INTERNATIONAL MONETARY FUND

IMF Country Report No. 19/40

ITALY

February 2019

2018 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR ITALY

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2018 Article IV consultation with Italy, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its January 25, 2019 consideration of the staff report that concluded the Article IV consultation with Italy.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on January 25, 2019, following discussions that ended on November 13, 2018, with the officials of Italy on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on December 18, 2018.
- An **Informational Annex** prepared by the IMF staff.
- A **Staff Supplement** updating information on recent developments.
- A **Statement by the Executive Director** for Italy.

The documents listed below have been or will be separately released.

Selected Issues

The IMF's transparency policy allows for the deletion of market-sensitive information and premature disclosure of the authorities' policy intentions in published staff reports and other documents.

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INTERNATIONAL MONETARY FUND

COM COMMUNICATIONS DEPARTMENT

Press Release No. 19/31
FOR IMMEDIATE RELEASE
February 6, 2019

International Monetary Fund
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Washington, D. C. 20431 USA

IMF Executive Board Concludes 2018 Article IV Consultation with Italy

On January 25, 2019, the Executive Board of the International Monetary Fund (IMF) concluded the 2018 Article IV consultation[1] with Italy.

The Italian economy has been recovering modestly from the global financial and euro area sovereign debt crises. Employment and labor force participation have risen, unemployment has fallen, and banks' nonperforming loans have declined. Nevertheless, significant challenges remain. Real incomes per capita are still near the level of two decades ago and have fallen steadily behind euro area peers, poverty rates are elevated, and public debt is very high.

After growing by 1.6 percent in 2017, the fastest in nearly a decade, economic growth slowed in 2018. This reflected slower euro area growth, adverse terms of trade, and higher domestic policy uncertainty as evidenced in elevated sovereign borrowing costs. Growth is projected at 1 percent in 2018, 0.6 percent in 2019, and below 1 percent in 2020 and beyond.

The new government, which took office in June 2018, intends to lift growth and social outcomes. It is implementing measures to facilitate early retirement, tackle poverty, undertake active labor market policies, and increase public investment, among others.

Executive Board Assessment[2]

Executive Directors noted that Italy's longstanding structural weaknesses have contributed to a challenging economic situation, including sluggish income growth, elevated unemployment, and high public debt. They welcomed the authorities' focus on supporting growth and improving social outcomes as well as the recent moderation of the 2019 fiscal plans. Directors welcomed the authorities' intention to put high public debt on a firm downward path, in view of the downside risks. They generally noted, however, that the authorities' strategy falls short of comprehensive reforms needed to address the longstanding structural impediments to sustained

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board.

[2] At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

growth and, therefore, risks leaving the economy vulnerable. They recommended that priority needs to be given to implementing a comprehensive package of structural reforms, growth-friendly and inclusive fiscal consolidation, and further strengthening bank balance sheets.

Directors emphasized that decisive structural reforms to raise productivity and unlock Italy's potential are critical to improve economic outcomes and enhance resilience. In this context, they welcomed the adoption of the new general insolvency framework, the anti-corruption law, and the measures to enhance public investment management, as well as the authorities' intention to cut red tape and simplify administrative procedures. Directors underscored the need to liberalize product and service markets and reduce the size of and uncertainty over dismissal costs. Directors encouraged the authorities to decentralize wage bargaining, although a number of Directors acknowledged potential political economy challenges. They supported implementing these reforms as a comprehensive package that would yield important synergies and reduce structural unemployment as well as raise productivity and investment. Directors also called for further progress in streamlining procurement and reforming local state-owned enterprises.

Directors considered that credible and high-quality fiscal consolidation is key to putting public debt firmly on a downward path and reducing sovereign spreads. They recommended a gradual and balanced adjustment toward a small overall surplus in the medium term. Some Directors concurred with a consolidation pace that is broadly consistent with the preventive arm of the Stability and Growth Pact. Directors emphasized that fiscal adjustment should be underpinned by high-quality measures to promote growth and social inclusion. They underscored the need to protect the poor by means of a modern guaranteed minimum income program, reduce current spending, avoid reversing past pension reforms, and raise public investment. Directors also highlighted the need to broaden the tax base—including by addressing large VAT compliance gaps, rationalizing other tax expenditures, avoiding tax amnesties, prioritizing strict enforcement and introducing a modern property tax on primary residences—and lower the tax wedge on labor.

Directors emphasized that safeguarding public finances is essential to financial sector stability. They welcomed the important progress in reducing non-performing loans, increasing provisions and building capital buffers. Directors noted that weak profitability and sustained high sovereign yields pose challenges to the banking system. They encouraged further strengthening the banking system and also emphasized the importance of continuing to reduce costs and non-performing loans, and strengthening bank governance. They considered that the consolidation of cooperative banks into three new banking groups should be completed promptly while subjecting all three groups to asset quality reviews. Directors further stressed that swift recapitalization of weaker banks or timely and effective use of the resolution framework is essential to address outstanding weaknesses, and avoid excessive costs to the taxpayers and the rest of the banking system.

Italy: Selected Economic Indicators, 2017–23

(Annual percentage change, unless noted otherwise)

		Projections					
	2017	2018	2019	2020	2021	2022	2023
Real GDP	1.6	1.0	0.6	0.9	0.7	0.6	0.6
Real domestic demand	1.3	1.1	0.6	1.1	0.8	0.6	0.6
Final domestic demand	1.7	1.0	0.7	1.0	0.8	0.6	0.6
Private consumption	1.5	0.6	0.7	1.1	0.8	0.7	0.6
Public consumption	-0.1	0.3	-0.1	0.9	0.6	0.5	0.5
Gross fixed capital formation	4.3	3.2	1.4	1.0	0.6	0.6	0.7
Stock building 1/	-0.3	0.1	0.0	0.0	0.0	0.0	0.0
Net exports 1/	0.3	-0.1	0.0	-0.1	-0.1	0.0	0.0
Exports of goods and services	5.7	2.4	1.8	1.7	1.5	1.4	1.3
Imports of goods and services	5.2	3.1	2.0	2.1	2.0	1.6	1.3
Savings 2/	20.4	20.7	20.7	20.6	20.4	20.4	20.3
Investment 2/	17.6	18.3	18.2	18.3	18.5	18.7	18.9
Resource utilization							
Potential GDP	0.4	0.4	0.4	0.5	0.5	0.6	0.6
Output gap (percent of potential)	-1.5	-0.9	-0.6	-0.2	-0.1	-0.1	-0.1
Employment	1.2	1.2	0.6	0.7	0.6	0.5	0.4
Unemployment rate (percent)	11.3	10.7	10.5	10.3	10.1	10.0	9.9
Prices							
GDP deflator	0.5	1.1	1.5	1.5	1.6	1.7	1.7
Consumer prices	1.3	1.2	1.3	1.5	1.6	1.7	1.7
Hourly compensation 3/	1.2	1.9	1.9	1.9	2.0	2.1	2.2
Productivity 3/	2.1	0.3	0.2	0.5	0.3	0.4	0.4
Unit labor costs 3/	-1.0	1.6	1.6	1.5	1.7	1.7	1.8
Fiscal indicators							
General government net lending/borrowing 2/	-2.4	-1.9	-2.1	-2.9	-3.0	-3.0	-3.0
General government primary balance 2/ 4/	1.3	1.6	1.4	0.7	0.7	0.8	1.0
Structural overall balance (percent of potential GDP)	-1.6	-1.5	-1.8	-2.8	-3.0	-3.0	-3.0
Structural primary balance (percent of potential GDP) 4/	2.0	2.0	1.7	0.9	0.8	0.9	1.1
General government gross debt 2/	131.2	131.4	130.9	130.7	130.9	131.0	131.1
Exchange rate regime							
Exchange rate (national currency per U.S. dollar)	0.9	0.8	...	...	...	...	...
External sector 2/							
Current account balance	2.8	2.4	2.5	2.2	1.9	1.7	1.4
Trade balance	3.2	2.5	2.7	2.5	2.2	2.0	1.8

Sources: National Authorities; and IMF staff estimates.

1/ Contribution to growth.

2/ Percent of GDP.

3/ In industry (including construction).

4/ Primary revenue minus primary expenditure.

INTERNATIONAL MONETARY FUND

ITALY

STAFF REPORT FOR THE 2018 ARTICLE IV CONSULTATION

December 18, 2018

KEY ISSUES

Developments. A new government took office in June 2018 on a platform to improve growth and social outcomes. It has inherited a challenging situation—notwithstanding the recovery of the past few years, real incomes remain at the levels of two decades ago, unemployment is elevated, poverty has risen, and public debt is very high. Its policies center on a sizable fiscal stimulus, with plans to assist the poor, raise public investment and partially reverse pension reforms, among others. But this has increased debt sustainability concerns. In recent months, sovereign spreads vis-à-vis German bunds have jumped to multi-year highs while bank valuations have shrunk by about one third. Italy and the European Commission (EC) are discussing potential revisions of the fiscal plan in relation to the EC's excessive deficit procedure.

Outlook. Growth has slowed; the risk of a recession has risen. Although the planned stimulus could lift growth temporarily, rising funding costs for banks and the sovereign risk undermining growth further. Market concerns could attenuate somewhat in the near term if there is a potential deal between Italy and the EC. Staff is nonetheless concerned that the authorities' policies could leave Italy vulnerable to a renewed loss of market confidence, even in the absence of further shocks. Moreover, debt could increase sooner and faster if new challenges materialize; Italy could then be forced into a notable fiscal contraction, pushing a weakening economy into a recession. The burden would fall disproportionately on the vulnerable.

Recommendations. The authorities' objective to improve economic and social outcomes is welcome. However, faster potential growth is the only durable way for Italy to improve outcomes and enhance resilience. Staff recommends a package of structural reforms, a credible fiscal consolidation based on growth-friendly and inclusive measures, and bank balance sheet strengthening:

- *Structural reforms*: decentralize wage bargaining to align wages with productivity at the firm level; pursue ambitious service market liberalization; reform the public administration; and modernize the insolvency system.
- *Fiscal policy:* undertake a modest and balanced consolidation to ensure that debt declines—by cutting current spending, modernizing the safety net for the poor, increasing public investment, broadening the tax base, and lowering taxes on labor.
- *Financial stability*: continue progress in reducing nonperforming loans, restructuring operations and improving profitability; consolidate and rationalize smaller banks; build capital buffers that are effective in resolution; and improve governance.

Approved By
Mahmood Pradhan (EUR) and Tamim Bayoumi (SPR)

The mission visited Rome, Milan and Frankfurt during July 12–26, 2018, and Rome and Frankfurt during November 6–14, 2018. It comprised Rishi Goyal (head), Nazim Belhocine, Daniel Garcia-Macia, Alvar Kangur, Mehdi Raissi (all EUR), and Dermot Monaghan (MCM). Poul Thomsen (EUR) attended the concluding meetings. Alessandro Leipold, Domenico Fanizza, and Cristina Collura (OED) also attended at various times. The mission met with Deputy Prime Minister Di Maio, Finance Minister Tria, Bank of Italy Governor Visco, European Affairs Minister Savona, Justice Minister Bonafede, Public Administration Minister Bongiorno, Cabinet Secretary Giorgetti, parliamentarians, senior government and SSM officials, as well as representatives from the private sector, financial sector, academia, and trade unions. José Garrido (LEG), Marta Burova and David Velazquez-Romero (both EUR) assisted from headquarters.

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CONTEXT

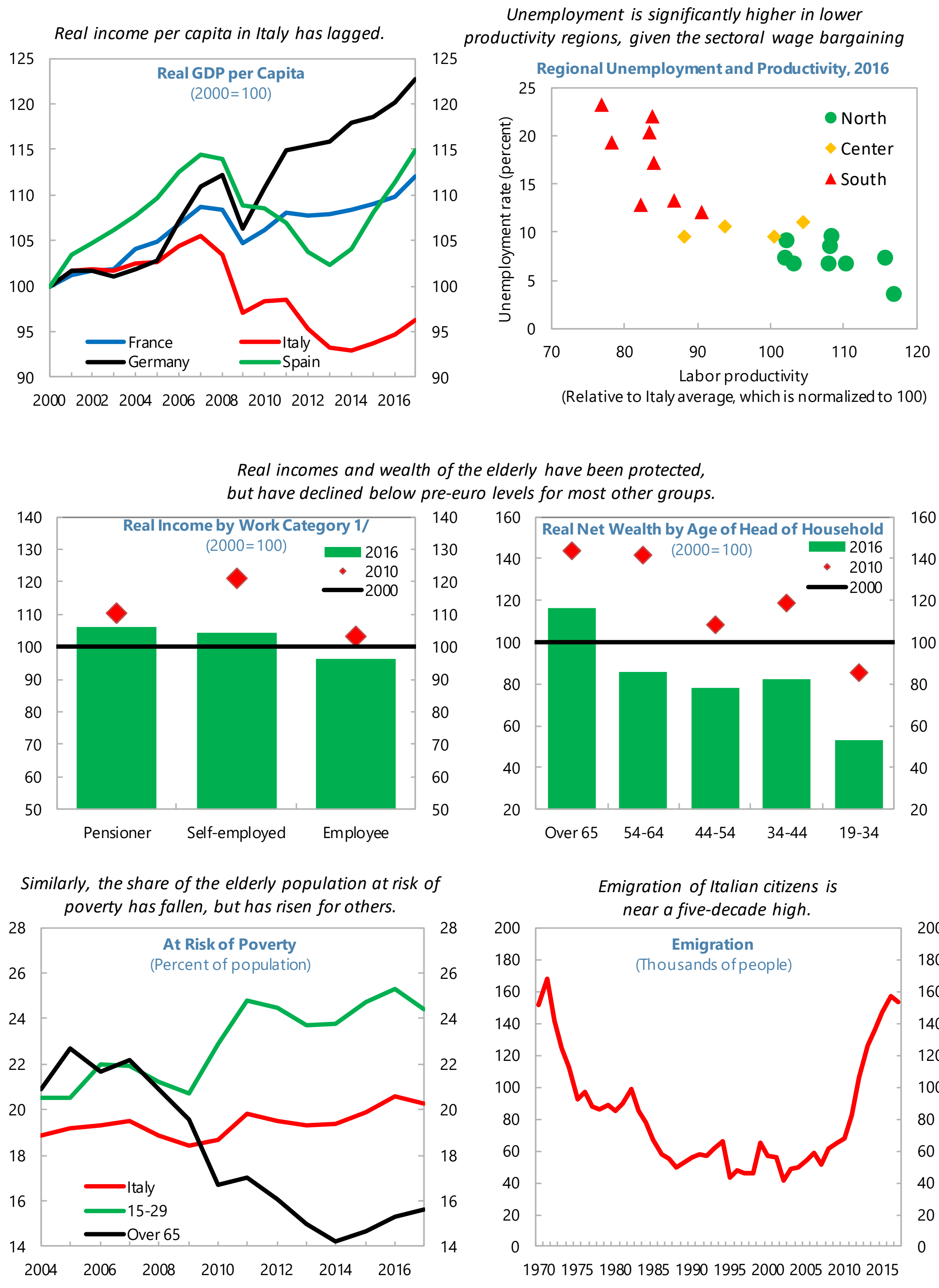
1. Italy has been struggling with low economic growth and poor social outcomes. Real incomes per capita are at the level of two decades ago and have fallen steadily behind those in euro area peers. Unemployment has averaged 10 percent since the 1990s, through multiple economic cycles; it is markedly higher in lower productivity regions. The living standards of middle-aged and younger generations have eroded. Over 20 percent of households are at risk of poverty. Emigration of Italian citizens is near a five-decade high (Figure 1).

2. Structural weaknesses are at the core of this economic underperformance. Total factor productivity has been weak since the 1990s, stagnating in the tradable sector and declining in the non-tradable sector (Figure 2; IMF working papers 18/33 and 18/61). Constrained by rigidities such as market inefficiencies, high taxation and an inefficient public sector that successive governments have been unable to redress effectively, Italian firms struggled to adapt to global technological and trade developments. Wage growth outpaced productivity growth, contributing to high structural unemployment. Easy access to finance pre-crisis boosted demand, but the double-dip recession earlier this decade and the subsequent tightening of credit conditions set Italy back further. Unit labor costs in manufacturing remain well above the euro area average, impairing competitiveness, investment, and a robust recovery. Implementing structural reforms, such as decentralizing wage bargaining and liberalizing service markets, are, thus, of overarching importance.

3. High public debt and an inadequate composition of fiscal policy have also contributed to Italy's underperformance. Public debt, above 130 percent of GDP and the second highest in Europe, has been a perennial source of vulnerability. Fears of sustainability led to Italy's double-dip recession and deepest post-war downturn just a few years ago. Italy has run primary fiscal surpluses that on average were higher than its euro area peers, but these were insufficient to lower debt and secure stability. The quality of fiscal policy has also insufficiently supported growth or shielded the vulnerable. The burden of high taxes has fallen on labor (not wealth), public investment has been squeezed, and social benefits have centered on generous pensions, treating (as in the rest of Europe) poverty principally as an old-age issue. These policies have favored older generations at the expense of the young and working age population. Aiming for an adequate primary surplus to reduce debt, underpinned by high quality pro-growth and inclusive measures, is thus also important.

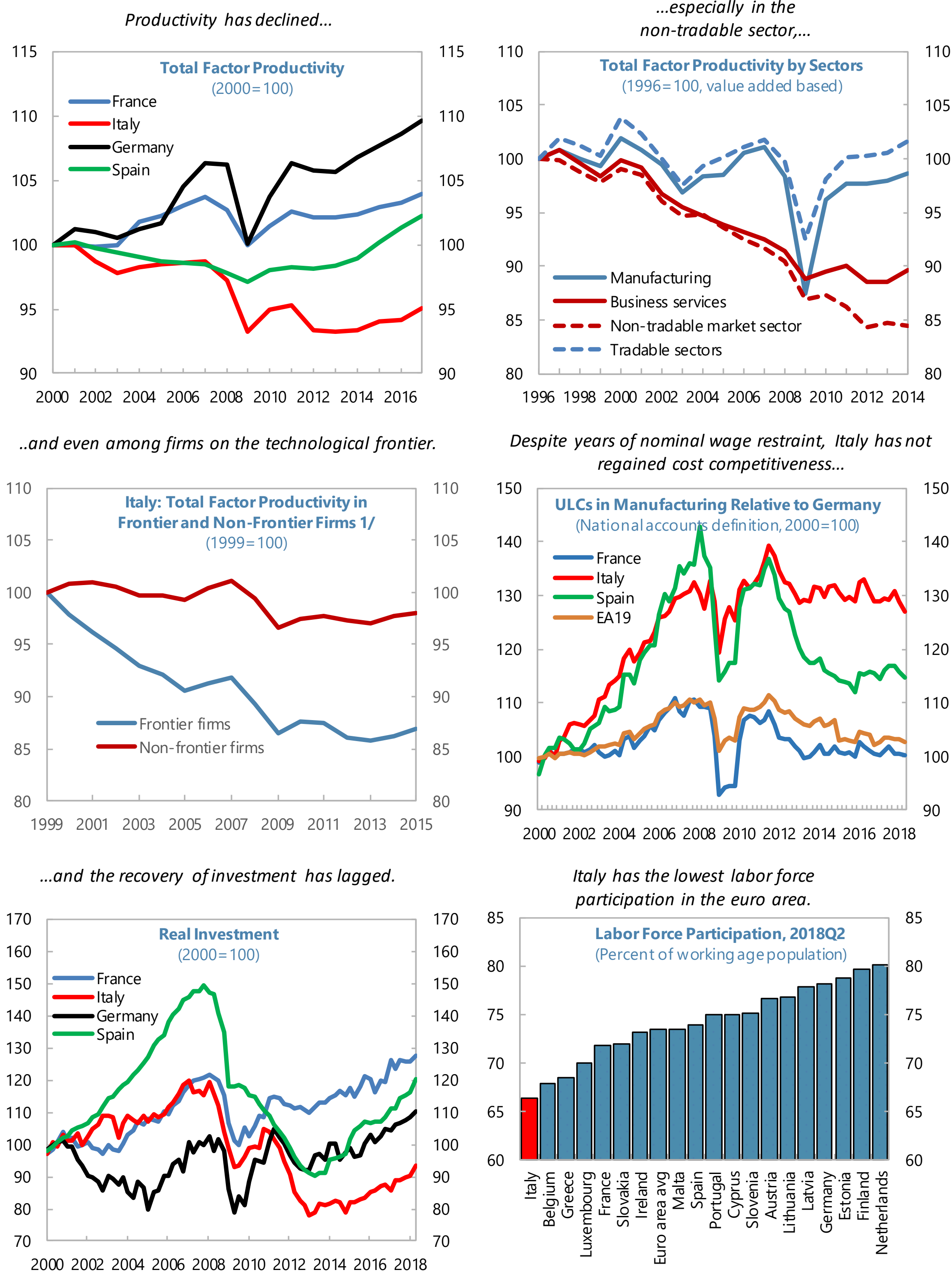
4. A new government took office with the goal of reigniting growth and supporting those left behind—through a large fiscal stimulus. A coalition government was formed in early June 2018 comprising the Five Star Movement and the League. Their platform centers on a sizable fiscal expansion, based on measures to facilitate earlier retirement, help the poor and unemployed, raise public investment, and reduce tax rates. The stimulus plan accelerates the trend since 2013 of easing fiscal policy to support growth. In fact, Italy has tightened fiscal policy in only three years since 2007 and only five years since euro accession.[1]

[1] During 2000–05, Italy eased fiscal policy—in structural primary terms—by 5½ percent of GDP versus 1 percent in the rest of the euro area. When the global financial crisis struck, it eased fiscal policy further by nearly 2 percent of GDP, before sharply tightening the stance in 2012–13. During 2014–17, it again eased fiscal policy by over 2 percent of GDP and spent entirely its considerable interest savings that emanated from accommodative monetary policy.



Sources: IMF, WEO; Eurostat; ISTAT; Bank of Italy; C.Bonifazi, 2009, "The Italian transition from an emigration to immigration country"; and IMF staff estimates.

Figure 2. Italy: Structural Problems Are at the Core of Italy's Underperformance, 1996–2018



Sources: Eurostat; EU KLEMS; Haver Analytics; and IMF staff estimates.
1/ Frontier firms are defined as those in top five percent of total factor productivity distribution in 1999. IMF Working Papers 18/33 and 18/61.

RECENT DEVELOPMENTS

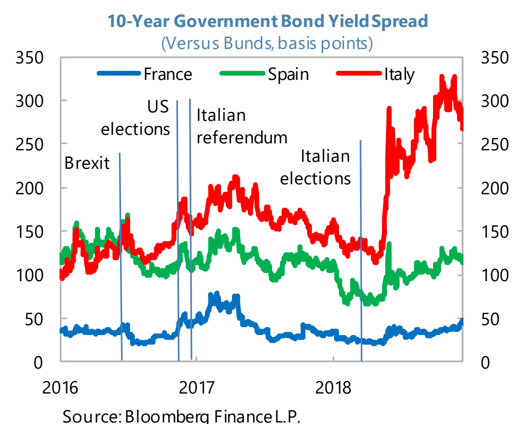
5. The economy grew relatively quickly in 2017 but has slowed since then. It grew by 1.6 percent in 2017, the fastest in nearly a decade, driven by robust euro area growth and accommodative monetary conditions. However, it slowed thereafter, contracting slightly on a sequential basis in 2018:Q3. Policy uncertainty—reflected in elevated sovereign spreads—is weighing on domestic demand; weaker external demand and high oil prices have also contributed. High-frequency indicators point to continued weakness: purchasing managers' indices signal contraction ahead, although consumer confidence indicators remain near post-crisis highs so far.

6. Labor market conditions have generally improved. Employment and labor force participation are at historical peaks, reflecting GDP growth, the dividends of the 2011 pension reform and the 2015 Jobs Act, and hiring incentives. Unemployment fell to 10.2 percent in 2018:Q3, close to its historical average, but involuntary part-time employment remains elevated. Contractual wages grew by 2 percent led by the public sector. Headline inflation rose to 1.6 percent driven by higher energy prices, but core inflation was subdued at 0.7 percent in November 2018.

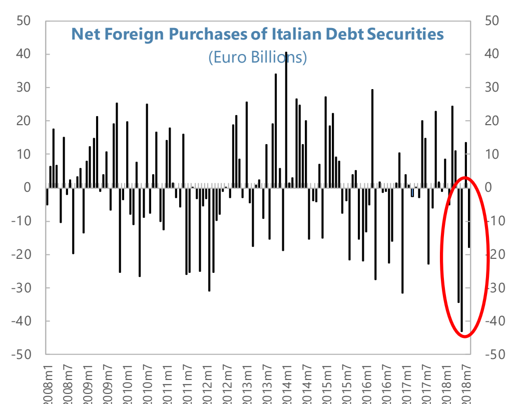
7. With economic growth outpacing potential growth, the output gap has narrowed. Subdued core inflation and increased involuntary part-time employment point to still prevailing slack. On the other hand, a job vacancy rate at its pre-crisis average, capacity utilization near historical peaks, and high structural unemployment indicate closing gaps. Staff applies judgment to favor arguments for greater slack and estimates a gap of about -1 percent for 2018, which is between those of the authorities and some other international institutions (Box 1).

8. Fiscal policy is set to expand sizably in 2019. The 2018 budget of the preceding government continued the practice of postponing previously-announced adjustment plans, repealing again legislated VAT rate hikes and failing to specify high-quality offsetting measures. For 2019, the new authorities plan to enact a sizable stimulus. The draft budget plan of November 2018 estimated that the structural primary surplus will deteriorate by ¾ percent of GDP next year and be constant thereafter. The corresponding headline deficit target is 2.4 percent of GDP in 2019, falling slowly to 1.8 percent in 2021. However, staff's and most external analysts' estimates are higher (¶30).

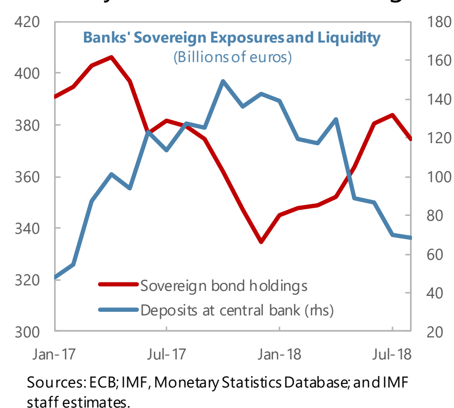
9. Market concern about the fiscal trajectory has led to higher yields and volatility. Since early May, the benchmark 10-year sovereign yield has increased to around 3–3½ percent. Spreads vis-à-vis German bunds were near their highest levels since early 2013. Moody's downgraded Italy to one notch above junk (with stable outlook); Fitch and S&P rate Italy at two notches above junk but have placed it on a negative outlook. Banks, seen as most exposed to the sovereign, have seen their market valuations decline by ⅓ in recent months.



10. Foreigners have been selling Italian securities while domestic residents have continued to build their net foreign asset position. These reflect concerns about Italian risk and relatively low investment returns domestically. Portfolio outflows intensified in Q2–Q3 totaling €72 billion, about 80 percent of which were related to government securities, and contributed to widening Italy's Target 2 balance to over €490 billion, an all-time high. Meanwhile, the external current account surplus has declined somewhat after reaching a multi-year high of 2.7 percent of GDP in 2017, as higher energy costs and weaker foreign demand have reduced the trade surplus. The external position is assessed to be broadly in line with fundamentals (Annex I). But with unit labor costs above euro area peers, the real effective exchange rate is moderately overvalued by 0–10 percent.



11. The Italian financial sector has stepped in to buy government securities, reinforcing the sovereign-bank link. The banking system bought about €45 billion since April 2018. The rise in sovereign spreads has adversely impacted banks' capital and insurance companies' solvency ratios.[2] Banks' costs of tapping wholesale funding have risen sharply and access to bond markets has been limited.[3] In November 2018, Unicredit, Italy's largest and one of its strongest banks, privately placed a dollar-denominated 5-year senior note at a coupon of about 7.8 percent, substantially higher than a similar 1 percent coupon euro-denominated bond issued in January 2018. In December 2018, a mid-sized bank issued a 10-year subordinated bond at a coupon of 13 percent. These highlight banks' challenges in accessing wholesale funding; if sustained, banks would likely be forced to deleverage. Banks' overall liquidity position appears adequate at present, benefiting from about €240 billion of TLTRO funds (or the Targeted Longer-Term Refinancing Operations of the Eurosystem), which fall due in 2020–21. Deposits have been stable. Passthrough to private sector borrowing rates has been relatively contained so far. Meanwhile, credit to the private sector has continued to grow modestly, including in 2018:Q3. Credit to households has grown since 2015, but credit to firms started to grow only in 2018. Among firms, it has been growing for the strongest firms but shrinking for weaker ones.



Sources: ECB; IMF, Monetary Statistics Database; and IMF staff estimates.

[2] The rise in sovereign yields contributed to a fall in tier 1 capital ratio of the banking sector by 40 basis points in 2018:Q2. According to the Bank of Italy, a 100 basis point increase in sovereign spreads could reduce the CET1 ratio of significant banks by 40 basis points and of less significant banks by 90 basis points (as the latter hold a larger share of their assets in sovereign bonds). The insurance sector holds over ⅓ of their assets in sovereign assets, with life insurers accounting for most of the exposure, and are required to mark their assets to market. Elevated spreads have resulted in solvency ratios falling by almost 10 percent on average; the generally long-term nature of the liabilities (unlike for banks), however, attenuates immediate concerns about stability.

[3] Outstanding bank bonds fell 17 percent year-on-year to €246 billion in September 2018. The maturing debt was predominantly converted into deposits, which contributed to keeping funding costs down and limited passthrough. Wholesale sources funded about €552 billion of Italian banking system liabilities as of August 2018.

12. Banks' asset quality has improved notably over the past year, but most banks struggle with weak profitability and are vulnerable to rising spreads and slowing growth. Gross nonperforming loans (NPLs) fell from 16½ percent of loans in 2015 to about 10 percent in mid-2018, mainly through sales. This is a notable reduction by any standard, though NPLs remain well above the 3.6 percent average of the main EU banks.[4] New NPL formation has fallen to pre-crisis levels. Provisioning coverage rose to 55 percent, 9 percent above the average of the main EU banks. In mid-2018, banks reported a common equity tier 1 (CET1) ratio of 13.2 percent, 0.6 percentage points less than at end-2017 and 1.3 percentage points below the average of the main EU banks.[5] The return on equity has improved, mostly due to lower provisioning and the transition to the IFRS9 accounting standard. But profitability continues to be weighed down by the high cost of capital and operating costs. Corporate health has improved, as enterprise default rates have fallen to pre-crisis levels; however, according to Cerved, the largest Italian provider of credit information for firms, nearly ½ of firms are still classified as vulnerable or risky, and profitability of small and medium-sized firms remains 20 percent below pre-crisis levels.

OUTLOOK AND RISKS

13. Growth is projected to slow further, and the risk of recession has risen. Headwinds have increased: euro area growth has been marked down, the terms of trade have deteriorated, and the ECB's net asset purchase program is to end. Without accounting for the rise in sovereign spreads, the fiscal stimulus could temporarily boost growth, if the authorities' plans are well targeted to high-multiplier activities, i.e., social benefits are provided to liquidity-constrained households and quality public investment projects are executed swiftly. These require well-designed social welfare and public investment management systems. However, the sharp rise in sovereign spreads would mitigate any temporary benefits of the planned stimulus in the near term; if persistent, they risk further undermining growth in the medium term (Box 2).[6] On balance, growth is projected to decline from 1.6 percent in 2017 to 1 percent in 2018, about ¾ percent in 2019–20, and 0.6 percent beyond.

14. Risks are significant and to the downside (Annex II). The extent to which risks materialize depends largely on Italy's policies**.** Perceptions of possible actions by its European partners and the ECB vis-à-vis banks' funding needs also matter**,** although these would not address sovereign funding needs**.**

- On the downside, elevated sovereign spreads could weigh further on domestic demand. Sizable gross fiscal financing needs—above 20 percent of GDP annually—mean that Italy must access markets regularly at sustainable yields, with the amounts to be absorbed by markets slated to

[4] The data for the main EU banks are from the EBA 2018 Transparency Exercise.

[5] Four of Italy's largest banks participated in the 2018 EU-wide stress test. In the adverse scenario, their fully-loaded CET1 ratio fell by 3.9 percentage points at end-2020, similar to that observed for other European banks. However, Italian banks were found to be more vulnerable to credit risk (or growth shocks).

[6] Staff uses multipliers of 0.5–0.7 in the first year and 0.7–0.9 in the second year, depending on the quality and speed of implementation of the authorities' plans. The planned fiscal impulse translates into a higher real GDP (relative to the baseline) by 0.4–0.6 percent in the first two years. However, the persistent rise in sovereign spreads is projected to lower GDP by about 0.2–0.4 percent in those years, while hurting growth further in the period beyond.

rise with the announced end of the ECB's net asset purchase program.[7] Persistently elevated spreads would exacerbate pressures on banks' funding costs and profitability, accelerate passthrough to private borrowing costs as banks would need to re-start issuances to cover their rollover needs, further complicate plans to replace TLTRO funding that fall due in 2020–21 and raise MREL, and curtail credit provision (Box 3). Smaller banks are more vulnerable, owing to limited access to wholesale funding markets. Liquidity outflows from the banking system, a higher probability of bank failures from increased funding pressures and falling asset values, unfavorable government bond auctions, and rating downgrades of the sovereign and banks[8] are key risks. The persistence of international trade tensions could also weigh on investment.

- On the upside, an earlier and more rapid easing of financial conditions or larger-than-expected demand effects of the planned fiscal easing and from monetary policy would boost growth.

15. Spillovers from heightened stress in Italy would be global and significant. These would transmit principally through higher risk aversion globally and repricing of risky assets. In late May 2018, global spillovers included the largest safe-haven related intra-day yield declines in U.S. Treasuries and German bunds since 2010, and contagion to Greek, Portuguese, and Spanish yields. More recently, however, spillovers have been contained. Acute stress in Italy could push global markets into uncharted territory, for example, if there were to be an unprecedented downgrade to junk status of a very large advanced sovereign issuer. Given that Italian debt is held widely, a broad-based reversal of portfolio flows could occur, including from emerging markets. The impact could be large within the euro area. French, Spanish, Portuguese, and Belgian banks have sizable exposures to Italy. Subsidiaries of Italian banks are systemically important in some Central and Eastern Europe countries such as Croatia and Serbia. A broader loss of confidence in high-debt euro area countries would generate larger and wider losses.

Authorities' Views

16. The authorities were confident that growth would over-perform expectations. They stood by their growth targets of about 1½ percent in 2019–21, but acknowledged higher downside risks. They attributed higher spreads and weaker sentiment to temporary uncertainty that would be resolved once the details and impact of their plans are clear. They affirmed their commitment to pursue prudent policies and not to exceed their deficit targets. They highlighted Italy's strong fundamentals among which are the persistent fiscal primary and external current account surpluses, a nearly balanced net international investor position, sizable household savings, and long maturity of government bonds. They emphasized that banks have abundant liquidity, deposits have been stable, and the pass-through of higher sovereign spreads to private sector borrowing costs has been limited. They view protectionism as the main downside risk to growth.

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[7] From March 2015 to October 2018, the Eurosystem's net purchases of Italian public debt (QE) were €362 billion, compared to gross medium- to long-term bond issuances of about €600 billion. Starting January 2019, the market would need to finance about 95 percent of Italy's annual gross financing needs; the rest is Eurosystem reinvestment.

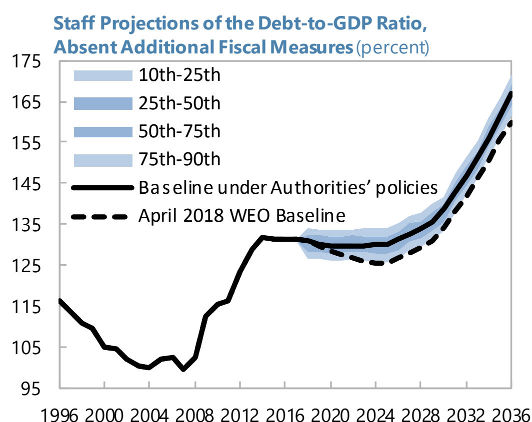
[8] Besides Moody's, Fitch and S&P (¶9), DBRS rates the Italian sovereign at three notches above junk. All four agencies would need to downgrade Italy below investment grade for the ECB to exclude it from its QE program or for haircuts on collateral to increase.

POLICY DISCUSSIONS

17. The authorities felt strongly that a fiscal stimulus is needed to promote economic growth and improve social outcomes. This is more so given the economic slowdown. They plan to raise public investment gradually to its pre-crisis level, which they argued would increase the return on private investment. They are working on measures to increase pension and other social benefit spending. They expect their pension measures to facilitate early retirement, thereby addressing the social strains among older workers while creating jobs for the young. Their citizenship income program is envisaged as an enhanced safety net to allow a dignified livelihood for all citizens and job training for those unemployed, which they view as essential to upgrading skills in the workforce. Together with incentives aimed at small and medium-sized firms and other measures, they expect to stimulate demand, improve living standards, and lift productivity.

18. With fiscal space at risk, the authorities' planned fiscal stimulus carries substantial downside risks. In staff's projections, debt would remain at around 131 percent of GDP over the next few years; then, it would rise with increasing interest rates during monetary policy normalization and higher pension spending (Annex III), absent additional fiscal measures. Materialization of modest adverse shocks relative to staff's baseline, such as slowing growth or rising spreads, would increase debt further, raising the risk that eventually Italy could be forced by markets into a sharp fiscal consolidation when the economy is weakening. This could transform a slowdown into a recession. International and Italy's previous experience suggest that the cost of a significant fiscal tightening when the economy is weak falls disproportionately on the vulnerable. Any temporary gain in growth from the stimulus over the near term is thus likely to be outweighed by the substantial risk of a deterioration when shocks materialize. Italy and the EC have been discussing potential changes to the draft budget plan in relation to the EC's Excessive Deficit Procedure (EDP) based on the debt criterion. The EDP would entail specifying corrective fiscal actions that ensures debt declines firmly over several years.[9]

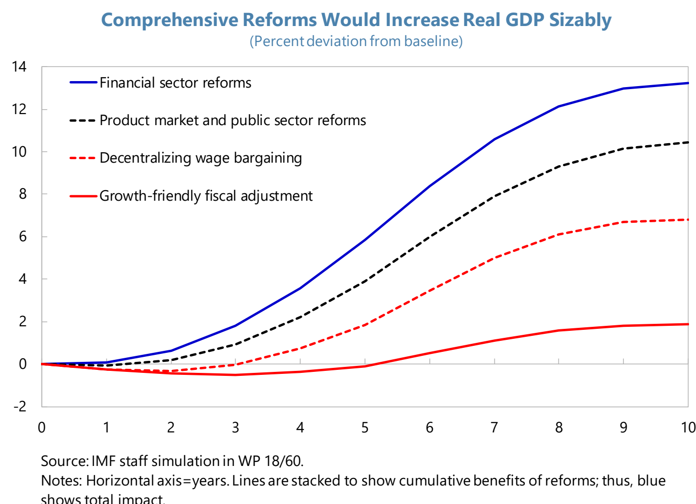
Staff Projections of the Debt-to-GDP Ratio, Absent Additional Fiscal Measures (percent)



19. In staff's view, higher potential growth is the only durable way to improve economic outcomes and strengthen resilience, not fiscal stimulus or reform reversals. Structural reforms to raise productivity and unlock Italy's potential need to be the overarching priority; without them, no strategy to lift incomes or secure stability can endure. The quality of fiscal policy needs to become more growth friendly and inclusive. Italy also needs to put to rest any concern about public debt sustainability. This requires credible consolidation to put the debt-to-GDP ratio on a firm downward trajectory. Further strengthening banks' balance sheets would enhance their resilience

[9] An EDP based on the debt criterion has never been used and, if launched, could imply Italy being in the EDP for a protracted period. Lack of corrective action could imply application of a series of escalating sanctions, such as withholding structural funds or imposing fines.

and allow them to fully play their role in supporting the economy. Firm implementation of this package of reforms would reduce risks, bolster investor confidence, and enhance resilience (Annex IV). Staff simulations suggest that implementation could, over the next decade, close competitiveness gaps, boost Italy's real GDP by about 13 percent, and lower public debt by about 20 percent of GDP (IMF working papers 18/59, 18/60 and 18/61, and Annex V).



Source: IMF staff simulation in WP 18/60.
Notes: Horizontal axis=years. Lines are stacked to show cumulative benefits of reforms; thus, blue shows total impact.

A. Structural Reforms to Boost Productivity Growth

20. The government's agenda is focused on interventions in the labor market, public administration, and justice system. In mid-2018, they approved a "Dignity Decree" aimed primarily at tackling temporary employment. Legislation is being prepared or considered to fight corruption, cut red tape, and modernize the insolvency framework, among others.

21. In staff's view, a significantly stronger emphasis is needed on labor and product market reforms. To effectively tackle Italy's structural rigidities, staff recommends measures beyond public administration and insolvency to include labor and product market reforms. Such reforms offer the prospect of raising efficiency, growth, and jobs, including in the near term.

Reforming Labor Market Institutions

22. The authorities are seeking to reduce temporary employment and support job search. The "Dignity Decree" increases job protection by making it costlier to dismiss workers and limits incentives to use temporary contracts by requiring employers to justify extending such contracts beyond one year. Moreover, a recent constitutional court ruling delinked dismissal costs from the length of employment. These have increased the uncertainty over, and costs of, dismissals, thus reversing a key benefit of the 2015 Jobs Act. As part of the budget, the authorities also plan to allocate 0.1 percent of GDP in additional resources for unemployment centers. Finally, a minimum wage in sectors not subject to collective wage bargaining could be envisaged.

23. Staff recommends decentralizing wage bargaining as a reform of first-order importance. By facilitating re-alignment of wages with productivity at the firm and regional levels, Italy's high structural unemployment would fall, as would the continued heavy resort to temporary employment (IMF working paper 18/61). In this context, consideration could be given to introducing a minimum wage, differentiated by regions to account for differing labor productivity levels, unemployment rates, and living costs. The uncertainty over, and the costs of, dismissals, which are high in international comparison, should be lowered to encourage hiring and preserve key benefits

of the Jobs Act.[10] To raise Italy's labor force participation, which is the lowest among euro area countries, consideration should be given to well-designed reductions in the tax wedge on secondary earners. Enhanced active labor market policies are welcome; cross-country experience suggests effective local administration is essential for success.[11]

Promoting Competition

24. Over the past year, progress in improving competition has been weak. In August 2017, parliament approved the Annual Competition Law for the first time since 2009 when the requirement to approve such a law annually was legislated. However, the emphasis was more on consumer protection while actual pro-competition measures were weakened significantly during the parliamentary debates, limiting its economic impact. Implementation of various provisions were subsequently weakened or delayed even further, during the parliamentary discussions of the budget last year as well as more recently (e.g., on the liberalization of energy tariffs, reform of local state-owned enterprises, and minimum fees for professionals). The authorities are also considering whether to reverse the 2011 reform on liberalized retail hours.

25. Promoting competition is critically important for raising productivity. Greater competition would allow more productive firms to enter the market and grow and less productive ones to diminish or exit, thus contributing to an efficient allocation of resources while providing improved choices and lower costs for customers. Measures to stimulate competition have been shown to spur growth in the near term as well (World Economic Outlook, April 2016). Staff recommends tackling barriers to competition that are high in sectors such as local services, professions, and retail. Consideration should be given to decisively addressing these regulatory impediments and barriers in a new competition law that the authorities have indicated an interest in preparing. The enforcement powers of the Competition Authority should also be strengthened.

Improving the Business Environment

26. Public sector inefficiencies and a slow justice system are long-standing issues. Over the years, various governments have prioritized reforms in these areas, but success has been limited. For instance, Italy ranks well on *de jure* indicators of the business environment but it continues to rank relatively poorly on perception-based ones that aim to reflect *de facto* conditions. It is the third-last among euro area countries in the World Bank's Doing Business indicators and has not improved in the World Economic Forum's competitiveness index rankings, notwithstanding legislative reform initiatives in recent years. This points to continuing challenges with reform implementation. Specific

[10] Empirical analysis confirms that the Jobs Act contributed to improving job market mobility and more open-ended hires (Boeri and Garibaldi, 2018, and Sestito and Viviano, 2018).

[11] Employment centers operate under the competences of different levels of government in Italy and the modalities of their cooperation with the private sector are not clearly defined, notwithstanding the creation in 2015 of the National Agency for Active Labor Market Policies. According to the Bank of Italy, in 2017, just over 25 percent of job seekers had contacts with an employment center while the share of the unemployed who found a job in the private sector through employment centers was just 2 percent, with wide regional differences. Even in countries with a longer tradition of active labor market policies, the probability that an unemployed person would find a job through an employment center is not high: it was 7 percent in France and Germany in 2016.

barriers to the ease of doing business include a high regulatory burden, weak governance, and an inefficient legal framework where bankruptcy procedures take about 6 years on average.

27. The authorities plan to advance some important initiatives in public sector reform, but greater efforts are needed. They are aiming to cut red tape and simplify procedures through digitization and improve efficiency by reforming managerial roles and fighting absenteeism. They are tackling corruption through preventive and more punitive measures. In addition, rationalizing and simplifying procurement is needed—both to secure the savings achieved by the recent centralized purchasing units and to tackle difficulties related to public work projects. Progress is also needed in streamlining, consolidating or privatizing local state-owned enterprises. To ensure success where several past attempts at reform have faltered, it would be important to improve the managerial and administrative capacity to implement reforms and address weaknesses in coordination between the center and regions. Publishing ambitious targets (or key performance indicators) would allow the government to track and clearly communicate progress.

28. The authorities are modernizing the insolvency framework. A delegating law was approved in October 2017, establishing high-level principles to modernize the framework. Prompt adoption and implementation of the relevant legislative decrees, while adhering closely to international best practice, is advisable. However, the special insolvency regime for large enterprises is excluded from the reform. This special regime is inefficient and costly (IMF working paper 18/218). It is advisable to fold it into the modernized framework, with specific well-defined circumstances for potential state intervention if necessary, in line with international best practice. Complementary efforts are needed to ensure the effectiveness of the reform, such as improving court functioning, ensuring qualified insolvency administrators, and reforming civil procedures to simplify processes, facilitate collateral sales and incentivize courts to reduce backlogs. Consistent implementation across the country would require development of uniform practices and attention to resource allocation. Making more intensive use of out-of-court restructuring is also recommended.

Authorities' Views

29. The authorities agreed with the need to increase potential growth but considered demand-side policies to be of primary importance. On labor market policies, they do not consider decentralizing wage bargaining a priority. They view the current system of two-tier bargaining, which provides for productivity bonuses, as sufficient to link wages with productivity. They expressed confidence in their active labor market plans to generate substantial positive impacts on training and employment. On competition policy, they clarified that some of the reversals occurred before they took office. They argued that it was necessary to delay or change some reforms to address employment and compensation concerns; the possible introduction of limits on the operations of large retailers is a means to support smaller shops. On the business environment, they questioned the methodology embedded in the World Bank's Doing Business indicators but acknowledged that Italian-based surveys of households and entrepreneurs highlight perceived weaknesses in the justice system, public administration, and business regulation. They emphasized that their public administration initiatives would be successful, given their focus on managers as enablers of reform and plans to closely monitor implementation in regions. They

intend to issue all the decrees for their insolvency reform by mid-January 2019, and continue with civil justice reforms to reduce the backlog in courts and length of commercial and civil litigations.

B. Fiscal Policy to Safeguard Stability and Support Inclusive Growth

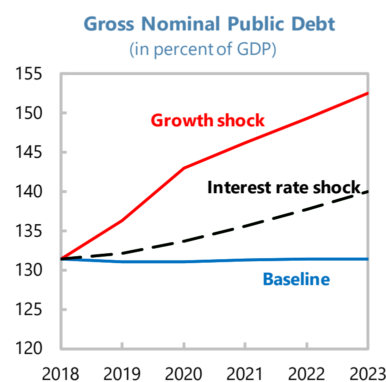
30. Based on the government's stimulus plan, staff projects fiscal deficits to rise toward 3 percent of GDP. The bulk of the stimulus is devoted to expanding social protection and pension benefits, while some resources are allocated to public investment and income tax cuts (text table). Savings come from unspecified spending cuts of about 0.2 percent of GDP, mostly one-off revenue-raising measures such as slightly higher taxes on financial institutions, and an anticipated tax amnesty. There are no high-quality measures to broaden the tax base. For 2020–21, the safeguard clause, which specifies a rise in VAT and excise rates to meet fiscal targets, is reinstated in the amount of 0.7–0.8 percent of GDP. The authorities are targeting relatively optimistic growth rates and privatization proceeds, based on which they expect debt to decline to 126 percent of GDP by 2021. Staff projects a deficit of 2.7 percent of GDP in 2019 and close to 3 percent for 2020–21 (unless there is broad political support to activate the VAT safeguard clause or find compensatory measures, which however have proven difficult to do in the past). Debt would remain very high at about 131 percent of GDP and vulnerable to shocks.

Italy: Revised Fiscal Targets for 2019–21
(Percent of GDP)

	2018	2019	2020	2021
Measures in 2019 Draft Budgetary Plan				
Citizenship income program		-0.4	-0.4	-0.4
Pension reform reversals		-0.4	-0.4	-0.4
Higher public investment		-0.2	-0.3	-0.3
Spending cuts		0.2	0.1	0.1
Lower income taxes for self-employed/small businesses		0.0	-0.1	-0.1
Revenue raising measures		0.4	0.2	0.2
Tax amnesty ("fiscal peace")		0.0	0.1	0.1
Other		-0.2	-0.3	-0.3
Cancellation of safeguard clause		-0.7	-0.3	-0.2
Authorities' targets (2018 DEF Update)	-1.8	-2.4	-2.1	-1.8
Authorities' growth assumptions	1.2	1.5	1.6	1.4
Staff estimates/projections	-1.9	-2.7	-2.8	-3.0
Staff growth assumptions	1.0	0.8	0.7	0.6

Sources: 2019 Draft Budgetary Plan (November 2018); Update Note to 2018 Economic and Financial Document (DEF) (October 2018); and IMF staff estimates.

31. A large expansion now risks a potentially sharp adjustment when conditions deteriorate. Even a modest slowdown in growth would result in higher deficits and a rising debt ratio.[12] Instead, with external conditions still favorable and growth above potential, staff recommends gradually consolidating the public finances to put debt on a firm downward trajectory and rebuild credibility over time. Staff recommends a consolidation package of about 2½ percent of GDP during 2019–23 (starting from the 2018 outturn), based on higher revenues and lower spending.[13] A target of a small overall surplus



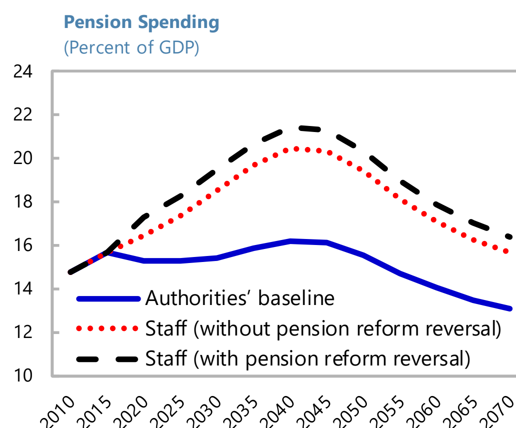
[12] If growth falls to about ½ percent in 2019–20, deficits could breach the 3 percent of GDP ceiling under the Stability and Growth Pact and debt would rise. A confidence crisis that catalyzes a similar scale of adjustment as in 2011–12 would fully undo the gains in incomes since the crisis.

[13] Revenues would increase as a lower labor tax wedge (1½ percent of GDP) is more than offset by higher VAT collections from reduced policy and compliance gaps (1 percent of GDP), rationalized personal income tax deductions or expenditures (½ percent of GDP), and a modern property tax on primary residences (½ percent of GDP). On the expenditure side, public investment is increased (½ percent of GDP), a modern guaranteed minimum income scheme is put in place for the poor (½ percent of GDP), while public consumption and pensions are lowered to meet the consolidation target.

to be achieved in 4–5 years via a balanced adjustment would ensure that debt declines firmly. It would also mean that, when adverse shocks materialize, Italy would not be forced into a sharp consolidation and, thus, shield the poor and the vulnerable.

32. Staff's recommended consolidation should be supported by a shift in the composition of policies to promote growth and social inclusion. Italy's pension spending, the second highest in the euro zone, has crowded out resources for public investment and a modern safety net for the poor. The tax wedge on labor is high, and wealth taxes are relatively low. The incidence of income and consumption taxes falls on a narrow base, given large tax expenditures and compliance gaps. The authorities' policies do not alter this low-quality mix. Making policies more growth-friendly and inclusive requires reducing current spending, protecting the poor, raising capital spending, broadening the tax base, and lowering tax rates on productive factors. In this regard:

- *Pensions:* Italy implemented important reforms in the past, including in 2011, that aimed to contain its high spending in the very long term. The authorities are considering changes, however, that would reverse some reforms and reduce the effective retirement age.[14] Such changes would increase pension spending further, impose even more burdens on younger generations, leave less room for pro-growth policies, and lead to lower employment rates among older workers. Based on cross-country evidence, it is unlikely that the expected wave of retirements would create as many jobs for the young (the lump-of-labor fallacy). Even under unchanged policies, Italy faces significant pension pressures over the next 2–3 decades that will strain the fiscal accounts, as also confirmed by the EC's 2018 Ageing Working Group.[15] This points to the urgency of rationalizing excesses within the system, ensuring actuarial fairness (i.e., closely linking pensioners' lifetime benefits with their lifetime contributions), preserving the indexation of retirement age to life expectancy, and adjusting pension parameters to secure affordability (IMF working paper 18/59).



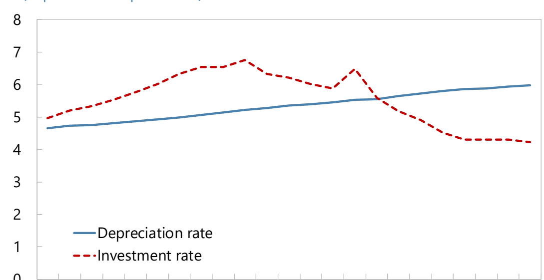
- *Alleviating poverty*: Welfare spending apart from pensions and unemployment insurance is notably lower than the euro area average and insufficiently shields the poor. Italy needs a modern, guaranteed minimum income scheme targeted to the poor—one that avoids welfare

[14] For instance, people could retire at the age of 62 years, with 38 years of contribution. This would significantly ease the conditions for workers to retire, who currently need to be 66.7 years old to retire with at least 20 years of contributions, or alternatively have nearly 42–43 years of paid contributions irrespective of age. The effective retirement age is currently 63½ years. If implemented, such a measure would add to the eight 'safeguard' adjustments that have already been introduced since 2011 to enhance exit flexibility.

[15] The authorities rely on very optimistic employment and productivity growth assumptions to project stable pension dynamics over the next 2–3 decades, but staff analysis shows that pensions rise notably under prudent macroeconomic assumptions (IMF working paper 18/59). The proposed reversal of pension reforms could increase pension spending by up to a further 1 percent of GDP.

dependence and disincentives to work and is not time bound. The authorities' citizenship income program could be more generous than the current inclusion income program, in terms of benefit levels and number of beneficiaries. Benefits should be set at levels that do not distort incentives to find regular work. International good practice suggests: (i) capping benefits at 40–70 percent of the relative poverty level; (ii) including gradual benefit phase-outs, income disregards, or conditional in-work benefits to incentivize regular work; and (iii) implementing adequate controls to prevent abuse and ensuring effective local administrative capacity. Introducing this modernized scheme in the context of a comprehensive review of the social protection system is recommended, by gradually scaling up the inclusion income program and rationalizing other support programs, at a cost of ½–¾ percent of GDP (Selected Issues Paper).

- *Increasing public investment*. The authorities' intention to gradually increase public investment to support growth, with the aim of returning toward pre-crisis levels over time, is welcome. To support this scaling up and improve the efficiency of investment spending, it is even more important that the government's objective of accelerating decision-making processes, improving public investment management, and strengthening implementation capacity is effectively met. Offsetting budgetary measures are needed to ensure consistency with the recommended consolidation path.



Sources: Istat / Haver, staff calculations.
Note: calculations are based on public administration and defence; compulsory social security; education; human health; and social work activities.

- *Improving the tax system*. The authorities are expanding a flat tax regime for the self-employed, introducing a permanent tax break on reinvested profits, and changing several tax incentives (such as abolishing the allowance for corporate equity, changing R&D tax incentives, and eliminating the simplified tax regime for the self-employed and small businesses). Staff is concerned that these changes add to a history of numerous marginal changes to the tax system, exacerbating uncertainty, eroding the neutrality of the tax system, and damaging the business environment.[16] Instead, staff recommends a comprehensive reform to broaden the tax base, promote efficiency, and ensure fairness. Such a reform should address large VAT compliance and policy gaps, rationalize tax expenditures, tax wealth through a modern property tax on primary residences (based on updated cadastral values), and emphasize stricter enforcement. The expected phasing-in of the mandatory electronic transmission of receipts to the Revenue Agency, together with the e-invoicing regime, should support tax compliance. Tax amnesties should be avoided; international experience confirms that any temporary benefits are offset by weaker tax compliance. Any consideration of flattening personal income tax rates needs to be consistent with the consolidation path recommended above, be evaluated holistically with the structure of benefits, maintain progressivity and neutrality, and reduce distortions.

[16] The new tax incentive on reinvested profits that replaces the allowance for corporate equity (ACE) could increase the complexity of the system. ACE is an effective means to reduce the bias toward debt and encourage investment.

Authorities' Views

33. The authorities considered their fiscal stimulus plans to be appropriate for supporting growth and social inclusion. They argued that their pension and citizenship income measures are needed urgently to tackle current social strains. These measures would promote turnover in the workforce, create jobs for the young, and gradually rejuvenate the skill base in the public sector. Time is required to design these measures; they could be introduced in 2019:Q2. The authorities stressed that a critical pillar of their strategy is the revitalization of public investment, which would be accompanied by streamlined administrative procedures and enhanced technical capacity to accelerate the implementation of sound projects. They noted that their draft budget plan was based on prudent macroeconomic projections and does not include the effects of their higher GDP growth targets on government revenues. In that regard, they viewed the deficit level for 2019 of 2.4 percent of GDP as an upper bound. Alongside privatization receipts (1 percent of GDP), they expect their debt reduction targets to be achievable and adequate to safeguard investor confidence.

C. Policies to Strengthen Financial Sector Stability

34. Safeguarding the public finances is a pre-requisite for financial sector stability. Tail risks are re-emerging with the recent rise in sovereign yields. Sustained high yields would potentially reduce banks' capital further, raise funding costs, and increase liquidity pressures related not least to maturing bank bonds and TLTROs that fall due in 2020–21.[17] They would complicate plans to raise substantial volumes of the so-called MREL (or minimum requirements for own funds and eligible liabilities), which are all the more important as most banks may find it difficult to grow sufficient loss-absorbing capital buffers through retained earnings. They would also lower investor interest and increase cleanup costs of NPL disposals,[18] as well as weigh on bank profitability and credit provision. Banks with relatively more concentrated exposures to the sovereign and less access to diverse funding sources could be more at risk. In view of the downside risks, enhanced monitoring and planning is advisable.

35. The important progress underway in improving bank balance sheet health needs to continue to restore resilience and enable the sector to fully support the economy. The focus on asset quality, alongside the economic recovery, has borne positive results (¶12). Intensive supervisory oversight of NPL reduction should continue in the significant banks (i.e., the banks supervised directly by the SSM), which are seeking to further reduce NPLs to 7 percent of loans by end-2020. It should be extended fully to smaller banks with high NPLs to ensure that their strategies and targets are ambitious and credible. The SSM's thematic review of profitability drivers and business models of the major euro area banks identified no systemic issues for Italian banks, but

[17] Failure to maintain a healthy liability term structure will adversely impact banks' net stable funding ratio. This ratio is a new liability metric and requirement due to be introduced by the European authorities in the coming years. Markets could discriminate against banks with low ratios relative to peers.

[18] The price banks face for the government guarantee of NPL securitization tranches (the "GACS" scheme) has also increased substantially with rising CDS spreads and a change in the methodology to using the 2-month CDS average rather than the 6-month average used previously.

found considerable opportunities for individual banks to improve their business models and processes. Following from these findings, assertive supervisory oversight is recommended to ensure banks proactively identify and address capital-depleting business lines. Supervisory benchmarking and guidance to banks would promote more effective and consistent use of risk-based pricing, cost allocation, and scenario analysis frameworks.

36. The consolidation of smaller banks should not be delayed further. About 270 cooperative banks are expected to consolidate into three new banking groups, two of which would be supervised directly by the SSM and subject to an asset quality review in 2019. Proceeding quickly with the consolidations and subjecting all three groups to an asset quality review would help address lingering concerns over the health and viability of the smaller banks. The supervisors should ensure robust governance, sound risk management, and viable business models through ambitious and credible targets. Consideration should be given to pursuing the issues identified also in the residual smaller banks, including any that do not join the new groups.

37. Dealing with weak banks remains a challenge. Two medium-sized banks were required to raise fresh capital in 2018. However, one of them, which has undergone repeated capitalizations in recent years and is supervised directly by the SSM, could do so only when a private rescue fund—financed by contributions from other Italian private banks—acted as a buyer of last resort, purchasing the bank's subordinated debt to enable it to meet its minimum regulatory capital requirements by an end-2018 deadline and committing to fully underwrite a share capital increase that the bank has scheduled for April 2019. Tackling some problem banks thus continues to burden the system. Swift recapitalization of problem banks or the timely and effective use of the resolution framework is essential to avoid weaknesses from lingering, excessively burdening taxpayers and the rest of the system, and threatening stability.

38. Ensuring adequate bail-in-able instruments is a related challenge. The bail-in of retail subordinated debt created substantial challenges in past bank resolutions and led to costly taxpayer and private interventions, despite the debt being held mostly by the wealthiest households (IMF working paper 18/196). A large volume of fresh bail-in-able debt is needed, and banks will be required to increase MREL buffers in the coming years. Introducing safeguards is recommended to ensure this new MREL is effective, including by limiting the proportions of MREL allowed to be held by retail investors and rigorous public enforcement of MiFID rules.[19]

39. Governance needs to be strengthened. Legislative gaps in Italy's implementation of the EU fit and proper rules for bank management need to be closed. When implemented, the 2015 EBA and 2016 ECB guidance relating to fit and proper assessments can be applied in full.

[19] See "Subordinated Debt and Self-placement: Mis-selling of Financial Products," European Parliament, PE 618.994—June 2018.

Authorities' Views

40. The authorities are aware of the challenges facing the banking system and highlighted the progress underway in safeguarding financial stability.

- There was broad agreement that sustained elevated sovereign yields will have increasingly negative consequences for the financial sector. The Italian authorities noted that passthrough has been limited so far, deposits have been stable throughout the system, banks have sufficient capital headroom to withstand some further increase in sovereign yields, and adverse effects would be expected over the medium term if elevated yields were to be sustained.

- They acknowledged that the expiration of TLTROs could adversely impact on the term structure of banks' liabilities. They clarified that the liquidity rules, including the new net stable funding ratio, are currently being decided at the European level and would not come into force before 2021, thus providing time for banks to adjust.

- The authorities highlighted that the intensive oversight of NPL reduction has resulted in notable improvements in asset quality. The Italian authorities noted that new NPL formation is currently below pre-crisis levels, provisioning coverage is above the average of the main euro area banks, and NPLs net of provisions are 5 percent of loans compared to 2.3 percent among the main euro area banks. They also noted that credit supply is not hindered by NPLs.

- The authorities agreed with the need for continued improvements in bank efficiency and profitability. The Italian authorities questioned the extent to which the supervisor should challenge a bank's business strategy given it is not prescribed in regulation, while capital and liquidity rules provide the means to tackle banks if business models fail. They affirmed that the consolidation of small cooperative banks is necessary, and should proceed with only minor delays and adjustments to the original reform.

- The authorities also agreed with the need for more timely solutions for problem banks, including the importance of building MREL buffers. They acknowledged that low appetite for Italian-issued MREL in wholesale capital markets could result in some banks relying on the local retail market. But the Italian authorities emphasized that future risks to burden sharing by retail holders of subordinated debt are diminishing gradually as existing instruments mature, and risks of future mis-selling were addressed through adoption and evolution of MiFID regulation.

STAFF APPRAISAL

41. The new authorities' emphasis on growth and social inclusion is welcome. Italy has been struggling with low economic growth and weak social outcomes for many years. Real personal incomes are at the level of two decades ago; unemployment has averaged close to 10 percent over this period; living standards of middle-aged and younger generations have eroded; and emigration of Italian citizens is near a five-decade high.

42. The authorities have inherited difficult and long-standing problems. Italy's challenges relate primarily to structural weaknesses and inadequate policies. First, productivity growth has been anemic since the mid-1990s. Although numerous structural reform efforts were undertaken over the years, these were neither comprehensive nor sustained. Second, the quality of fiscal policy has been weak, favoring the elderly while penalizing the younger and working age population. Pension spending is high and increasing, the tax burden falls on a narrow base, labor is taxed heavily while wealth is not, the social safety net is neither adequate nor well targeted to the poor, and public investment has been falling. Third, public debt has remained very high and a perennial source of vulnerability. Italy has run larger fiscal primary surpluses than its euro area peers, but these were not sustained at the levels needed to reduce debt significantly.

43. Staff is concerned, however, that the authorities' strategy falls short of the comprehensive reforms needed to turn Italy around. The authorities are approaching Italy's economic problems mainly through the lens of insufficient demand. The structural reform content of their strategy needs strengthening. While the expected insolvency reform and the aim to protect the poor and raise public investment are welcome, reforms are being weakened or reversed in other areas, such as labor and product markets and pensions. These could prove costly. For example, international experience cautions against facilitating early retirements to create large numbers of jobs for the young; if Italy pursues this course, it risks paying an even more expensive pension bill and placing greater burdens on younger generations. The quality of the proposed fiscal policy also needs strengthening, with progress lacking on broadening the tax base or lowering the labor tax wedge.

44. Staff is also concerned that the authorities' policies risk leaving Italy vulnerable. The cost of tapping wholesale funding for Italian banks have already risen sharply and the economy has slowed. If sovereign spreads remain elevated, it is likely that higher costs will pass through to firms and households, banks will deleverage, financial stability concerns will rise, and growth will fall further. Although sovereign yields could moderate somewhat in the near term if there is an agreement between Italy and the European Commission in relation to the excessive deficit procedure, staff is concerned that Italy's public debt will remain high and vulnerable to shocks. Even under the favorable assumption that the stimulus plan delivers a short-term boost to output, public debt is likely to remain at its current high level for the next three years, after which it is projected to rise. It would rise sooner and faster, if modest adverse shocks were to materialize. A potential loss of market confidence could force Italy into a sharp fiscal consolidation, pushing a weakening economy into a sharper recession and imposing disproportionate costs on the vulnerable. Any temporary gain in growth from the planned stimulus is thus likely to be outweighed by the risk of a substantial deterioration when adverse shocks materialize.

45. Italy needs structural reforms, fiscal consolidation based on notably improved quality of policies, and bank balance sheet strengthening. Structural reforms to raise productivity and unlock Italy's potential need to be the overarching priority. Without them, no strategy to lift incomes or secure stability can endure—as faster potential growth is the only durable way to improve economic outcomes and enhance resilience. The authorities are urged to improve the quality of fiscal policy to make it more growth friendly and inclusive. With fiscal space at risk, they are also urged to put to rest concerns about public debt sustainability, which requires credible consolidation.

Moreover, further strengthening banks' balance sheets would enhance resilience and allow the banking sector to fully play its role in supporting the economy.

46. Firm implementation of such a package of measures would reduce risks, bolster investor confidence, and enhance resilience. This is critical to safeguard stability and growth in the near term, where recession risks have risen amid the still unfolding adverse effects of higher sovereign spreads on private financing costs and given emerging risks to the global outlook. It would also yield potentially sizable gains over the medium term by closing competitiveness gaps, boosting real incomes, and notably lowering public debt.

47. Consideration should be given to broadening structural reforms to include significant labor and product market reforms. Decentralizing wage bargaining would reduce structural unemployment and informality by facilitating the alignment of wages and productivity at the firm level. Reducing the size and uncertainty over dismissal costs, which are high in international comparison, would foster job creation. Steady progress in liberalizing product and service markets—by lowering barriers to competition that are high in sectors such as local public services, professions, and retail—can raise productivity, investment and employment. The expected modernization of the general insolvency framework is welcome; folding Italy's special regime for large enterprises into this general regime would increase efficiency and reduce costs. Welcome steps are planned in tackling corruption, cutting red tape and simplifying administrative procedures, among others. Further progress is needed in streamlining procurement and reforming local state-owned enterprises. Establishing ambitious targets or key performance indicators would allow the government to track and communicate progress.

48. Undertaking a credible fiscal consolidation would safeguard public finances and reduce financing costs. Consolidating the fiscal accounts while external conditions are still favorable and economic growth is above potential would limit the short-term output costs. A target of a small overall surplus in 4–5 years, achieved via a balanced adjustment, would ensure that debt declines firmly. It also means that, when adverse shocks materialize, Italy would not be forced into a sharp fiscal consolidation. In other words, the automatic stabilizers would work more effectively than would otherwise be the case, thereby shielding the poor and the vulnerable.

49. The recommended adjustment needs to be underpinned by a shift in the composition of policies to promote growth and social inclusion. Making fiscal policy more growth-friendly and inclusive requires protecting the poor, reducing current spending, raising public investment, broadening the tax base, and lowering the tax wedge on labor. Specifically:

- Italy needs a modern, guaranteed minimum income scheme targeted to the poor. Such a scheme should avoid welfare dependence and disincentives to work and not be time bound. Consideration should be given to introducing this modernized scheme in the context of a comprehensive review of the social protection system, by gradually scaling up the current inclusion income program and rationalizing other income support programs.

- Pension reform reversals should be avoided. Changes that reduce the effective retirement age will increase spending further, impose even more burdens on younger generations, leave less room for pro-growth policies, and lower employment rates among older workers. Even under unchanged policies, Italy faces significant spending pressures over the next 2–3 decades that will strain the fiscal accounts. It is therefore urgent that the various excesses within the system are rationalized, actuarial fairness ensured (i.e., pensioners' lifetime benefits closely linked with their lifetime contributions), and pension parameters adjusted to secure affordability.
- The authorities' intention to gradually increase public investment to support growth is welcome. This scaling up needs to be supported by improved public investment management and strengthened implementation capacity to ensure efficiency of spending. Offsetting budgetary measures are needed to safeguard consistency with the recommended consolidation path.
- A comprehensive reform of the tax system is needed to broaden the tax base, lower the tax wedge on labor, promote efficiency, and support fairness. Large VAT compliance and policy gaps need to be addressed, tax expenditures rationalized, a modern property tax introduced on primary residences, and stricter enforcement prioritized. Tax amnesties should be avoided.

50. A pre-requisite to financial sector stability is safeguarding the public finances. Sustained high sovereign yields pose increasing challenges, especially for weaker banks. This includes potential strains from capital losses on sovereign exposures, adverse effects on banks' funding and capital raising plans (including for the so-called MREL), pressures on still relatively weak profitability, and crowding out of credit to the private sector. In view of the downside risks, enhanced monitoring and planning are advisable.

51. Building on the important progress underway to improve the health of the banking system, further actions are needed to strengthen bank balance sheets. Problem assets have been reduced sharply, capital levels have increased, and profitability has been improving gradually. This progress needs to continue on all fronts to restore the resilience of the banking system and enable it to fully support the real economy. Close supervisory oversight of NPL reduction strategies of significant banks should be maintained, and the guidance to less significant banks complemented with a similar approach to oversight. As with the larger banks, the supervisor should ensure that less significant banks have realistic and coherent business model and cost reduction assumptions. The consolidation of cooperative banks into three new banking groups should not be delayed; subjecting all three groups to asset quality reviews would help address lingering concerns over the health and viability of the smaller banks. Governance needs to be strengthened. Moreover, swift recapitalization of problem banks or the timely and effective use of the resolution framework is essential to avoid weaknesses from lingering, excessively burdening taxpayers and the rest of the system, and threatening stability.

52. It is recommended that the next Article IV consultation be held in the usual 12-month cycle.

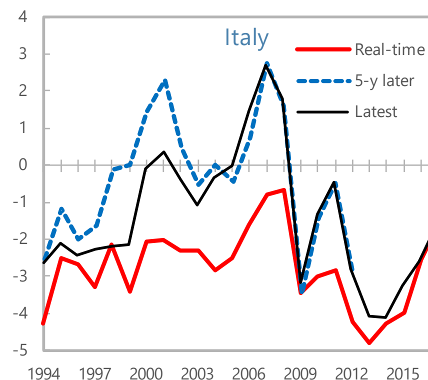
Box 1. Italy's Output Gap

Italy's output gap is subject to uncertainty, with some arguments favoring sizable slack. Real GDP and domestic demand are still about 4 and 7 percent, respectively, below their pre-crisis peaks in 2007. Unemployment is well above its pre-crisis low of 6 percent. Involuntary part-time employment has risen to 10 percent of the labor force and contributed to a decline in hours worked per person. Core inflation remains subdued. These indicators suggest slack is ample.

Other evidence points to notably smaller slack. This principally reflects Italy's low potential growth, including pre-crisis that makes it fraught to compare current outcomes with immediate pre-crisis outcomes, as well as the argument that economic growth since the crisis has outpaced potential growth. Productivity has been depressed from long-standing structural rigidities and balance sheet strains; the double-dip recession has weighed on investment (IMF working paper 15/230); and emigration has reached its highest levels in nearly five decades. Capacity utilization in industry and job vacancy rates are near historical peaks, the share of long-term unemployed has remained persistently high, and total unemployment is close to its historical average. These indicators suggest a narrowing output gap.

Fund staff estimates have sought to balance these competing considerations, while favoring arguments for greater slack. Staff uses the multi-variate filter of the April 2015 WEO that estimates potential output directly from the Phillips curve (relating cyclical unemployment and inflation) and Okun's law (relating cyclical unemployment and the output gap). This filter points to a gap that is almost closed in 2019. Staff imposes judgment to give the benefit of the doubt to the arguments for greater slack. The estimate of about -1 percent of potential GDP for 2018 is between those of the authorities (-1.9 percent) and some other international institutions (the EC is -0.3 percent).

That said, strong caution is advised in excessively favoring arguments for greater slack. A historical review of forecasts made in real time suggests that staff estimates of Italy's output gap have been systematically large and negative. In each year from 1994 through 2017, staff estimated Italy's output for that year to be significantly negative, averaging -2¾ percent of potential GDP. It was not close to zero or positive, notwithstanding that output gaps over multiple business cycles normally would average zero. Only several years later (e.g., 5 years) would staff substantially revise these estimates upwards (text chart).[1] Staff analysis of euro area countries suggests that such "negative bias" in real-time output gaps tends to be more pronounced for highly indebted countries and at relatively good times. It is caused by the inability to predict recessions as well as judgment that contribute to over-estimating potential output.



[1] The real-time estimate is the output gap for year t in the Fall WEO issued in year t. The estimate 5-years later is the gap for year t made in the Fall WEO of year t+5 and the latest estimates for all years come from the Fall 2017 WEO.

Box 2. Fiscal Multipliers

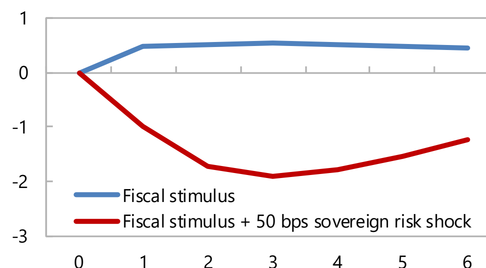
Fiscal multipliers in Italy are expected to be in the medium range in normal times. Among its structural characteristics, labor market rigidities, a weak social safety net, a relatively low propensity to import, and membership in a monetary union tend to increase the size of multipliers in normal times. However, several structural features such as a high-level of public debt, expenditure inefficiencies, and sizable tax evasion decrease the size of multipliers. Conjunctural (temporary) factors such as a negative output gap and constrained interest rates at the effective lower bound tend to increase the size of multipliers from normal levels. Based on these considerations, as also outlined in FAD's guidance note, Italy's multipliers are assessed to be in the medium range of 0.5–0.7 in the first year and 0.7–0.9 in the second year (IMF, "Fiscal Multipliers: Size, Determinants, and Use in Macroeconomic Projections," Technical Notes and Manuals 14/04). The quality and speed of implementation of measures would determine the exact size of multipliers.

The authorities' average multiplier estimates are below one. The Bank of Italy estimated that a 1 percent of GDP increase in social transfers and public investment or a similar-sized reduction in employers' social contributions lead to 0.1–0.3, 0.9–1.1, and 0.4–1.2 percent increases in real GDP (relative to the baseline) over the first two years, respectively.[1] The Ministry of Finance estimated spending multipliers of 0.9–1.1 in both years and revenue multipliers of 0.2–0.4 in the first year and 0.6–0.8 in the second year (Economic and Financial Update Document, 2017). In their 2019 draft budget plan, the authorities estimate an average multiplier of 0.5 in the first year.

To assess the impact of the authorities' fiscal expansion plan on growth, staff uses multipliers in the medium range. Abstracting from any offsetting growth effects of higher sovereign spreads, simulations based on the IMF's G20 model of a 1.1–1.3 percent of GDP in discretionary measures (relative to the baseline)—which consist of increases in social spending (0.9 percent of GDP) and public investment (0.2–0.3 percent of GDP) and a reduction in personal income taxes (0.1 percent of GDP)—indicate a first-year real GDP impact of about 0.7 percent in normal times. This increases to about 1 percent at peak.

But the net impact depends on the extent to which persistently higher sovereign spreads shrinks Italy's GDP. The key is how quickly expectations and private sector borrowing costs adjust. Simulating the effects of the authorities' stimulus package with an increase in sovereign spreads of 50 basis points (relative to the October 2018 WEO projections), the text chart shows the range of outcomes between a no-adjustment scenario (i.e., the increase in spreads is not expected to persist) and an immediate or complete adjustment scenario (i.e., the increase in spreads is immediately recognized to be permanent). In the former, there is no offset from the rise in spreads. In the latter, the stimulus is more than fully offset (i.e., a contractionary fiscal expansion occurs immediately).

Impact Fiscal Stimulus and Sovereign Risk on Real GDP
(Percent deviation from baseline)



Source: IMF staff illustrative simulations.
Notes: Fiscal stimulus is scaled to staff projected change in cyclically adjusted primary balance vis-a-vis the baseline. Sovereign risk shock is assumed permanent and perfectly anticipated. Simulations assume non-responsive interest rate.

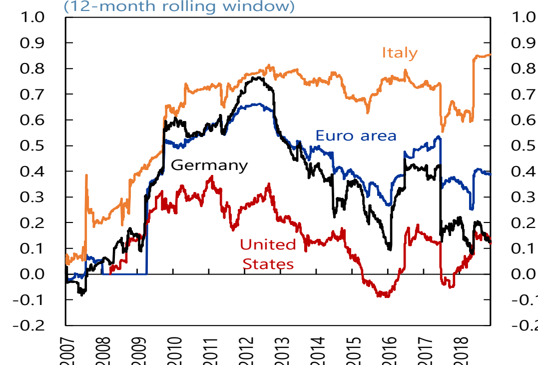
These considerations make for a highly uncertain outlook in the near term, but for a decidedly negative impact in the medium term. For the near term, staff assumes there is a small net positive impact of the stimulus. This is based on an intermediate case in which expectations adjust gradually to persistently higher spreads and pass-through to private sector borrowing costs occurs with a lag (Box 3). But over the medium term, as the stimulus fades, the negative effect of the persistently high spreads dominates. Lowering spreads—by pursuing staff's recommended policies and reducing risks—would boost growth.

[1] Bulligan, G., Busetti, F., Caivano, M., Cova, P., Fantino, D., Locarno, A. and L. Rodano, 2017, "The Bank of Italy econometric model: an update of the main equations and model elasticities," Banca d'Italia Working Paper No. 1130.

Box 3. Propagation of Sovereign Spreads to Bank Funding, Lending Costs, and Credit

Increased sovereign spreads generally imply higher funding costs for banks. Italy exhibits a stronger correlation of sovereign and bank credit default spreads than other advanced economies. Empirical analysis shows that a 100 basis point increase in sovereign spreads translates swiftly to a 15–20 basis points rise in large Italian bank bond yields relative to other euro area banks. This is due mainly to the large exposure of Italian banks to the sovereign. The impact is stronger for newly-issued bonds, with a contemporaneous response of 80–100 basis points. Simultaneously, banks typically increase their deposit rates by 20–40 basis points in the quarter of the spread increase.[1] Passthrough in recent months has been limited, however—banks have managed to keep overall funding costs down by converting maturing bonds to deposits and have drawn down excess deposits at the central bank to finance increased holdings of government bonds, among other measures.

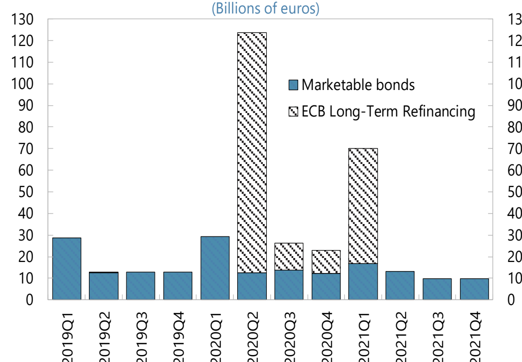
Correlations of Changes in Bank and Sovereign CDS Spreads
(12-month rolling window)



Sources: Bloomberg Financial Market LP and IMF staff calculations.

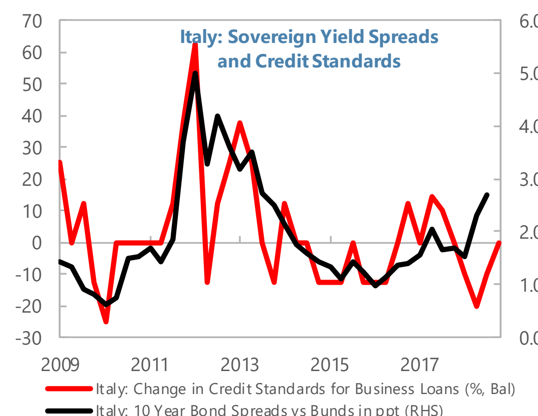
Sustained high sovereign spreads would make banks' funding environment very challenging. As noted in ¶11, Unicredit's private placement of a 5-year note in November 2018 at a coupon above 7.8 percent (compared to 1 percent in January 2018) confirms the significant difficulties banks have been facing and explains their limited access to markets since early 2018. Banks' debt amortization profile includes substantial redemptions in 2020–21, related to the ECB's long-term refinancing operations. Banks will eventually need to re-access markets. Sustained high sovereign spreads imply significant, and in some cases prohibitive, cost pressures for banks, which would not only impair funding but also lead to deleveraging, impacting growth.

Italian Bank Redemptions
(Billions of euros)



Sources: Bloomberg; and IMF staff estimates.

The cost and availability of credit to firms and households would be negatively affected. During the 2011–12 confidence crisis, Italian banks tightened lending conditions to firms and households considerably, increased lending rates, and reduced credit. Empirical analyses suggest that a 100 basis point increase in sovereign yields passes through, within a quarter, to bank lending rates to the private sector of 25–70 basis points and to lower bank lending by 0.4–3 percentage points annually. The impact is higher and faster in stressful times.[2] Consequently, domestic demand and economic growth would suffer.



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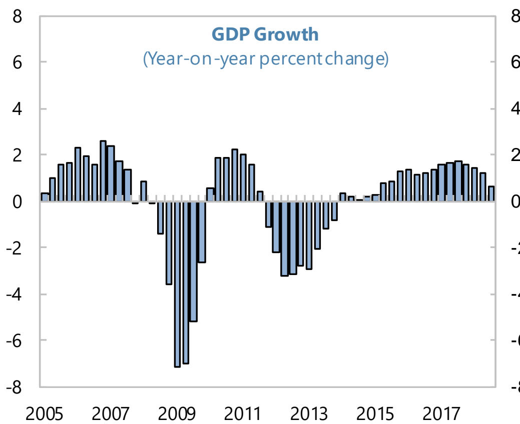
[1] See Zoli (2013) and Albertazzi and others (2014) for the empirical evidence.

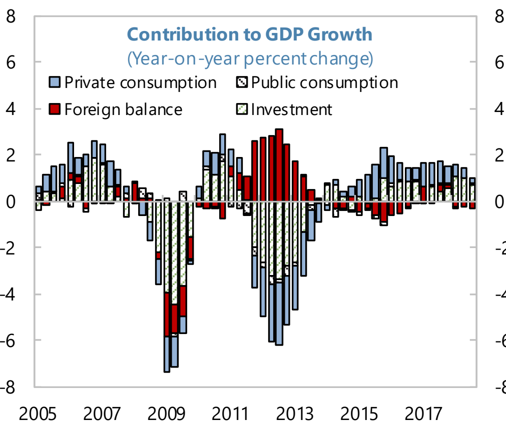
[2] For the empirical evidence, see: Albertazzi and others (2014); Zoli (2013); Del Giovane and others (2013); Bofondi and others (2017); Bottero and others (2015); and Doerr and others (2018).

Figure 3. Italy: High Frequency and Real Economy Developments, 2005–18

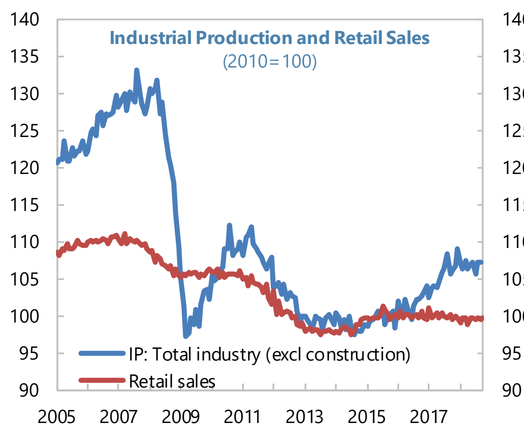
Economic growth has been slowing…

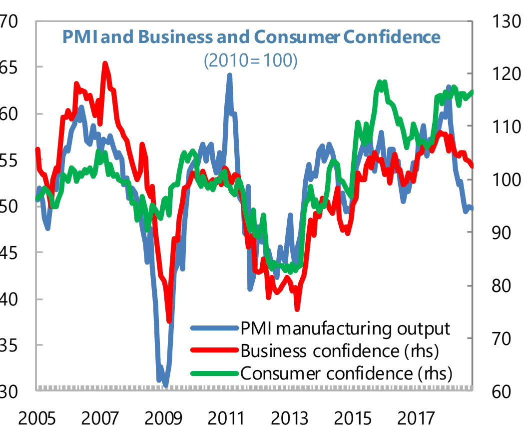


..driven by weaker domestic and external demand.

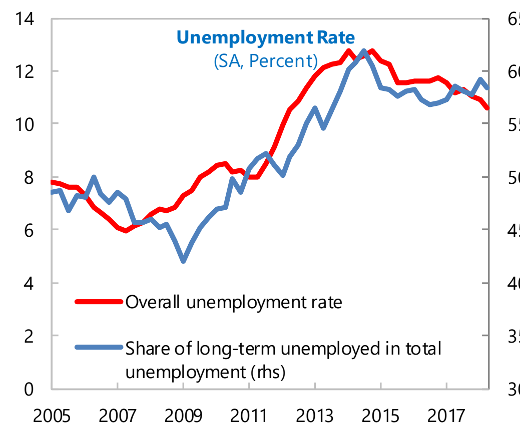


High frequency indicators point to slowing growth.

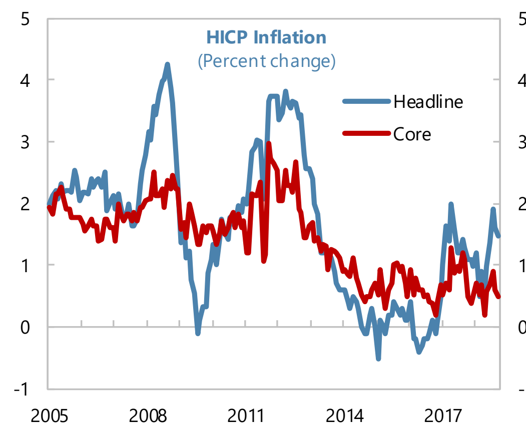




Unemployment has declined towards its historical average, which remains quite high.



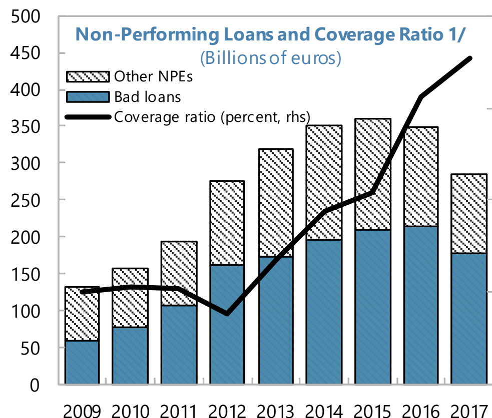
Headline inflation recently picked up but core inflation remains subdued.



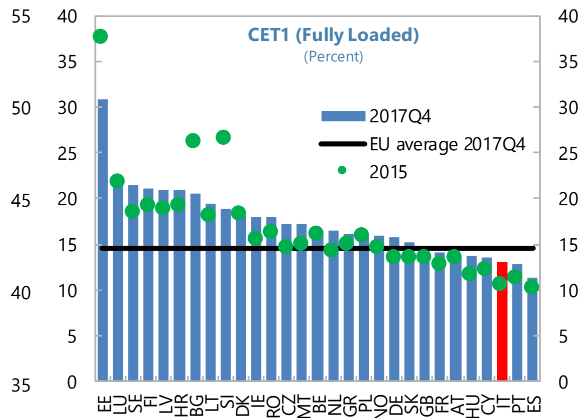
Sources: ISTAT; Bloomberg Finance L.P.; and IMF staff estimates.

Figure 4. Italy: Financial Sector Developments, 2008–18

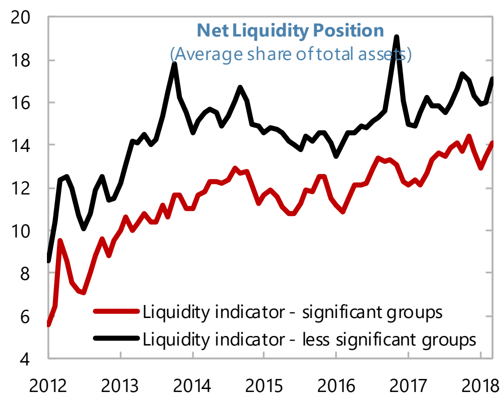
NPLs fell in 2017, and the coverage ratio improved.



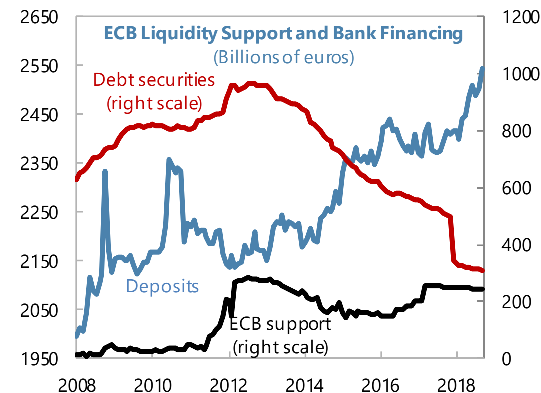
Despite capital increases by some significant banks, Italy continues to lag behind other EU countries.



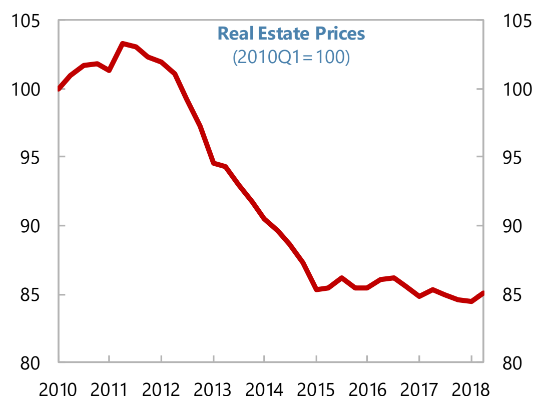
The system as a whole has adequate liquidity and collateral currently.



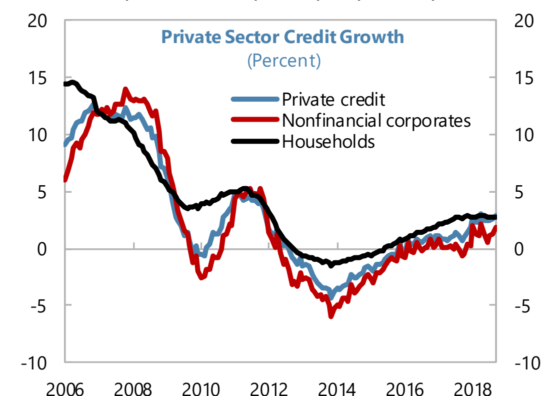
As the stock of bonds issued by Italian banks has reduced, deposits have increased.



Real estate prices have yet to rebound.



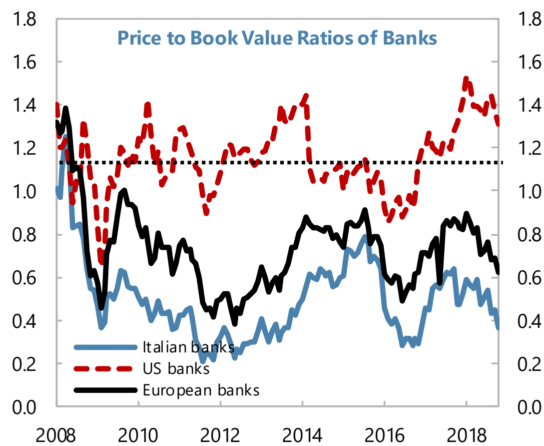
Credit to households has been growing since 2015, but to firms started growing only recently.



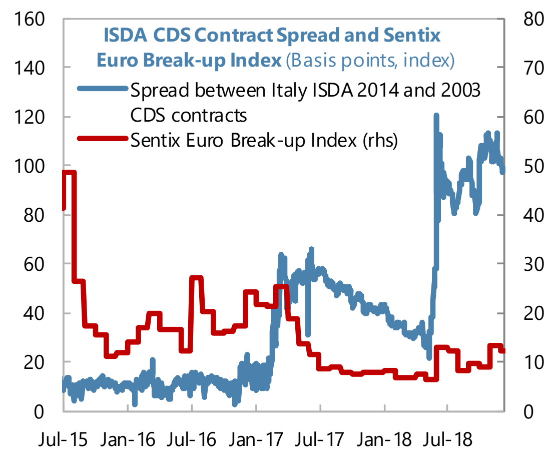
Sources: Bloomberg Finance L.P.; Bank of Italy; S&P Global Market Intelligence; ECB; European Banking Authority; and IMF staff estimates.
Notes: The net liquidity position is the difference between eligible assets for use as collateral for Eurosystem refinancing operations and cumulative expected net cash flows over the next 30 days.
1/ Bank of Italy data starting from 2012.

Figure 5. Italy: Financial Sector Assets and Valuations, 1995–2018

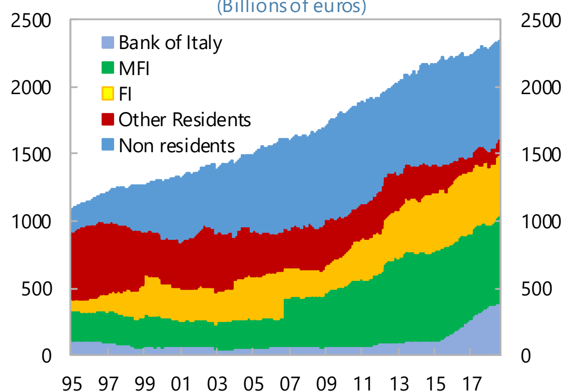
Italian bank equity prices remain relatively weak.

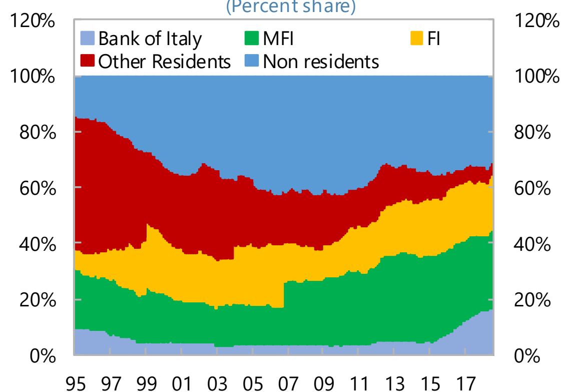


The tail risk of redenomination has re-appeared.

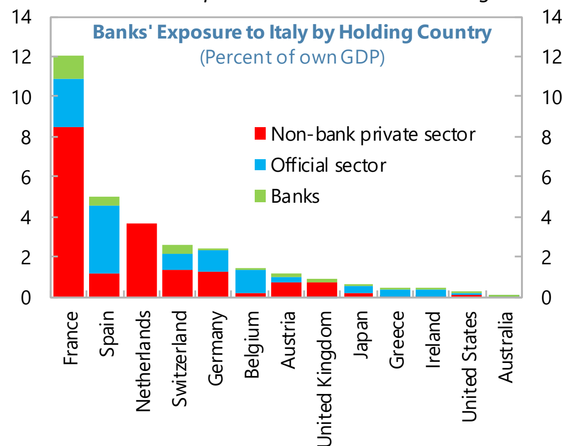


The Italian financial sector is heavily exposed to the Italian sovereign.

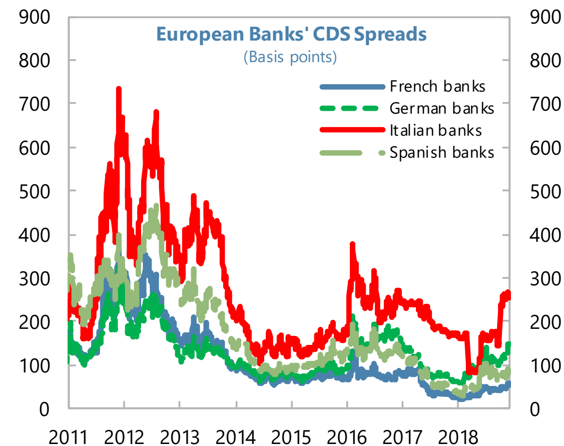




The French, Spanish, and Belgian banking systems have sizable exposures to the Italian sovereign.



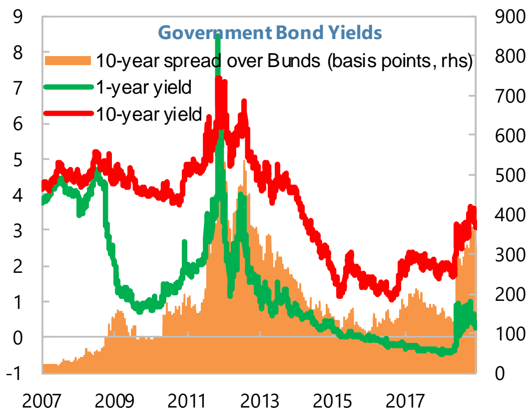
The CDS spreads of Italian banks have risen notably.



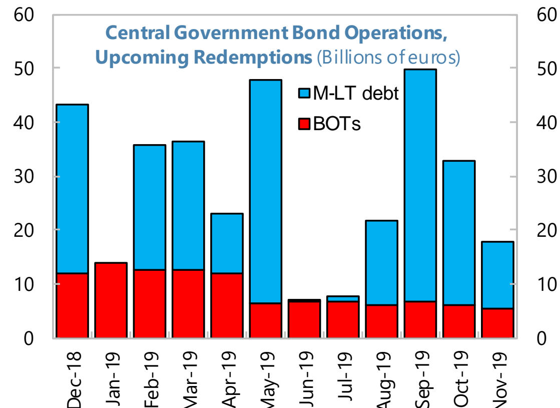
Sources: Bloomberg, L.P.; Bank of Italy; Bank of International Settlements; and IMF staff estimates.

Figure 6. Italy: Fiscal Developments and Issues, 2007–18

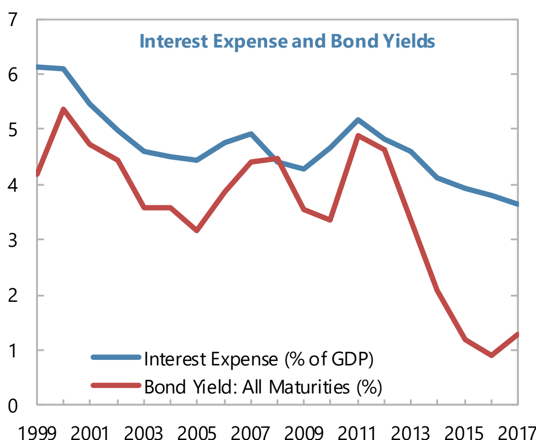
Government bond yields have risen sharply since April 2018.



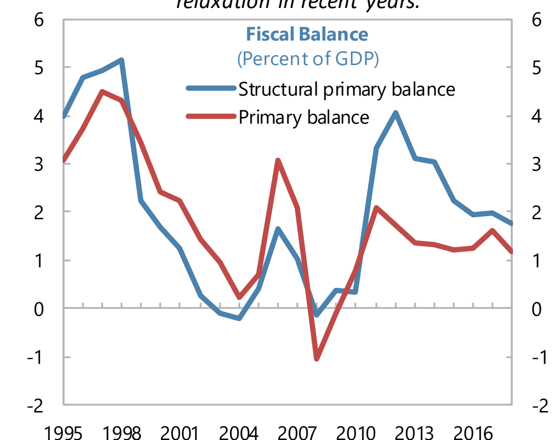
Bond redemptions coming due over the next 12 months are notable.



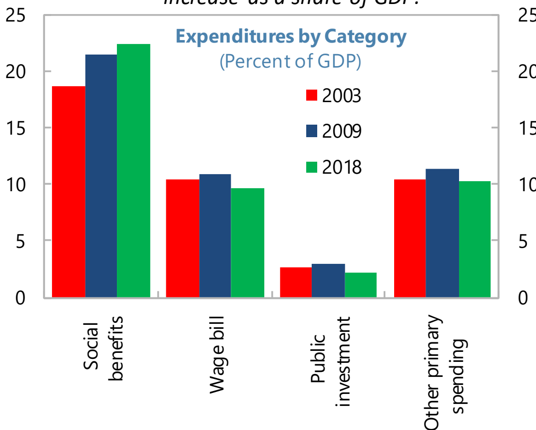
While interest expense has declined...



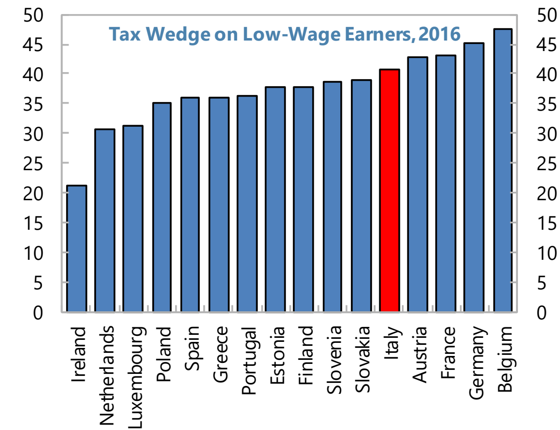
...there has been a sizable (structural) fiscal relaxation in recent years.



Social benefits, including pensions, continue to increase as a share of GDP.



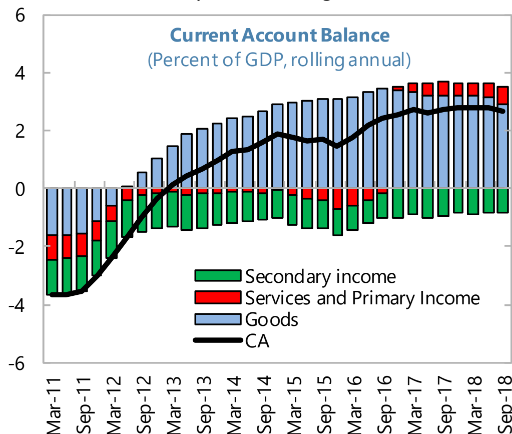
The labor tax wedge remains high.



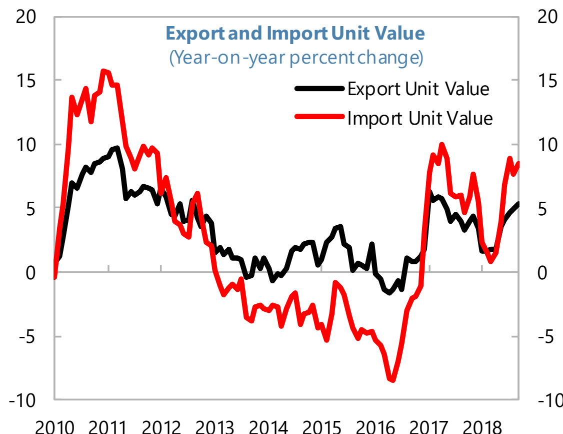
Sources: Eurostat; Bloomberg Finance L.P.; and Bank of Italy.

Figure 7. Italy: External Developments, 2011–18

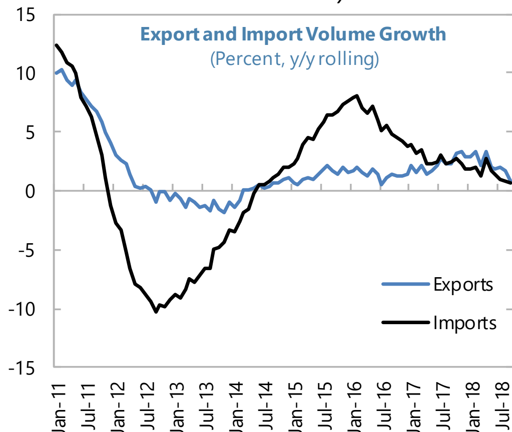
The external current account surplus is being sustained by an increasing income balance.



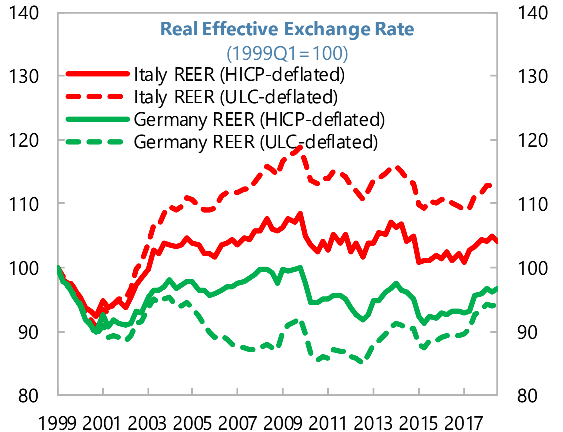
The terms of trade have reversed sharply.



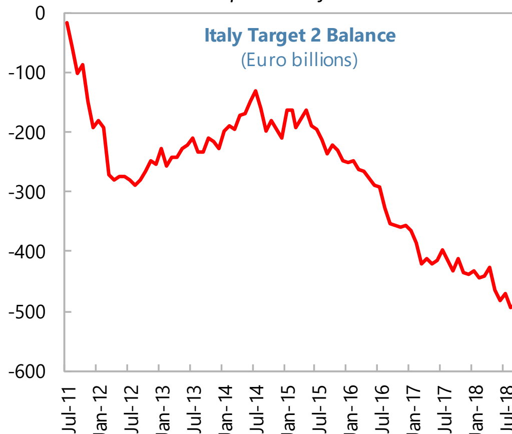
Real exports have not been able to lead the recovery...



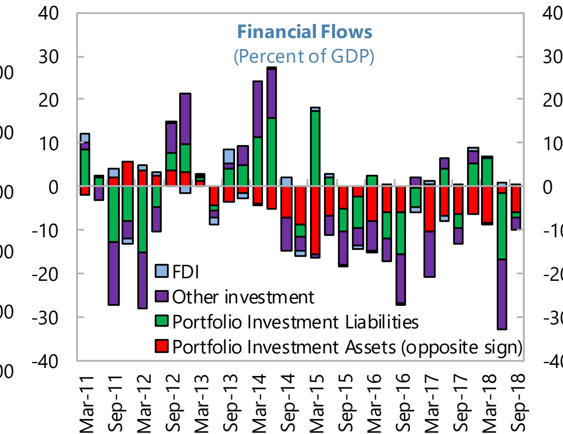
...while the ULC-gap vis-a-vis Germany remains very large.



Target 2 liabilities have risen rapidly above 25 percent of GDP...



...mirroring net outflows from financial account that largely reflect residents' net purchases of foreign assets.



Sources: Haver; Eurostat; and IMF staff estimates.

Table 1. Italy: Summary of Economic Indicators, 2017–23 1/

(Annual percentage change, unless noted otherwise)

		Projections					
	2017	2018	2019	2020	2021	2022	2023
Real GDP	1.6	1.0	0.8	0.7	0.6	0.6	0.6
Real domestic demand	1.3	1.1	0.9	0.8	0.7	0.6	0.6
Final domestic demand	1.7	1.1	0.9	0.8	0.7	0.6	0.6
Private consumption	1.5	0.6	0.9	0.8	0.7	0.6	0.6
Public consumption	-0.1	0.5	0.4	0.5	0.5	0.5	0.5
Gross fixed capital formation	4.3	3.2	1.3	0.9	0.6	0.5	0.7
Stock building 2/	-0.3	0.1	0.0	0.0	0.0	0.0	0.0
Net exports 2/	0.3	-0.1	-0.1	-0.1	-0.1	0.0	0.0
Exports of goods and services	5.7	2.4	1.8	1.8	1.5	1.4	1.3
Imports of goods and services	5.2	3.0	2.2	2.2	1.9	1.6	1.4
Savings 3/	20.4	20.4	20.3	20.1	20.0	20.0	19.9
Investment 3/	17.6	18.2	18.1	18.3	18.4	18.7	18.9
Resource utilization							
Potential GDP	0.4	0.4	0.4	0.5	0.5	0.5	0.6
Output gap (percent of potential)	-1.4	-0.9	-0.5	-0.2	-0.1	-0.1	-0.1
Employment	1.2	1.3	0.7	0.7	0.6	0.5	0.4
Unemployment rate (percent)	11.3	10.7	10.4	10.2	10.1	10.0	9.9
Prices							
GDP deflator	0.5	1.1	1.5	1.5	1.6	1.7	1.7
Consumer prices	1.3	1.3	1.4	1.5	1.6	1.7	1.7
Hourly compensation 4/	1.2	1.9	1.9	1.9	2.0	2.1	2.2
Productivity 4/	2.1	0.1	0.4	0.3	0.3	0.4	0.4
Unit labor costs 4/	-1.0	1.9	1.5	1.6	1.7	1.7	1.8
Fiscal indicators							
General government net lending/borrowing 3/	-2.4	-1.9	-2.7	-2.8	-3.0	-3.0	-3.0
General government primary balance 3/ 5/	1.3	1.6	0.9	0.8	0.8	0.9	1.0
Structural overall balance (percent of potential GDP)	-1.6	-1.5	-2.4	-2.7	-2.9	-3.0	-3.0
Structural primary balance (percent of potential GDP) 5/	2.0	2.0	1.2	1.0	0.9	0.9	1.1
General government gross debt 3/	131.2	131.4	131.1	131.1	131.3	131.4	131.4
Exchange rate regime	Member of the EMU						
Exchange rate (national currency per U.S. dollar)	0.9	...	...	...	...	...	...
External sector 4/							
Current account balance	2.7	2.3	2.3	1.9	1.6	1.3	1.0
Trade balance	3.2	2.5	2.6	2.4	2.2	2.0	1.8

Sources: National Authorities; and IMF staff estimates.

1/ IMF staff estimates and projections are based on the government's 2019 draft budget plan and September 2018 Update Note of the Economic and Financial Document.

2/ Contribution to growth.

3/ Percent of GDP.

4/ In industry (including construction).

5/ Primary revenue minus primary expenditure.

Table 2. Italy: Statement of Operations—General Government (GFSM 2001 Format), 2010–23

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
									Projections					
	(Billions of euros)													
Revenue	732.9	748.3	772.3	772.5	776.2	787.3	785.9	799.7	813.6	832.8	850.5	868.2	889.3	911.1
Taxes	453.9	464.9	488.0	484.9	487.5	493.3	495.1	501.9	504.9	516.9	529.5	542.1	555.8	569.9
Social contributions	213.7	216.3	215.8	215.3	214.3	219.1	220.6	225.7	234.2	239.7	243.1	246.5	252.1	257.9
Grants	1.7	3.4	4.2	3.9	4.9	5.6	1.0	2.5	2.5	2.5	2.5	2.5	2.5	2.5
Other revenue	63.6	63.8	64.2	68.4	69.3	69.3	69.2	69.6	72.0	73.8	75.4	77.1	78.9	80.8
Expenditure	800.5	808.6	819.3	819.4	825.5	830.4	828.9	840.8	846.5	881.4	902.5	924.4	947.3	970.3
Expense	800.3	808.4	819.1	818.9	825.0	830.0	828.4	840.7	846.4	881.3	902.4	924.3	947.2	970.2
Compensation of employees	172.5	169.6	166.1	164.8	163.5	162.1	164.0	164.2	169.4	173.3	177.1	181.0	185.1	189.4
Use of goods and services	87.4	87.2	87.0	89.6	88.9	89.9	92.2	94.9	96.9	95.5	97.6	99.7	102.0	104.4
Consumption of fixed capital	42.8	42.7	43.4	44.4	44.5	44.6	44.1	44.3	43.0	48.6	52.0	55.5	56.8	58.1
Interest	68.8	76.4	83.6	77.6	74.4	68.1	66.3	65.5	64.4	66.9	70.2	74.1	77.6	82.3
Social benefits	345.0	349.1	354.8	363.2	371.1	376.7	380.9	386.7	394.7	419.9	429.1	438.4	448.4	458.7
Other expense	83.7	83.4	84.2	79.3	82.7	88.6	80.9	85.0	78.1	77.0	76.4	75.7	77.4	77.3
Net acquisition of nonfinancial assets	0.2	0.2	0.2	0.5	0.5	0.5	0.5	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Net lending/borrowing 1/	-67.6	-60.2	-47.1	-46.9	-49.3	-43.2	-42.9	-41.1	-32.9	-48.6	-52.0	-56.3	-58.1	-59.2
	(Percent of GDP, unless otherwise indicated)													
Revenue	45.7	45.7	47.9	48.1	47.9	47.7	46.5	46.4	46.2	46.2	46.2	46.1	46.2	46.3
Taxes	28.3	28.4	30.3	30.2	30.1	29.9	29.3	29.1	28.7	28.7	28.8	28.8	28.9	29.0
Social contributions	13.3	13.2	13.4	13.4	13.2	13.3	13.1	13.1	13.3	13.3	13.2	13.1	13.1	13.1
Grants	0.1	0.2	0.3	0.2	0.3	0.3	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Other revenue	4.0	3.9	4.0	4.3	4.3	4.2	4.1	4.0	4.1	4.1	4.1	4.1	4.1	4.1
Expenditure	49.9	49.4	50.8	51.1	50.9	50.3	49.1	48.7	48.1	48.9	49.0	49.1	49.2	49.3
Expense	49.9	49.4	50.8	51.0	50.9	50.2	49.0	48.7	48.1	48.9	49.0	49.1	49.2	49.3
Compensation of employees	10.8	10.4	10.3	10.3	10.1	9.8	9.7	9.5	9.6	9.6	9.6	9.6	9.6	9.6
Use of goods and services	5.4	5.3	5.4	5.6	5.5	5.4	5.5	5.5	5.5	5.3	5.3	5.3	5.3	5.3
Consumption of fixed capital	2.7	2.6	2.7	2.8	2.7	2.7	2.6	2.6	2.4	2.7	2.8	2.9	2.9	2.9
Interest	4.3	4.7	5.2	4.8	4.6	4.1	3.9	3.8	3.7	3.7	3.8	3.9	4.0	4.2
Social benefits	21.5	21.3	22.0	22.6	22.9	22.8	22.5	22.4	22.4	23.3	23.3	23.3	23.3	23.3
Other expense	5.2	5.1	5.2	4.9	5.1	5.4	4.8	4.9	4.4	4.3	4.1	4.0	4.0	3.9
Net acquisition of nonfinancial assets	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net lending/borrowing 1/	-4.2	-3.7	-2.9	-2.9	-3.0	-2.6	-2.5	-2.4	-1.9	-2.7	-2.8	-3.0	-3.0	-3.0
Memorandum items:														
Primary balance 2/	-0.1	0.8	2.1	1.7	1.4	1.3	1.2	1.3	1.6	0.9	0.8	0.8	0.9	1.0
Structural primary balance 2/	0.4	0.4	3.3	4.1	3.1	3.0	2.2	2.0	2.0	1.2	1.0	0.9	0.9	1.1
Change in structural primary balance 3/	0.5	0.0	3.0	0.7	-1.0	-0.1	-0.8	-0.3	0.0	-0.8	-0.2	-0.1	0.0	0.2
Structural balance 3/	-3.7	-4.1	-1.5	-0.6	-1.1	-0.8	-1.4	-1.6	-1.5	-2.4	-2.7	-2.9	-3.0	-3.0
Change in structural balance 3/	0.5	-0.4	2.6	1.0	-0.5	0.3	-0.6	-0.2	0.1	-0.9	-0.3	-0.2	-0.1	0.0
General government gross debt 1/	115.4	116.5	123.4	129.0	131.8	131.6	131.4	131.2	131.4	131.1	131.1	131.3	131.4	131.4

Sources: National Authorities; and IMF staff estimates.

1/ State aid following the liquidation of two banks in June 2017 is reflected in public debt (0.6 percent of GDP), but not in net lending/borrowing, pending clarity on their statistical treatment.

2/ Primary revenue minus primary expenditure.

3/ Percent of potential GDP.

Table 3. Italy: Summary of Balance of Payments, 2015–23

	2015	2016	2017	2018	2019	2020	2021	2022	2023
				Projections					
				(Billions of euros)					
Current account balance	25.0	43.1	47.3	39.9	40.9	34.2	29.5	24.7	20.2
Balance of goods and services	48.5	54.7	51.8	40.6	43.7	40.7	36.7	32.6	28.8
Goods balance	51.1	57.7	55.7	43.6	47.3	44.9	41.3	37.9	34.7
Exports	406.0	410.0	439.5	461.8	473.7	487.8	500.5	512.9	525.4
Imports	354.9	352.4	383.8	418.3	426.4	442.9	459.1	475.0	490.7
Services balance	-2.6	-2.9	-3.9	-3.0	-3.6	-4.1	-4.7	-5.4	-5.9
Credit	88.7	91.1	97.9	102.1	104.6	107.3	110.0	112.7	115.5
Debit	91.3	94.0	101.7	105.1	108.2	111.5	114.7	118.1	121.5
Primary income balance	-8.2	5.0	10.2	15.5	13.8	10.5	10.2	9.9	9.6
Credit	54.0	64.2	66.2	72.6	72.3	70.2	71.2	72.3	73.5
Debit	62.2	59.2	56.0	57.1	58.5	59.7	61.0	62.4	63.9
Secondary income balance	-15.3	-16.7	-14.7	-16.3	-16.6	-17.0	-17.4	-17.8	-18.2
Capital account balance	3.9	-3.1	-0.9	1.8	1.8	1.8	1.9	1.9	2.0
Financial account	35.2	65.4	47.2	41.6	42.7	36.1	31.4	26.6	22.2
Direct investment	2.4	-4.1	-11.2	2.3	2.6	3.0	3.5	3.9	4.3
Portfolio investment	97.5	159.5	98.4	58.7	10.2	9.8	-15.4	-3.1	-22.7
Other investment	-67.6	-85.9	-36.9	-17.1	30.3	22.9	42.6	24.9	39.5
Derivatives (net)	2.3	-3.0	-5.7	-2.3	-0.5	0.3	0.8	1.0	1.1
Reserve assets	0.5	-1.2	2.7	0.0	0.0	0.0	0.0	0.0	0.0
Net errors and omissions	6.3	25.4	0.8	0.0	0.0	0.0	0.0	0.0	0.0
				(Percent of GDP)					
Current account balance	1.5	2.5	2.7	2.3	2.3	1.9	1.6	1.3	1.0
Balance on goods and services	2.9	3.2	3.0	2.3	2.4	2.2	1.9	1.7	1.5
Goods balance	3.1	3.4	3.2	2.5	2.6	2.4	2.2	2.0	1.8
Services balance	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.3	-0.3
Primary income balance	-0.5	0.3	0.6	0.9	0.8	0.6	0.5	0.5	0.5
Secondary income balance	-0.9	-1.0	-0.9	-0.9	-0.9	-0.9	-0.9	-0.9	-0.9
Capital account balance	0.2	-0.2	-0.1	0.1	0.1	0.1	0.1	0.1	0.1
Financial account	2.1	3.9	2.7	2.4	2.4	2.0	1.7	1.4	1.1
Direct investment	0.1	-0.2	-0.7	0.1	0.1	0.2	0.2	0.2	0.2
Portfolio investment	5.9	9.4	5.7	3.3	0.6	0.5	-0.8	-0.2	-1.2
Other investment	-4.1	-5.1	-2.1	-1.0	1.7	1.2	2.3	1.3	2.0
Derivatives (net)	0.1	-0.2	-0.3	-0.1	0.0	0.0	0.0	0.1	0.1
Reserve assets	0.0	-0.1	0.2	0.0	0.0	0.0	0.0	0.0	0.0
Net errors and omissions	0.4	1.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Gross external debt	125.2	122.6	123.6	124.2	122.7	120.9	121.0	120.7	121.8
Public sector	66.3	69.1	71.8	73.3	72.2	70.5	70.6	70.3	71.4
Private sector	58.9	53.5	51.8	50.9	50.5	50.4	50.4	50.4	50.4

Sources: National Authorities; and IMF staff estimates. BPM6 presentation.

Table 4. Italy: Financial Soundness Indicators, 2012–18 1/

(Percent, unless otherwise noted)

	2012	2013	2014	2015	2016	2017	2018
	Core FSIs for Deposit-taking institutions						
Regulatory capital to risk-weighted assets	13.4	13.7	14.3	14.8	13.8	16.7	16.0
Regulatory tier 1 capital to risk-weighted assets	10.5	10.6	11.9	12.3	11.3	14.3	13.8
Nonperforming loans net of provisions to capital	79.7	89.9	93.4	89.0	85.2	58.0	45.7
Nonperforming loans to total gross loans	13.7	16.5	18.0	18.1	17.1	14.4	9.9
Sectoral distribution of loans to total loans:							
Loans to Residents	75.5	75.7	75.3	74.3	76.9	75.5	74.4
Loans to Deposit takers	2.6	2.7	2.5	2.5	2.3	2.5	2.6
Loans to Central Bank	1.1	0.8	0.6	0.8	2.8	4.3	3.8
Loans to Other financial corporations	6.0	6.1	6.6	7.4	7.7	7.6	7.7
Loans to General government	2.6	2.5	2.4	2.0	1.9	1.5	1.5
Loans to Nonfinancial corporations	37.2	36.8	36.8	35.4	34.6	32.3	31.5
Loans to Other domestic sectors	25.9	26.9	26.5	26.2	27.6	27.3	27.4
Loans to Nonresidents	24.5	24.3	24.7	25.7	23.1	24.5	25.6
Growth of bank loans to private non-MFI 2/	-0.9	-3.7	-1.6	-0.4	1.1	1.8	2.9
Nonfinancial corporations	-2.1	-5.2	-2.3	-0.6	0.2	0.2	1.9
Households	-0.5	-1.3	-0.6	0.7	1.9	2.8	2.8
Return on assets	-0.1	-0.8	-0.2	0.3	-0.5	0.6	0.3
Return on equity	-0.9	-11.5	-2.8	3.4	-7.7	7.5	4.0
Interest margin to gross income	53.8	49.1	50.4	47.7	48.4	48.2	48.4
Net open position in foreign exchange to capital	1.2	2.0	0.0	0.3	1.5	1.3	0.3
	Encouraged FSIs for Deposit-taking institutions						
Capital to assets	5.4	5.4	5.9	6.2	5.5	6.6	6.3
Large exposures to capital	91.8	81.9	210.3	205.6	249.6	211.9	231.6
Gross asset position in financial derivatives to capital	76.7	70.2	70.8	84.4	80.9	43.8	64.1
Gross liability position in financial derivatives to capital	83.2	75.5	71.6	85.8	84.5	41.3	84.6
Personnel expenses to noninterest expenses	55.7	57.7	55.0	52.8	53.0	54.3	51.7
Spread between reference lending and deposit rates (basis points)	263.9	284.1	292.1	272.5	243.9	226.2	220.8
Spread between highest and lowest interbank rates (basis points)	12.4	19.7	9.9	33.6	8.1	5.0	0.9
Customer deposits to total (noninterbank) loans	67.9	70.5	70.6	75.2	86.1	80.9	70.9
Foreign-currency-denominated loans to total loans	8.3	8.8	9.5	10.0	9.7	8.6	8.4
Foreign-currency-denominated liabilities to total liabilities	6.3	6.4	7.1	7.9	7.9	7.3	7.3

Sources: IMF, Financial Soundness Indicators

1/ Data from the IMF Financial Soundness Indicators database have been updated, when possible, with Bank of Italy's or ECB's data. 2018Q2 data is latest available.

2/ Data are from Bank of Italy.

Annex I. Italy's External Sector Assessment

	Italy
Foreign asset and liability position and trajectory	**Background**. Italy's net international investment position (NIIP) reached -7 percent of GDP at end-2017, returning broadly to the level at end-2000 (-6 percent of GDP). Gross assets and liabilities, however, reached 157 and 164 percent of GDP respectively, both 58 percentage points higher than in 2000. TARGET2 liabilities rose from about 15 to 26 percent of GDP between end-2015 and end-2017, in part reflecting residents' net purchases of foreign assets and the creation of liquidity by the Bank of Italy's participation in the ECB's asset purchase program. Debt securities represent about ¾ of gross external liabilities, half of which is owed by the public sector. Modest current account (CA) surpluses forecast should continue to improve gradually the NIIP. **Assessment**. Further strengthening of balance sheets would reduce vulnerabilities, related to the high public debt and potential negative feedback loops between the debt stock and debt servicing costs.
Current account	**Background**. Italy's CA averaged -1¼ percent of GDP in the decade following euro adoption. Starting in 2013, it moved into balance; by 2017, it registered a multi-year high surplus of 2.7 percent of GDP before declining somewhat in 2018 as higher energy costs and weaker external demand reduced the trade surplus. About two-thirds of the improvement since 2013 was driven by Italy's growing trade surplus, supported initially by lower commodity prices and subsequently by a rebound in external demand. The rest was due to a higher income balance following the increase in residents' net purchases of foreign assets and a reduction of external liabilities' payments, related not least to the impact of monetary policy. In terms of saving and investment, declining investment accounted for ⅔ of the improvement in the CA since 2010, while higher public saving contributed most of the rest. **Assessment**. The cyclically-adjusted CA is estimated at 2.1 percent of GDP in 2017, -0.3 p.p. below the EBA estimated CA norm of 2½ percent of GDP. 1/ Staff assesses a CA gap in the range of -1.3 and +0.7 percent of GDP. Italy's sizable and long-standing structural rigidities, however, hamper its ability to improve competitiveness (also reflected in negative residuals from the EBA CA model). 2/
CA Assessment 2017	Actual CA: 2.8 | Cycl. Adj. CA: 2.1 | EBA CA Norm: 2.5 | EBA CA Gap: -0.3 | Staff Adj.: 0.0 | Staff CA Gap: -0.3
Real exchange rate	**Background**. From 2016 to 2017, the CPI-based real effective exchange rate (REER) appreciated by 0.8 percent while the ULC-based REER was unchanged. From a longer perspective, stagnant productivity and rising labor costs have led to a gradual appreciation of the REER since Italy joined the euro area, both in absolute terms and relative to the euro area average (by about 10 percent using ULC-based indices). As of November 2018, the REER appreciated by a further 3.9 percent relative to the 2017 average. **Assessment**. The EBA level and index REER models suggest a modest overvaluation of 5.4 percent and 7.2 percent, respectively. This is generally consistent with, but slightly below, the persistent wage-productivity differentials vis-à-vis key partners, and it corresponds to a CA gap in the lower end of the staff-assessed CA gap range. 3/ Taken together, staff assesses a REER gap of 0–10 percent.
Capital and financial accounts: flows and policy measures	**Background.** Portfolio and other-investment inflows typically have financed the CA deficits of the past, despite a modest net FDI outflow, without much difficulty. Italy's financial account posted net outflows of about 3 percent of GDP in 2017, largely reflecting residents' net purchases of foreign assets, even as foreign investment in Italian portfolio securities continued. **Assessment.** While supported by monetary accommodation by the ECB, Italy remains vulnerable to market volatility, owing to the large refinancing needs of the sovereign and banking sectors, and the potentially tight credit conditions from the still high stock of NPLs in the banking sector.
FX intervention and reserves level	**Background.** The euro has the status of a global reserve currency. **Assessment.** Reserves held by the euro area are typically low relative to standard metrics, but the currency is free floating.
Technical Background Notes	1/ The CA norm for 2017 (2.5 percent) is lower than in 2016 (4.4 percent), reflecting methodological refinements to the EBA framework, particularly as it pertains to capturing demographic effects and credit cycles. For Italy, the refined model indicates a positive, but smaller, contribution of demographics (1.7 instead of 3.4 percent), and a small positive contribution of policies (including credit) of 0.3 percent (instead of -0.5 percent as in 2016). 2/ IMF Working Paper No. 18/60, "Italy: Quantifying the Benefits of a Comprehensive Package" provides an overview of the structural distortions and the impact on the REER in Italy. 3/ The elasticity of the REER to the CA gap is estimated to be 0.26.

Overall Assessment

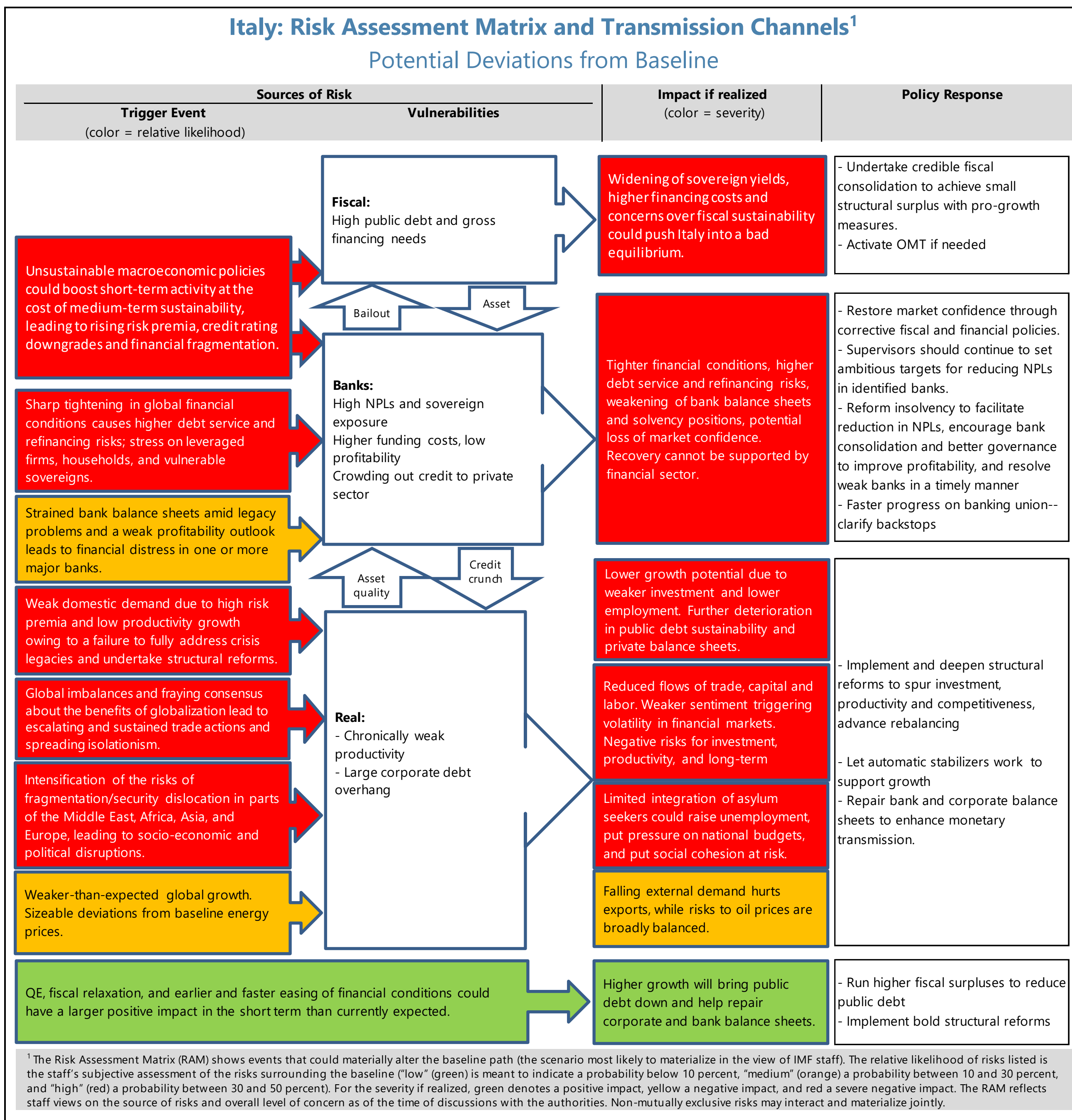
Overall Assessment: *The external position in 2017 was broadly in line with fundamentals and desirable policy settings. Recent developments and the projected outturn for 2018 suggest that this assessment remains valid.*

Nonetheless, improving competitiveness would help strengthen growth, consistent with reducing high unemployment and public debt, and safeguard the external balance sheet.

Potential policy responses:

Strong implementation of structural reforms, including to improve the wage bargaining mechanism to better align wages with productivity at the firm level, as well as efforts to strengthen bank balance sheets will be critical to improving competitiveness, boosting potential growth, and reducing vulnerabilities. Credible, growth-friendly and inclusive fiscal consolidation will also help reduce external vulnerabilities and maintain investor confidence.

Annex II. Risk Assessment Matrix



[1] The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood of risks listed is the staff's subjective assessment of the risks surrounding the baseline ("low" (green) is meant to indicate a probability below 10 percent, "medium" (orange) a probability between 10 and 30 percent, and "high" (red) a probability between 30 and 50 percent). For the severity if realized, green denotes a positive impact, yellow a negative impact, and red a severe negative impact. The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly.

Annex III. Debt Sustainability Analysis

Italy's public debt is very high at about 131 percent of GDP. In the baseline, debt remains broadly stable for the next few years. It then rises under staff's projection of rising interest rates as monetary conditions normalize and of higher pension spending. In the event of modest adverse shocks or further fiscal relaxation, debt would rise earlier and faster. Implementing an ambitious structural reform and fiscal adjustment package is essential to putting debt on a firm downward trajectory and, thus, to securing sustainability.

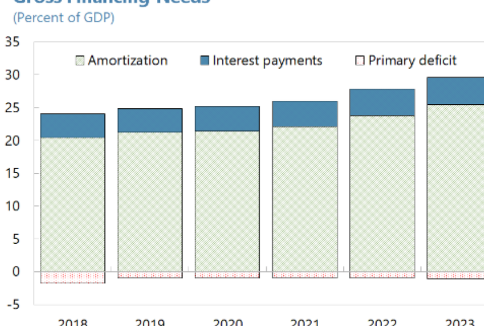
1. Public debt in Italy is very high and a key source of vulnerability.

- Debt increased from about 100 percent of GDP in 2007 to 131.2 percent of GDP in 2017.[1] In percent of GDP, it is the second highest in the euro area, after Greece.

- Gross financing needs are sizable, related to large rollover needs. The structure of debt partially mitigates refinancing risks. About two-thirds of debt is held by domestic investors. Average residual maturity is around 7½ years and about 75 percent of debt is at fixed interest rates, which moderates the pass-through to the budget of rising interest rates.

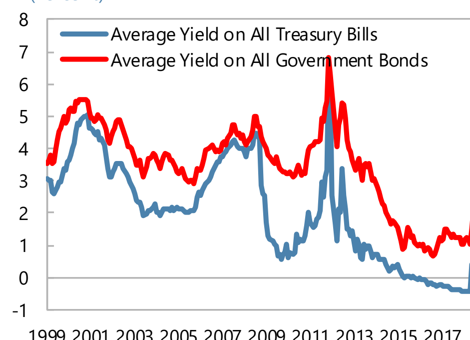
- Notwithstanding the recent increase is spreads, the ECB's accommodative stance has helped to bring yields down in recent years, and its sovereign bond purchasing program has mitigated refinancing risk. Since March 2015, the Eurosystem's net purchases of Italian public debt were €362 billion, compared with gross medium- to long-term bond issuances of about €600 billion.

Gross Financing Needs
(Percent of GDP)



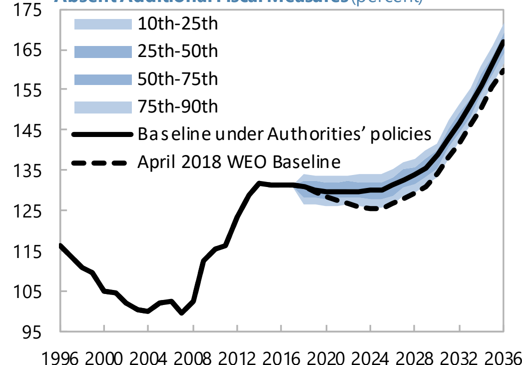
Sources: Bloomberg and IMF staff

Treasury Bills and Government Bond Yeilds
(Percent)



Source: Haver Analytics.

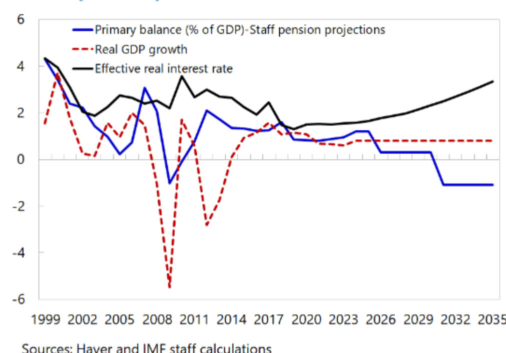
Staff Projections of the Debt-to-GDP Ratio, Absent Additional Fiscal Measures (percent)



2. Public debt is projected to remain broadly stable over the medium term, after which it is projected to rise. In the baseline, debt is projected to remain broadly stable at about 131 percent of GDP, owing to the historically subdued interest rates. But

[1] The definition of public debt comprises EDP debt of the General Government, which includes the Central Government, Regional Governments, Local Government, and Social Security Funds. EDP debt is a subset of General Government consolidated debt, excluding items such as certain trade credits and other accounts payable. Stocks are recorded at their face value and thus usually exclude unpaid accrued interest.

debt would rise in the longer term under staff's projections of rising interest rates during monetary policy normalization and of pension spending. The assumptions underpinning the baseline:

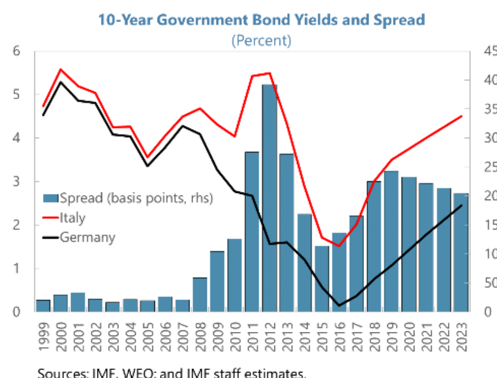


- Real GDP growth is projected to average ¾ percent annually during 2018–23 and about 0.7 percent thereafter. This rate of growth is higher than what it has been over the past two decades. The GDP deflator is projected to rise from 0.5 percent in 2017 to a steady state of around 1¾ percent over the next few years.[2]

- The government is assumed to maintain an average structural primary surplus of about 1 percent of GDP over the period 2018–2023. Thereafter, the primary balance would deteriorate with higher pension spending (by about 3 percent of GDP above the authorities' projections over the period 2017–2035, cumulatively). As highlighted in IMF working paper 18/59, the authorities rely on very optimistic employment and productivity growth assumptions to project stable pension dynamics over the next 2–3 decades, while staff showed that pensions rise notably under prudent macroeconomic assumptions—see the text figure in ¶32. The proposed reversal of pension reforms would increase pension spending by a further 1 percent of GDP.

- Over the medium term, staff projects an effective nominal interest rate of about 3 percent, or an average interest bill of about 3.9 percent of GDP. The marginal cost of borrowing, i.e., at issuance, is projected to increase to 2.9 percent in 2019 from a low of 0.7 percent in 2017. Spreads vis-à-vis German bunds are assumed to decline gradually from an average of 225 basis points in 2018 to 205 basis points in 2023. The average cost of debt rises gradually as monetary policy normalizes, with the effective nominal interest rate increasing to around 5 percent by 2035 (3½ percent in real terms).

- An effective real interest rate of 3½ percent (about 50 basis points higher than the average over 1996–2017), with real GDP growth of ⅔ percent (higher than the historical average), implies a debt stabilizing primary balance of about 3½ percent of GDP.



Debt Stabilizing Primary Balance

(At 131 percent of GDP)

		Real GDP growth rate (in percent)			
		0.0	0.5	1.0	1.5
Real interest rate (in percent)	2.5	**3.3**	2.7	2.0	1.3
	3.0	3.9	**3.3**	2.7	2.0
	3.5	4.5	3.9	**3.3**	2.6
	4.0	5.1	4.5	3.9	**3.3**

[2] The deflator is assumed to be below the euro area steady state rate of about 2 percent, owing to lagging productivity growth. The larger the differential in productivity growth between Italy's tradable and non-tradable sectors, relative to the euro area, the lower will the deflator in Italy need to be to sustain competitiveness measured in terms of unit labor costs.

- Privatization outturns over the years have been consistently below targeted amounts. The authorities have indicated potential privatization receipts of 1 percent of GDP in 2019. This would exceed the cumulative receipts collected over the past five years.

Privatization Receipts: Objectives and Outturns, 2013–21 1/
(Percent of GDP)

	2013	2014	2015	2016	2017	2018	2019	2020	2021
Objectives									
2013 DEF (April 2013)	1.0	1.0	1.0	1.0	1.0	…	…	…	…
Update to the 2013 DEF (September 2013)	…	0.5	0.5	0.5	0.5	…	…	…	…
2014 DEF (April 2014)	…	0.7	0.7	0.7	0.7	…	…	…	…
Update to the 2014 DEF (September 2014)	…	0.3	0.7	0.7	0.7	0.7	…	…	…
2015 DEF (April 2015)	…	…	0.4	0.5	0.5	0.3	…	…	…
Update to the 2015 DEF (September 2015)	…	…	0.4	0.5	0.5	0.5	…	…	…
2016 DEF (April 2016)	…	…	…	0.5	0.5	0.5	0.3	…	…
Update to the 2016 DEF (September 2016)	…	…	…	0.1	0.5	0.5	0.3	…	…
2017 DEF (April 2017)	…	…	…	…	0.3	0.3	0.3	0.3	…
Update to the 2017 DEF (September 2017)	…	…	…	…	0.2	0.3	0.3	0.3	…
2018 DEF (April 2018)	…	…	…	…	…	0.3	0.3	0.3	0.0
Update to the 2018 DEF (September 2018)	…	…	…	…	…	0.3	0.3	0.3	0.0
Revised Draft Budget Plan 2019	…	…	…	…	…	0.3	1.0	0.3	0.0
Outturns	0.1	0.2	0.4	0.1	0.0	…	…	…	…

1/ The objectives expressed as a percentage of GDP are those indicated in the various planning documents.

3. **Important risks are embedded in the baseline assumptions.** Italy's forecast track record in recent years is comparable to that of other surveillance countries, with the forecast errors for real GDP growth and inflation close to the median across all surveillance countries. However, Italy's projected fiscal stance is subject to significant downside risks.

- Sizable and sustained primary surpluses of about 4 percent of GDP will be needed to put debt on a firm downward trajectory. Italy has a history of running primary surpluses; primary surpluses averaged 1¼ percent of GDP during 2001–17. However, these were insufficient to ensure debt would not rise.[3]

- A more expansionary fiscal stance than in the baseline, e.g., if government implements further tax cuts in 2020 and beyond (as promised in their coalition agreement), or if public investment is raised to 3 percent of GDP by 2023 (as announced during the discussion of the new fiscal plan), would further increase debt.

4. **Materialization of moderate shocks would result in debt rising earlier and faster, e.g.:**

- *Standard growth shock.* Real output growth rates are assumed to be lower by one standard deviation for two years starting in 2019, resulting in an average growth of -1½ percent in

[3] Cross-country evidence suggests that sustaining large primary surpluses in the absence of growth has been difficult in post-war history (see country report 17/229, Annex III).

2019–20. Furthermore, for every 1 percentage point decline in growth, inflation is assumed to decline by 25 bps. The primary balance would decline, reaching -1.5 percent of GDP by 2023. Debt increases to 152.5 percent of GDP and fails to come down over the projection period.

- *Interest rate shock*. Spreads could increase further, for instance, from an accelerated exit from accommodative monetary policies in the United States and euro area, political uncertainty, or a re-emergence of concerns about debt sustainability. A further increase in spreads of 205 bps is assumed (during the 2011–12 episode, spreads increased above 500 bps). Higher borrowing costs are passed on to the real economy, depressing growth by 0.4 p.p. for every 100 bps increase in spreads. The implicit average interest rate on debt rises to 4 percent by 2023. Debt increases to around 140 percent of GDP by 2023.

- *Contingent liability shock*. Negative surprises, such as from the financial system, could lead to a one-time increase in non-interest expenditure that is standardized to about 10 percent of banking sector assets. This is assumed to be accompanied by lower growth for two consecutive years by -1½ percentage points, and lower inflation by ½ percent. The primary balance is assumed to worsen by 11 percent of GDP in 2019, e.g., from costs to recapitalize the banking system or of other contingent fiscal liabilities (as reported by Eurostat).[4] Debt rises to 166 percent of GDP by 2023. Gross financing needs would be significantly higher.

[4] Government guarantees, the government's off-balance sheet liabilities related to public-private partnerships, and liabilities of government-controlled entities (public corporations) classified outside general government amounted to 2.4, zero, and 51.9 percent of GDP, respectively, at end-2016 (source: Eurostat).

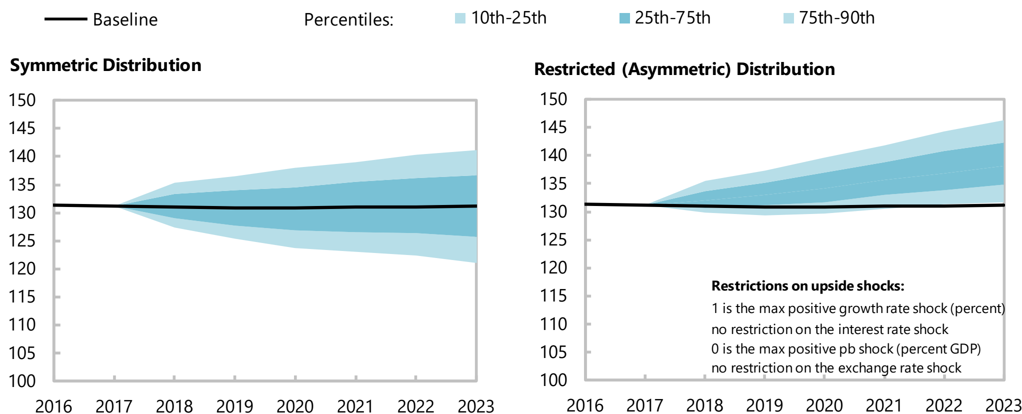
Figure A3.1. Italy: Public DSA Risk Assessment

Heat Map

Debt level [1/]	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability shock
Gross financing needs [2/]	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability Shock
Debt profile [3/]	Market Perception	External Financing Requirements	Change in the Share of Short-Term Debt	Public Debt Held by Non-Residents	Foreign Currency Debt

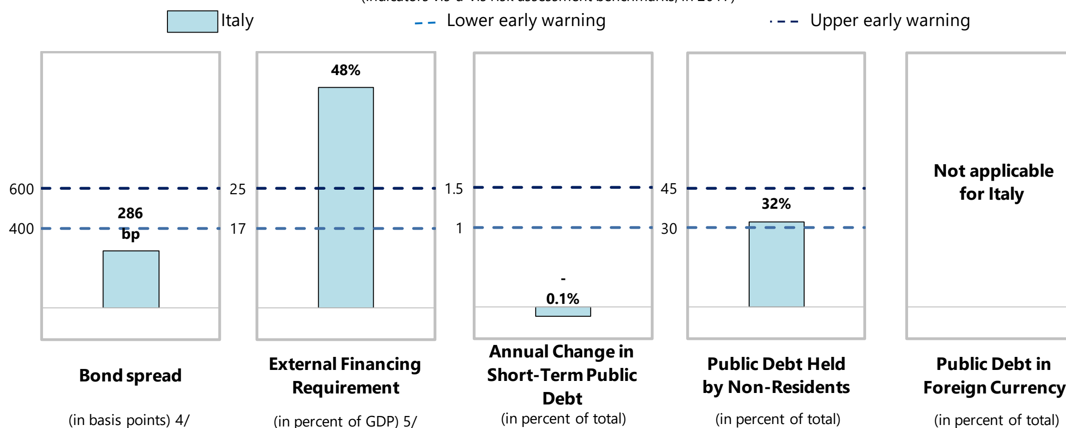
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2017)



Source: IMF staff.

1/ The cell is highlighted in green if debt burden benchmark of 85% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

2/ The cell is highlighted in green if gross financing needs benchmark of 20% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

3/ The cell is highlighted in green if country value is less than the lower risk-assessment benchmark, red if country value exceeds the upper risk-assessment benchmark, yellow if country value is between the lower and upper risk-assessment benchmarks. If data are unavailable or indicator is not relevant, cell is white.
Lower and upper risk-assessment benchmarks are:

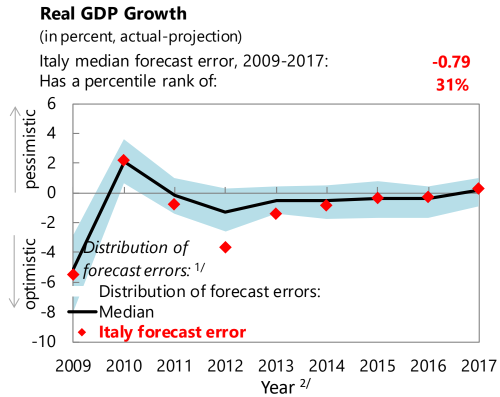
400 and 600 basis points for bond spreads; 17 and 25 percent of GDP for external financing requirement; 1 and 1.5 percent for change in the share of short-term debt; 30 and 45 percent for the public debt held by non-residents.

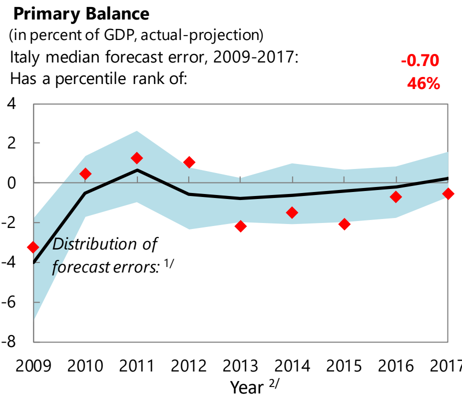
4/ Long-term bond spread over German bonds, an average over the last 3 months, 01-Sep-18 through 30-Nov-18.

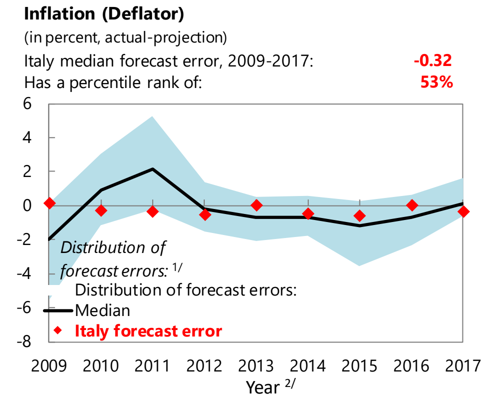
5/ External financing requirement is defined as the sum of current account deficit, amortization of medium and long-term total external debt, and short-term total external debt at the end of previous period.

Figure A3.2. Italy: Public DSA—Realism of Baseline Assumptions

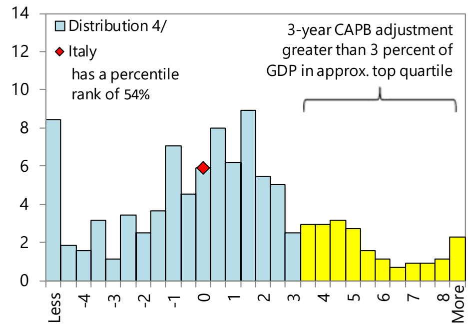
Forecast Track Record, versus all countries

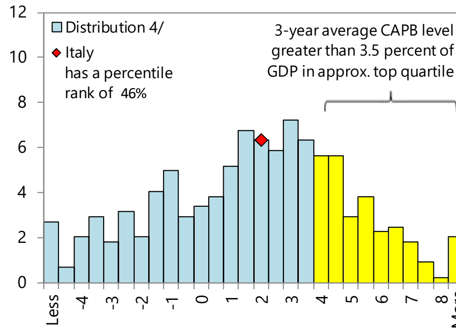




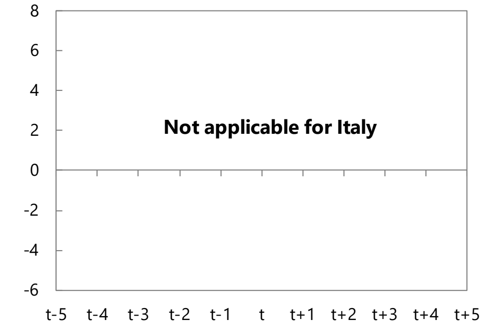


Assessing the Realism of Projected Fiscal Adjustment





Boom-Bust Analysis 3/



Source : IMF Staff.

1/ Plotted distribution includes all countries, percentile rank refers to all countries.

2/ Projections made in the spring WEO vintage of the preceding year.

3/ Not applicable for Italy, as it meets neither the positive output gap criterion nor the private credit growth criterion.

4/ Data cover annual observations from 1990 to 2011 for advanced and emerging economies with debt greater than 60 percent of GDP. Percent of sample on vertical axis.

Figure A3.3. Italy: Public Sector Debt Sustainability Analysis (DSA)—Baseline Scenario

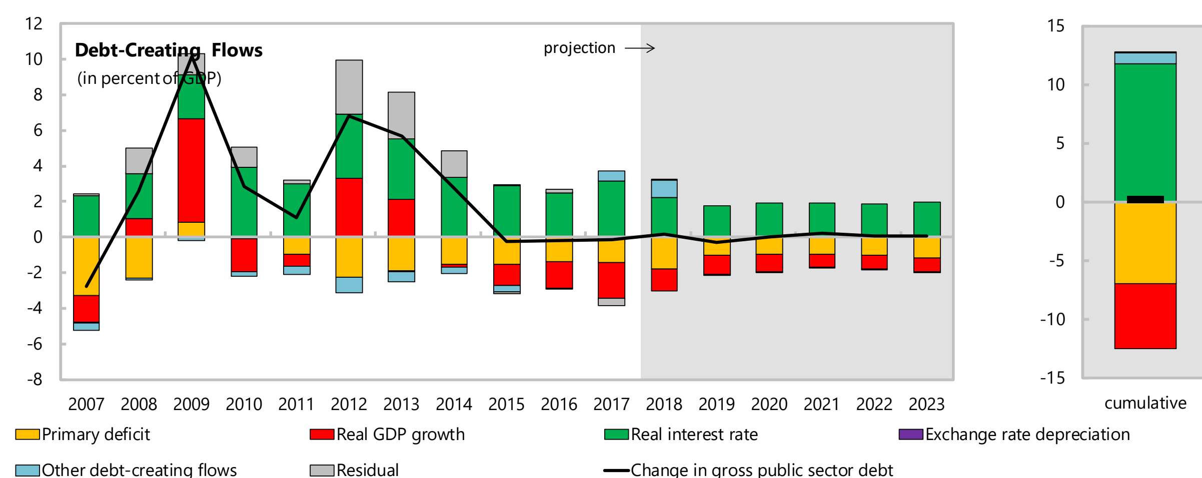
(in percent of GDP unless otherwise indicated)

Debt, Economic and Market Indicators [1/]

	Actual			Projections						As of November 30, 2018		
	2007-2015 [2/]	2016	2017	2018	2019	2020	2021	2022	2023	Sovereign Spreads		
Nominal gross public debt	118.0	131.4	131.2	131.4	131.1	131.1	131.3	131.4	131.4	EMBIG (bp) 3/		292
Public gross financing needs	28.5	23.8	24.9	22.4	23.6	23.6	24.1	25.5	26.7	5Y CDS (bp)		236
Net public debt	107.5	118.9	119.0	119.4	119.4	119.6	120.1	120.4	120.7			
Real GDP growth (in percent)	-0.7	1.1	1.6	1.0	0.8	0.7	0.6	0.6	0.6	Ratings	Foreign	Local
Inflation (GDP deflator, in percent)	1.5	1.1	0.5	1.1	1.5	1.5	1.6	1.7	1.7	Moody's	Baa3	Baa3
Nominal GDP growth (in percent)	0.7	2.3	2.1	2.1	2.3	2.2	2.2	2.3	2.3	S&Ps	BBB	BBB
Effective interest rate (in percent) [4/]	4.1	3.1	3.0	2.8	2.9	3.0	3.1	3.1	3.3	Fitch	BBB	BBB

Contribution to Changes in Public Debt

	Actual			Projections							
	2007-2015	2016	2017	2018	2019	2020	2021	2022	2023	cumulative	debt-stabilizing primary balance [9/]
Change in gross public sector debt	3.2	-0.2	-0.1	0.2	-0.3	0.0	0.2	0.1	0.0	0.2	
Identified debt-creating flows	2.0	-0.4	0.3	0.2	-0.3	0.0	0.2	0.1	0.0	0.2	
Primary deficit	-1.5	-1.4	-1.4	-1.8	-1.0	-1.0	-0.9	-1.0	-1.2	-6.9	1.2
Primary (noninterest) revenue and grants	46.6	46.5	46.4	46.2	46.2	46.2	46.1	46.2	46.3	277.3	
Primary (noninterest) expenditure	45.1	45.1	44.9	44.4	45.2	45.2	45.2	45.2	45.1	270.3	
Automatic debt dynamics [5/]	3.8	1.0	1.1	1.0	0.7	1.0	1.2	1.1	1.2	6.2	
Interest rate/growth differential [6/]	3.8	1.0	1.1	1.0	0.7	1.0	1.2	1.1	1.2	6.2	
Of which: real interest rate	3.0	2.5	3.1	2.3	1.8	1.9	1.9	1.9	2.0	11.8	
Of which: real GDP growth	0.8	-1.5	-2.0	-1.3	-1.1	-0.9	-0.8	-0.8	-0.8	-5.6	
Exchange rate depreciation [7/]	0.0	0.0	0.0	...	...	...	...	...	...	...	
Other identified debt-creating flows	-0.4	-0.1	0.6	1.0	0.0	0.0	0.0	0.0	0.0	1.0	
Privatization Receipts (negative)	-0.2	-0.1	0.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Other debt flows (incl. ESM and Euroarea loans)	-0.2	0.0	0.0	1.0	0.0	0.0	0.0	0.0	0.0	1.0	
Residual, including asset changes [8/]	1.2	0.2	-0.4	0.0	0.0	0.0	0.0	0.0	0.0	0.0	



Source: IMF staff.

1/ Public sector is defined as general government.

2/ Based on available data.

3/ Long-term bond spread over German bonds.

4/ Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.

5/ Derived as [(r - π(1+g) - g + ae(1+r)]/(1+g+π+gπ)) times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

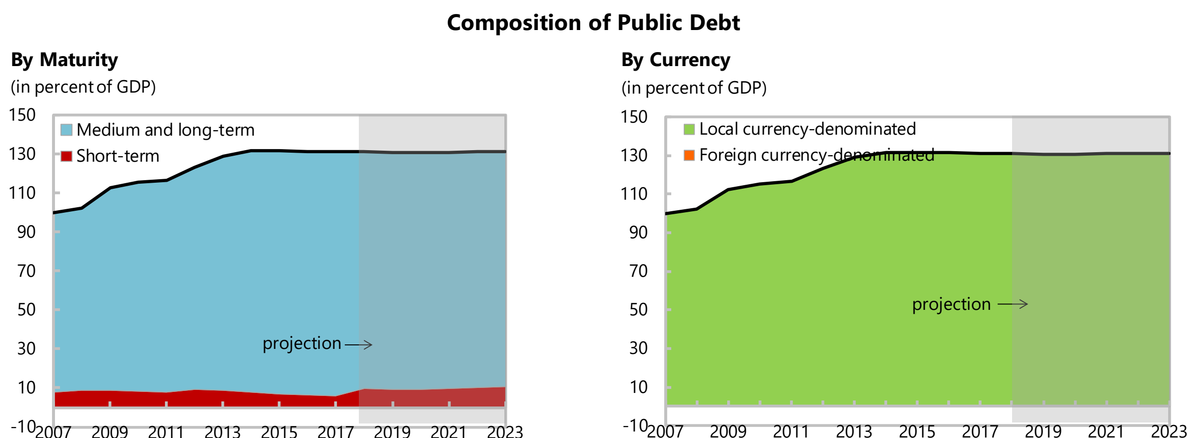
6/ The real interest rate contribution is derived from the numerator in footnote 5 as r - π (1+g) and the real growth contribution as -g.

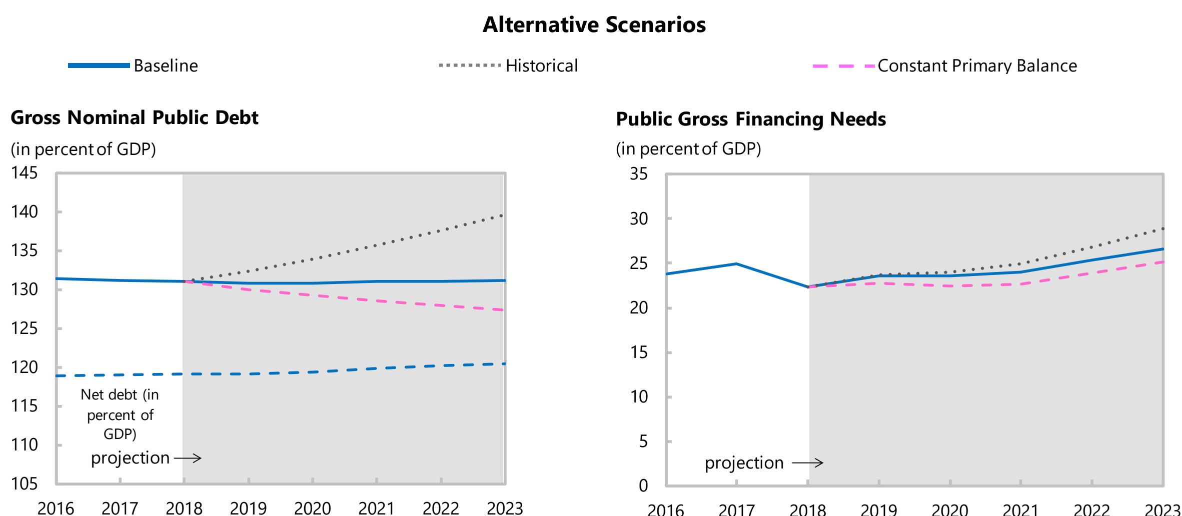
7/ The exchange rate contribution is derived from the numerator in footnote 5 as ae(1+r).

8/ Includes asset changes and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Figure A3.4. Italy: Public DSA—Composition of Public Debt and Alternative Scenarios





Underlying Assumptions

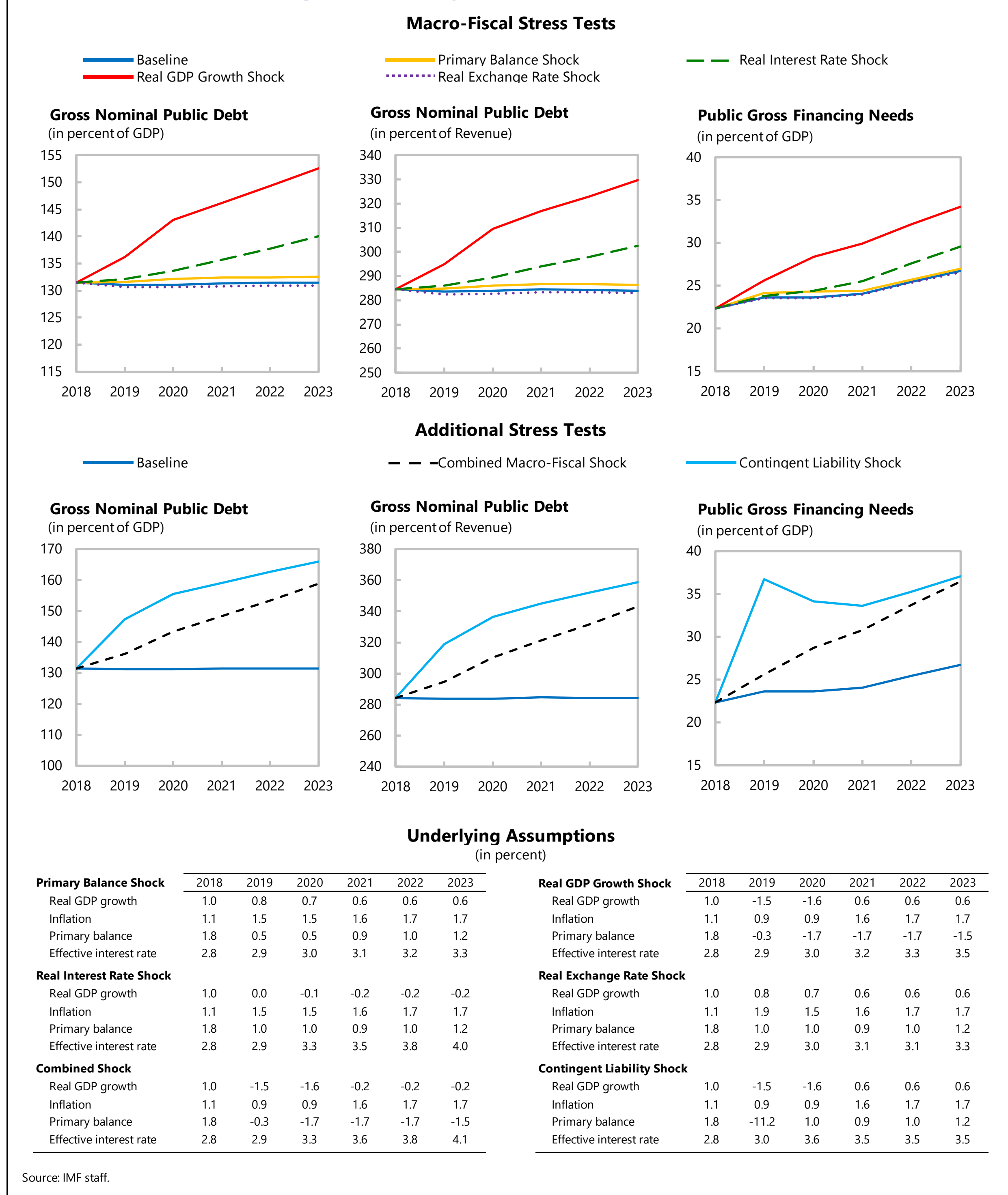
(in percent)

Baseline Scenario	2018	2019	2020	2021	2022	2023
Real GDP growth	1.0	0.8	0.7	0.6	0.6	0.6
Inflation	1.3	1.5	1.5	1.6	1.7	1.7
Primary Balance	1.8	1.0	1.0	0.9	1.0	1.2
Effective interest rate	2.8	2.9	3.0	3.1	3.1	3.3
Constant Primary Balance Scenario						
Real GDP growth	1.0	0.8	0.7	0.6	0.6	0.6
Inflation	1.3	1.5	1.5	1.6	1.7	1.7
Primary Balance	1.8	1.8	1.8	1.8	1.8	1.8
Effective interest rate	2.8	2.9	3.0	3.1	3.1	3.3

Historical Scenario	2018	2019	2020	2021	2022	2023
Real GDP growth	1.0	-0.5	-0.5	-0.5	-0.5	-0.5
Inflation	1.3	1.5	1.5	1.6	1.7	1.7
Primary Balance	1.8	1.3	1.3	1.3	1.3	1.3
Effective interest rate	2.8	2.9	3.1	3.3	3.5	3.7

Source: IMF staff.

Figure A3.5. Italy: Public DSA—Stress Tests



Underlying Assumptions
(in percent)

	2018	2019	2020	2021	2022	2023
Primary Balance Shock						
Real GDP growth	1.0	0.8	0.7	0.6	0.6	0.6
Inflation	1.1	1.5	1.5	1.6	1.7	1.7
Primary balance	1.8	0.5	0.5	0.9	1.0	1.2
Effective interest rate	2.8	2.9	3.0	3.1	3.2	3.3
Real Interest Rate Shock						
Real GDP growth	1.0	0.0	-0.1	-0.2	-0.2	-0.2
Inflation	1.1	1.5	1.5	1.6	1.7	1.7
Primary balance	1.8	1.0	1.0	0.9	1.0	1.2
Effective interest rate	2.8	2.9	3.3	3.5	3.8	4.0
Combined Shock						
Real GDP growth	1.0	-1.5	-1.6	-0.2	-0.2	-0.2
Inflation	1.1	0.9	0.9	1.6	1.7	1.7
Primary balance	1.8	-0.3	-1.7	-1.7	-1.7	-1.5
Effective interest rate	2.8	2.9	3.3	3.6	3.8	4.1

	2018	2019	2020	2021	2022	2023
Real GDP Growth Shock						
Real GDP growth	1.0	-1.5	-1.6	0.6	0.6	0.6
Inflation	1.1	0.9	0.9	1.6	1.7	1.7
Primary balance	1.8	-0.3	-1.7	-1.7	-1.7	-1.5
Effective interest rate	2.8	2.9	3.0	3.2	3.3	3.5
Real Exchange Rate Shock						
Real GDP growth	1.0	0.8	0.7	0.6	0.6	0.6
Inflation	1.1	1.9	1.5	1.6	1.7	1.7
Primary balance	1.8	1.0	1.0	0.9	1.0	1.2
Effective interest rate	2.8	2.9	3.0	3.1	3.1	3.3
Contingent Liability Shock						
Real GDP growth	1.0	-1.5	-1.6	0.6	0.6	0.6
Inflation	1.1	0.9	0.9	1.6	1.7	1.7
Primary balance	1.8	-11.2	1.0	0.9	1.0	1.2
Effective interest rate	2.8	3.0	3.6	3.5	3.5	3.5

Source: IMF staff.

Annex IV. Progress Against IMF Recommendations

2017 Article IV Policy Advice	Actions Since 2017 Article IV	Next Steps
I. Structural Reforms		
Labor Markets		
Modernize wage bargaining by giving primacy to firm-level contracts, clarifying rules on representativeness, and possibly establishing a minimum wage that is differentiated across regions. Monitor take-up of new open-ended contract. Consider extending the new open-ended contract to all existing work arrangements in the private sector and reduce dismissal costs, which is high in OECD comparison. Scale up spending on ALMPs. Enhance coordination with local authorities and improve centralized data collection and job matching. Monitor effectiveness of delivery, or consider providing ALMPs alongside passive labor market policies.	A "Dignity Decree" was approved in mid-2018 which increases dismissal costs and reduces incentives to use temporary contracts by requiring employers to justify extending such contracts beyond one year. A recent constitutional court ruling delinked dismissal costs from the length of employment, increasing uncertainty over such costs. On ALMPs, the authorities plan to allocate 0.1 percent of GDP in 2019 in additional resources for unemployment centers.	Decentralize wage bargaining as a measure of first-order importance to facilitate the re-alignment of wages with productivity at the firm and regional levels. In this context, consider introducing a minimum wage, differentiated by regions to account for differing productivity levels, unemployment rates, and living costs. Lower the uncertainty over and costs of dismissals, which remain high in international comparison. On ALMPs, ensure effective coordination between the central and local administrations, with close attention to design and incentives.
Product Markets		
Strengthen the competition law in line with the recommendations of the Competition Authority and ensure an annual process of adopting pro-competition laws. Enhance competition in areas such as local public service provision, transport, and closed professions. Fully implement existing legislation (e.g., retail sector) and enhance the Authority to sanction anti-competitive practices.	Parliament approved the Annual Competition Law in August 2017. The actual pro-competition measures included in the law were weakened significantly during the parliamentary debates, as well as subsequently.	Tackle decisively barriers to competition that are high in sectors such as local services, professions, and retail, including through a new competition law if needed. Refrain from reversing or weakening past reforms. Strengthen the enforcement powers of the Competition Authority.

2017 Article IV Policy Advice	Actions Since 2017 Article IV	Next Steps
Public Administration		
Implement fully the public administration reform and broaden public sector reform to include all local public services, reorganize careers and accountability of public sector managers, improve the skill mix in the public sector, enhance mobility, match positions with skills, and align wages with productivity. Implement fully the new procurement reform, broaden its coverage, and remove remaining impediments to competition. Monitor reform outcomes.	Implementing decrees for the reform of public sector managers have expired. The new government is introducing a bill to reform public administration by cutting red tape, simplifying procedures through digitization, and improving efficiency by reforming managerial roles and fighting absenteeism. The implementation of the privatization or rationalization of public enterprises has been weakened and delayed to 2020.	Given repeated shortfalls in reforming successfully, improve the managerial and administrative capacity to implement reforms and address weaknesses in coordination between the center and regions. Enhance the effectiveness of procurement reform—by securing savings of the centralized purchasing units and tackling difficulties in public works. Streamline, consolidate or privatize local state-owned enterprises. Publish ambitious targets or key performance indicators to track and clearly communicate progress.
Insolvency reforms		
Adopt promptly the proposed insolvency overhaul, while maintaining ambitious goals for the rationalization of corporate debt restructuring and special procedures for large enterprises. Implementation requires considerable efforts to improve court functioning, the qualification of insolvency administrators, and the development of registries and platforms for the sale of collateral.	A delegating law was approved in October 2017, establishing high-level principles to modernize the insolvency framework. Registries and a platform for the sale of collateral were created and made operational.	Adopt and implement the relevant legislative insolvency reform decrees. Fold the special insolvency regime for large enterprises into the modernized insolvency framework. Improve court functioning and ensure qualified insolvency administrators. Reform civil procedures to simplify processes, facilitate collateral sales, and incentivize courts to reduce backlogs. Consistent implementation across Italy would require development of uniform practices and attention to resource allocation.
II. Fiscal Policy		
Consolidation		
Adjust the structural primary balance by about 1½ percent of GDP, cumulatively, over 2018–20.	The 2018 budget postponed adjustment, repealing legislated VAT rate hikes and failing to specify high-quality offsetting measures. The 2019 draft budget plan envisages a sizable expansion for 2019–21 to increase spending on pensions, other social benefits and public investment and to lower income tax rates.	Undertake a credible and balanced consolidation that delivers a small overall surplus in 4–5 years to put debt on a firm downward trajectory.

2017 Article IV Policy Advice	Actions Since 2017 Article IV	Next Steps
Improve the quality of fiscal policy		
Cut current primary spending (including pensions), while supporting the vulnerable and raising capital spending	The 2019 draft budget plan allocates more resources for pensions and other social benefits, including for partially reversing the 2011 pension reform) and for a citizenship income program, as well as for public investment. It also offers incentives to boost investment.	Cut current primary spending. Avoid pension reform reversals; rationalize pockets of excesses and adjust pension parameters to secure pension sustainability. Comprehensively review the social protection system, with a view to scaling up the current inclusion income program to a modern, guaranteed minimum income scheme. Raise capital spending, ensure high quality projects are selected, and tackle implementation bottlenecks.
Lower tax rates on productive factors, shift taxation toward property and consumption, and broaden the tax base.	The 2018 budget lowered the corporate income tax rate and reduced social security contributions for select groups of new employees. The 2019 draft budget plan provides tax relief to the self-employed and small enterprises. Consideration is being given to a "fiscal peace" program.	Undertake a comprehensive reform to broaden the tax base, promote efficiency, and ensure fairness. Broaden the tax base by reducing VAT compliance and policy gaps, removing other inefficient tax expenditures, introducing a modern property tax on primary residences, and combating tax evasion through stricter enforcement. Reduce the labor tax wedge further. Avoid tax amnesties and reduce tax uncertainties.
III. Financial Stability		
Accelerate NPL resolution and improve balance sheet health		
Require banks to present comprehensive strategies for reducing NPLs significantly over the medium term. Provide guidance and assessment on banks' approaches to provisioning and loan restructuring practices as well as capacity to resolve NPLs using internal tools. Deploy intensive and assertive supervisory challenge to further promote more coherent and realistic business models.	Significant banks agreed with the SSM on ambitious NPL reduction targets that have supported notable reductions in NPLs. The Bank of Italy issued streamlined guidance on NPL reduction strategies to less significant banks and approached them to present their NPL reduction plans. The ECB/SSM's thematic review identified considerable opportunities for individual banks to improve their business models and processes. Introduction of IFRS9 has provided temporary relief for balance sheet strains.	Continue intensive supervisory oversight to ensure NPL reduction strategies are ambitious and credible for significant banks and extend fully to smaller banks. Deploy assertive supervisory oversight to ensure banks proactively identify and address capital-depleting business lines; benchmarking and guidance would promote more effective and consistent use of risk-based pricing, cost allocation, and scenario analysis frameworks.

2017 Article IV Policy Advice	Actions Since 2017 Article IV	Next Steps
Enhance efficiency and supervisory oversight of consolidation		
Assess ex ante whether the newly emerging consolidated banking groups are sound from capital, asset, management and liquidity perspectives, and profitable over the long run. Subject all emerging groups to asset quality reviews, ensure robust governance and risk management structures, and follow up on issues found in the remaining smaller banks. Set for each bank ambitious and credible targets for risk management and rationalization, accompanied by a viability assessment.	The formation of the new banking groups has been delayed. The groups are expected to emerge from the consolidation of some 270 cooperative banks by 2019:Q1. Two are expected to fall under direct ECB/SSM supervision and will be subject to an asset quality review.	Ensure—through intensive and assertive supervisory challenges and by imposing ambitious and credible targets—that banks have sound risk management and realistic and coherent business model assumptions. Undertake rigorous supervisory analysis to ensure the three emerging banking groups start with a clean bill of health and are profitable over the long term, including by undertaking an asset quality review of all emerging groups, ensuring robust governance and risk management structures, and following up on issues found in the remaining smaller banks.
Effective use of resolution framework		
Effective use of the framework for the timely and orderly resolution of failing banks would prevent the costs of the weaker banks from being borne by the rest of the system and eventually raising stability concerns. To address concerns about bailing in retail investors, consider identifying and dealing firmly with cases of mis-selling to retail investors and safeguarding poor households through a means-tested social safety net.	A medium-sized bank that has undergone repeated recapitalizations in recent years and is supervised directly by the SSM was in effect bailed out by a group of Italian banks that purchased the bank's subordinated debt while committing to underwrite a share capital increase.	For problem banks, swift recapitalization or timely and effective use of the resolution framework is essential to avoid weaknesses from lingering too long, excessively burdening taxpayers and the rest of the system, and threatening stability. Safeguards should be introduced to ensure expected new MREL is effective, including by limiting the proportions of MREL held by retail investors and rigorous enforcement of MiFID rules.

Annex V. Recently Published IMF Working Papers on Italy

This annex summarizes IMF Working Papers published in the past year that seek to address key policy issues in Italy in the areas of structural reforms (papers A, B, and C), fiscal policy (paper D), financial sector (papers E and F), and a recommended comprehensive reform strategy (paper G).

A. Competitiveness and Wage Bargaining Reform in Italy

Prepared by Alvar Kangur
Published on March 2018
Internet Link: WP/18/61

Abstract: The growth of Italian exports has lagged that of euro area peers. Against the backdrop of unit labor costs that have risen faster than those in euro area peers, this paper examines whether there is a competitiveness challenge in Italy and evaluates the framework of wage bargaining. Wages are set at the sectoral level and extended nationally. However, they do not respond well to firm-specific productivity, regional disparities, or skill mismatches. Nominally rigid wages have also implied adjustment through lower profits and employment. Wage developments explain about 45 percent of the manufacturing unit labor cost gap with Germany. In a search-and-match DSGE model of the Italian labor market, this paper finds substantial gains from moving from sectoral- to firm-level wage setting of at least 3.5 percentage points lower unemployment (or higher employment) rate and a notable improvement in Italy's competitiveness over the medium term.

B. Corporate Indebtedness and Low Productivity Growth of Italian Firms

Prepared by Gareth Anderson and Mehdi Raissi
Published on February 2018
Internet Link: WP/18/33

Abstract: Productivity growth in Italy has been persistently anemic and has lagged that of the euro area over the period 1999–2015, while the indebtedness of its corporate sector has increased. Using the ORBIS firm-level database, this paper studies the long-term impact of persistent corporate-debt accumulation on the productivity growth of Italian firms and investigates whether total factor productivity growth varies with the level of corporate indebtedness. We employ a novel estimation technique proposed by Chudik and others (2017) to account for dynamics, bi-directional feedback effects, cross-firm heterogeneity, and cross-sectional dependence arising from unobserved common factors (for example, oil price shocks, labor and product market frictions, and stance of global financial cycle). Filtering out the effects of unobserved common factors and controlling for firm-specific characteristics, we find significant negative effects of persistent corporate debt build-up on total factor productivity growth, and weak evidence of a threshold level of corporate debt, beyond which productivity growth drops off significantly. Our results have strong policy implications, for example the design of the tax system should discourage persistent corporate debt accumulation, and effective and timely frameworks to reduce corporate debt overhangs are essential.

C. The Insolvency Regime for Large Enterprises in Italy: An Economic and Legal Assessment

Prepared by Nazim Belhocine, Daniel Garcia-Macia, and José Garrido
Published on September 2018
Internet Link: WP/18/218

Abstract: A unique feature of Italy's insolvency framework is a special regime for large enterprises known as "extraordinary administration". This paper evaluates the merits of this special regime by assessing its efficacy and success in achieving its stated goals and comparing its features to international standards and best practices. The paper finds that the special regime for large enterprises is rarely successful in achieving its stated aim of restructuring companies and instead leads in most cases to the sale of the business after 2–3 years of administration. Once the parts of the group that are viable are sold, the remaining assets are disposed during a liquidation phase which is lengthier, than the general regime. Throughout this process, creditors' rights are sidelined, and their investment is eroded, hindering legal certainty for creditors and more generally economic efficiency, investment and job creation. The paper estimates such cost and finds that the combined loss to creditors and the state could translate to a cost per transferred employee of about 14 times GDP per capita. The shortcomings of the special regime suggest grounds for its repeal. Based on international best practice and experience, the paper concludes that consideration should be given to folding the special regime into the general insolvency regime, with added provisions to allow for state intervention in specific well-defined circumstances.

D. Italy: Toward a Growth-Friendly Fiscal Reform

Prepared by Michal Andrle, Shafik Hebous, Alvar Kangur and Mehdi Raissi
Published on March 2018
Internet Link: WP/18/59

Abstract: Published in late 2017, the Italian medium-term fiscal plan aims to achieve structural balance by 2020, although concrete, high-quality measures to meet the target are yet to be specified. This paper seeks to contribute to the discussion by (i) assessing spending patterns to identify areas for savings; (ii) evaluating the pension system; (iii) analyzing the scope for revenue rebalancing; and (iv) putting forward a package of spending cuts and tax rebalancing that is growth friendly and inclusive, could have limited near-term output costs, and would achieve a notable reduction in public debt over the medium term. Such a package could help the authorities balance the need to bring down public debt and, thus, reduce vulnerabilities while supporting the economic recovery.

E. Credit-Supply Shocks and Firm Productivity in Italy

Prepared by Sebastian Doerr, Mehdi Raissi and Anke Weber
Published on October 2018
Internet Link: https://doi.org/10.1016/j.jimonfin.2018.06.004.

Abstract: The Italian economy has been struggling with low productivity growth and bank balance sheet strains. This paper examines the implications for firm productivity of adverse shocks to bank lending in Italy, using a novel identification scheme and loan-level data on syndicated lending. We exploit the heterogeneous loan exposure of Italian banks to foreign borrowers in distress, and find that a negative shock to bank credit supply reduces firms' loan growth, investment, capital-to-labor ratio, and productivity. The transmission from changes in credit supply to firm productivity relates to labor market rigidities, which delay or distort the adjustment of firms' desired labor and capital allocations, and thereby reduce firms' productivity. Effects are stronger for firms with higher capital intensity and external financial dependence.

F. Household Wealth and Resilience to Financial Shocks in Italy

Prepared by Daniel Garcia-Macia
Published on August 2018
Internet Link: WP/18/196

Abstract: High household wealth is often cited as a key strength of the Italian economy. Both in absolute terms and relative to income, the Italian household sector is wealthier than most euro area peers. A sizable fraction of this wealth is held by the rich and upper middle classes. This paper documents the changes in the Italian household sector's financial wealth over the past two decades, by constructing the matrix of bilateral financial sectoral exposures. Households became increasingly exposed to the financial sector, which in turn was exposed to the highly indebted real and government sectors. The paper then simulates different financial shocks to gauge the ability of the household sector to absorb losses. Simple illustrative calculations are presented for a fall in the value of government bonds as well as for bank bail-ins versus bailouts.

G. Italy: Quantifying the Benefits of a Comprehensive Reform Package

Prepared by Michal Andrle, Alvar Kangur and Mehdi Raissi
Published on March 2018
Internet Link: WP/18/60

Abstract: This paper seeks to quantify the net benefits of a comprehensive reform package aimed at addressing Italy's inter-related challenges. Specifically, it simulates the growth and competitiveness effects of a package of fiscal, financial, wage bargaining, and other structural reforms. Credible implementation of such a package yields substantial medium-term dividends at negligible near-term growth costs. Real GDP growth is estimated to be substantially higher over the medium term, while the real effective exchange rate depreciates notably.

INTERNATIONAL MONETARY FUND

ITALY

December 18, 2018

STAFF REPORT FOR THE 2018 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

Prepared By

European Department
(In consultation with other departments)

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FUND RELATIONS

(As of December 3, 2018)

Mission: Rome, Milan and Frankfurt during July 12–26, 2018, and Rome and Frankfurt during November 6–14, 2018. The concluding statement of the mission is available at https://www.imf.org/en/News/Articles/2018/11/13/ms111318-italy-staff-concluding-statement-of-the-2018-article-iv-consultation.

***Staff team*:** Messrs. Rishi Goyal (head), Nazim Belhocine, Daniel Garcia-Macia, Alvar Kangur, Mehdi Raissi (all EUR), Dermot Monaghan (MCM). Mr. Poul Thomsen (EUR) attended the concluding meetings. Messrs. Alessandro Leipold and Domenico Fanizza, and Ms. Cristina Collura (OED) also attended at various times.

***Country interlocutors*:** Deputy Prime Minister Di Maio, Finance Minister Tria, Bank of Italy Governor Visco, European Affairs Minister Savona, Justice Minister Bonafede, Public Administration Minister Bongiorno, Cabinet Secretary Giorgetti, parliamentarians, senior government and SSM officials; Fiscal Council; Observatory for Italian Public Accounts; major Italian and international banks; the Securities and Exchange Commission (CONSOB); Social Security Institute (INPS); the Competition Authority; Consiglio Superiore della Magistratura; Anti-Corruption Authority (ANAC); Italian Statistical Agency (Istat); Conference of the State and Regions; representatives of trade unions (CGIL, CSIL, and UIL); Confederation of Italian Industry (Confindustria); Italian Banking Association (ABI); academics and other private sector analysts.

***Fund relations*:** The previous consultation discussions took place during May 29–June 12, 2017. The associated Executive Board's assessment is available at: https://www.imf.org/en/News/Articles/2017/07/27/pr17302-imf-executive-board-concludes-2017-article-iv-consultation-with-italy and the staff report and other mission documents at: https://www.imf.org/en/Publications/CR/Issues/2017/07/27/Italy-2017-Article-IV-Consultation-Press-Release-Staff-Report-and-Statement-by-the-Executive-45139.

Italy accepted the obligations under Article VIII and, apart from certain security restrictions, maintains an exchange rate system free of restrictions.

***Data*:** Italy subscribes to the Fund's Special Data Dissemination Standard, and comprehensive economic data are available on a timely basis (Table 1).

Membership Status: Joined March 27, 1947; Article VIII.

General Resources Account:	SDR Million	Percent Quota
Quota	15,070.00	100.00
Fund holdings of currency	13,403.88	88.94
Reserve Tranche Position	1,666.25	11.06
Lending to the Fund		
New arrangements to borrow	696.25	

SDR Department:	SDR Million	Percent Allocation
Net cumulative allocation	6,576.11	100.00
Holdings	5,496.58	83.58

Outstanding Purchases and Loans: None

Financial Arrangements: None

Projected Obligations to Fund (SDR million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2018	2019	2020	2021	2022
Principal					
Charges/Interest	2.67	11.23	11.23	11.22	11.23
Total	2.67	11.23	11.22	11.22	11.23

Exchange Rate Arrangement: Italy entered the final stage of European Economic and Monetary Union on January 1, 1999, at a rate of 1,936.27 Italian lire per 1 euro. The euro floats freely and independently against other currencies.

Italy maintains an exchange system free of restrictions on the making of payments and transfers for current international transactions, except for the exchange restrictions imposed by Italy solely for the preservation of national or international security that have been notified to the Fund pursuant to Executive Board Decision No. 144-(52/51).

Article IV Consultations: Italy is on the standard 12-month consultation cycle. The previous consultation discussions took place during May 29–June 12, 2017, and the staff report (IMF Country Report No. 17/237, 07/27/17) was discussed on July 21, 2017.

ROSCs/FSAP:

Standard Code Assessment	**Date of Issuance**	**Country Report**
Fiscal Transparency	October 9, 2002	No. 02/231
Data	October 18, 2002	No. 02/234
Fiscal ROSC update	November 2003	No. 03/353
Fiscal ROSC update	February 2006	No. 06/64
FSAP	September 2013	No. 13/300

Technical Assistance:

Year	**Department/Purpose**
2007	FAD: Public Expenditure Management
2012	FAD: Tax Policy
2015	FAD: Tax Administration

STATISTICAL ISSUES

(As of December 8, 2018)

<table>
<tr><th colspan="2">I. Assessment of Data Adequacy for Surveillance</th></tr>
<tr><td colspan="2">General: Data provision is adequate for surveillance. Italy's economic and financial statistics are comprehensive and of generally high quality. Data are provided to the Fund in a comprehensive manner (Table 1). The authorities regularly publish a full range of economic and financial data, as well as a calendar of dates for the main statistical releases. Italy is also subject to the statistical requirements of Eurostat and the European Central Bank (ECB), including the timeliness and reporting standards, and it has adopted the European System of Accounts 2010 (ESA2010).</td></tr>
<tr><td colspan="2">National Accounts: Further improvements should be considered regarding changes in inventories in the quarterly national accounts, which are currently derived as a residual and lumped together with the statistical discrepancy.</td></tr>
<tr><td colspan="2">Government Finance Statistics: Data on Grants and Other revenues are not reported as part of the 2015 GFS submission while this information was provided in previous years.</td></tr>
<tr><td colspan="2">Monetary and Financial Statistics: The ECB reporting framework is used for monetary statistics and data are reported to the IMF through a "gateway" arrangement with the ECB for publication in the IFS. Monetary statistics for Italy are published in the IFS cover data on central banks and other depository corporations (ODCs) using Euro Area wide residency criterion.</td></tr>
<tr><td colspan="2">Financial Sector Surveillance: Italy participates in the IMF's financial soundness indicators (FSIs). The Italian authorities report all of the 12 core FSIs and 11 of the 13 encouraged FSIs for deposit takers semi-annually to the IMF and quarterly on their National Summary Data Page. In addition, 12 FSIs for other sectors are compiled and reported. FSI reporting is timely.</td></tr>
<tr><td colspan="2">External Sector Statistics: The Bank of Italy adopted the standards for reporting Balance of Payments (BOP) and International Investment Position (IIP) data on the basis of the Balance of Payments and International Investment Position Manual, 6th edition (BPM6) in the second half of 2014. In addition, Italy participates in the IMF's Coordinated Direct Investment Survey (CDIS) and Coordinated Portfolio Investment Survey (CPIS).</td></tr>
<tr><th colspan="2">II. Data Standards and Quality</th></tr>
<tr><td>Italy has subscribed to the Special Data Dissemination Standard (SDDS) since 1996 and posts its metadata on the Dissemination Standards Bulletin Board (DSBB). In 2015 Italy adhered to SDDS Plus, together with the first group of adherents.

Implementing G-20 DGI recommendations: Italy has achieved compliance with the core requirements in relation to many DGI recommendations for which data templates have been already defined. Further progress in the future is likely to be made on the reporting frequency of Financial Soundness Indicators.</td><td>A data ROSC was disseminated in 2002.</td></tr>
</table>

Table 1. Italy: Common Indicators Required for Surveillance

(As of December 3, 2018)

	Date of latest observation	Date received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of Publication[7]
Exchange Rates	Nov 2018	Nov 2018	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	Sept 2018	Nov 2018	M	M	M
Reserve/Base Money	Sept 2018	Nov 2018	M	M	M
Broad Money	Sept 2018	Nov 2018	M	M	M
Central Bank Balance Sheet	Sept 2018	Nov 2018	M	M	M
Consolidated Balance Sheet of the Banking System	Sept 2018	Nov 2018	M	M	M
Interest Rates[2]	Nov 2018	Nov 2018	D	D	D
Consumer Price Index	Oct 2018	Nov 2018	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3]—General Government[4]	Q3:2018	Nov 2018	Q	Q	Q
Revenue, Expenditure, Balance and Composition of Financing[3]–Central Government	Sept 2018	Nov 2018	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Sept 2018	Nov 2018	M	M	M
External Current Account Balance	Sept 2018	Nov 2018	M	M	M
Exports and Imports of Goods and Services	Oct 2018	Nov 2018	M	M	M
GDP/GNP	Q3:2018	Nov 2018	Q	Q	Q
Gross External Debt	Q3:2018	Nov 2018	Q	Q	Q
International Investment position[6]	Q3:2018	Nov 2018	Q	Q	Q

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5] Including currency and maturity composition.
[6] Includes external gross financial asset and liability positions vis-à-vis nonresidents.
[7] Daily (D); weekly (W); monthly (M); quarterly (Q); annually (A); irregular (I); and not available (NA).

INTERNATIONAL MONETARY FUND

ITALY

January 17, 2019

STAFF REPORT FOR THE 2018 ARTICLE IV CONSULTATION—SUPPLEMENTARY INFORMATION

Prepared by European Department (In consultation with other departments)

1. This supplement provides information that became available after the staff report was issued on December 18, 2018.

2. The thrust of staff's appraisal remains unchanged.

A. 2019 Budget and Medium-Term Fiscal Plans

3. The authorities lowered the 2019 fiscal deficit target from 2.4 percent to 2 percent of GDP, in part by delaying full implementation of key policies. This followed discussions with the European Commission (EC) on avoiding the launch of an excessive deficit procedure. Measures include delaying by a few months implementation of the planned pension reversal and the citizenship income program while reducing their budgeted allocations for 2019, lowering public investment, increasing gambling taxes among others, and disposing of real estate assets. The authorities will freeze spending of about 0.1 percent of GDP as a safeguard if revenues fall short. They lowered annual real GDP growth projections from 1½ percent to about 1 percent in 2019–21.

4. The authorities also reduced their deficit targets for 2020–21 through increased resort to the "VAT safeguard clause". The revised targets are 1.8 percent and 1.5 percent of GDP, respectively, down by 0.3 percentage points each year. These targets are underpinned by plans for very sizable VAT and excise tax rate hikes, i.e., the safeguard clause. Excluding these tax rate hikes—in view of their poor implementation history—would imply overall deficits of 3 percent of GDP in 2020–21.

5. Italian yields moderated slightly following the EC's announcement that it does not intend to launch an excessive deficit procedure at this stage. The 10-year sovereign yield fell about 25 basis points. Nevertheless, the yield remains high at about 2¾ percent, with spreads vis-à-vis German bunds around 250 basis points. As noted in the staff report, sustained high sovereign spreads risk passing through to borrowing costs of firms and households, weighing on credit provision and growth, and raising financial stability concerns.

6. Staff updated the macroeconomic projections to reflect the revised fiscal plan (Table 1). As the projected fiscal stimulus has largely shifted from 2019 to 2020, real GDP growth was lowered from 0.8 percent to 0.6 percent in 2019 and increased from 0.7 to 0.9 percent in 2020. Over the medium term and in line with the staff report, the negative effect of sustained high spreads dominates the contribution of the stimulus, leaving projections broadly unchanged.

7. Staff remains concerned about Italy's vulnerability as outlined in the staff report. Delayed implementation of the authorities' fiscal plans implies that, although the deficit target for 2019 is lower, there is no fundamental improvement in policies. The deficit is projected to rise from about 2.1 percent of GDP in 2019 to 3 percent of GDP in 2020 and beyond, unless there is broad political support to activate the VAT safeguard clause or find compensatory measures, which however have proven difficult to do in the past. Public debt would remain very high at above 130 percent of GDP and vulnerable to adverse shocks.

B. Government's Flagship Measures

8. In a decree law approved by the government on January 17, 2019, the authorities specified the design of their pension reversal and citizenship income measures. Consistent with staff concerns, drawbacks in design carry risks for potential growth and fiscal costs.

- *Reversal of past pension reforms.* Early retirement rules were eased notably. This would raise the number of pensioners, lower labor force participation and potential growth, and add to an already high pension bill. Workers who are at least 62 years of age with a minimum 38 years of contributions have become eligible for early retirement. Women who are at least 59 years of age with a minimum 35 years of contributions are also eligible. These are well below the statutory retirement age of 66 years 7 months and the effective retirement age of 63½ years. The potential pool of early retirees was further expanded by allowing workers to fill gaps in their contribution history at subsidized rates. Moreover, automatic adjustments of the statutory retirement age to life expectancy were canceled for 2019–20. Measures to limit the cost include delaying payouts, specifying that early pension benefits cannot be combined with labor income above a certain limit, and offering the scheme on an experimental basis during 2019–21.

- *Citizenship income program.* The new means-tested, poverty relief program will become operational in April 2019 and replace the inclusion income program. Beneficiaries must commit to participating in local public works and accept at least one of three job offers made by employment centers. However, benefits are very high, set at 100 percent of the relative poverty line for tenants without income, compared to international good practice of 40–70 percent. The benefits are relatively more generous in the South, where the cost of living is lower, implying correspondingly larger disincentives to work as well as risks of welfare dependency. Moreover, although benefits are targeted to the poor, added benefits decline too quickly with family size (penalizing poor larger families) while pensioners are treated preferentially. Adequate controls will be essential for effective targeting.

C. Financial Sector Developments

9. The ECB/SSM appointed temporary administrators to Italy's tenth largest bank, following its failure to raise equity to meet regulatory capital requirements. In early January 2019, the European Central Bank (ECB)/Single Supervisory Mechanism (SSM) intervened Banca Carige, which accounts for less than 1 percent of system assets and had been given until end-2018 to complete a capital strengthening plan or seek a merger with a stronger partner. The bank went through multiple rounds of capital raising in the last four years, had nonperforming exposures above 25 percent of total loans at mid-2018, and saw its share price fall over 80 percent in 2018. In late 2018, its entire issuance of subordinated debt (€320 million) was purchased at a coupon of 13 percent by other Italian banks, via the voluntary arm of the deposit insurance scheme, with the aim of providing funds to underwrite the share capital increase. The rejection by the bank's shareholders of the share capital increase, however, led to the resignation of most of its management team and Board. To safeguard financial stability, the government passed an emergency law that allows for a precautionary recapitalization of up to €1 billion and extended guarantees to the bank for new bond issuances of up to €3 billion until June 2019. The temporary administrators have been appointed until early April and the SSM has given the bank until end-2019 to meet its capital requirements in a sustainable manner.

Table 1. Italy: Summary of Economic Indicators, 2017–23

(Annual percentage change, unless noted otherwise)

		Projections					
	2017	2018	2019	2020	2021	2022	2023
Real GDP	1.6	1.0	0.6	0.9	0.7	0.6	0.6
Real domestic demand	1.3	1.1	0.6	1.1	0.8	0.6	0.6
Final domestic demand	1.7	1.0	0.7	1.0	0.8	0.6	0.6
Private consumption	1.5	0.6	0.7	1.1	0.8	0.7	0.6
Public consumption	-0.1	0.3	-0.1	0.9	0.6	0.5	0.5
Gross fixed capital formation	4.3	3.2	1.4	1.0	0.6	0.6	0.7
Stock building 1/	-0.3	0.1	0.0	0.0	0.0	0.0	0.0
Net exports 1/	0.3	-0.1	0.0	-0.1	-0.1	0.0	0.0
Exports of goods and services	5.7	2.4	1.8	1.7	1.5	1.4	1.3
Imports of goods and services	5.2	3.1	2.0	2.1	2.0	1.6	1.3
Savings 2/	20.4	20.7	20.7	20.6	20.4	20.4	20.3
Investment 2/	17.6	18.3	18.2	18.3	18.5	18.7	18.9
Resource utilization							
Potential GDP	0.4	0.4	0.4	0.5	0.5	0.6	0.6
Output gap (percent of potential)	-1.5	-0.9	-0.6	-0.2	-0.1	-0.1	-0.1
Employment	1.2	1.2	0.6	0.7	0.6	0.5	0.4
Unemployment rate (percent)	11.3	10.7	10.5	10.3	10.1	10.0	9.9
Prices							
GDP deflator	0.5	1.1	1.5	1.5	1.6	1.7	1.7
Consumer prices	1.3	1.2	1.3	1.5	1.6	1.7	1.7
Hourly compensation 3/	1.2	1.9	1.9	1.9	2.0	2.1	2.2
Productivity 3/	2.1	0.3	0.2	0.5	0.3	0.4	0.4
Unit labor costs 3/	-1.0	1.6	1.6	1.5	1.7	1.7	1.8
Fiscal indicators							
General government net lending/borrowing 2/	-2.4	-1.9	-2.1	-2.9	-3.0	-3.0	-3.0
General government primary balance 2/ 4/	1.3	1.6	1.4	0.7	0.7	0.8	1.0
Structural overall balance (percent of potential GDP)	-1.6	-1.5	-1.8	-2.8	-3.0	-3.0	-3.0
Structural primary balance (percent of potential GDP) 4/	2.0	2.0	1.7	0.9	0.8	0.9	1.1
General government gross debt 2/	131.2	131.4	130.9	130.7	130.9	131.0	131.1
Exchange rate regime			Member of the EMU				
Exchange rate (national currency per U.S. dollar)	0.9	0.8	...	...	...	...	...
External sector 2/							
Current account balance	2.8	2.4	2.5	2.2	1.9	1.7	1.4
Trade balance	3.2	2.5	2.7	2.5	2.2	2.0	1.8

Sources: National Authorities; and IMF staff estimates.
1/ Contribution to growth.
2/ Percent of GDP.
3/ In industry (including construction).
4/ Primary revenue minus primary expenditure.

Statement by Domenico Fanizza, Executive Director for Italy
January 25, 2019

On behalf of the Italian authorities, we thank staff for their informative set of papers and the constructive policy discussion during the Article IV mission.

I. Background

Italy has suffered from the effects of the double-dip recession that lowered GDP per capita by 12 percent from 2007 to 2013. The crisis has exacerbated some of the adverse impacts of globalization on the Italian economy, and significant portions of the population have been left behind by the following modest recovery, which has not yet brought per-capita income to its pre-crisis level. Moreover, the impact of persistent low growth on public finances has constrained the available resources to address social issues, which have become increasingly pressing. The strategy of the new Italian government, which took office last June, provides a policy response to these challenges by fostering growth and social inclusion while preserving financial stability. My authorities know well that to lift growth in a durable manner they need to implement a comprehensive package of structural reforms. However, the two political parties that are partners in government have chosen to focus on a limited set of measures as specified in a "*government contract*", on which they could find an agreement. These measures support three major objectives. First, addressing some pressing social issues. Second, taking steps to improve growth prospects. Third, maintaining financial stability by ensuring that social and pro-growth policy are consistent with placing the country's high public debt-to-GDP ratio on a declining path.

II. Recent Developments

The budget law, adopted on December 30th, ensures compliance of Italy's 2019 budget with the EU fiscal rules and entails a neutral fiscal stance in 2019. The budget law safeguards the new government's social inclusion policies, while ensuring that the debt-to-GDP ratio starts to decline in 2019. The general government deficit is set at 2.0 percent for 2019, 1.8 percent for 2020, and 1.5 percent for 2021. To ensure that the 2019 target is fully met, the budget law introduces a safeguard mechanism that places spending allocations for 2 billion euro (0.12 percent of GDP) in escrow; these resources will be released only if the updated projections as of July 2019 suggest that the budgetary performance is consistent with the target (net of one-off revenues).

The budget law reflects updated official macroeconomic forecasts. Weaker than expected growth in the third quarter of 2018, the sizable reduction in government expenditure compared to the initial draft budget law, and the worsening of leading indicators for the European and global business cycles have led the government to revise down its growth outlook. Growth is now forecast at 1 percent of GDP in 2018 and 2019, 1.1 percent of GDP in 2020, and 1 percent of GDP in 2021.

Despite this weaker outlook, public debt will be reduced from 131.7 to 128.2 percent of GDP between 2018 and 2021. Such reduction reflects: (a) further fiscal efforts, with

an improvement of the structural primary balance (which has been positive since 2006) to 2.9 percent of GDP in 2021; and (b) the dismission of government assets in the context of efforts to leverage additional resources for investments in infrastructures and urban renewal. Following the adoption of the budget law, **the spread between 10-year Italian and German government securities lowered** from the November 2019 peak of over 320 basis points, and today it is at 250 basis points. In 2018, Italy issued 390 billion euros of government securities at an average issuance cost of 1.07 percent. So far, there have not been signs of a pass-through of these levels of the BTP-Bund spread into higher lending rates to the real domestic economy.

My authorities are fully aware of the adverse impact of large and lasting increases in risk premia. However, several factors have enhanced the Italian economy's resilience and have mitigated the impact of the less favorable financial conditions: (a) private sector debt is among the lowest in the euro area; (b) the external position is strong, with a sizable current account surplus and a favorable net investment position that has now returned close to balance; (c) the high average residual maturity of public debt, mostly issued at fixed rates, that slows down the transmission of market interest rates to the average cost of the debt; and (d) the strengthened banking system that has built substantial capital buffers.

III. The Authorities' Reform Agenda

My authorities concur with staff that the key problems of the Italian economy are low growth and weak social outcomes. To address these challenges, the authorities will reinvigorate public investment, improve the business climate, and design more effective social-inclusion and labor-market policies.

➢ *Higher Public Investment*

- ✓ **Re-launching public investment is a key element of my authorities' agenda**. As a ratio to GDP, public investment has fallen by more than one percentage point of GDP since 2009, and spending for maintaining existing public infrastructures has also declined. Moreover, project implementation time and cost overruns have expanded under the joint effect of poor project preparation and bureaucratic red tape. Thus, both the level and the quality of public investment need to improve. The budget law has introduced several measures to strengthen the central and local administrations' capacities in project planning and management, and the effectiveness of the decision-making process. Simplification of the Procurement Code and the public-private partnership (PPP) framework are also in the pipeline. This enhanced capacity would help invest 118 billion euros, already allocated to public investments and not yet disbursed.

➢ *Improving the Business Climate to Spur Private Investment*

- ✓ **Actions have already been taken to improve the efficiency of the public administration and to fully implement the reforms legislated in the past**.

The government is addressing the disparity in the quality of public services across regions through several measures.[1] The government also intends to enhance the digitalization and simplification of procedures. An anti-corruption law that defines stricter measures to detect and prosecute criminal offences against the public administration was adopted in December.

- ✓ **The government adopted a reform that overhauls the bankruptcy and insolvency frameworks in January**. The new system introduces: (a) an early warning system to prevent transitory financial distress from turning into fully fledged economic crises; (b) more effective creditors' involvement; (c) streamlined procedures and a framework to manage the insolvency of more companies in a group; and (d) measures to facilitate the debt discharge of small businesses and consumers. Moreover, recently adopted laws aimed at favoring a more effective management of non-performing loans (NPLs) have helped reduce the time it takes to sell assets in foreclosing procedures.

- ✓ **The reforms of the civil justice and the reorganization of courts implemented in previous years are making an impact.** The number of the on-going civil proceedings and the backlog have dropped, as the on-line civil trial has become operational. The length of proceedings is still high; however, the trend clearly signals a reduction of civil trials' disposition time. The government is determined to further improve effectiveness and efficiency and plans to further streamline civil proceedings and hire more judges.

- ✓ **The government intends to review the personal income tax and harmonize it with the corporate income tax to reduce the tax burden**. In order to implement these reforms in a sustainable manner, however, broad discussions are needed to build consensus and to secure budget resources, which will require time and extensive work. In the meantime, the budget law extended a flat tax regime for low and middle income individual entrepreneurs, artisans and self-employed workers and provides a tax incentive on reinvested profits.

➢ *Job Market and Social Inclusion*

- ✓ **To improve the functioning of the job market, the government is introducing active labor market policies** that – in addition to providing protection against poverty – will help job seekers preserve human capital, reduce the costs of job search, and eventually facilitate the matching of supply and demand. Key measures are: (a) the introduction of a citizenship income to be granted to those who are actively engaged in job search and/or training; and (b) the strengthening

[1] These measures, among others, include: (a) multi-year plans to improve the quality of services with measurable outputs and well-defined managerial responsibilities; (b) creation of a central unit tasked with monitoring results and imposing corrective actions; and (c) more targeted hiring procedures.

of the regional centers assisting job seekers to identify vacancies. The citizenship income will capitalize on the experience of the current inclusion income program.

- ✓ **To remove distortions and the unequal treatment of age-cohorts determined by previous reforms, the government has introduced corrections to the current pension system.** Specifically, early retirement under flexible rules (workers with at least 62 years of age, and 38 years of contribution) will be allowed for a 3-year window. These provisions do not reverse previous reforms, including the indexation of retirement age to life expectancy, and preserve actuarial fairness. My authorities believe these measures will help address the widespread social discontent that past reforms have determined and could foster youth employment and labor productivity.

IV. Banking Sector

The Italian banking sector has proved resilient, thanks to increased capital buffers, improved credit quality, and growing disposal of NPLs. Wholesale funding costs remain around their lowest since the beginning of the century. Nevertheless, my authorities remain fully committed to further strengthening banks and safeguarding financial stability, building on the substantial advances achieved in recent years. Further enhancing capitalization, efficiency, and profitability, most notably by diversifying sources of revenue and reducing operating costs, remain key priorities.

Banks have strengthened their capital base since the onset of the Great Financial Crisis. The Common Equity Tier 1 ratio reached an average of 13.1 percent in September 2018, up from 7.0 percent at the end of 2008. This strengthening took place amid the enforcement of stricter rules on minimum capital requirements (Pillar 1) and supplementary requirements by supervisors (Pillar 2).

The credit quality has improved substantially, reflecting both strict supervisory oversight and prudent risk taking by banks. The ratio of new NPLs to total performing loans stood at 1.7 percent in the third quarter of 2018, down from 6.1 percent at end 2009; the current ratio has dropped below its pre-crisis levels.

The burden of outstanding net NPLs on Italian banks has shrunk to less than 5 percent of banks' total loans. Gross NPLs dropped to 216 billion euro at end September 2018, from a peak of 360 billion euro at end 2015. Over the same period, net NPLs fell to 99 billion euro from 197 billion euro, with a coverage ratio that increased by 9 percentage points to 54 percent. The development of a secondary market for NPLs has played a key role behind this reduction, allowing the disposal of gross bad loans for 80 billion euro over the period. Both the government guarantee on the securitization of bad loans (introduced in 2016 and set to expire in March 2019) and the analytical reporting of bad loans launched by Bank of Italy in 2016 have helped the secondary market to develop.

My authorities are committed to further strengthen and cement the progress made in recent years. To help banks become more proactive in managing their NPLs, the Bank of Italy issued guidelines on NPL reduction strategies for Less Significant Institutions in January 2018 and is currently evaluating the plans submitted by banks. Measures to reduce NPLs, restore profitability and strengthen balance sheets are particularly important, considering the ongoing transformation of the financial sector and the need to adapt to the new approaches to banking regulation and supervision. It also remains critical for banks to resolutely pursue strategies to tackle the challenges of technological development and competitive pressures.