

THE OPERATING CONTEXT



Economic and social scenario

ECONOMIC TRENDS IN 2016

In 2016, the world economy continued its moderate growth trend. Commodity prices picked up. The outcome of the UK referendum on staying in the European Union led to a considerable depreciation in the pound. In the United States, growth in employment and income continued at a steady pace. In December, the Federal Reserve raised official rates by 25 base points. Asia was the most dynamic region of emerging economies, even though the growth rate slowed down in India and China, while Latin America and CSI countries reported a further downturn in GDP. In the euro area, the annual variation in GDP was just above 1.5%, which was sufficient for a progressive fall in the unemployment rate. Inflation gradually rose to 1.1%. In March, the ECB cut the deposits rate to -0.40%, the main refinancing rate to zero, and marginal lending rate to 0.25%. It increased the scope of the purchase programme to 80 billion a month and the duration to the end of 2017. A new long term refinancing programme, TLTRO II, was also launched. The euro/dollar exchange rate fluctuated considerably during 2016: appreciation was followed by a gradual weakening, to close the year at 1.05.

In Italy, economic growth came to a near standstill in the second quarter, picking up in the rest of the year. The annual variation in GDP was 1% throughout 2016, for calendar-adjusted values and +0.9% for raw data. Industrial production continued to increase and employment went up for the third year running, to +1.3% from +0.8% in 2015. However, the rate of unemployment only decreased slightly (from 11.9% to 11.7% on average per year), due to an increase in the labour force participation rate (the rate of activity went up from 64.1% to 64.9%, reaching a new record high). The youth unemployment rate fell to a greater extent, although figures were still high (37.8% on average in 2016 against 40.4% in 2015). However, the positive effect of welfare cuts for new fixed-term employment on permanent employment figures diminished during the year (reduced by 40% compared to the previous year). On an international level, the Italian economy maintained a considerable surplus in current items of the balance of payments.

As for tax policies, the public deficit in relation to GDP improved compared to 2015, however the debt/GDP ratio grew marginally. The spread for German debt went up, above all due to the uncertainty of the referendum of 4 December and banking system tensions. The quick resolution to the government crisis

which followed, and extension of the ECB purchase programme reassured investors, even though various rating agencies revised their debt outlook downwards. The BTP-Bund differential, for a ten-year maturity, closed at 162 bps, up by 68 bps from June. The spread for Italian public debt reached an all-time low of 1.05% on 14 August, closing the year at 1.83%.

THE CREDIT MARKET

Bank loans for the private sector picked up in 2016, albeit at a moderate pace, reaching around 1% in autumn. The recovery was supported by the dynamics of household loans, which gradually increased to a figure of 1.9% yoy in December. The upswing in household loans was driven by a very buoyant residential mortgage sector, due to new loans and the renegotiation of existing ones. Specifically, the growth in fixed-rate loans continued, due to the very low levels of interest rates applied and a smaller spread between fixed and floating rates. The increase in new loans is consistent with the upturn in the residential property market, with double digit dynamics. Consumer credit also went up, driven by purchases of durable goods.

On the contrary, the trend in loans to non-financial companies was still sluggish overall. The increase in medium term loans continued to be offset by the negative performance of short term loans, in a scenario where the liquidity of most companies is rated as sufficient or more than sufficient. The trend is due to different dynamics per sector and size of business. In particular, loans to the manufacturing industry, after increasing in the first half of the year, weakened, while the decrease in loans for the construction industry was accentuated. Conversely, loans for the services sector recovered during the year. As regards borrower size, loans to medium/large companies came to a standstill, while loans to small businesses continued to decrease. The business loan trend must be considered in the context of a demand/supply which was still improving during the first half of the year and then settled during the second half, with a selective boost from demand from some segments. According to a credit survey of banks conducted by the Bank of Italy, demand from businesses, after a particularly robust start to the year, gradually weakened. Conversely, ratings and expectations of household loan applications remained extremely positive throughout 2016, recording a considerable increase. Demand for mortgages was

particularly buoyant and consumer credit also picked up. Company ratings also confirmed improved credit access conditions.

Credit quality indexes improved. After a slow-down in growth, non-performing loans started to fall in the last part of the year, due to disposals and securitisation. Non-performing loans stabilised in relation to total loans. The number of new non-performing loans slowed down visibly, reaching a record low since mid-2008 in the third quarter, in terms of flow in relation to performing loans.

Credit market conditions were favourable, with bank rates at all-time lows. During 2016, bank rates fell further, and then levelled off, above all at the end of the year. As regards rates for new loans to non-financial companies, the decrease was evident above all in the two middle quarters of the year, slowing down in the last part. Spreads with the euro area were annulled for minor loans and were negative for loans above 1 million. Rates for new residential mortgages reached all-time lows, and then settled at the end of the year. In this context, rates on loans continued to fall, with the overall average falling to below 3% from halfway through the year, to all-time lows.

SAVINGS AND BANK DEPOSITS

The growth in real disposable income supported the savings rate of Italian households in 2016. However, negative periods of financial markets, with uncertainty and considerable volatility, had an impact on household loan operations, with figures slightly down year on year. In terms of investment approaches, trends of ongoing investors' asset restructuring were confirmed. In a context of very low interest rates, household investments were mainly focused on asset management, albeit to a lesser extent than 2015, and bank current account deposits continued to grow considerably, due to the low-cost opportunities of holding liquidity. Conversely and also as a result of banks' reduced funding needs, the collapse of bonds continued and time deposits confirmed their downturn. Similarly to the four previous years, divestments of government securities – penalised by low yields – continued. Despite a considerable uncertainty, the asset management industry was robust, with a positive performance and increase in stock. Funding was fairly substantial in the first quarter, and then affected by the outcome of the UK referendum, picking up in the second half of the year. Therefore, the financial portfolio of households saw a further increase in the incidence of mutual funds and insurance and pension products.