timely manner.