THE ITALIAN VIEW
THE NARROW PATH

Issue#02 | August 2017 | www.mef.gov.it | Italian Ministry of Economy and Finance

Ministero dell'Economia e delle Finanze

THE ITALIAN BANKING SYSTEM AT A TURNING POINT

The Italian banking system has long since been waiting for a comprehensive reform addressing structural inefficiencies and structural rigidities. As of 2014, the Government has defined **a comprehensive reform plan while also tackling the crisis affecting several banks**.

To begin with this latter topic, **three interventions involved seven banks** that were experiencing major strains. The first intervention required the resolution of four small and medium-sized regional banks that led to the formation of "bridge banks" in charge of continuing operations, thus rescuing 12 billion euros in savings for about 1 million customers.

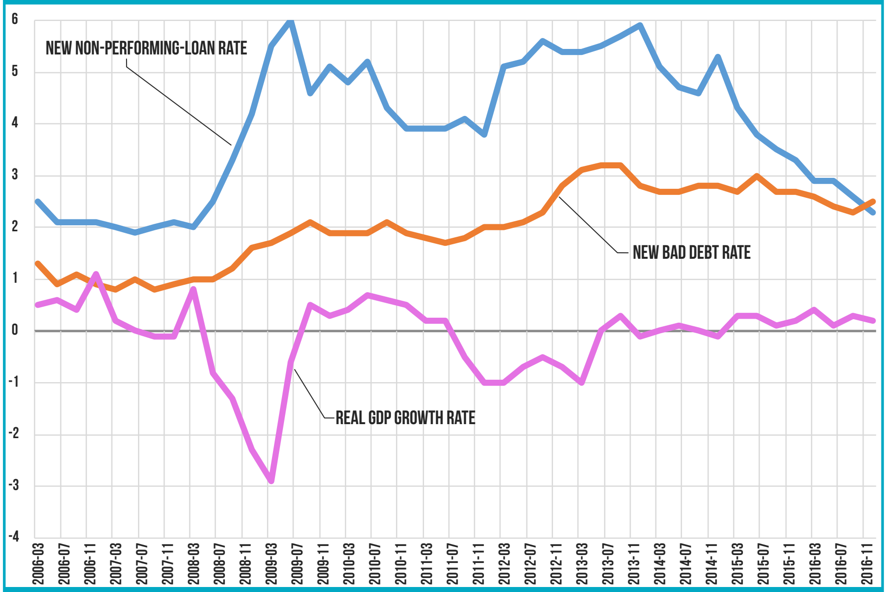
The resolution procedures ended in April 2017 with the sale of three "bridge banks" to a larger bank (UBI). BPER acquired the fourth in June 2017. Buyers were selected through a fair, open and transparent procedure. This resolution did not imply any State aid, thus requiring a major effort by the banking sector. The private sector provided 4.7 billion euros to avoid bankruptcy and its social and entrepreneurial consequences, preserving the issue of loans to over 200,000 small and medium-sized businesses, small retailers and craftsmen.

More recently, the Government intervention was addressed to the liquidation of Banca Popolare di Vicenza and Veneto Banca. After the ECB recognized the two banks as "failing or likely to fail", the Single Resolution Board stated - under the EU Banking Recovery and Resolution Directive - that the crisis had to be dealt with according to national insolvency rules, since a resolution was not applicable. Consequently, the Italian Government started a liquidation procedure assisted by public resources combined with the sale of some assets and liabilities of the two banks to Intesa Sanpaolo. The Government, after having shared the burden of the intervention with shareholders and junior bondholders, committed around 4.8 billion euros in cash and around 12 billion euros in guarantees for that purpose. As in previous cases, **the procedure preserved the flow of credit to clients of the insolvent banks (families, businesses, craftsmen)**, and limited the impact on the social and business environments of one of the best performing regions in the Country.

Eventually, the precautionary recapitalization of Monte dei Paschi di Siena was approved at the beginning of July by the European Commission, as part of the restructuring plan 2017-2021, including the disposal of 28.6 billion euros of gross bad loans. **The recapitalization was needed to put the bank in conditions to successfully face the adverse scenario** of the stress tests that the ECB ran in 2016. The precautionary recapitalization includes 3.9 billion euros of direct capital injection and up to 1.5 billion euros of compensation in favor of retail subordinated bondholders, meeting certain conditions, whose bonds are mandatorily converted into equity.

By facing each case with a suitable solution, according to the specific nature and magnitude, both European and Italian rules could be **implemented offering the best possible solutions**. Improvements in the banking industry are a different matter altogether, they require a deeper and more thorough

CREDIT RISK INDICATORS AND GDP GROWTH
(QUARTERLY DATA; PER CENT AND GROWTH RATE)



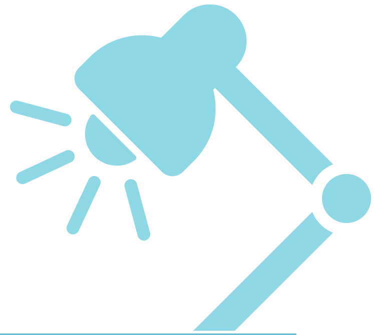
SOURCE: BANK OF ITALY, FINANCIAL STABILITY REPORT I/17

INDUSTRIAL PRODUCTION 02
DIGITALY 03
SPENDING REVIEW 04

approach, to be pursued through structural reforms designed to reduce inefficiencies and address the issue of non-performing loans (NPLs).
The reform of large cooperative banks (the so-called "Popolari"), introduced as early as January 2015, aims at **consolidating and bolstering the Italian banking system**. Banks included in the cluster were forced to transform into joint stock companies, and as a result, two of them merged, creating the third largest group in Italy. The reform of smaller cooperative banks promotes consolidation in the industry, as well as the adoption of more efficient business models reducing the exposure to market risks. Finally, the self-reform of banking foundations is meant to put **greater emphasis on the community-based initiatives of the foundations** in place of interfering with the management of participated banks.

Alongside such structural reforms of the banking sector, the Government has adopted measures to **encourage the creation** of a market for non-performing loans, which helps to **reduce the burden** of those assets and **restore an adequate flow of lending to the real economy**.
These provisions include the institution of a guarantee on the Securitization of Bad Loans (GACS), which is a State guarantee on ABS' senior tranches granted upon request by the banks. Changes to Italian insolvency rules and to foreclosures procedures also may help in creating a market for NPLs, as they improve the efficiency of insolvency proceedings and streamline the enforcements of creditors' rights. The legislation now includes a series of measures to reduce lead-time for foreclosures such as: competition in pre-bankruptcy agreements with creditors; acceleration of sale transactions to ensure higher NPLs value; new rules for debt restructuring; easier access to credit for troubled companies; amendment of the regulations governing the deductibility of credit losses; and agreements secured by real estate assets, where parties may agree that transfer of the assets will become effective upon default by the borrower.

Even after facing a long recession, **the Italian banking sector has proven to be sound and resilient.** The stock of NPLs is shrinking at an increasing pace, while the origination rate of new exposure is approaching pre-crisis level. Those comprehensive interventions on specific banks and on the industry as a whole reduced and in some cases excluded major sources of risk. Overall, after years of adjustments, the Italian banking industry is returning to positive, effective and promising levels of performance.



INDUSTRIAL PRODUCTION

RECENT DATA CONFIRM THAT THE RECOVERY IS TAKING HOLD

In May, industrial production rose by 1.5% on previous month, setting the average of the last three months to 0.9% on the previous quarter. The internal market contributed to this increase by 1.6 while the external sector contributed by 1.2%. The same variable marks an increase by 7.6% if compared to May 2016.

Industrial orders are up by 4.3%. Internal orders rose by 3.9% while the external sector registered an increase by 4.9%. If compared to May 2016 this index registered a **13.7% increase**.

INDUSTRIAL PRODUCTION

MAY 2017

+7.6%

YEAR ON YEAR

SOURCE: ISTAT (DESEASONALISED)

INDUSTRIAL ORDERS

MAY 2017

+13.7%

YEAR ON YEAR

SOURCE: ISTAT (DESEASONALISED)

DIG|TALY

A PLAN FOR DIGITAL TRANSFORMATION

Italy is launching its most radical Public Sector transformation plan by setting up an ambitious digitalisation strategy.

The Prime Minister, Paolo Gentiloni, recently signed the Three Year Plan for Digital Transformation of the Public Administration.

The Digital Transformation Team, led by the Government Commissioner for the Digital Agenda, Diego Piacentini, designed the Plan in line with the objectives of the European eGovernment Action Plan 2016–2020.

It will guide the Public Sector through a comprehensive and coherent process of digital transformation.

The Plan is fostering investments in technology across the Public Sector, according to a strategic 2017–2019 vision for new digital infrastructures.

Once in place, the new technology will enable the administration to deliver simpler and more effective services to citizens and businesses by adopting: flexible methods; a mobile first approach; secure, interoperable, scalable, highly reliable digital architectures, based on clearly defined application programming interfaces (APIs).

The open source paradigm and the collaborative approach are part of the Government strategy.

The Plan is aimed at information technology officers in the Public Service – national and local authorities – and the wider audience of public managers.

The digital transformation is already introducing a leap in the quality of public goods and services provided to citizens and businesses. The preliminary results are extremely encouraging.

MAIN FACTS SOURCE: AGENCY FOR DIGITAL ITALY

ELECTRONIC INVOICES ISSUED TO PUBLIC ADMINISTRATIONS	62 MILLION FROM JANUARY 2015 UNTIL MARCH 2017
DIGITAL IDENTITIES RELEASED	1.6 MILLION
ONLINE PAYMENT TO THE PUBLIC SECTOR	70% OF PUBLIC ADMINISTRATIONS ACCEPT ELECTRONIC PAYMENTS
DIGITAL HEALTH FILES	10/20 ITALIAN REGIONS THAT HAVE ALREADY IMPLEMENTED THE DIGITAL HEALTH FILE

SPENDING REVIEW:
THE NEW BUDGET RULES AND THE PUBLIC PROCUREMENT SYSTEM

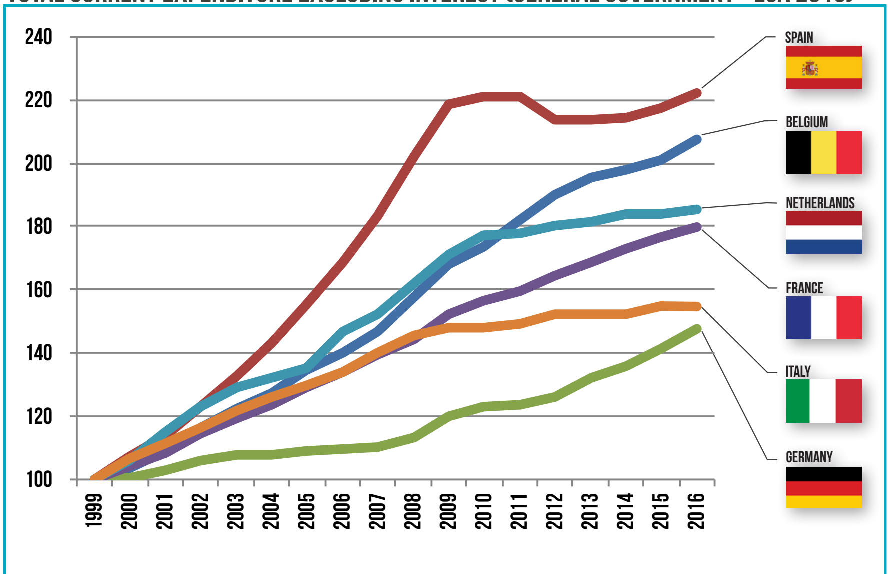
The Narrow Path is not only about quantity but also about the quality of fiscal consolidation. Expenditure cuts and the tax reform fully took into account the impact on potential and cyclical growth.

As a crucial part of the Government's strategy, **the Spending Review earmarked 25 billion euros in 2016, 30.3 in 2017, 31.7 in 2018 and in 2019 24.5 billion euros worth of public funds to be allocated over the next few years**. The Spending Review is not only about spending less but it is especially about diverting savings towards priority policies in order to boost growth.

The 2017 Budget will be the first according to the new set of Budget rules. The new system includes an annual spending review exercise that is now compulsory and fully embedded in the Budget process. Under the new regime **all Ministries will be responsible of their own annual revision of spending** that will nevertheless preserve ring-fenced areas as: public investment, prevention and mitigation of natural disasters, post-earthquake reconstruction, migration and the fight against poverty. The new mechanism will contribute to sustaining the current effort of keeping public spending under control, which has already brought good results if compared to our partners in the euro area.

The reduction in the number of public procurement centres plays a central role in securing the results of the spending review and in permanently increasing quality and efficiency. Until recently, there were more than 36,000 entitled procurement centres. **Now, only 32 procurement entities can make bids above the EU ceiling. Others can only operate through digital platforms for purchases below that threshold, dealing with qualified suppliers. In 2016, the new procurement system through the digital platforms allowed a 23% decrease over 2015 in the average price for each single unit purchased.**

TOTAL CURRENT EXPENDITURE EXCLUDING INTEREST (GENERAL GOVERNMENT - ESA 2010)



SOURCE: EUROPEAN COMMISSION ANNUAL MACROECONOMIC DATABASE

PUBLIC FINANCE:
4 POINTS BEYOND THE COMMONPLACE

Since 2014, Italy has been striking the balance between stimulating cyclical and potential growth while stabilising high public debt. This is the Narrow Path.

Let us look more closely at the details of Italy's fiscal adjustment since the financial crisis. Some regular observers might be surprised.

01 Italy's control over public finance has been among the most solid in the Eurozone in the last 7 years. Between 2009 and 2016, only six Eurozone countries had a deficit below 3 per cent. Since 2012, Italy has been consistently below the 3% ceiling and the 9 year average deficit was 3.4 per cent despite the larger GDP contraction. The official deficit forecast for 2017 is 2.1.

02 If we take a closer look at debt composition and consider primary balances, Italy is the country that, together with Germany, maintained the highest primary surplus on average (1.1 per cent) during the 2009-16 period.

03 Italy is the country that put in place the most significant public finance consolidation measures in the euro area after Greece. Indeed, if we correct the primary balance series for the cycle, Italy's consolidation effort turns out to be the strongest after Greece, that received financial assistance.

04 Italy ranks among the low risk countries with regard to long-term public finance sustainability, according to the European Commission's S2 indicator that measures the long-term resilience of public finances.

FOCUS
CONSOLIDATION AND PROMOTING GROWTH
WWW.MEF.GOV.IT/CONSOLIDATION/

WWW.MEF.GOV.IT
COMUNICAZIONE.MEF@MEF.GOV.IT

In Italy, since the financial crisis, our duty as policy makers has been stabilising a high public debt while bringing the economy out of sluggish or negative growth and The Narrow Path is an image of the difficulties we are facing and the goals we are achieving. Here we update periodically a professional audience about the evolution of structural conditions affecting the economic activity in the country.