INTERNATIONAL MONETARY FUND

IMF Country Report No. 20/79

ITALY

2020 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR ITALY

March 2020

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 2020 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 March 18, 2020 consideration of the staff report that concluded the Article IV consultation with Italy.
- A **Staff Supplement** updating information on recent developments.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on March 18, 2020. The staff report reflects discussions with the Italian authorities in January 2020 and is based on the information available as of January 28, 2020. It focuses on Italy's medium-term challenges and policy priorities and was prepared prior to the outbreak of COVID-19 in Italy. It, therefore, does not cover the outbreak or the related policy response, which has since become the overarching near-term priority. The outbreak has greatly amplified uncertainty and downside risks around the outlook. Staff is closely monitoring this health crisis and will continue to work on assessing its impact and the related policy response in Italy and globally.
- An **Informational Annex** prepared by the IMF staff.
- A **Statement by the Executive Director** for Italy.

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

Financial Stability System Assessment

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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PRESS RELEASE

PR20/94

IMF Executive Board Concludes 2020 Article IV Consultation with Italy

FOR IMMEDIATE RELEASE

WASHINGTON, DC – March 20, 2020 On March 18, 2020, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with Italy (see important note below on the timing of the report, which predates the outbreak of COVID-19).[2]

Executive Board Assessment[3]

Executive Directors expressed deep sympathy to the Italian people and the authorities for the high human and economic costs of the COVID 19 pandemic. They also conveyed their solidarity with Italy at this difficult time and commended the authorities for their resolute response, including their most recent decisive actions, and called for coordinated regional and international actions to address the effects of the pandemic.

While Directors broadly agreed with the thrust of the staff appraisal, they noted that the extensive discussion of medium-term issues in the staff report reflected the challenges and priorities facing Italy prior to the outbreak of COVID 19. They recognized and supported the authorities' near-term priorities that have rightly shifted to combating the pandemic and supporting health care, workers, firms and households.

Directors considered that the outbreak has created both health and economic emergencies that need to be addressed urgently, while amplifying uncertainty and downside risks. Once the health crisis has passed, they stressed the need to implement a comprehensive package of measures to boost potential growth and enhance resilience. This should comprise structural reforms to raise productivity and investment, a credible medium-term fiscal consolidation to put public debt on a firm downward path, and measures to support financial sector health.

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[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] The staff report reflects discussions with the Italian authorities in January 2020 and is based on the information available as of January 28, 2020. It focuses on Italy's medium-term challenges and policy priorities and was prepared prior to the outbreak of COVID-19 in Italy. It, therefore, does not cover the outbreak or the related policy response, which has since become the overarching near-term priority. The outbreak has greatly amplified uncertainty and downside risks around the outlook. Staff is closely monitoring this health crisis and will continue to work on assessing its impact and the related policy response in Italy and globally.

[3] 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.

Directors commended the authorities for their prudent implementation of fiscal policy in 2019 that was better than expected. They recognized that the fiscal balance will worsen this year on account of the pandemic effects and response. They welcomed the authorities' plan to undertake medium term fiscal consolidation, once the pandemic has subsided, and urged implementing growth friendly and inclusive measures, including comprehensive tax reform.

Directors commended the authorities for the progress made in strengthening banks' balance sheets. They welcomed the findings of the FSAP and stressed the need to address resolutely remaining financial sector vulnerabilities, strengthen banking sector resilience, improve the viability of bank business models, and reinforce the crisis management framework. Most Directors noted that the use of the Deposit Guarantee Scheme (DGS) for preventive measures outside resolution or liquidation could be a useful instrument, in line with the DGS Directive. Moreover, its use should not be overly restricted but justified on a case by case basis. While acknowledging the importance of moderating the sovereign bank nexus, many Directors pointed to the need for a careful assessment of the benefits and costs and that the envisaged approach should be in line with discussions at the EU level.

Italy: Selected Economic Indicators, 2017–22

	2017	2018	2019	2020	2021	2022
Real Economy (change in percent)						
Real GDP	1.7	0.8	0.3	-0.6	0.8	0.8
Final domestic demand	1.5	1.2	0.4	-0.1	0.7	0.7
Exports of goods and services	5.4	2.3	1.2	-1.9	5.3	3.2
Imports of goods and services	6.1	3.4	-0.4	-2.0	4.9	3.1
Consumer prices	1.3	1.2	0.6	0.7	1.0	1.2
Unemployment rate (percent)	11.3	10.6	10.0	10.4	10.2	10.1
Public Finances						
General government net lending/borrowing 1/	-2.4	-2.2	-1.6	-2.6	-2.4	-2.3
Structural overall balance (percent of potential GDP)	-1.8	-1.9	-1.3	-1.5	-1.8	-1.8
General government gross debt 1/	134.1	134.8	134.8	137.0	136.9	136.2
Balance of Payments (percent of GDP)						
Current account balance	2.7	2.6	3.0	3.1	3.2	3.0
Trade balance	3.0	2.5	3.3	3.3	3.3	3.2
Exchange Rate						
Exchange rate regime				Member of the EMU		
Exchange rate (national currency per U.S. dollar)	0.9	0.8	0.9	…	…	…
Nominal effective rate: CPI based (2000=100)	100.9	103.8	…	…	…	…

Sources: National Authorities; and IMF staff calculations.

1/ Percent of GDP.

INTERNATIONAL MONETARY FUND

ITALY

March 11, 2020

STAFF REPORT FOR THE 2020 ARTICLE IV CONSULTATION—SUPPLEMENTARY INFORMATION

Prepared by European Department
(In consultation with other departments)

This supplement provides information that became available after the staff report was issued on February 28, 2020.

A. Developments Related to COVID-19

1. There has been a notable rise in the number of COVID-19 cases in Italy since mid-February. As of March 9, Italy ranked second behind China in the number of COVID-19 cases worldwide. Over 9,000 people contracted the virus, up from three in mid-February. The daily net inflow has been positive, exceeding 1,000 net new cases in recent days; hence, the number of cases has risen quickly. About 80 percent of cases are concentrated in the three largest economic regions in the North—Lombardy, Veneto, and Emilia Romagna—constituting close to 40 percent of national GDP, although cases have been diagnosed across Italy.

2. The authorities moved resolutely with containment measures. Immediately following the outbreak, some localities were quarantined, and public health safety measures were taken. Emergency measures were expanded as the infection spread. On March 7, in response to a further escalation in cases, several provinces were put in lockdown. Schools and universities, various public offices, and public gathering spaces are to be closed until early April. Companies in the services sectors have asked their employees to work from home. As with some other countries, a ban on exports of personal protective equipment was also imposed. On March 9, a nation-wide lockdown was announced.

3. The authorities also announced a package of fiscal measures. On March 5, Minister Gualtieri noted the government's plan to legislate one-off measures that would increase the overall deficit by €6.3 billion in 2020. Measures include additional funds for healthcare and civil protection, income support for workers who have been laid off, suspension of tax payments for small- and medium-size enterprises, and state guarantees for banks to support credit. The European Commission has been fully supportive and acknowledged the need for flexibility in the fiscal framework.

4. Mirroring the action in global financial markets, Italian asset valuations have fallen sharply. As of March 9, the 10-year sovereign spread vis-à-vis German bunds rose to 228 basis points, over 90 basis points above pre-outbreak levels (February 21). The 10-year sovereign yield increased to around 1.4 percent. The stock market index fell 25 percent, while bank stocks fell around 30 percent.

B. Fiscal and Economic Data Revisions for 2019

5. The 2019 fiscal deficit came in at 1.6 percent of GDP while real GDP growth was marginally higher than preliminary estimates. These data were released after the staff report was issued. The fiscal outcome was significantly better than the authorities' estimate of 2.2 percent of GDP last November. It reflects improved revenue collection, notably tax compliance efforts. As a result, the public debt/GDP ratio remained constant, albeit through a higher tax burden. Social benefit and public capital spending were also higher than previously estimated. Meanwhile, national accounts revisions confirmed the contraction at end-2019. Real GDP growth in 2019 was 0.3 percent, marginally higher than preliminary estimates and mainly reflecting a weaker contribution of imports.

C. Staff's Updated Projections

6. In view of the above developments, it is clear that growth will be lower although the extent is likely to remain highly uncertain for some time. The spread of COVID-19 poses a major economic challenge, including through business and public service closures, fewer working days and lower labor supply, cutbacks in service activities such as those linked to tourism, and reduced demand from lower consumer and business confidence. Preliminary indicators show sharp reductions in the number of flights and travel bookings. The external environment has also weakened. Compared to the staff report, staff have revised the growth forecast for 2020 down from about ½ percent to about –½ percent. Given the escalated lockdown measures and the wider outbreak across Europe, there is a high risk of a notably weaker outturn. Growth over the medium term is projected at around 0.7 percent, although this too is subject to uncertainty about the duration and extent of the crisis.

7. The fiscal balance projections are moderately weaker, owing to the necessary response to, and the economic effects of, the COVID-19 outbreak. For 2020, this reflects two partially offsetting effects. On one hand, better revenue collection that contributed to the improved 2019 outturn would, all else equal, improve the 2020 projection. On the other hand, the government's planned support measures and the weaker economic environment would deteriorate the fiscal position. Altogether, staff projects an overall deficit of 2.6 percent of GDP in 2020. The deficit could be higher, if the impact of the virus is prolonged and growth is substantially weaker. The deficit improves slightly over the medium term, consistent with the government's previously announced plans.

8. Uncertainty is very high and risks to the outlook are sharply to the downside. While the revised forecast reflects materialization of some downside risks, uncertainty remains very high on the potential spread and impact of COVID-19. If infections continue to rise, prolonged business

disruptions and deterioration in confidence would likely follow, resulting in a further sharp contraction in economic activity and potentially reigniting the sovereign-bank nexus. Prolonged weakness in key trading partners as a result of the broader global outbreak would also further impact on the economy, just as Italy's weakness will affect its trading partners. Correspondingly, the public debt/GDP ratio would also worsen.

9. While the thrust of staff's appraisal remains unchanged, staff strongly supports the authorities' prompt response to this health crisis. The authorities' near-term efforts are rightly focused on limiting and containing the deleterious human and economic effects of the COVID-19 outbreak.

Table 1. Italy: Summary of Economic Indicators, 2017–25

(Annual percentage change, unless noted otherwise)

	2017	2018	2019	Projections 2020	2021	2022	2023	2024	2025
Real GDP	1.7	0.8	0.3	-0.6	0.8	0.8	0.8	0.7	0.6
Real domestic demand	1.8	1.1	-0.2	-0.6	0.6	0.7	0.7	0.8	0.6
Final domestic demand	1.5	1.2	0.4	-0.1	0.7	0.7	0.7	0.7	0.6
Private consumption	1.5	0.9	0.4	-0.4	0.8	0.7	0.7	0.7	0.6
Public consumption	-0.1	0.1	-0.4	0.4	-0.1	0.2	0.3	0.3	0.3
Gross fixed capital formation	3.2	3.1	1.4	0.2	1.3	1.4	1.3	1.3	1.1
Stock building 1/	0.2	-0.1	-0.6	-0.5	-0.1	0.0	0.0	0.0	0.0
Net exports 1/	0.0	-0.3	0.5	0.0	0.2	0.1	0.1	0.0	0.0
Exports of goods and services	5.4	2.3	1.2	-1.9	5.3	3.2	3.0	2.8	2.8
Imports of goods and services	6.1	3.4	-0.4	-2.0	4.9	3.1	2.9	3.1	3.0
Savings 2/	20.7	20.9	21.0	20.8	20.9	21.1	21.2	21.3	21.4
Investment 2/	18.1	18.3	18.0	17.7	17.7	18.0	18.2	18.5	18.7
Resource utilization									
Potential GDP	0.4	0.3	0.3	0.1	0.3	0.5	0.5	0.6	0.6
Output gap (percent of potential)	-1.2	-0.7	-0.7	-1.4	-1.0	-0.6	-0.4	-0.2	-0.1
Employment	1.2	0.8	0.6	-0.2	0.4	0.2	0.2	0.1	0.1
Unemployment rate (percent)	11.3	10.6	10.0	10.4	10.2	10.1	10.0	10.0	10.0
Prices									
GDP deflator	0.7	0.9	0.9	0.8	0.9	1.2	1.4	1.5	1.5
Consumer prices	1.3	1.2	0.6	0.7	1.0	1.2	1.4	1.5	1.5
Hourly compensation 3/	2.6	1.7	2.5	1.7	1.8	1.8	1.9	1.9	2.0
Productivity 3/	2.7	0.4	0.2	-0.1	0.6	0.8	0.8	0.8	0.7
Unit labor costs 3/	-0.2	1.3	2.3	1.8	1.2	1.1	1.1	1.2	1.3
Fiscal indicators									
General government net lending/borrowing 2/ 5/	-2.4	-2.2	-1.6	-2.6	-2.4	-2.3	-2.2	-2.2	-2.1
General government primary balance 2/ 4/	1.2	1.5	1.7	0.7	0.9	0.9	0.9	0.9	0.9
Structural overall balance (percent of potential GDP) 5/	-1.8	-1.9	-1.3	-1.5	-1.8	-1.8	-1.8	-1.8	-1.7
Structural primary balance (percent of potential GDP) 4/	1.7	1.7	2.1	1.8	1.4	1.3	1.3	1.3	1.2
General government gross debt 2/	134.1	134.8	134.8	137.0	136.9	136.2	135.4	134.3	132.8
Exchange rate regime				Member of the EMU					
Exchange rate (national currency per U.S. dollar)	0.9	0.8	0.9	...	...	...	...	...	...
Nominal effective rate: CPI based (2000=100)	100.9	103.8	102.8	...	...	...	...	...	...
External sector 2/									
Current account balance	2.7	2.6	3.0	3.1	3.2	3.0	3.0	2.8	2.7
Trade balance	3.0	2.5	3.3	3.3	3.3	3.2	3.0	2.9	2.7

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.

5/ For 2020, it includes a package of one-off measures (0.4 percent of GDP) in the face of the COVID-19 outbreak.

Table 2. Italy: Statement of Operations–General Government (GFSM 2001 format), 2012–25

	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025
								Projections						
	(Billions of euros)													
Revenue	773.9	775.7	779.5	790.7	791.5	804.3	818.5	841.4	845.8	857.9	875.7	893.9	914.5	935.5
Taxes	487.4	484.4	486.6	490.3	495.5	501.1	504.9	516.5	517.6	526.0	537.2	549.2	562.2	575.3
Social contributions	215.9	215.4	214.4	219.1	220.6	225.6	234.5	242.0	241.7	244.2	249.1	254.2	259.9	265.5
Grants	2.9	4.2	5.2	5.8	1.3	2.7	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.8
Other revenue	67.8	71.7	73.4	75.4	74.1	75.0	77.3	81.0	84.6	85.9	87.6	88.7	90.7	92.9
Expenditure	821.8	821.7	827.6	832.9	832.3	846.8	857.3	870.7	893.0	901.3	918.2	935.7	956.7	977.3
Expense	821.5	821.3	827.0	832.4	831.9	846.7	857.2	870.6	892.9	901.2	918.1	935.6	956.6	977.2
Compensation of employees	168.0	166.8	165.2	163.9	166.4	167.2	172.5	173.3	174.6	177.6	181.1	185.1	189.1	193.1
Use of goods and services	90.9	91.9	91.8	92.8	96.4	98.8	101.2	100.5	101.5	102.0	103.0	105.2	107.5	109.6
Consumption of fixed capital	47.8	47.8	48.0	48.1	47.9	48.1	47.3	47.8	50.1	51.4	53.9	55.1	58.0	61.0
Interest	83.8	77.9	74.5	68.1	66.4	65.5	64.6	60.3	60.1	58.9	59.0	58.3	59.0	58.9
Social benefits	355.0	363.4	371.3	376.9	380.8	386.5	394.5	408.9	419.6	428.8	437.3	446.7	456.6	466.6
Other expense	75.9	73.5	76.1	82.7	74.0	80.6	77.1	79.8	87.0	82.4	83.8	85.2	86.3	88.1
Net acquisition of nonfinancial assets	0.3	0.4	0.6	0.5	0.3	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Net lending/borrowing	-47.8	-46.0	-48.1	-42.2	-40.8	-42.5	-38.8	-29.3	-47.2	-43.3	-42.5	-41.8	-42.2	-41.8
	(Percent of GDP, unless otherwise indicated)													
Revenue	47.6	48.1	47.9	47.8	46.7	46.3	46.3	47.1	47.2	47.1	47.2	47.1	47.2	47.2
Taxes	30.0	30.0	29.9	29.6	29.2	28.9	28.6	28.9	28.9	28.9	28.9	28.9	29.0	29.0
Social contributions	13.3	13.4	13.2	13.2	13.0	13.0	13.3	13.5	13.5	13.4	13.4	13.4	13.4	13.4
Grants	0.2	0.3	0.3	0.3	0.1	0.2	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Other revenue	4.2	4.4	4.5	4.6	4.4	4.3	4.4	4.5	4.7	4.7	4.7	4.7	4.7	4.7
Expenditure	50.6	51.0	50.9	50.3	49.1	48.8	48.5	48.7	49.9	49.5	49.4	49.3	49.3	49.3
Expense	50.6	50.9	50.8	50.3	49.1	48.8	48.5	48.7	49.9	49.5	49.4	49.3	49.3	49.3
Compensation of employees	10.3	10.3	10.2	9.9	9.8	9.6	9.8	9.7	9.8	9.8	9.8	9.8	9.8	9.7
Use of goods and services	5.6	5.7	5.6	5.6	5.7	5.7	5.7	5.6	5.7	5.6	5.5	5.5	5.5	5.5
Consumption of fixed capital	2.9	3.0	3.0	2.9	2.8	2.8	2.7	2.7	2.8	2.8	2.9	2.9	3.0	3.1
Interest	5.2	4.8	4.6	4.1	3.9	3.8	3.7	3.4	3.4	3.2	3.2	3.1	3.0	3.0
Social benefits	21.9	22.5	22.8	22.8	22.5	22.3	22.3	22.9	23.4	23.5	23.5	23.5	23.5	23.5
Other expense	4.7	4.6	4.7	5.0	4.4	4.6	4.4	4.5	4.9	4.5	4.5	4.5	4.5	4.4
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	-2.9	-2.9	-3.0	-2.6	-2.4	-2.4	-2.2	-1.6	-2.6	-2.4	-2.3	-2.2	-2.2	-2.1
Memorandum items:														
Primary balance 1/	2.0	1.8	1.4	1.4	1.3	1.2	1.5	1.7	0.7	0.9	0.9	0.9	0.9	0.9
Structural primary balance 1/	3.3	4.1	3.2	3.2	2.3	1.7	1.7	2.1	1.8	1.4	1.3	1.3	1.3	1.2
Change in structural primary balance 2/	2.9	0.8	-0.9	0.0	-0.9	-0.6	0.0	0.4	-0.3	-0.4	0.0	0.0	0.0	0.0
Structural balance 2/	-1.6	-0.5	-1.0	-0.6	-1.3	-1.8	-1.9	-1.3	-1.5	-1.8	-1.8	-1.8	-1.8	-1.7
Change in structural balance 2/	2.4	1.0	-0.5	0.4	-0.7	-0.5	-0.1	0.6	-0.3	-0.3	0.0	0.0	0.0	0.0
General government gross debt	126.5	132.4	135.3	135.3	134.8	134.1	134.8	134.8	137.0	136.9	136.2	135.4	134.3	132.8

Sources: National Authorities; and IMF staff estimates.

1/ Primary revenue minus primary expenditure.

2/ Percent of potential GDP.

INTERNATIONAL MONETARY FUND

ITALY

STAFF REPORT FOR THE 2020 ARTICLE IV CONSULTATION

February 28, 2020

KEY ISSUES

The staff report reflects discussions with the Italian authorities in January 2020 and is based on the information available as of January 28, 2020. It focuses on Italy's medium-term challenges and policy priorities and was prepared prior to the outbreak of COVID-19 in Italy. It, therefore, does not cover the outbreak or the related policy response, which has since become the overarching near-term priority. The outbreak has greatly amplified uncertainty and downside risks around the outlook. Staff is closely monitoring this health crisis and will continue to work on assessing its impact and the related policy response in Italy and globally.

Developments: Over the past year, fiscal policy implementation was better than expected and constructive engagement with the European Commission helped to avoid the launch of the EU's Excessive Deficit Procedure. Following the formation of a pro-EU government in September 2019, borrowing costs fell sharply, mitigating financing pressures. Nonetheless, domestic policy uncertainty and the weakening external environment have taken a toll. Against the backdrop of low potential growth, the economy has slowed markedly, while the average real income per capita remains 7 percent below pre-crisis (2007) levels. Unemployment is high, at its historical average of close to 10 percent, with notably higher rates in some regions and among the youth. An outbreak of COVID-19 in recent days has significantly increased uncertainty.

Issues: The overarching challenges are to raise growth and enhance resilience. Staff projects growth in Italy to be the lowest in the EU over the next five years. High public debt remains a key source of vulnerability. Substantial progress has been made in strengthening bank balance sheets, but important weaknesses remain.

Recommendations: To durably raise growth and reduce vulnerabilities, Italy needs faster potential growth and medium-term fiscal consolidation. Current low interest rates provide a timely opportunity to implement mutually-reinforcing measures:

- *Structural reforms:* further liberalize product and service markets; decentralize wage bargaining to realign wages with labor productivity at the firm level; enhance public sector efficiency; and deploy the new insolvency code.
- *Fiscal policy:* implement a credible medium-term consolidation that targets a small overall surplus and puts debt on a firmly declining path. Establish credibility by

legislating upfront pro-growth and inclusive measures, such as reforming the tax system to broaden the base, lower statutory rates and help fight evasion, cutting current primary spending, and improving the design of the social safety net.

- *Financial sector:* improve bank profitability by rationalizing costs and encouraging further consolidation; bolster capital in weak banks; continue reducing nonperforming loans; strengthen the crisis management framework; and use prudential policies to attenuate still strong sovereign-bank links.

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

The mission visited Rome, Milan and Frankfurt during January 14–28, 2020. It comprised Rishi Goyal (head), Ernesto Crivelli, Daniel Garcia-Macia, La-Bhus Fah Jirasavetakul, Natalia Novikova (all EUR), Mark Adams, and Dermot Monaghan (both MCM). May Khamis (MCM, FSAP mission chief) joined the mission to conclude the FSAP discussions. Domenico Fanizza and Cristina Quaglierini (OED) also participated. The mission met with Finance Minister Gualtieri, Bank of Italy Governor Visco, Labor Minister Catalfo, Cabinet Secretary Fraccaro, senior government and SSM officials, and representatives from the parliament, private sector, trade unions, and academia. Nazim Belhocine (EUO), Marta Burova and David Velazquez-Romero (both EUR) assisted from headquarters.

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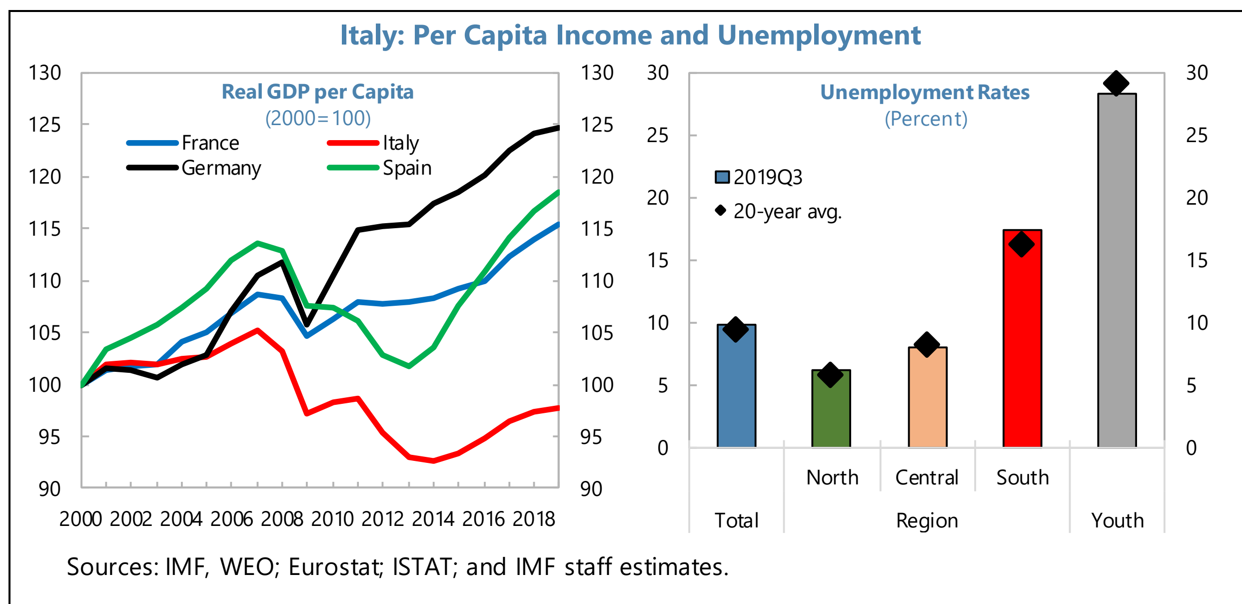
CONTEXT

1. Italy's social and economic situation remains challenging. More than a decade after the global financial crisis, real income per capita is below pre-euro levels and has fallen further behind peers. The burden has fallen disproportionately on the young and working age population while generous social benefits have shielded the elderly. Unemployment is high, at its historical average of nearly 10 percent, with much higher rates in the South and among the youth. Female labor force participation is the lowest in the EU. Emigration of Italian citizens is near a five-decade high.

Italy: Per Capita Income and Unemployment



Sources: IMF, WEO; Eurostat; ISTAT; and IMF staff estimates.

2. Low productivity growth and high public debt underlie Italy's challenges. Productivity growth has been weak for over two decades (Figure 1), as Italy's policies and institutions have adapted insufficiently to an evolving global technological and trade landscape. Sustained high unit labor costs, barriers to competition, elevated tax rates on labor, and an inefficient public sector and judicial system, among others, have weighed on employment and growth. High public debt is a persistent source of vulnerability, forcing Italy to run larger primary fiscal surpluses than its peers and limiting its ability to respond to shocks. The quality of fiscal policy has also insufficiently supported growth or protected the vulnerable. These factors and the corresponding advice have been elaborated in recent staff reports (see the staff reports for the 2017 and 2018 Article IV consultations, and Annex I) and by others such as the Bank of Italy and the EU Commission.

3. Italy's governments over the years have taken necessary actions when faced with episodic market strains. In the face of elevated sovereign borrowing costs, they implemented procyclical tightening (e.g., 2012–13) or overperformed budget targets. This has typically helped to assuage near-term market concerns. However, policies have not sufficed to durably lower debt and secure stability, particularly during normal times. With little buy-in by Italy's body politic at large, reforms to raise potential growth have been lacking or generally faltered in implementation.

RECENT DEVELOPMENTS

4. A new government took office in September 2019 and sovereign yields declined notably. The Five Star Movement and the Democratic Party formed a coalition, after the League pulled out of the previous government. They have adopted a more cooperative stance with the European Commission which, against the backdrop of accommodative ECB policy, resulted in a further drop in sovereign yields. The 10-year yield has fallen to around 100 basis points, down from about 340 basis points in late 2018. Although bank deposit and lending rates remained relatively stable throughout the period of elevated yields in 2018–19, this decline has helped banks to place bonds at lower cost and increased the value of their sovereign holdings.

5. The economy, however, has slowed sharply since early 2018. In 2017, real GDP grew at 1.7 percent, the fastest in over a decade. Since then, headwinds from external demand and heightened domestic policy uncertainty have weighed on the economy (Figure 2). Investment and consumption growth have weakened. Consequently, annual GDP growth halved in 2018 to 0.8 percent. In 2019, it is estimated at 0.2 percent, with the last quarter of the year registering the weakest quarterly growth in nearly 7 years. In mid-February 2020, an outbreak of COVID-19 led to quarantines in some localities across five provinces.

6. Unemployment is high, with a large structural component. Labor force participation and employment rates are at record highs (Figure 3) but remain among the lowest in the EU. Unemployment is at 9.8 percent. It is over 17 percent in the South and over 25 percent among youth. Hours worked per employee are below their historical average and the involuntary part-time employment rate remains elevated. Wage growth is modest. At end-2019, headline inflation was 0.5 percent, also reflecting lower energy prices; core inflation was 0.7 percent.

7. The size of the output gap is uncertain, but there is consensus that potential growth is low. The 2019 output gap is estimated at nearly -1 percent of potential GDP.[1] This estimate is in between the authorities' estimate of -1.8 percent and the EU Commission's estimate of close to zero. Others see even larger gaps, reflecting alternative assumptions about Italy's ability *absent reforms* to achieve higher potential *levels* of output. Most observers, however, agree that Italy's potential *growth* remains too low, held back by long-standing structural rigidities. Staff projects potential growth at around ½ percent.

8. The fiscal stance was slightly expansionary in 2019, with implementation better than expected. To avoid an Excessive Deficit Procedure at end-2018 and in mid-2019, fiscal policy implementation was prudent (Figure 4). The new social programs in the 2019 budget—the "Quota 100" early retirement rule and the citizenship income program—were under-executed; revenue collection was better than expected (including higher dividends from the Bank of Italy and Cassa Depositi e Prestiti, the state-owned investment bank); and the interest bill was lower. The overall

[1] This estimate reflects staff judgment to favor a larger gap, given the weaknesses in the labor market, beyond what is derived from the methodology of the April 2015 WEO. As documented in IMF working paper 19/200, judgment has been applied consistently to favor large, negative output gaps in real time for Italy for every single year since 1994.

deficit for 2019 is estimated at 2.1 percent of GDP—better than the originally projected deficit of 2.4 percent of GDP at the time of budget approval—implying a structural primary deterioration of 0.1 percent of GDP.

9. The external position is assessed to be broadly in line with fundamentals (Annex II). With import growth subdued, Italy is running a sizable current account surplus, which is estimated to have reached a multi-year high of 2.9 percent of GDP in 2019 (Figure 5). However, the real effective exchange rate suggests modest overvaluation, especially as the run up in unit labor costs over the past two decades has yet to be corrected. The net international investment position is in balance. Volatile capital outflows have reversed; foreign investors returned to Italian debt since June 2019 as fears about policy implementation receded.

10. Banking sector health has continued to improve (Figures 6–7).

- The capital (fully loaded Common Equity Tier 1) ratio of major Italian banks increased to 13 percent at September 2019, narrowing the gap to the EU average to 1.5 percentage points.[2]

- Two failing mid-sized banks were put under administration and subsequently recapitalized by one of the Italian deposit guarantee schemes.[3]

- Nonperforming loans (NPLs) have fallen from 16 percent of gross loans in 2016 to 7.3 percent in September 2019, with NPL sales at or above targets even considering the market strains of 2018–19. About half of the reduction involved government guarantees for senior securitized tranches under the so-called GACS (Guarantee for the Securitization of Bad Loans) scheme, which has also catalyzed growth of the secondary market for NPLs. NPL disposals have focused on bad loans with little prospect to return to performing status, increasing the share of "unlikely-to-pay" loans in banks' remaining NPL portfolios.

- Liquidity remains robust and deposits continue to increase as bank-issued bonds held by households mature. The largest banks have strong bond market access, but many banks remain heavily reliant on the ECB's Targeted Longer-Term Refinancing Operation (TLTRO) program to boost profitability and long-term financing. The ECB's new system of tiered remuneration for excess reserves incentivized euro area banks to lend to their Italian counterparts, resulting in a one-off increase in reserves of around €50 billion and contributing to a narrowing of the Target 2 balance to -25 percent of GDP at end-2019.

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[2] These estimates are for the 11 major Italian banks covered in the EBA's Risk Dashboard, including ICCREA and Cassa Central Banca, two newly consolidated large groups of mutual banks.

[3] Banca Carige, with assets of €25 billion, was recapitalized for the fourth time in as many years and a new board was elected in early 2020. Administrators of Banca Popolare di Bari, the largest southern bank with assets of €13 billion, are preparing a recapitalization and restructuring plan, with implementation expected in 2020:Q3.

11. Meanwhile, lending to firms contracted. Bank credit to households grew by 2.6 percent year-on-year in December 2019, an equal mix of consumer credit and mortgages, accompanied by a significant easing of credit standards and declining costs. Credit to non-financial corporates, however, contracted further, by -2.0 percent in the same period. Banks are lending to firms with good credit ratings, but these firms' external funding needs have weakened with declining growth and investment. Credit continues to contract in construction, in trade, and for small firms. The credit gap, which measures the difference between bank credit and its historical trend, is negative at 10 percent of GDP, indicating a sizable post-crisis shortfall of credit in Italy's financial system. In this context, the Bank of Italy decided to keep the countercyclical capital buffer rate at zero for 2020:Q1.

OUTLOOK AND RISKS

12. Growth is projected to be modest going forward. With macroeconomic policies supportive, growth is forecast at about ½ percent in 2020 and 0.6–0.7 percent thereafter, the lowest in the EU. This is slightly above Italy's potential growth rate, implying a gradual narrowing of the output gap over the medium term and consequent rise in core inflation (albeit slower than in euro area peers). In the near term, high frequency indicators signal a subdued outlook (Figure 2), while the COVID-19 outbreak has significantly increased uncertainty. Headwinds from the external environment are weighing on investment and exports. Lingering domestic uncertainty is hampering the recovery of private consumption, with signs of precautionary savings. In the medium term, productivity growth is forecast to remain low. Hence, real income per capita is projected to return to pre-crisis levels only in the mid-2020s.

Real GDP Growth Projections

	2019	2020	2021	2022
Ministry of Economy and Finance	0.1	0.6	1.0	1.0
Bank of Italy	0.2	0.5	0.9	1.1
National Statistical Institute	0.2	0.6	n/a	n/a
European Commission	0.1	0.3	0.6	0.7
OECD	0.2	0.4	0.5	n/a
Consensus Forecasts	0.2	0.3	0.6	n/a
IMF	0.2	0.4	0.7	0.7

Sources: Bank of Italy, Ministry of Economy and Finance, National Statistical Institute, European Commission, OECD, Consensus Forecasts, and IMF staff estimates.

Note: IMF projections reflect staff's view at the time of the mission in January 2020, and do not yet incorporate possible negative impacts of the COVID-19 outbreak.

13. Low potential growth means adverse shocks could lead to much weaker outcomes. Global trade tensions and geopolitical events that could lead to hikes in risk aversion and the oil price are among the downside risks (Annex III). While immediate Brexit-related uncertainty has declined since the recent U.K. elections, there could still be some disruption if no agreement is reached on the future relationship. Weakness in key trading partners such as Germany would weigh on exports and investment via manufacturing supply chains, particularly in machinery and transport equipment. Italy remains sensitive to increases in sovereign spreads, given its high public debt and sizable gross fiscal financing needs (Annex IV). Materialization of risks could lower demand and raise borrowing costs, increasing the debt/GDP ratio. Broader and longer restrictions on economic activity related to the potential spread of COVID-19 as well as adverse confidence effects could weaken growth further. Although significantly less likely than a year ago, a spike in sovereign or bank borrowing costs could have large adverse spillover effects, mainly through confidence channels.[4] On the other hand, a timely resolution of trade tensions and a stronger response of demand to lower yields could raise growth to about 1 percent.

[4] The Italian sovereign is rated between one and three notches above sub-investment grade. All major rating 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.

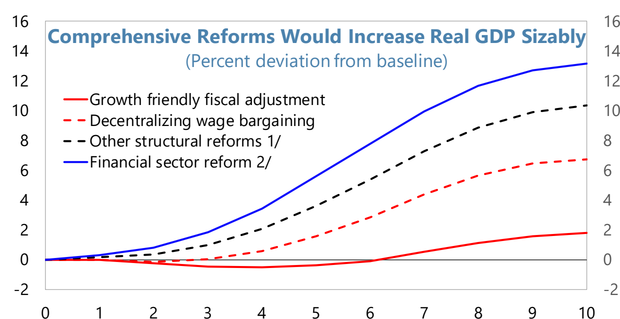
Authorities' Views

14. The authorities envisage higher growth than staff over the medium term. Following the spread of COVID-19, they have noted downside risks to their near-term growth forecasts. For 2021–22, they project real GDP growth around 1 percent, underpinned by a pickup in investment, related also to a planned acceleration in public capital spending. They consider downside risks to stem externally from trade tensions, geopolitical events and the economic performance of key European trading partners, and domestically from possible delays in the implementation of public investment plans. They concur that the external position is in balance but believe that the past overvaluation in unit labor costs has largely been corrected.

POLICY DISCUSSIONS

15. The authorities recognize the importance of implementing prudent policies to maintain market confidence and of undertaking reforms to unlock growth. They plan to implement a modestly expansionary fiscal stance in 2020. They are prioritizing the fight against tax evasion to help finance growing spending needs and create space for tax cuts. They envisage a Green New Deal, increasing sustainable infrastructure investment. They intend to continue reform efforts of public administration and the justice system. Building on progress to date, they also expect further strengthening of the banking system.

16. Italy needs higher potential growth and lower public debt to durably improve economic outcomes and break from its vulnerability to episodic market pressures. To that end, it is advisable to put in place a package of mutually-reinforcing labor and product market reforms, a healthier banking system, and credible medium-term fiscal consolidation. Consolidation should be underpinned by pro-growth and inclusive measures, including lower tax rates on labor, base broadening, and lower current spending (especially on the pension bill). The current low interest rates in Italy provide an opportunity to implement such a package, which would help narrow the income gap with euro area peers and set the stage for faster productivity growth. It would also contribute to notably lowering the public debt ratio and, over time, generate some fiscal space for further pro-growth measures.



Source: IMF WP/18/60; updated to reflect a neutral fiscal stance in the first year and gradual consolidation in the medium term.
Notes: Horizontal axis=years. Lines are stacked so that blue shows the total impact.
1/ Other structural reforms include (i) closing half of the gaps in product market regulations (PMR) and in public sector efficiency vis-a-vis EU peers at the frontier over the medium term, and
(ii) a budget-neutral reallocation of untargeted transfers towards ALMPs and targeted social safety net.
2/ Financial sector reform requires a steady reduction in the NPL ratio towards the long-term average.

A. Structural Reforms

17. Over the past two decades, several reforms were initiated but the results were limited. In the labor market, efforts were aimed, among others, at balancing worker protection with the need for flexibility through resort to temporary contracts, introduction of a new type of permanent contract, and clarification of dismissal costs and procedures. Product market measures sought to open competition in select sectors. Recurrent efforts at simplification attempted to tackle public sector inefficiencies that have compounded the costs of doing business. Insolvency and civil justice reforms tried to reduce substantially the time to resolve disputes. However, in many areas, results were notably less than what was hoped for (EC 2019; OECD 2019), owing to shortfalls in implementation, weakening or reversal of reform efforts, or an incomplete set of measures.

Addressing Rigidities in the Labor Market

18. Notwithstanding wage moderation in recent years, wages remain high relative to productivity. This gap—reflecting wage rigidities emanating from the nation-wide sectoral wage bargaining system that benefits labor market insiders at the expense of those outside—has depressed investment (Box 1, IMF working paper 20/38). It has thus hindered job creation and contributed to high structural unemployment. It has also meant that adjustment occurs through unemployment and incentivizes the use of temporary contracts that disproportionately impact younger workers. Given regional variation in labor productivity and cost of living, it has contributed to large regional differences in unemployment and competitiveness, by compressing the nominal wage distribution regardless of such differentials (NBER working paper 25612).

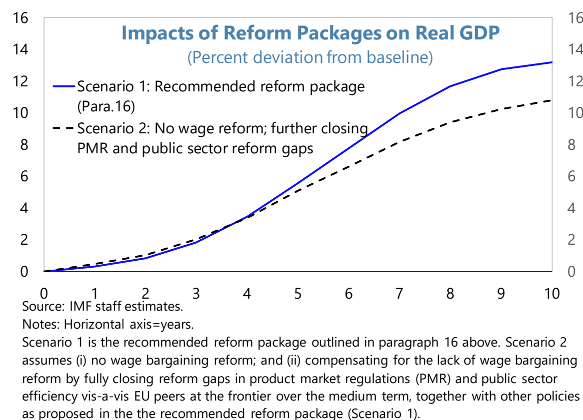
19. Realigning wages with labor productivity at the firm level would encourage investment, facilitate job creation, and lower structural unemployment. This would require modernizing the wage bargaining system.[5]

- *Recommendation:* Ideally, wage bargaining should be decentralized, giving primacy to firm-level contracts. The growth dividend of such a reform is estimated at about 5 percent of GDP over a decade (IMF working paper 18/60). Together with measures to liberalize product market competition and enhance public sector efficiency—namely, closing half of the gap vis-à-vis EU peers at the frontier over the medium term—such a reform would yield large benefits (¶16).

- *Authorities' approach:* Given the political challenges of reforming wage bargaining, however, Italy has sought to encourage second-tier firm-level bargaining within the existing system. This has had very limited impact, however. Only a small number of firms have resorted to it, as trust among social partners remains low by international comparison.

[5] Italy has a two-tier wage bargaining system, where the first-tier sector wage agreements are centralized, and a second-tier of firm-level bargaining, subordinated to the national sectoral contract, can provide productivity-related bonuses. Empirical evidence suggests that two-tier systems do not enhance wage flexibility in EU countries, including Italy, as firms tend to adjust employment in such systems (Boeri 2014; Boeri 2015).

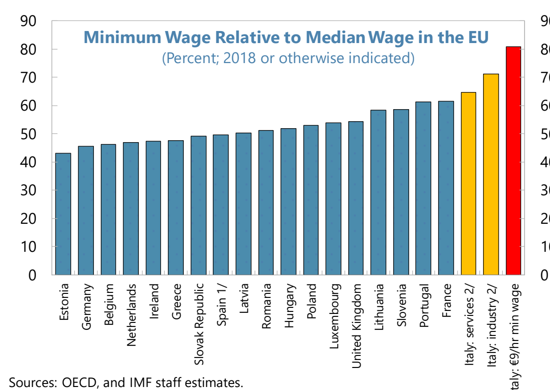
- *Trade-offs:* The authorities prefer raising productivity through other measures than wage bargaining reforms. These efforts could replicate some of the benefits of reforming wage bargaining. For instance, an alternative reform package could strive to move Italy to the frontier of product market and public sector efficiency in the EU—which would entail ambitious efforts, given the weak reform history. However, the possible gains of this alternative package would fall short of what can be achieved through a comprehensive strategy that includes labor market reform (text chart).



Source: IMF staff estimates.
Notes: Horizontal axis=years.
Scenario 1 is the recommended reform package outlined in paragraph 16 above. Scenario 2 assumes (i) no wage bargaining reform; and (ii) compensating for the lack of wage bargaining reform by fully closing reform gaps in product market regulations (PMR) and public sector efficiency vis-a-vis EU peers at the frontier over the medium term, together with other policies as proposed in the the recommended reform package (Scenario 1).

20. The authorities may introduce a statutory minimum wage and intend to continue improving active labor market policies (ALMPs).

- *Statutory minimum wage:* Italy does not have a statutory minimum wage, but *de facto* minima are set in the nation-wide sectoral contracts. These average €7½ per hour (70 percent of the median wage, above the 40–60 percent range in the EU). Consideration is being given to adopting a statutory minimum wage, possibly at €9 per hour, close to the level in Germany. Setting a high minimum wage relative to labor productivity would add to the rigidities in wage setting, further depress investment, and exacerbate informality and regional differences in employment outcomes. But a statutory minimum wage could be considered in the context of decentralizing wage bargaining, differentiated by regions to account for variations in labor productivity and living costs.



Sources: OECD, and IMF staff estimates.
1/ Staff estimates to reflect the 2019 minimum wage increase.
2/ Lowest wages in sectoral collective wage agreements.

- *Active Labor Market Policies:* the authorities are increasing staffing of employment centers and further developing electronic platforms for matching job seekers and employers. To improve the performance of employment centers, financial incentives are provided, conditional on job placement. Since labor market activation is the responsibility of local administrations, effective coordination with the center, with attention to design and monitoring, remains essential.

21. Complementary measures would enhance the functioning of the labor market. Well-designed reductions in the tax wedge on secondary earners, together with increased supply of child- and elderly-care services, could help raise female labor force participation and narrow gender employment gaps. Lowering the high cost of, and uncertainty over, dismissals would encourage hiring. Given low tertiary education attainment rates and persistent skill mismatches, improvements in higher education and skill acquisition would also help raise productivity.

Promoting Competition and Improving the Business Environment

22. Staff urged the authorities to prioritize service market reforms. Promoting competition would bring important benefits in the near as well as medium terms (April 2016 WEO). There have been no major reforms in this area since a competition law was approved in 2017. Implementation of legislated pro-competitive measures, such as the liberalization of energy tariffs and local public transport, has been repeatedly postponed. Barriers to competition remain high in sectors where productivity is low and declining, such as professional services, retail, and local services. Staff's analysis (Box 2, IMF working paper 20/39) shows that, in sectors characterized by high markups, such as professional services, the priority should be to remove entry barriers (e.g., by abolishing quotas for regulated professions and eliminating minimum tariffs). Sectors with a large mass of low productivity firms, such as retail, would benefit from fostering consolidation, lowering exit barriers, and generally lifting impediments to firm growth. The enforcement powers of the Competition Authority could also be strengthened.

23. The authorities intend to continue reforming public administration. Their plans include: simplifying procedures and increasing digitization; enhancing accountability through improved performance evaluations; and hiring new talent with the necessary skills to replace retiring workers. As initiatives in several of these areas have been attempted previously, it would be important to apply lessons from experience to enhance the chances of success. These include improving the capacity to implement reforms, timely and consistent follow through and, importantly, resisting backtracking. Establishing and publishing key performance indicators to track and communicate progress would support reform efforts. Completing previous efforts to reform public procurement and local state-owned enterprises (SOEs) is also important (Annex V, IMF working paper 20/40):

- *Public procurement*: only about half of the 2016 procurement code has entered into force, while a recent emergency decree that aimed to speed up processes came at a cost to transparency. The remaining provisions of the code should be implemented, with care taken to strike a balance between simplifying complex procedures and safeguarding transparency.

- *Local SOEs*: although the 2016 reform sought to reduce the shareholdings in local SOEs, enhance competition and increase efficiency, there has been limited progress. For instance, just 2 percent of total shareholdings have been successfully divested by the target deadline. Enforcement could be enhanced by more assertive involvement of the Court of Auditors to challenge and sanction non-compliance.

24. Timely implementation of the new insolvency code and simplification of civil procedures can lower the cost of doing business and balance sheet clean-up. The authorities plan to streamline civil judicial procedures. This should help reduce the length of trials and further lower the number of pending cases in Italy, which remain among the highest in the EU (EC's Justice Scoreboard, 2019). For the insolvency code to enter into force by August 2020, the authorities are working to issue pending secondary legislation, such as on insolvency practitioners and early warning indicators. It is advisable to pursue stronger specialization of courts. The special insolvency regime for large enterprises should also be folded into the general insolvency framework.

Enhancing Governance and Anti-Corruption

25. Efforts to enhance governance can strengthen institutions and improve the business environment.[6] A new anti-corruption law was adopted in 2019. It aims to reinforce the legal framework in line with international requirements to enhance the prosecution and sanctioning of corruption, including for criminal corporate liability, and to amend the rules on the statute of limitations for corruption and other complex financial crimes. Effective implementation is key. Good governance more generally would strengthen broader reform implementation efforts and further magnify payoffs to other structural reforms (October 2019 WEO Chapter 3).

26. Italy has a mature and sophisticated AML/CFT framework. It has a well-developed legal and institutional framework.[7] Money laundering offences are generally investigated and prosecuted in an effective manner, and the courts apply dissuasive sanctions. In general, international cooperation delivers appropriate information, financial intelligence, and evidence, facilitating action against criminals and proceeds. Italy updated its AML/CFT national risk assessment in 2019.[8] The results consider corruption—domestic and transnational—as a highly significant threat among the money laundering related offenses.

27. Italy should continue to strengthen its AML/CFT effectiveness, particularly to deter the laundering of foreign proceeds of corruption, given the significant risk in this area. Some of the areas identified are: (i) reporting entities—especially lawyers, accountants and notaries—should enhance the implementation of customer due diligence for beneficial owners and clients that are foreign politically-exposed persons, and continue to report suspicious transactions; (ii) information on beneficial owners of companies and trusts is generally accessible in a timely manner, but cross-checking is needed to ensure reliability; and (iii) the effectiveness of Italy's international cooperation framework can be improved through the implementation of an effective case management system. The 2019 follow-up report to FATF shows progress, including in improving the legislative framework for customer due diligence obligations, implementing risk-based supervision, and issuing guidelines to strengthen the compliance with AML/CFT obligations of lawyers, accountants, and other designated professions. To improve transparency of companies and trusts, the authorities are in the process of establishing a register of beneficial ownership.

Authorities' Views

28. The authorities are planning to unveil a three-year national reform program in April. The objective is to raise productivity through investment and improve the business climate, while further reducing carbon emissions. Specific priorities include simplification and digitization in the public administration, a spending review, lower taxes, and civil justice reforms to streamline the

[6] Studies by the Bank of Italy—working papers nos. 868 and 1235—confirm the significant economic costs of organized crime. The first study estimates that foregone real GDP per capita amounts to 16 percent over three decades. Both studies document the adverse effects on productive activity and growth.

[7] This is based on the latest available (2016) Financial Action Task Force (FATF) Mutual Evaluation Report. A follow-up report related to AML/CFT legal reform was submitted to the FATF in March 2019.

[8] The initial national risk assessment was published in 2016, with an update in 2019.

length and processes of civil litigation. The authorities considered that they have made substantial progress in liberalizing product markets in recent years. On labor markets, they do not consider enhancing wage bargaining flexibility as necessary. They argued that wage moderation has improved competitiveness while the current system of collective bargaining sufficiently allows for firm-level productivity-related bonuses; further incentives have been provided to encourage their use. They reiterated their emphasis on active policies to enhance job seekers' employability. They see a statutory minimum wage, set at an appropriate level, as necessary to secure a minimum standard of living without diminishing the role of the current collective bargaining system.

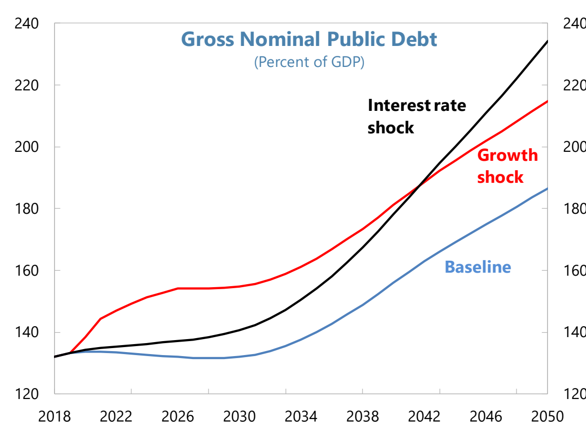
29. The authorities emphasized their strong commitment to AML/CFT effectiveness. They noted that all self-regulating bodies, such as lawyers, accountants and notaries, have developed technical rules, under the auspices of an inter-institutional body that coordinates AML/CFT policies and strategies, for analyzing and assessing risks, including regarding customer due diligence. They pointed to a significant rise in the number of reported suspicious transactions as evidence of success. Based on the updated national risk assessment, the authorities are enhancing the dialogue with, and training of, professionals for the risks they are exposed to and the performing of customer due diligence. They noted that Italy has implemented all EU instruments (e.g., framework decisions and directives) regulating judicial cooperation, mutual legal assistance, enforcement of confiscation orders, and joint investigation teams.

B. Fiscal Policy

30. Fiscal policy is set to be modestly expansionary in 2020 and neutral thereafter. The authorities are targeting an overall deficit of 2.2 percent of GDP in 2020, declining to 1.4 percent of GDP in 2022. Staff forecasts a higher deficit path, at about 2.4 percent of GDP in 2020 and declining very modestly thereafter. This reflects lower nominal GDP growth and excludes activation of future VAT safeguard clauses given the history of this measure (Annex IV). The structural primary balance deteriorates by 0.4 percent of GDP in 2020 and is neutral thereafter. The 2020 budget postpones planned hikes in VAT and excise rates; lowers taxes marginally; strengthens the fight against tax evasion; and extends incentives for investment. The authorities also plan to bring public investment gradually back to pre-crisis levels, including through the Green New Deal that targets an increase in sustainable infrastructure investment of 3 percent of GDP over 15 years.

31. Italy critically needs credible medium-term consolidation.

- Notwithstanding low interest rates currently, fiscal space remains at risk. In the baseline, the debt ratio is projected at close to 135 percent of GDP through the medium term owing to low interest rates. But it rises in the longer term owing to pension spending pressures. If modest adverse shocks were to materialize, such as a

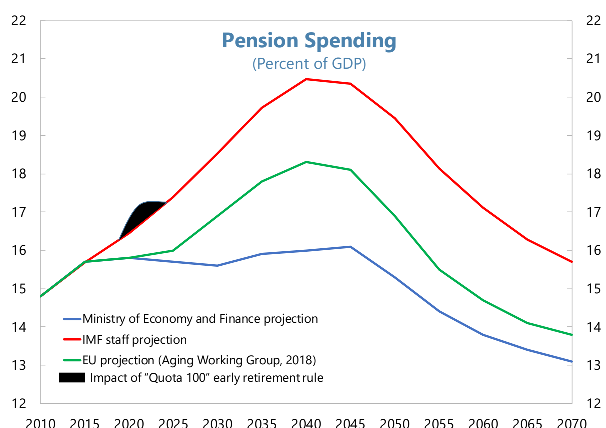


recession, debt would rise sooner and faster (Annex IV), heightening the risks of a sharp consolidation when the economy is weakening. It is thus strongly advisable to take advantage of the current low interest rates to implement credible medium-term consolidation.

- Putting credible medium-term consolidation policies in place—via a gradual and balanced adjustment that delivers an overall surplus of ½ percent of GDP by around 2025—would mitigate the need for a sharp adjustment when adverse shocks materialize. Credibility can be built by legislating upfront well-designed measures to promote growth and inclusion (¶s 32–34). Current primary spending should be reduced to achieve fiscal targets, while better focusing social protection to the poor and gradually increasing public investment. Reducing spending would also open room, alongside broadening of the tax base, for lowering the tax burden.

32. Reducing current primary spending would facilitate achieving medium-term fiscal targets, raising public investment and lowering taxes. Notwithstanding wage restraint, current primary spending has grown faster than real GDP over the past decade. This is largely due to rising pension spending that has crowded out space for capital spending and tax reductions. Fully implementing procurement reform and recommendations of past spending reviews would yield modest cuts to discretionary spending over time. Thus, options for more ambitious cutting and rebalancing of spending include:

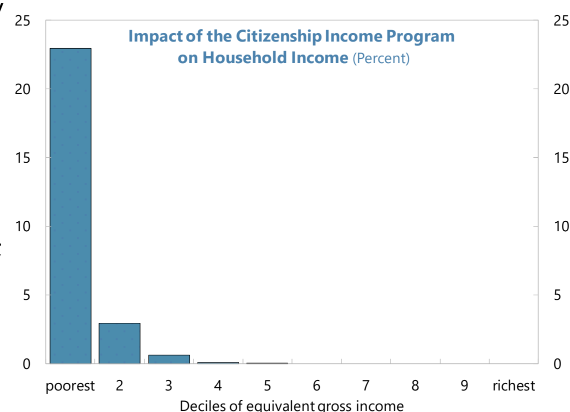
- *Lowering pension spending.* Notwithstanding past reforms, pension spending/GDP is projected to be high and rising in the coming decades. This reflects relatively low employment and productivity growth projections, population aging, and the generosity of the system.[9] The experimental "Quota 100" early retirement rule introduced in 2019 further increased pension spending and introduced a discontinuity in the retirement age that need to be addressed.[10] Staff advises preserving the indexation of retirement age to life expectancy, ensuring actuarial fairness including for options to retire early (i.e., closely linking lifetime benefits with lifetime contributions), and adjusting pension parameters to secure affordability (IMF working paper 18/59).



[9] For instance, replacement rates are 15–20 percent higher than in the EU, the weighted average accrual rate is 2 percent compared to around 1.5 percent in the EU, and benefits are based on relatively short earnings histories and low early retirement penalties.

[10] According to the Quota 100 rule, workers who are at least 62 years of age with a minimum 38 years of contributions are eligible for early retirement during 2019–21. Women who are at least 59 years of age with a minimum 35 years of contributions are also eligible. The potential pool of early retirees was further expanded by allowing workers to fill gaps in their contribution history at subsidized rates. Automatic adjustments of the statutory retirement age to life expectancy were canceled for 2019–20.

- *Improving the social safety net*. The citizenship income program—a means-tested, poverty relief measure introduced in 2019—targets the most vulnerable. But its design needs to be strengthened to avoid welfare dependence and disincentives to work. Benefits decline sharply if the eligible household starts to work, indicating very high marginal effective tax rates, especially at low wages. Set at 100 percent of the relative poverty line, benefits are well above international good practice. Marginal benefits decline too quickly with family size, thus penalizing larger families that tend to be poorer. International good practice suggests: (i) including more gradual benefit phase-outs, income disregards, or conditional in-work benefits to incentivize regular work; (ii) capping the benefit at 40–70 percent of the relative poverty line; (iii) adjusting benefits to account for differing costs of living across regions; and (iv) implementing adequate controls to prevent abuse and ensuring effective local administrative capacity.



- *Supporting investment*. The authorities' intention to continue increasing public investment gradually to pre-crisis levels needs to be supported by strengthening the quality of public investment management—through improved feasibility studies and prioritization of projects, faster decision-making processes, and enhanced implementation capacity. Additionally, policies to enhance investment in R&D and innovation would support productivity growth.

33. A comprehensive base-broadening tax reform can promote growth and inclusion and help tackle evasion. The tax system is overly complex, applies high statutory rates on a base that has been significantly eroded through exemptions and incentives, and suffers from large gaps (Annex VI, IMF working paper 20/37). Improving the design of the tax system by lowering high statutory rates on labor and broadening the base would promote growth and benefit lower- and middle-income households. It involves collecting revenues from sources that are less distortionary and, thus, less harmful to growth, such as VAT and recurrent taxes on immovable property (including primary residences).

- *Lowering the tax wedge on labor*. The average labor tax wedge in Italy is 47.9 percent, compared to the EU-15 average of 41.8 percent. The authorities' plan calls for a modest reduction by 0.2–0.3 percent of GDP in 2020–21. This is to be implemented by extending the national income tax bonus (from €80 per month to €100 per month) in 2020 and potentially folded into a planned tax reform in 2021. A more ambitious reduction to the EU average is recommended. It could cost 2 percent of GDP, which should be offset by significant base broadening.

- *Broadening the tax base*. Tax credits and deductions under the personal income tax system should be rationalized, especially those that are poorly targeted or disincentivize labor supply, such as the national income tax bonus. The use of VAT reduced rates should be streamlined. For instance, several goods and services currently subject to the reduced VAT rate of 10 percent are consumed largely by wealthier families, and can be streamlined without negative distributional

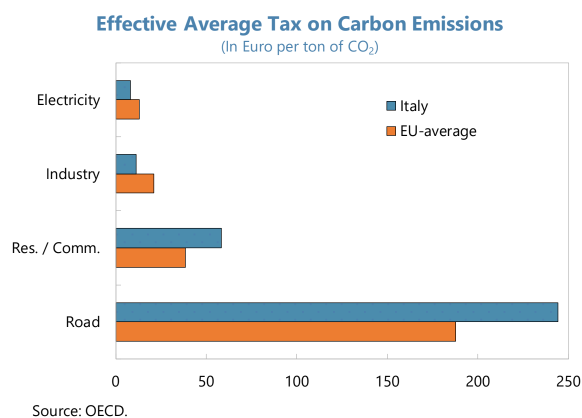
consequences. The cadastral system significantly erodes the tax base on immovable property and imposes a disproportionate burden on poorer households, which contributes to its unpopularity (the gap between market and cadastral valuations is largest for the rich). Therefore, updating the property valuation system is essential to address equity concerns and increase revenue collection at significantly lower statutory rates.

- *Tackling tax evasion.* Compliance gaps are large, estimated at €109 billion (about 6 percent of GDP) in foregone revenues. The renewed fight against evasion breaks from a history of granting amnesties. The authorities mandated electronic invoicing and transmission to the tax agency to support compliance. The 2020 budget envisages strengthening monitoring in areas where compliance risks are particularly high (such as in fuels); adding incentives to use traceable payment methods; and extending the VAT split-payment mechanism. The authorites are seeking to strengthen risk analysis by accessing data from financial institutions, which requires addressing privacy concerns. Strengthening the institutional and governance arrangements of the tax agency, including to address staffing gaps, and removing legal obstacles to tax debt collection would further support their efforts.

34. Italy's commitment to reduce carbon emissions by 20–25 percent by 2030 needs to be supported by strong policy action.[11] Italy's CO_2 emissions have been declining steadily since 2005. Options to further reduce emissions toward the 2030 commitment include:

- *Carbon taxation*. Taxes on the carbon content of fossil fuels are the most powerful and efficient tool to reduce emissions (Fiscal Monitor, October 2019). Carbon pricing can provide across-the-board incentives to reduce energy use and shift toward cleaner fuels and is relatively easy to administer. Current carbon taxation in Italy consists of specific taxes on energy use and, to a lesser extent, permit prices from the EU emissions trading system. According to the OECD, effective tax rates vary widely: the bulk of emissions (mostly in electricity) are taxed below €10 per ton of CO_2, while other sectors (residential, commercial, road) are taxed between €30–240 to reflect externalities such as congestion, accidents, and local air pollution. In some sectors, carbon taxation in Italy is already above the EU average. Staff estimates that reducing carbon emissions by 20 percent would require a uniform carbon tax of €70 per ton of CO_2, above which any pre-existing excise taxes should be added to correct for other externalities. This requires increasing taxes, mostly in electricity and industry. The tax should be phased-in gradually. The revenues generated could be used to compensate impacted households or offset distortionary taxes.

Effective Average Tax on Carbon Emissions
(In Euro per ton of CO_2)



Source: OECD.

[11] Staff calculations suggest that higher greenhouse gas emissions in the absence of mitigating policies could reduce real GDP per capita in Italy by an estimated 7 percent by 2100, as compared to about 5 percent in other EU countries (October 2019 Fiscal Monitor and October 2017 WEO, Chapter 3). The estimates are based on a projected increase in average global temperature of 0.04°C per year (Representative Concentration Pathway 8.5 scenario).

- *Additional public sector intervention*. Private investment in low-carbon technologies may be insufficient owing to technology-related market failures and other impediments.[12] The proposed Green New Deal can help through targeted public infrastructure investment to tackle network externalities (e.g., smart electricity grids, charging stations for electric vehicles). Additional policy options include energy price liberalization to reduce market distortions, targeted fiscal incentives to support R&D, and regulatory standards to promote clean energy deployment.

Authorities' Views

35. The authorities are confident of achieving their fiscal targets and lowering public debt over the medium term. They reiterated their strong commitment to the deficit target of 2.2 percent of GDP for 2020 and noted that the safeguard clauses have worked as intended, with offsetting measures taken to achieve targets agreed with the EU. They consider a very gradual consolidation appropriate, so as not to jeopardize the economic recovery and put social cohesion at risk. Higher growth and a return of inflation would facilitate a faster decline in debt, while prudent budget execution and past reforms, including of the pension system, underpin sustainability. They emphasized that the "Quota 100" early retirement rule is temporary and will expire next year as planned. Options for further flexibility in early retirement could be considered, including for precarious occupations, possibly with actuarially neutral cuts in benefits. They are planning a tax reform in 2021 to reduce further the tax wedge on labor and address equity concerns. They considered that new carbon taxes would need to be coordinated at the EU level so as not to adversely impact competitiveness.

C. Financial Stability

36. Substantial progress has been made in strengthening bank balance sheets, but important vulnerabilities remain. Improvements in bank capitalization and asset quality in recent years have been supported by the strengthening of EU regulations, the creation of the Single Supervisory Mechanism (SSM), and measures by the Italian authorities to reduce NPLs, improve governance and raise prudential requirements. Action has been taken to restructure or recapitalize several weak banks, and 270 cooperative banks have been consolidated into two banking groups supervised directly by the SSM and one Institutional Protection Scheme. However, capital ratios (fully loaded Common Equity Tier 1) remain below the EU average; the NPL ratio has declined sharply in recent years but remains more than twice the EU average, with several large banks still struggling with double-digit ratios; and some banks continue to rely heavily on ECBs' TLTRO. Downside risks identified in the FSAP vulnerability assessments, coupled with a modest growth outlook, indicate that many banks with material aggregate total asset share continue to be vulnerable to an adverse scenario. This highlights the need for further measures to underpin the resilience of the banking sector and enable it to fully support the real economy.[13]

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[12] These include: (i) knowledge spillovers that may prevent firms from capturing the full social benefits of developing and using new technologies; (ii) network externalities where extra infrastructure needed for one investor could potentially benefit other firms; (iii) market distortions that might impede low-carbon investment; and (iv) imperfections in financial markets reflecting limited financial instruments for low-carbon investments.

[13] Italy underwent a regular financial stability assessment under the IMF's Financial Stability Assessment Program (FSAP) in 2019 with the concluding meeting held in January 2020. For details, see the accompanying Italy Financial System Stability Assessment (Annex VII lists the key recommendations).

37. Boosting capital buffers and continuing to reduce NPLs are needed to enhance resilience in weak banks. The FSAP found that some systemic banks and less significant institutions (LSIs) remain vulnerable to adverse shocks, given their relatively lower capital levels and asset quality.[14] Supervisory action on capital should be guided by stress test findings and further review of the provisioning of unlikely-to-pay (UTP) portfolios. Continued supervisory emphasis is needed on reducing NPLs, for instance by extending the SSM's approach to setting bank-specific expectations for the gradual path to full provisioning of the existing NPL stock to LSIs with high NPLs and robustly challenging banks' NPL reduction plans.

38. Like many EU banks, Italian banks face operating profitability challenges and need to reduce costs and invest in technology (Box 3). Prospects are limited for revenue growth in an environment of low interest rates, an already high share of income from fees and commissions, and low projected economic growth. Although the two largest banks have decisively reduced operating costs in recent years and invested in new technology, many other banks have made less progress and risk falling further behind as higher yielding older loans mature and competition from fintech increases. Strong supervisory focus on cost reduction plans and the viability of business models should therefore continue, including for the newly consolidated cooperative sector. Facilitating further consolidation is also important in this regard.

39. Strengthening the Bank of Italy's powers and frameworks for crisis management, bank governance, and macroprudential policy would also enhance resilience.

- *Supervision and crisis management.* In tackling weak banks, the efforts of the Italian authorities have focused on market solutions. Escalation of corrective measures has generally taken time as consideration has been given to systemic implications and contagion risk. Going forward, consideration should be given to more timely escalation of corrective measures for weak banks to effect improvement (e.g., in capital levels, operational efficiency, governance) or achieve consolidation or orderly winddowns when needed so that weaknesses do not persist or even become exacerbated if not dealt with in a timely manner. The FSAP also highlighted that, as a general principle, care needs to be taken that the use of special administration does not delay decisive action when needed. The use of public funds in bank failures should be strictly limited to exceptional events that could undermine system-wide financial stability. To reinforce least cost outcomes and reduce moral hazard, the use of deposit guarantee scheme (DGS) funds for preventive measures outside of resolution or liquidation should be avoided as much as possible, used only in exceptional cases with strong prospects for successful rehabilitation and restoring long-term viability. Building additional loss-absorbing capacity over an appropriate transition period would support these goals and facilitate orderly resolution or liquidation of LSIs, in particular those for which a resolution strategy is foreseen. Active bankers should be removed from the DGSs' boards to strengthen their operational independence. The power to put financial institutions under compulsory administrative liquidation should be assigned to the Bank of Italy.

[14] The stress test findings by the Bank of Italy on Italian LSIs in mid-2019 were broadly in line with those in the FSAP.

- *Bank governance*. Governance weaknesses persist, not least regarding the fit and proper criteria for bank management. Legislative gaps in the implementation of the EU rules on fit and proper bank management should be closed promptly, starting with the issuance of the necessary government decree and ensuring firm implementation of reforms.

- *Macroprudential policies.* Establishing a national macroprudential authority, with the Bank of Italy playing a lead role, and an enhanced toolkit that comprises a systemic risk buffer and borrower-based tools can help in reducing future recurrence of banking sector stress. To that end, the authorities could consider using prudential policies to moderate the sovereign-bank nexus, with gradual phasing-in to minimize potential disruptions to markets.

Authorities' Views

40. The authorities highlighted that substantial progress has been made in the repair and consolidation of the banking sector, despite a difficult context. The Italian authorities noted the challenging backdrop of the past decade, including a sharp fall in output and weak recovery, limited fiscal support for the banking sector, and a new EU crisis management framework and interpretations of EU state aid discipline which, in their view, restricted the instruments available to tackle weak banks. In that context, they deemed the progress in strengthening the banking sector as a signal of the success of their supervisory and crisis management approach. They noted that banks' liquidity positions were strong, and banks could replace TLTROs when needed. They considered the reforms of the cooperative banks (popolari and mutual institutions) as significant steps in enhancing governance and effecting consolidation, and noted that further measures may be needed to promote consolidation, especially in the South. Further work on bank resilience would include addressing remaining pockets of vulnerability and improving profitability.

41. While welcoming the FSAP analysis, they felt that some recommendations could affect broader financial stability if implemented, especially given contagion risk and constraints within EU frameworks.

- The Italian authorities believed the FSAP's assessment of credit risk losses in the stress testing exercise reflect overly conservative assumptions and pointed to the improvement in sovereign spreads, asset quality, and value recovery from NPL sales since the stress tests were completed. They argued that the FSAP analysis reflected assumptions on likely future credit quality migration rather than actual provisioning shortfalls. They considered that the pace of NPL reduction to date had been swift and appropriately balanced and highlighted that excessive NPL reduction targets could generate unnecessary value destruction. In their view, extending the SSM's approach to setting bank-specific expectations for full provisioning of the existing NPL stock to LSIs with high NPLs is not necessary, given that such banks are already reducing the NPL stock in line with the plans agreed with the supervisor, and could have an adverse impact on the ongoing restructuring of "going-concern" SME loans. They also considered that new EU legislation already enforces a first pillar calendar approach on new loans.

- The Italian authorities agreed on the importance of timely and efficient solutions for dealing with weak banks but argued that—in a context in which technological change, low profitability, and slow economic growth hinder a few banks' capacity to raise capital and/or restructure operations—broader financial stability implications must be accounted for, such as possible contagion risk and indirect impacts on borrowers. They also observed that market solutions in dealing with problem banks are less disruptive with respect to piecewise liquidation.

- The Italian authorities agreed that it would be useful to have additional loss-absorbing capacity for some potentially systemic LSIs, but noted that small banks generally lack access to wholesale capital markets. This calls for some patience, so that any such banks subject to binding MREL requirements do not end up relying on the local retail market for satisfying them.

- The Italian authorities argued that shifting the existing private sector DGSs into the public sector is not necessary as they are allowed under the existing legal framework and are operating effectively. Transforming them would limit the ability to tackle weak banks in a timely manner owing to current EU state aid rules. They also argued that the ability of the DGS to engage in failure prevention measures subject to the least cost test should be maintained or even enhanced, also in light of what they viewed as the European authorities' restrictive interpretation of the public interest test for triggering the resolution procedure. They disagreed with the FSAP recommendation to increase deposit insurance contributions as targets are aligned with European minimum requirements.

- While acknowledging potential risks related to high domestic sovereign exposure by the financial sector, the Italian authorities pointed to the absence of international standards and the "contrarian investor" role played by financial institutions in this area. They stated that prudential policies to moderate the sovereign-bank nexus would need to be part of a broader European solution, also to avoid possible disruptions to the Italian sovereign bond market.

- On governance, the Italian authorities agreed that finalizing issuance of the decree on fit and proper requirements should be a priority but prefer to retain this, as well as resolution and liquidation ultimate decision powers, at the government level.

STAFF APPRAISAL

42. Italy faces a challenging outlook. The economy has slowed sharply, while real per capita income remains 7 percent below the pre-crisis peak and continues to fall behind euro area peers. Looking forward, growth is projected to be the lowest in the EU, reflecting weak potential growth and implying that real per capita income may return to pre-crisis levels only by the mid-2020s. Materialization of adverse shocks, such as escalating trade tensions, a slowdown in key trading partners, geopolitical events and wider and longer impacts related to the spread of COVID-19, could lead to much weaker outcomes.

43. Decisively turning around the economic and social situation requires broad political support for deep-seated reforms. Italy's body politic has taken corrective actions whenever the country has been faced with episodic market strains, which has typically helped to assuage near-term market concerns. But there has been little buy-in for policies to durably lower debt, secure stability and raise potential growth.

44. The challenge for the new government is to build support for a comprehensive package of reforms that raises potential growth and enhances resilience. The current low interest rates provide a window of opportunity. The authorities intend to announce a new three-year national reform program shortly, including measures to support investment and cut taxes further. They are urged to intensify structural reforms that tackle rigid wage bargaining, barriers to competition, and public sector and judicial inefficiencies. Credible medium-term fiscal consolidation is needed to lower public debt, underpinned by pro-growth and inclusive measures. Continued strengthening of the stability of the banking system and its ability to support the economy requires bolstering capital in weak banks and improving profitability and asset quality. Although the external position is broadly in line with fundamentals, these reforms would enhance competitiveness.

45. Steadfast implementation of structural reforms would unlock Italy's potential and durably improve outcomes. Reforms to decentralize wage bargaining and liberalize markets should be prioritized, as they would raise investment, create jobs, and yield sizable income gains. Notwithstanding wage moderation in recent years, wages remain high relative to productivity. Realigning wages with productivity at the firm level is thus essential, ideally by decentralizing wage bargaining. In this context, a statutory minimum wage could be considered, accounting for varying productivity levels and living costs across regions. Regulatory barriers to competition should be lowered by facilitating entry into sectors with high markups, removing exit barriers in sectors with many low-productivity firms, and generally lifting impediments to firm growth. Timely implementation of reforms to improve public sector efficiency and the insolvency and justice frameworks would further unlock Italy's potential over the medium term. Strengthening the AML/CFT framework and effectively implementing the anti-corruption law would also contribute to enhancing governance and improving the business environment.

46. Italy needs credible medium-term fiscal consolidation to safeguard stability. Public debt is projected to remain high over the medium term and to rise in the longer term owing to pension spending. Meanwhile, if adverse shocks were to materialize, debt would rise sooner and faster. Therefore, it is strongly advisable to implement credible medium-term consolidation while interest rates are low, by legislating upfront high-quality measures. A gradual and balanced adjustment targeting a small overall surplus in 4–5 years would ensure that debt declines firmly over time.

47. Consolidation should be underpinned by pro-growth and inclusive measures.

- Current primary spending should be reduced over the medium term to meet deficit targets while improving protection of the poor. Pension spending pressures should be contained by preserving the indexation of retirement age to life expectancy, ensuring actuarial fairness including for early retirement, and adjusting pension parameters to secure affordability. Poverty

alleviation programs should be designed in line with international best practice to avoid disincentives to work and welfare dependence. Public investment should continue to increase gradually, underpinned by better quality public investment management. Limiting uncertainty in tax matters would also improve the investment climate.

- A comprehensive tax reform would promote growth and labor force participation, while benefiting low- and middle-income households. An ambitious reduction in the labor tax wedge to the EU average should be considered, paid for with significant base broadening. There is considerable scope to: (i) rationalize tax credits and deductions in the personal income tax system, especially those that are not well targeted or disincentivize labor supply; (ii) streamline the use of VAT reduced rates, with attention to distributional consequences; and (iii) update the property valuation system that imposes a disproportionate burden on poorer households to address equity concerns and increase tax collection at significantly lower statutory rates. The fight against tax evasion needs to continue. Moreover, raising carbon taxes gradually over the next decade would allow Italy to meet its emissions reduction target. The revenues generated could be used to compensate impacted households or offset distortionary taxes.

48. Although substantial progress has been made in strengthening bank balance sheets, important challenges remain. Building on the considerable improvement in capitalization and asset quality of the banking sector, further efforts are needed to bring capital buffers and NPL ratios closer to EU averages and promote further consolidation of the banking sector. While improving recently, the profitability of many Italian banks—as in many EU peers—remains low, reflecting limited potential to increase revenue, structurally high operating costs, challenges to business models, and governance weaknesses. Exposures to the Italian sovereign are relatively large.

49. In line with the findings of the FSAP, the authorities are encouraged to continue bolstering banking sector resilience. NPL reduction plans should continue to be robustly challenged, with further attention given to unlikely-to-pay loans. The SSM's approach to setting bank-specific expectations for the full provisioning of the existing NPL stock could be extended to less significant institutions with high NPLs. Strong supervisory focus on the viability of business models and cost reduction plans must continue and intensify. The crisis management framework should be strengthened. Going forward, consideration should be given to more timely escalation of corrective measures for weak banks; the use of the deposit guarantee scheme for preventive measures should be avoided as much as possible, used only in exceptional cases with strong prospects for successful rehabilitation and restoring long-term viability; the use of public funds in bank failures should be strictly limited to exceptional events that could undermine system-wide financial stability; and additional loss absorbing capacity should be built up over an appropriate transition period to facilitate orderly resolution or liquidation of less significant institutions, particularly those for which a resolution strategy is foreseen.

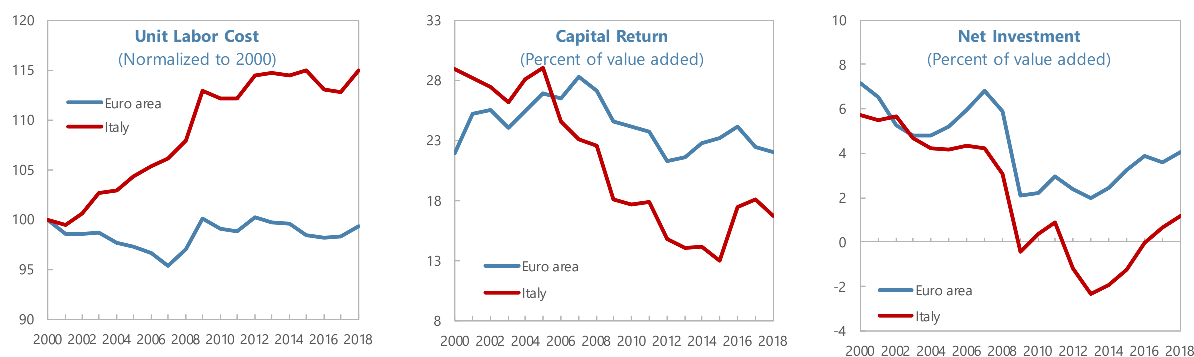
50. It is recommended that the next Article IV consultation be held in the usual 12-month cycle.

Box 1. Labor Costs and Corporate Investment in Italy[1]

Labor costs in Italy rose faster than labor productivity prior to the global financial crisis and have remained high since, weighing on job creation. National accounts data show that mounting labor costs have eroded corporate profits and capital returns since the Global Financial Crisis and reduced firms' capacity to invest. Although the fall in profitability and investment has been ubiquitous in the euro area, it has been exacerbated in Italy by the increase in labor costs (text charts).

Empirical analysis provides evidence for the impact of wages on investment at the sector and firm levels. Sectoral wage growth seems to not be associated with sectoral productivity growth[2] but is negatively related to investment. Firm-level data permit better identification of the effects of an increase in labor costs—by exploiting the interaction between sectoral wage growth (exogenous at the firm level) and the lagged labor share of the firm in a regression with firm and sector-year fixed effects. A one percent increase in real wages is estimated to cause a ⅓ percent fall in fixed capital. Profits absorb only ½ of the cost increase.

These results highlight the importance of labor market reforms, as part of an overall package that boosts productivity. As an illustration, a simple extrapolation of the above exercise suggests that a 6 percent real wage devaluation would bring net investment back to its pre-crisis average,[3] although to the extent complementary reforms (e.g., of product and service markets) credibly boost productivity, the need for such wage adjustment is reduced. On the other hand, introducing a €9 minimum wage (as was put before Parliament in a draft legislation) could reduce the fixed capital stock by 0.8 percent.[4]



Note: the capital return is equal to net income plus gross interest and dividends. Net investment is defined as fixed capital formation minus depreciation. Unit labor costs are calculated as labor compensation over value added, and are normalized to 100 in year 2000 to control for cross-country structural differences, including in the self-employment share.
Source: OECD National Accounts.

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[1] Prepared by Daniel Garcia-Macia (EUR), based on IMF working paper 20/38.

[2] This result is in line with the findings in Boeri et al., 2019 (NBER WP 25612)

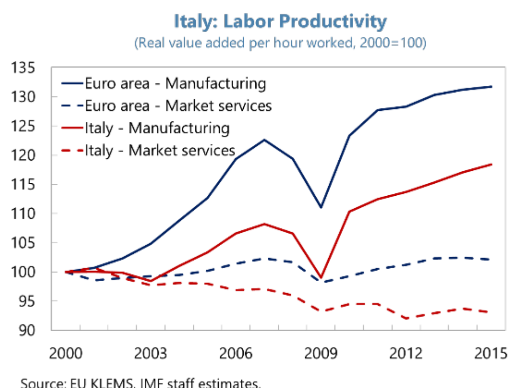
[3] This resonates with the external sector assessment (Annex II).

[4] The labor cost impact of a minimum wage is estimated by the National Social Security Institute (INPS) at €9.7 billion (XVIII Rapporto annuale, 2019).

Box 2. Service Market Reform Priorities in Italy[1]

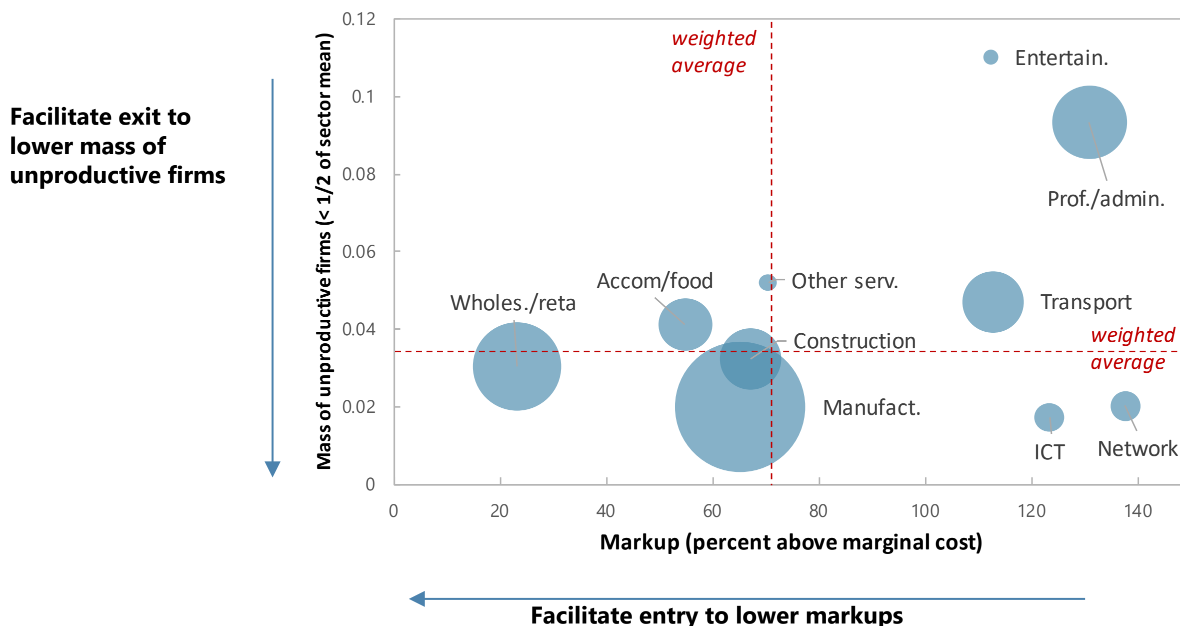
Italy's labor productivity in market services has declined since 2000, underperforming manufacturing and peer European countries, especially in strongly regulated sectors.

A model of firm competition with entry and exit barriers is used to identify policy priorities linked to sectoral characteristics.[2] Removing entry barriers is shown to be most efficient in sectors with high markups, while removing exit barriers is most efficient in sectors with a large tail of low productivity firms. Using firm-level data, sectors are classified according to their average markup and mass of unproductive firms (text chart).



Policy recommendations are as follows. In sectors with high markups, such as administrative and professional services, removing entry barriers consists of abolishing quotas for regulated professions, eliminating minimum tariffs, and repealing the requirement for a manager or owner to be a professional. In sectors with a large mass of unproductive firms, such as retail, policies should aim at: fostering consolidation; removing impediments to factor reallocation; and lowering exit barriers through a modernization of the insolvency framework, more efficient active labor policies, and a better design of the social safety net.

Italy: Sectoral Distortions and Policy Recommendations



Sources: Orbis, Eurostat and IMF staff calculations.
Note: Dot size is proportional to the sector's employment share. Markups are estimated following De Loecker and Warzynski (2012), using data for 2005–16. The vertical axis is based on value added per worker for 2011–16.

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[1] Prepared by Nazim Belhocine and Daniel Garcia-Macia (EUR), based on IMF working paper 20/39. The analysis benefited from codes by Federico Diez and Chiara Maggi (RES).

[2] The model is adapted from Feenstra (2003) and Felix and Maggi (2019).

Box 3. Profitability of Italian Banks[1]

Despite recent improvements, the profitability of Italian banks remains below the cost of equity.[2] EU peers also have weak profitability. But several aggravating factors make many Italian banks less attractive to investors and thus could continue to weigh on banks' ability to fully support the economy. These include NPL ratios that have fallen significantly but remain more than twice the EU average, fully loaded CET1 capital ratios that are almost 1.5 percentage points below EU peers, and material expected costs related to building loss-absorbing capacity and meeting revisions to the EU bank capital rules.

Using publicly available data for 327 Italian banks between 2014 and 2018, this analysis decomposes profitability to identify ways to improve it (box figure below).

Income growth opportunities are limited. Operating income grew by 2 percent in nominal terms for the largest banks in the 2014–18 period but fell by a similar amount for the smaller banks. Fee income did not grow as a percentage of assets in the period. Italian banks already have the highest share of fees in operating income in the EU, a large share of which is related to payment services and could come under pressure from increasing adoption of mobile payments and competition from fintech. Higher net interest margins at smaller banks are also vulnerable to the roll-off of higher yielding loans.

The two largest banks improved profitability by significantly reducing operating costs. This involved a 29 percent reduction in their branch network since 2014, alongside considerably more investment in information technology than other Italian significant institutions. Capital management, including disposal of subsidiaries and fresh capital raising, was needed to cover the substantial costs of downsizing. The result is a growing gap in revenue per branch compared to small and medium-sized banks.

To break even, i.e., achieve a return on equity equal to the cost of equity, Italian banks would need to reduce operating expenses by about 15 percent in aggregate. Achieving this through staff reduction alone would incur large upfront costs—circa €10 billion in the aggregate based on industry estimates of severance costs—while downsizing could also adversely impact revenue. For some banks, the capital impact of such a restructuring would be significant. Although the consolidation of smaller cooperative banks creates cost reduction opportunities, they have yet to finalize their operational plans and their ability to raise fresh capital remains constrained by their cooperative form.

Therefore, the authorities are encouraged to actively promote cost reduction and facilitate restructuring and exit of weak institutions. Strong supervisory focus remains important on business model viability, including for less significant institutions and cooperative groups. Other measures could seek to mitigate restructuring costs or facilitate investment in digitization. The authorities should also be prepared for market exit of weaker banks through further consolidation or orderly closure, which will require strengthening of the bank resolution and liquidation regime as recommended by the FSAP.

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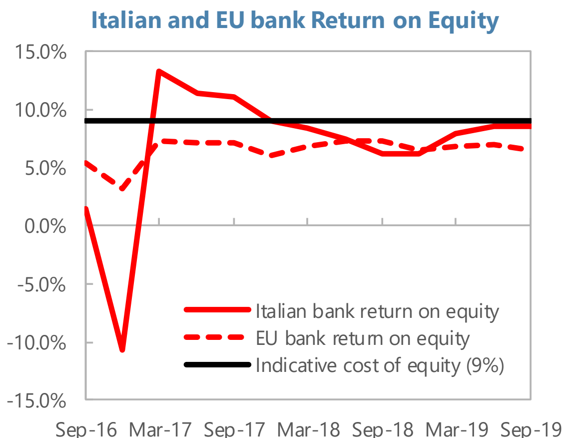
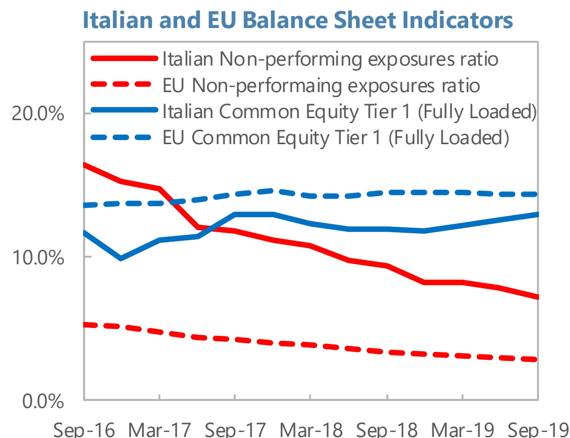
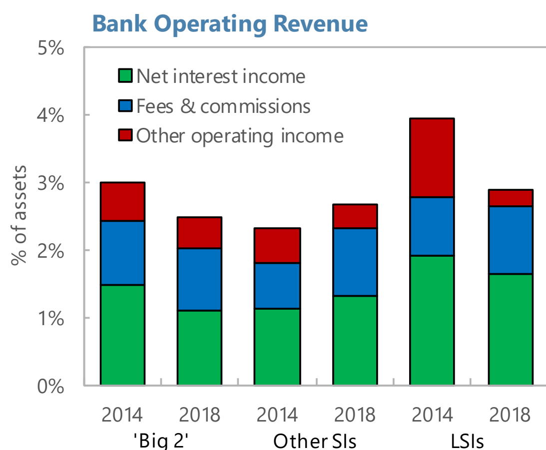
[1] Prepared by Mark Adams, Dermot Monaghan (both MCM) and Natalia Novikova (EUR).

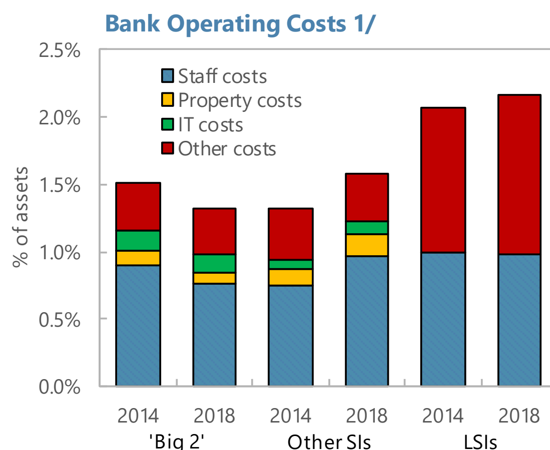
[2] The cost of equity is estimated at about 9 percent based on EBA survey responses.

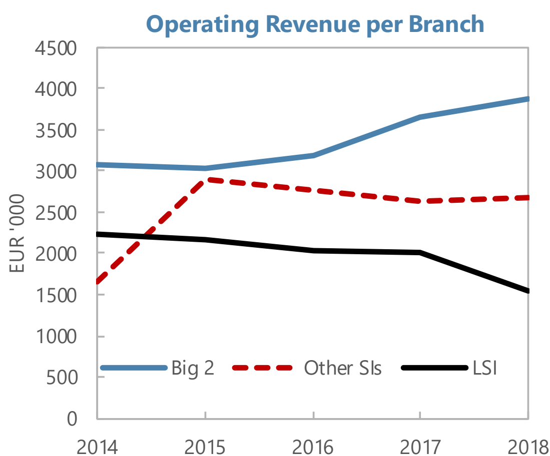
Box 3. Profitability of Italian Banks (Concluded)

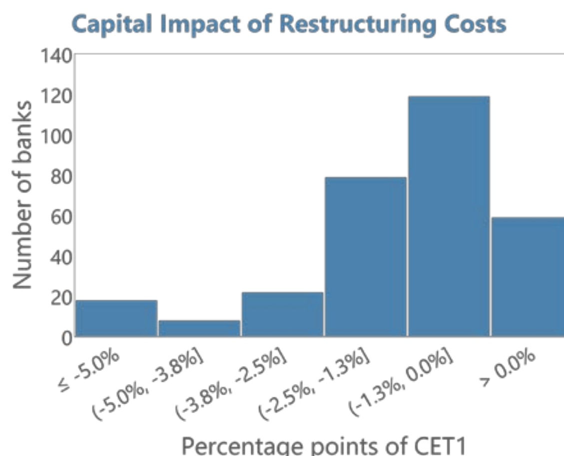






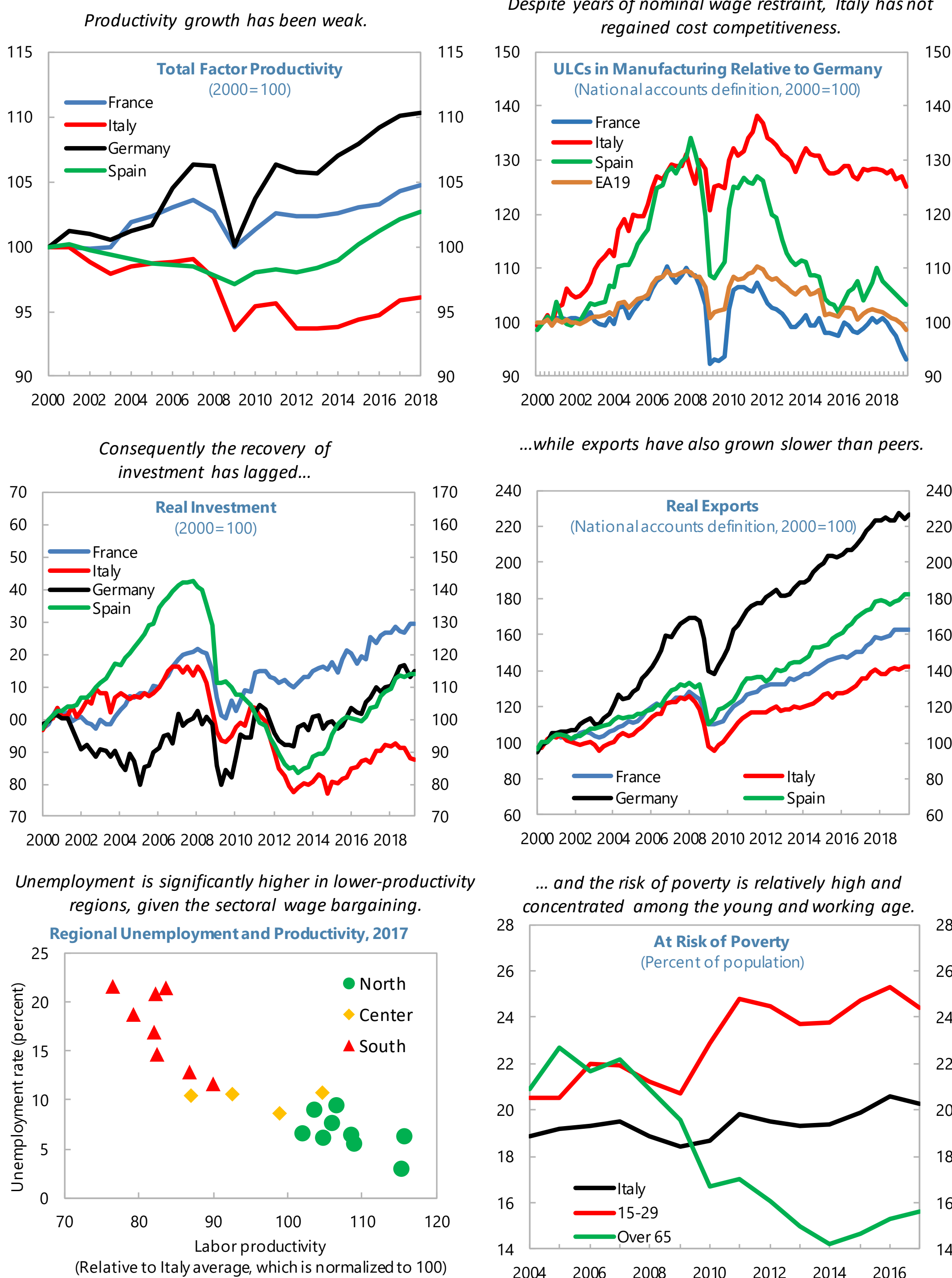






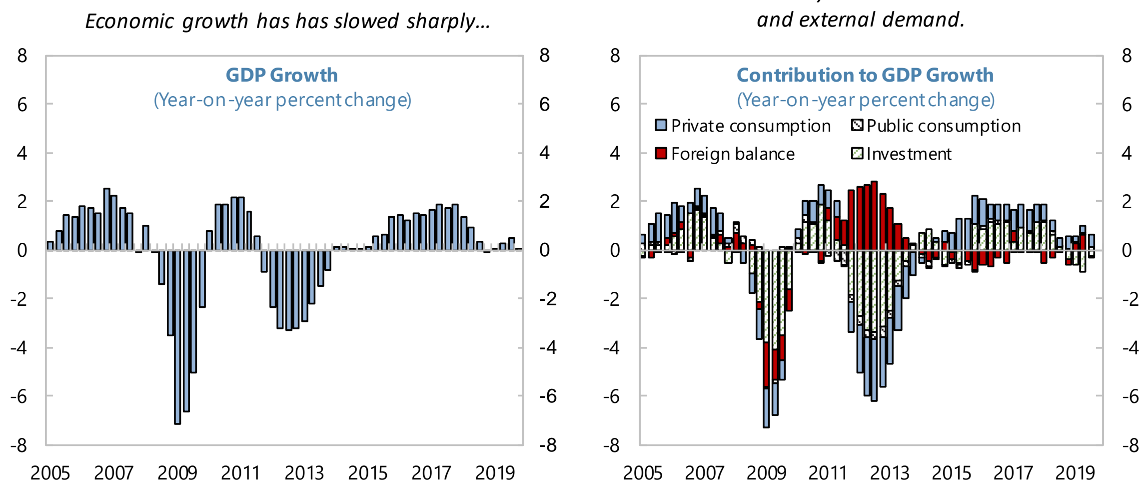
Sources: EBA Risk Dashboard; S&P Market Intelligence; and IMF staff estimates.
Notes on sample: EBA Risk Dashboard data is for 11 Italian banks (all Italian SIs excluding Banca Carige). 'Other SIs' exclude Banca Carige and BCC (which was not an SI in 2018).
1/ Property & IT costs are included in 'other' for LSIs due to data availability.

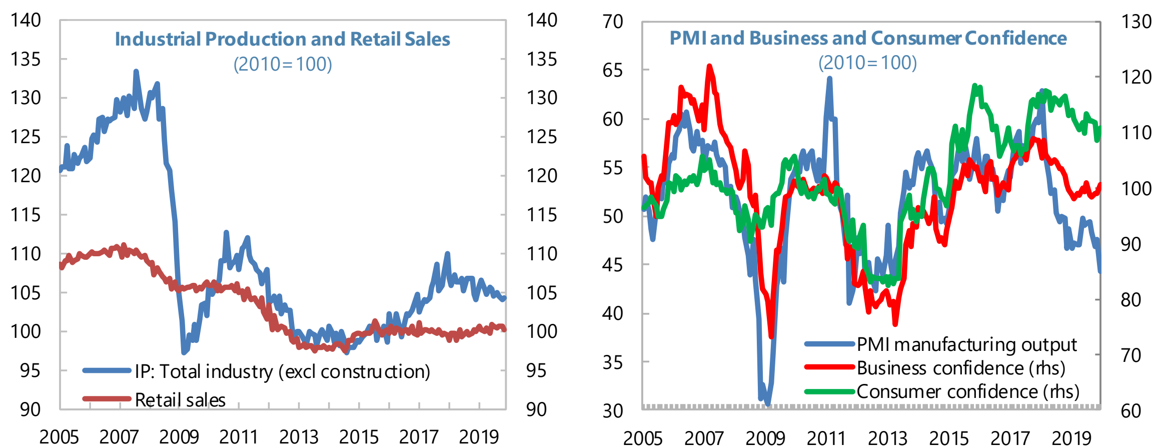
Figure 1. Italy: Economic Underperformance

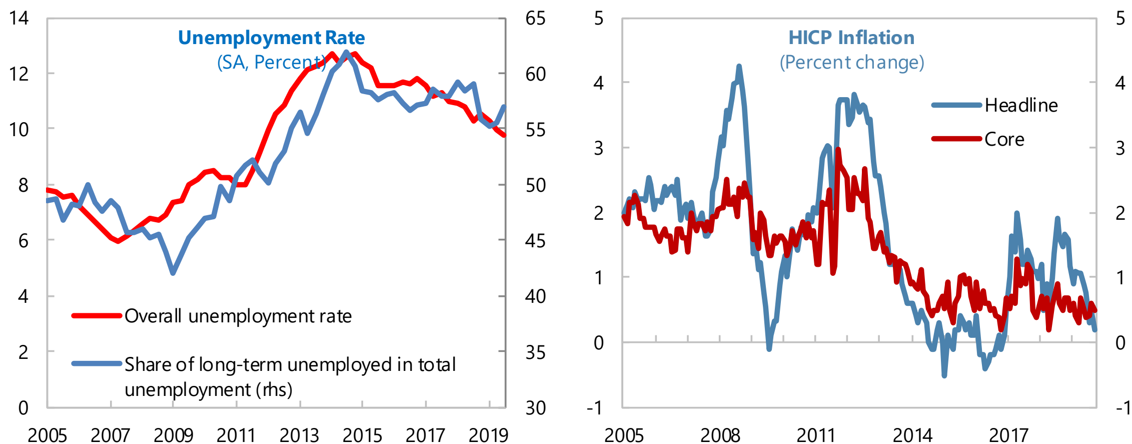


Sources: Eurostat; Haver Analytics; and IMF staff estimates.
Note: At risk of poverty is defined by Eurostat as the share of persons with an equivalized disposable income after social transfer below 60 percent of the national median equivalized disposable income after social transfers.

Figure 2. Italy: High Frequency and Real Economy Developments



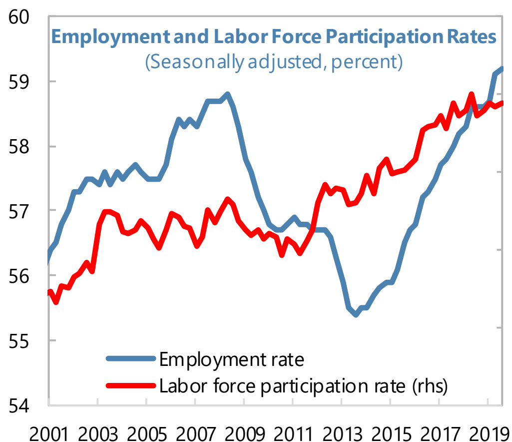




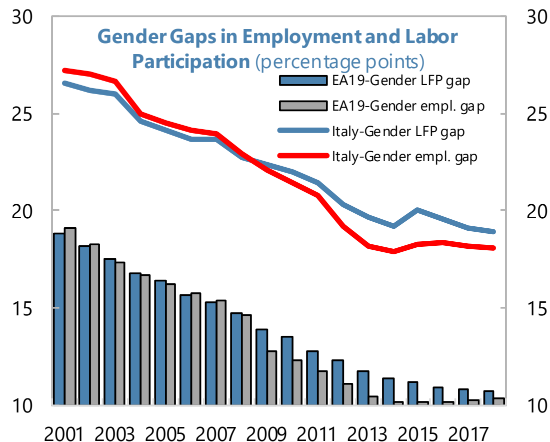
Sources: ISTAT; Haver Analytics; and IMF staff estimates.

Figure 3. Italy: Labor Market Developments

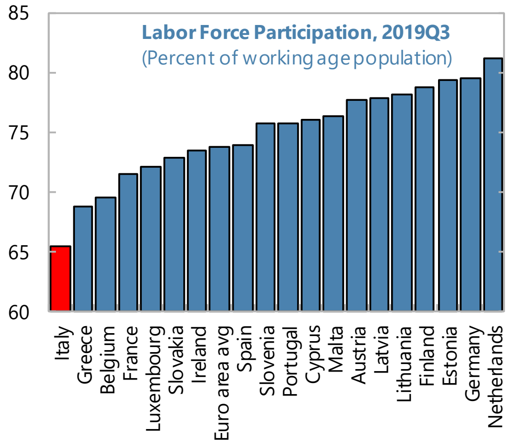
Employment and labor force participation (LFP) rates are at or near historical peaks.



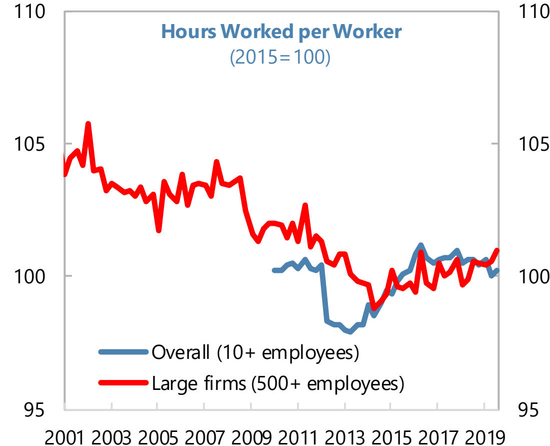
However, gender gaps remain large...



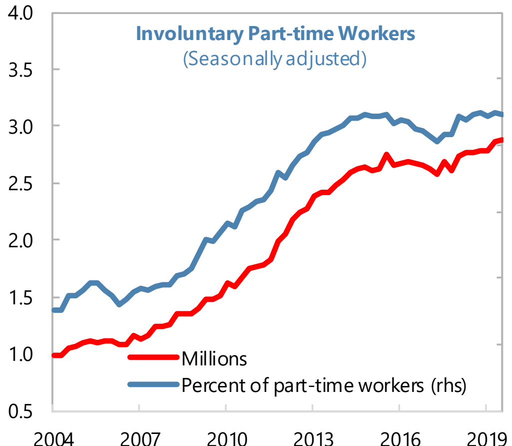
...and overall labor force participation is still among the lowest in the EU.



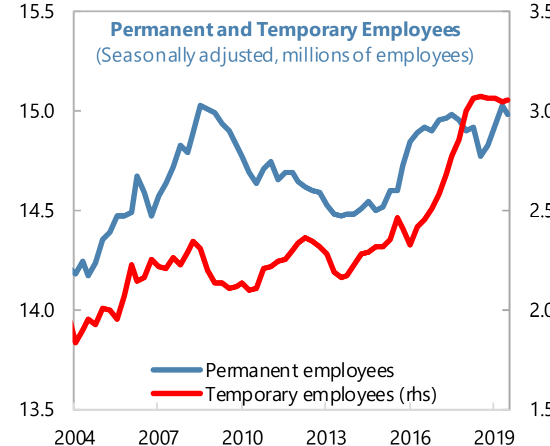
Hours worked are somewhat below their historical average...



...and the share of involuntary part-time workers is high.



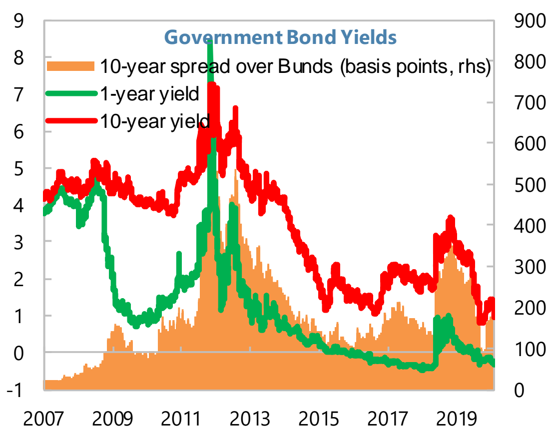
The use of temporary contracts remains high.



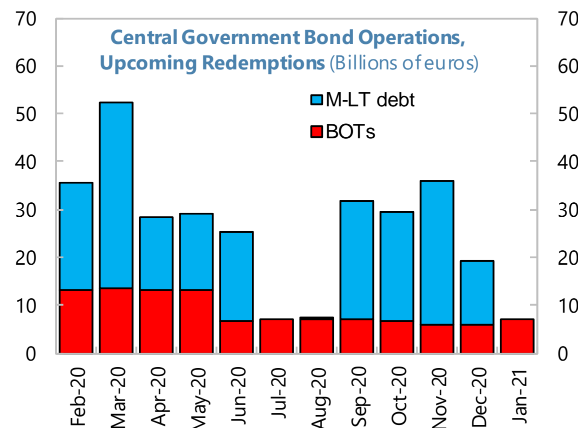
Sources: Eurostat; ISTAT; IMF staff estimates.

Figure 4. Italy: Fiscal Developments and Issues, 2007–20

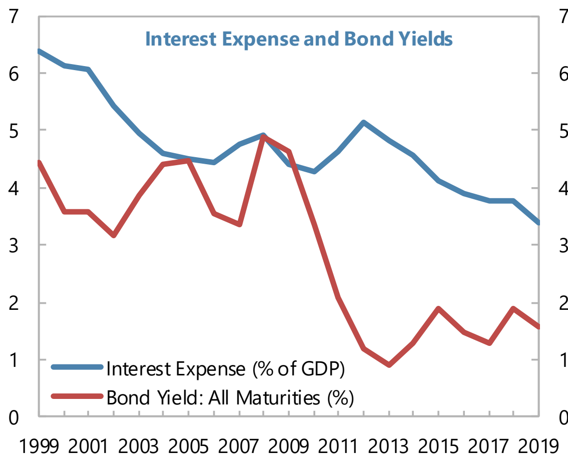
Government bond yields have declined sharply since June 2019.



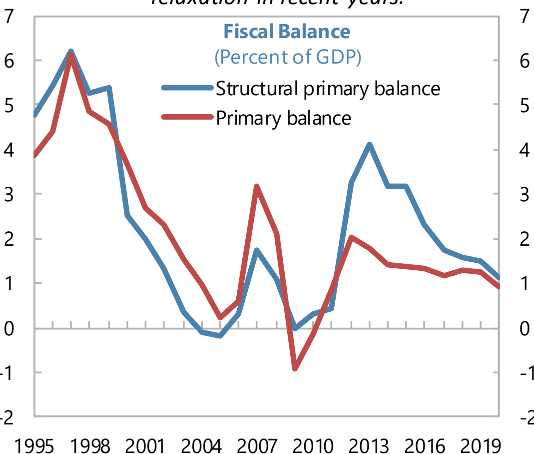
Bond redemptions coming due over the next 12 months are notable.



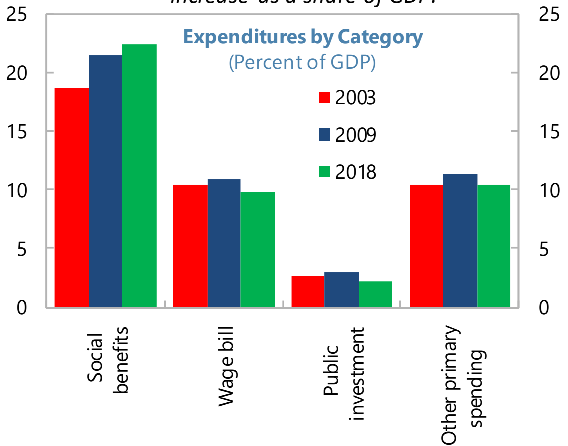
While interest expense has declined...



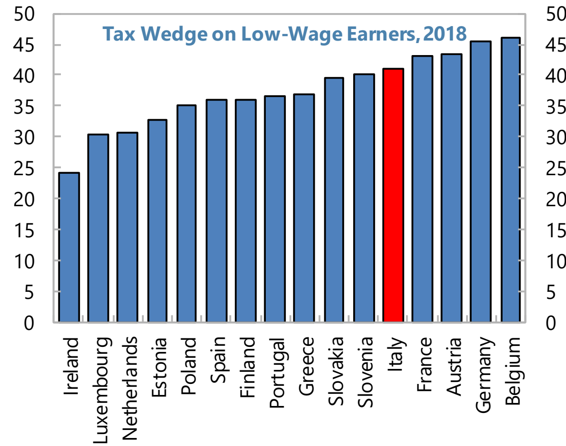
...there has been a sizable (structural) fiscal relaxation in recent years.



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



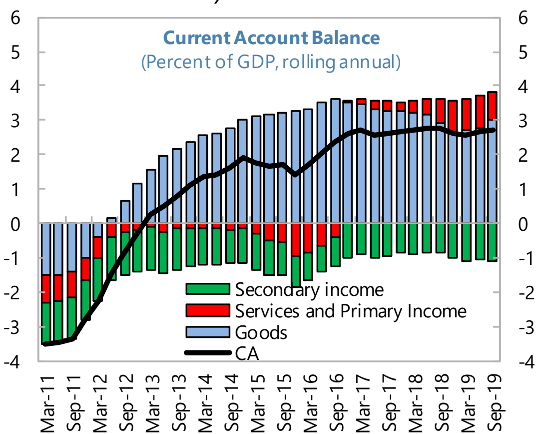
The labor tax wedge remains high.



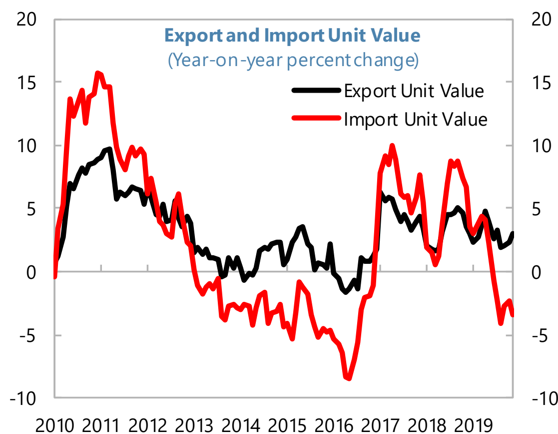
Sources: Eurostat; Bloomberg Finance L.P.; and Bank of Italy.

Figure 5. Italy: External Developments, 2011–19

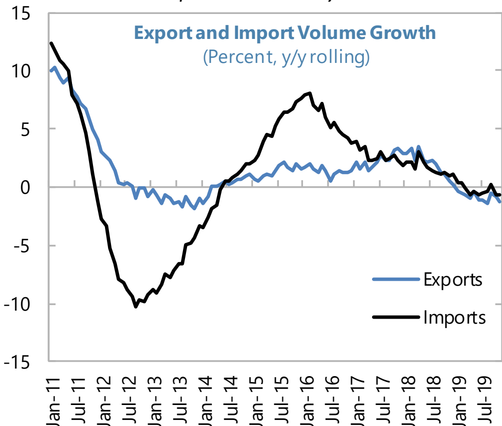
The persistent current account surplus is being sustained by a sizeable trade balance.



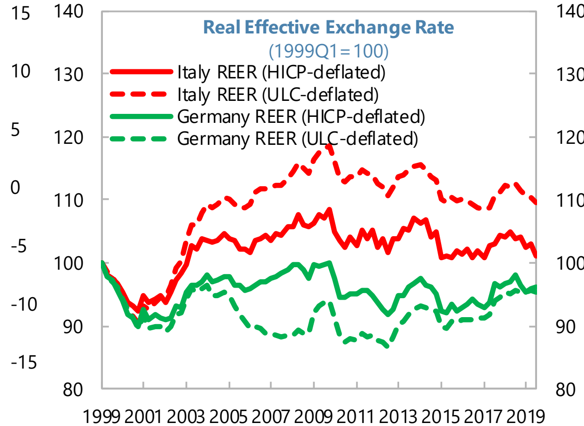
The terms of trade have improved recently.



Real exports have not been able to pull the economy...

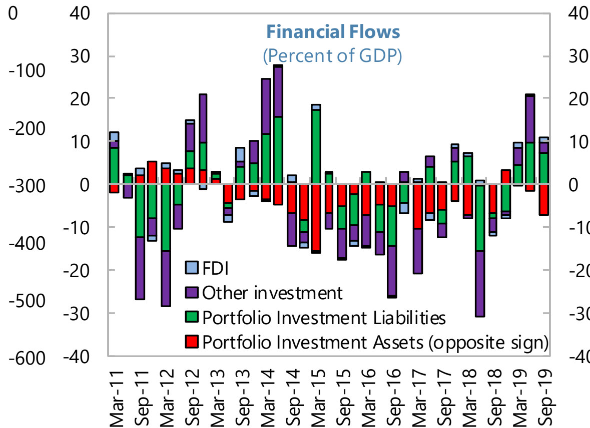


...while the ULC-gap vis-a-vis Germany remains high.



Target 2 liabilities improved following the ECB's new excess reserve renumeration.

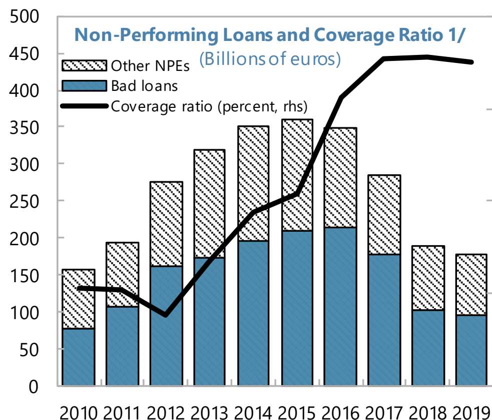
Foreign investors have returned to Italian paper.



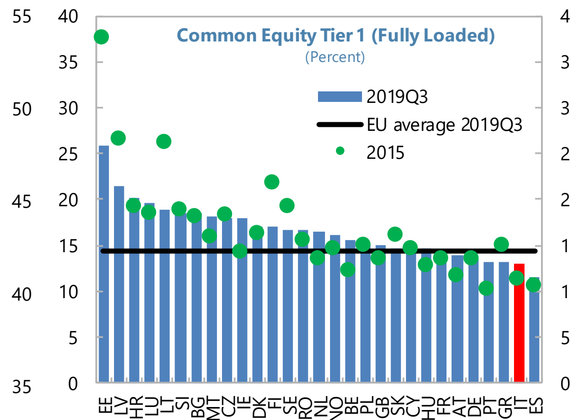
Sources: Haver; Eurostat; and IMF staff estimates.

Figure 6. Italy: Financial Sector Developments

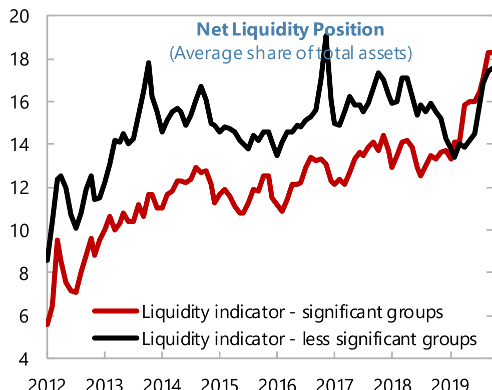
NPL stock has fallen notably since its 2015 peak, but the NPL ratio remains above EU average.



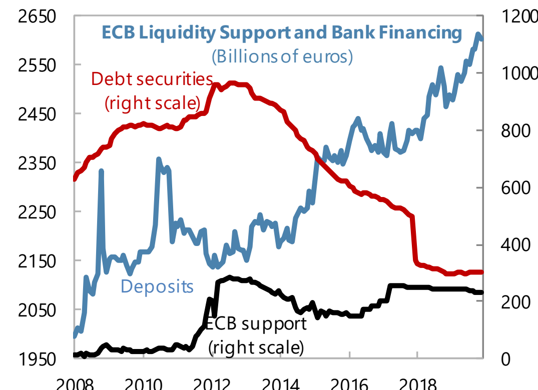
Major Italian banks continue to lag behind EU peers on capital adequacy, especially on a fully-loaded basis.



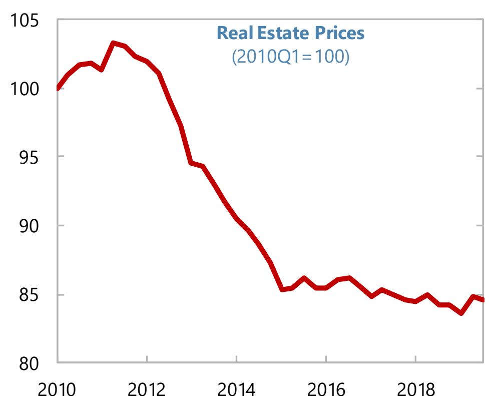
The system as a whole has adequate liquidity and collateral currently.



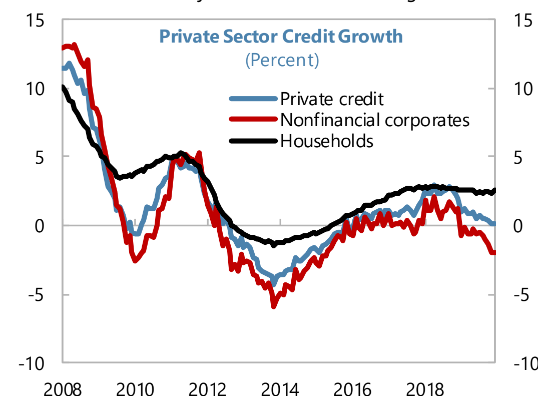
Deposit inflows remain strong, offsetting the decline in retail bonds.



Real estate prices have yet to rebound.



Credit to households has been growing since 2015, but credit to firms has been declining.



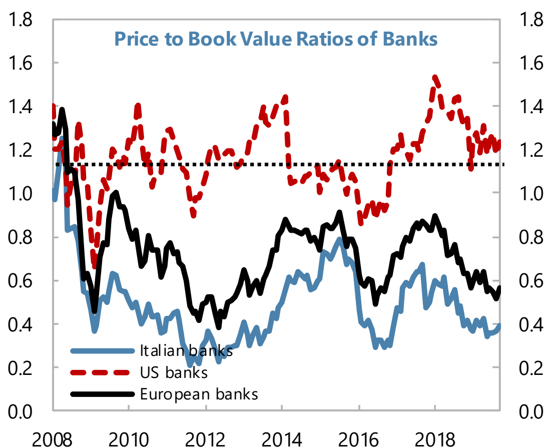
Sources: Bloomberg Finance L.P.; Bank of Italy; S&P Global Market Intelligence; ECB; European Banking Authority; and IMF staff estimates.

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.

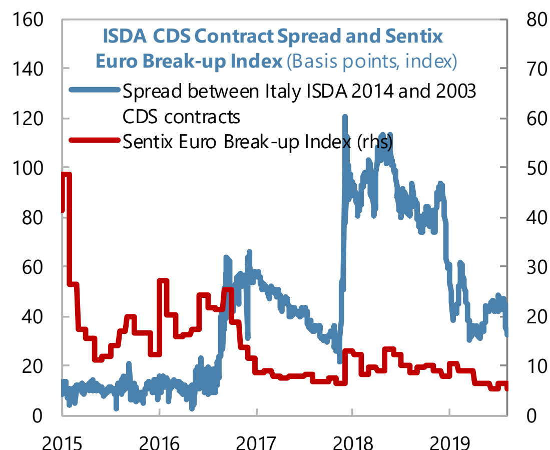
1/ Bank of Italy data starting from 2012.

Figure 7. Italy: Financial Sector Assets and Valuations

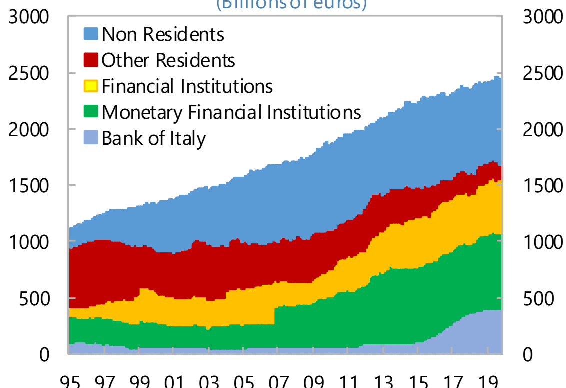
Italian bank equity prices remain relatively weak.

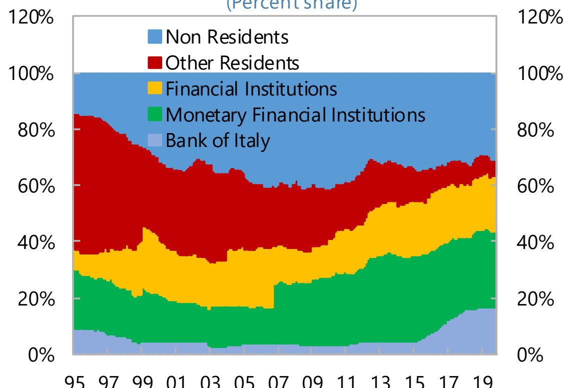


Redenomination risk has declined sharply.

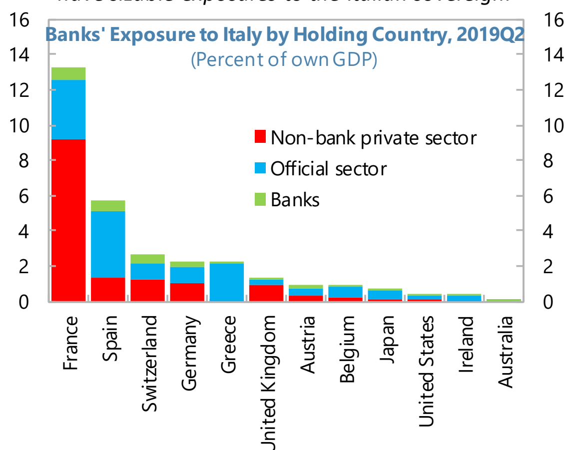


The Italian financial sector is heavily exposed to the Italian sovereign.

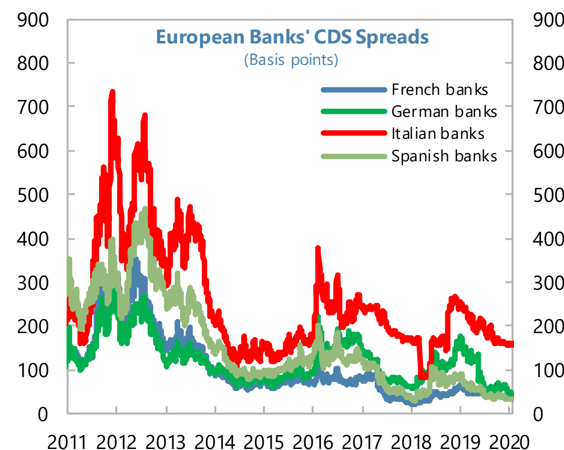




The French, Spanish, and Greek banking systems have sizable exposures to the Italian sovereign.



The CDS spreads of Italian banks have declined.



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

Table 1. Italy: Summary of Economic Indicators, 2016–25
(Annual percentage change, unless noted otherwise)

	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025
				Projections						
Real GDP	1.3	1.7	0.8	0.2	0.4	0.7	0.7	0.6	0.6	0.6
Real domestic demand	1.8	1.7	1.1	0.0	0.2	0.8	0.7	0.6	0.6	0.7
Final domestic demand	1.6	1.5	1.2	0.7	0.7	0.8	0.7	0.7	0.7	0.7
Private consumption	1.2	1.5	0.8	0.6	0.6	0.7	0.7	0.6	0.6	0.6
Public consumption	0.7	-0.2	0.4	-0.2	0.3	0.3	0.3	0.4	0.4	0.4
Gross fixed capital formation	4.0	3.3	3.2	2.4	1.6	1.5	1.3	1.1	1.1	1.1
Stock building 1/	0.2	0.2	-0.1	-0.8	-0.5	0.0	0.0	0.0	0.0	0.0
Net exports 1/	-0.5	0.1	-0.3	0.2	0.2	0.0	0.0	0.0	0.0	0.0
Exports of goods and services	1.9	6.0	1.8	1.8	2.7	3.1	3.0	3.0	2.9	2.8
Imports of goods and services	3.9	6.2	3.0	1.2	2.2	3.5	3.2	3.1	3.0	3.1
Savings 2/	20.2	20.6	20.8	20.2	20.2	20.1	20.1	20.2	20.2	20.3
Investment 2/	17.6	17.9	18.2	17.2	17.1	17.2	17.2	17.4	17.5	17.7
Resource utilization										
Potential GDP	0.3	0.4	0.3	0.3	0.4	0.4	0.5	0.6	0.6	0.6
Output gap (percent of potential)	-2.5	-1.2	-0.7	-0.8	-0.8	-0.5	-0.2	-0.2	-0.1	-0.1
Employment	1.3	1.2	0.8	0.6	0.2	0.2	0.2	0.2	0.1	0.1
Unemployment rate (percent)	11.7	11.3	10.6	10.0	10.1	10.0	10.0	9.9	9.9	9.9
Prices										
GDP deflator	1.1	0.7	0.9	0.6	1.0	1.0	1.2	1.4	1.5	1.5
Consumer prices	-0.1	1.3	1.2	0.6	0.9	1.1	1.3	1.4	1.5	1.5
Hourly compensation 3/	0.9	2.8	2.1	2.5	1.3	1.4	1.6	1.9	1.9	2.0
Productivity 3/	2.1	2.9	0.5	0.1	0.5	0.7	0.7	0.7	0.7	0.7
Unit labor costs 3/	-1.1	-0.1	1.6	2.4	0.8	0.7	0.9	1.2	1.2	1.2
Fiscal indicators										
General government net lending/borrowing 2/	-2.4	-2.4	-2.2	-2.1	-2.4	-2.3	-2.2	-2.2	-2.1	-2.1
General government primary balance 2/ 4/	1.3	1.2	1.3	1.3	0.9	0.9	0.9	0.9	0.9	0.9
Structural overall balance (percent of potential GDP)	-1.4	-1.8	-1.9	-1.7	-2.0	-2.0	-2.0	-2.0	-2.0	-2.0
Structural primary balance (percent of potential GDP) 4/	2.3	1.7	1.6	1.5	1.1	1.1	1.1	1.1	1.0	1.0
General government gross debt 2/	134.8	134.1	134.8	135.7	136.1	135.7	135.2	134.5	133.5	132.0
Exchange rate regime				Member of the EMU						
Exchange rate (national currency per U.S. dollar)	0.9	0.9	0.8	0.9	...	...	...	...	...	...
Nominal effective rate: CPI based (2000=100)	99.3	100.9	103.8	n.a.	...	...	...	...	...	...
External sector 2/										
Current account balance	2.6	2.7	2.6	2.9	3.0	2.9	2.9	2.8	2.7	2.6
Trade balance	3.4	3.2	2.7	3.4	3.3	3.3	3.2	3.2	3.1	3.0

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.

Table 2. Italy: Statement of Operations–General Government (GFSM 2001 Format), 2012–25

	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025
								Projections						
	(Billions of euros)													
Revenue	773.9	775.7	779.5	790.7	789.9	803.0	816.1	828.9	840.6	854.4	871.1	888.8	908.4	929.1
Taxes	487.4	484.4	486.6	490.3	494.8	500.3	503.9	507.4	516.7	526.5	537.1	549.1	561.5	574.5
Social contributions	215.9	215.4	214.4	219.1	220.6	225.6	234.9	240.9	243.4	246.2	250.8	255.7	261.1	266.7
Grants	2.9	4.2	5.2	5.8	1.3	2.7	2.7	2.7	2.7	2.7	2.7	2.7	2.7	2.7
Other revenue	67.8	71.7	73.4	75.4	73.3	74.4	74.6	77.9	77.8	79.1	80.6	81.4	83.1	85.2
Expenditure	821.8	821.7	827.6	832.9	830.7	845.1	854.6	867.0	884.1	896.5	912.3	930.0	950.1	970.6
Expense	821.5	821.3	827.0	832.4	830.4	845.0	854.5	866.9	884.0	896.4	912.2	929.9	950.0	970.5
Compensation of employees	168.0	166.8	165.2	163.9	166.0	166.8	172.4	172.9	175.2	178.4	181.7	185.4	189.3	193.2
Use of goods and services	90.9	91.9	91.8	92.8	96.2	98.7	100.4	99.2	101.3	102.0	102.3	104.4	106.6	108.6
Consumption of fixed capital	47.8	47.8	48.0	48.1	47.9	48.1	46.7	47.1	50.0	51.1	53.5	54.6	57.5	60.5
Interest	83.8	77.9	74.5	68.1	66.2	65.3	64.7	60.6	60.1	58.9	59.0	58.3	59.0	58.9
Social benefits	355.0	363.4	371.3	376.9	380.8	386.7	395.1	407.6	417.2	426.0	434.0	442.8	452.2	462.0
Other expense	75.9	73.5	76.1	82.7	73.3	79.3	75.3	79.5	80.3	79.9	81.7	84.4	85.4	87.4
Net acquisition of nonfinancial assets	0.3	0.4	0.6	0.5	0.3	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Net lending/borrowing	-47.8	-46.0	-48.1	-42.2	-40.9	-42.0	-38.6	-38.1	-43.5	-42.0	-41.3	-41.2	-41.7	-41.6
	(Percent of GDP, unless otherwise indicated)													
Revenue	47.6	48.1	47.9	47.8	46.6	46.2	46.2	46.6	46.6	46.5	46.6	46.6	46.6	46.7
Taxes	30.0	30.0	29.9	29.6	29.2	28.8	28.5	28.5	28.7	28.7	28.7	28.8	28.8	28.9
Social contributions	13.3	13.4	13.2	13.2	13.0	13.0	13.3	13.5	13.5	13.4	13.4	13.4	13.4	13.4
Grants	0.2	0.3	0.3	0.3	0.1	0.2	0.2	0.2	0.1	0.1	0.1	0.1	0.1	0.1
Other revenue	4.2	4.4	4.5	4.6	4.3	4.3	4.2	4.4	4.3	4.3	4.3	4.3	4.3	4.3
Expenditure	50.6	51.0	50.9	50.3	49.0	48.7	48.4	48.7	49.0	48.8	48.8	48.7	48.8	48.8
Expense	50.6	50.9	50.8	50.3	49.0	48.7	48.4	48.7	49.0	48.8	48.8	48.7	48.8	48.8
Compensation of employees	10.3	10.3	10.2	9.9	9.8	9.6	9.8	9.7	9.7	9.7	9.7	9.7	9.7	9.7
Use of goods and services	5.6	5.7	5.6	5.6	5.7	5.7	5.7	5.6	5.6	5.6	5.5	5.5	5.5	5.5
Consumption of fixed capital	2.9	3.0	3.0	2.9	2.8	2.8	2.6	2.6	2.8	2.8	2.9	2.9	3.0	3.0
Interest	5.2	4.8	4.6	4.1	3.9	3.8	3.7	3.4	3.3	3.2	3.2	3.1	3.0	3.0
Social benefits	21.9	22.5	22.8	22.8	22.5	22.3	22.4	22.9	23.1	23.2	23.2	23.2	23.2	23.2
Other expense	4.7	4.6	4.7	5.0	4.3	4.6	4.3	4.5	4.5	4.4	4.4	4.4	4.4	4.4
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	-2.9	-2.9	-3.0	-2.6	-2.4	-2.4	-2.2	-2.1	-2.4	-2.3	-2.2	-2.2	-2.1	-2.1
Memorandum items:														
Primary balance 1/	2.0	1.8	1.4	1.4	1.3	1.2	1.3	1.3	0.9	0.9	0.9	0.9	0.9	0.9
Structural primary balance 1/	3.3	4.1	3.2	3.2	2.3	1.7	1.6	1.5	1.1	1.1	1.1	1.1	1.0	1.0
Change in structural primary balance 2/	2.9	0.8	-0.9	0.0	-0.9	-0.6	-0.2	-0.1	-0.4	0.0	0.0	0.0	0.0	0.0
Structural balance 2/	-1.6	-0.5	-1.0	-0.6	-1.3	-1.8	-1.9	-1.7	-2.0	-2.0	-2.0	-2.0	-2.0	-2.0
Change in structural balance 2/	2.4	1.0	-0.5	0.4	-0.7	-0.5	-0.1	0.2	-0.3	0.0	0.0	0.0	0.0	0.0
General government gross debt	126.5	132.4	135.4	135.3	134.8	134.1	134.8	135.7	136.1	135.7	135.2	134.5	133.5	132.0

Sources: National Authorities; and IMF staff estimates.

1/ Primary revenue minus primary expenditure.

2/ Percent of potential GDP.

Table 3. Italy: Summary of Balance of Payments, 2016–25

	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025
				Projections						
				(Billions of euros)						
Current account balance	44.0	46.5	46.0	52.4	54.9	54.0	53.9	53.5	53.3	51.6
Balance of goods and services	55.9	52.0	44.6	57.5	57.2	55.4	54.5	53.2	52.3	49.9
Goods balance	60.0	56.7	47.3	60.2	60.3	60.1	60.4	60.2	60.1	59.1
Exports	406.3	436.8	451.3	467.9	485.3	503.9	525.0	548.2	573.5	600.2
Imports	346.3	380.2	404.0	407.7	425.0	443.8	464.6	488.0	513.4	541.0
Services balance	-4.1	-4.6	-2.7	-2.7	-3.2	-4.7	-5.9	-6.9	-7.8	-9.3
Credit	91.2	99.1	104.4	107.1	109.2	111.1	113.4	116.1	119.2	121.8
Debit	95.3	103.7	107.2	109.8	112.4	115.8	119.4	123.1	127.0	131.1
Primary income balance	4.8	9.2	18.8	13.1	16.2	17.4	18.5	19.7	20.9	22.1
Credit	63.8	72.4	78.7	69.9	73.8	76.0	78.3	80.7	83.1	85.7
Debit	59.0	63.2	59.9	56.8	57.6	58.6	59.7	61.0	62.2	63.6
Secondary income balance	-16.7	-14.8	-17.4	-18.2	-18.4	-18.7	-19.1	-19.5	-19.9	-20.3
Capital account balance	-2.6	0.7	-0.6	-1.0	1.2	1.5	1.5	1.5	1.6	1.6
Financial account	32.7	47.6	30.5	51.4	56.2	55.4	55.4	55.0	54.9	53.2
Direct investment	-11.1	0.4	-0.2	-1.3	-0.9	-0.5	-0.1	0.3	0.7	1.2
Portfolio investment	139.9	84.1	120.0	-62.9	13.2	5.1	15.6	-5.6	13.9	-5.2
Other investment	-91.6	-32.3	-89.3	113.8	42.7	50.1	39.3	59.8	39.8	56.8
Derivatives (net)	-3.3	-7.2	-2.7	1.8	1.1	0.8	0.6	0.5	0.5	0.5
Reserve assets	-1.2	2.7	2.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net errors and omissions	-8.6	0.5	-14.9	0.0	0.0	0.0	0.0	0.0	0.0	0.0
				(Percent of GDP)						
Current account balance	2.6	2.7	2.6	2.9	3.0	2.9	2.9	2.8	2.7	2.6
Balance on goods and services	3.3	3.0	2.5	3.2	3.2	3.0	2.9	2.8	2.7	2.5
Goods balance	3.5	3.3	2.7	3.4	3.3	3.3	3.2	3.2	3.1	3.0
Services balance	-0.2	-0.3	-0.2	-0.2	-0.2	-0.3	-0.3	-0.4	-0.4	-0.5
Primary income balance	0.3	0.5	1.1	0.7	0.9	0.9	1.0	1.0	1.1	1.1
Secondary income balance	-1.0	-0.8	-1.0	-1.0	-1.0	-1.0	-1.0	-1.0	-1.0	-1.0
Capital account balance	-0.2	0.0	0.0	-0.1	0.1	0.1	0.1	0.1	0.1	0.1
Financial account	1.9	2.7	1.7	2.9	3.1	3.0	3.0	2.9	2.8	2.7
Direct investment	-0.7	0.0	0.0	-0.1	0.0	0.0	0.0	0.0	0.0	0.1
Portfolio investment	8.3	4.8	6.8	-3.5	0.7	0.3	0.8	-0.3	0.7	-0.3
Other investment	-5.4	-1.9	-5.1	6.4	2.4	2.7	2.1	3.1	2.0	2.9
Derivatives (net)	-0.2	-0.4	-0.2	0.1	0.1	0.0	0.0	0.0	0.0	0.0
Reserve assets	-0.1	0.2	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net errors and omissions	-0.5	0.0	-0.8	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Gross external debt	122.9	122.1	120.9	121.8	120.8	120.3	119.3	119.3	118.3	118.1
Public sector	69.7	72.1	68.9	70.7	70.6	70.9	70.7	71.6	71.3	72.0
Private sector	53.1	50.0	51.9	51.1	50.3	49.4	48.6	47.8	46.9	46.1

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

Table 4. Italy: Financial Soundness Indicators, 2012–19[1]

(Percent, unless otherwise noted)

	2012	2013	2014	2015	2016	2017	2018	2019
	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	16.5
Regulatory tier 1 capital to risk-weighted assets	10.5	10.6	11.9	12.3	11.3	14.3	13.8	14.4
Nonperforming loans net of provisions to capital	79.7	89.9	93.4	89.0	85.2	58.0	45.7	37.3
Nonperforming loans to total gross loans	13.7	16.5	18.0	18.1	17.1	14.4	9.9	8.1
Sectoral distribution of loans to total loans:								
Loans to Residents	75.5	75.7	75.3	74.3	76.9	75.5	74.4	74.6
Loans to Deposit takers	2.6	2.7	2.5	2.5	2.3	2.5	2.6	2.3
Loans to Central Bank	1.1	0.8	0.6	0.8	2.8	4.3	3.8	3.9
Loans to Other financial corporations	6.0	6.1	6.6	7.4	7.7	7.6	7.7	7.7
Loans to General government	2.6	2.5	2.4	2.0	1.9	1.5	1.5	1.4
Loans to Nonfinancial corporations	37.2	36.8	36.8	35.4	34.6	32.3	31.5	30.7
Loans to Other domestic sectors	25.9	26.9	26.5	26.2	27.6	27.3	27.4	28.5
Loans to Nonresidents	24.5	24.3	24.7	25.7	23.1	24.5	25.6	25.4
Growth of bank loans to private non-MFI 2/	-0.9	-3.7	-1.6	-0.4	1.1	1.8	1.9	0.1
Nonfinancial corporations	-2.1	-5.2	-2.3	-0.6	0.3	0.2	1.2	-1.9
Households	-0.5	-1.3	-0.6	0.7	1.9	2.8	2.6	2.6
Return on assets	-0.1	-0.8	-0.2	0.3	-0.5	0.6	0.3	0.3
Return on equity	-0.9	-11.5	-2.8	3.4	-7.7	7.5	4.0	3.9
Interest margin to gross income	53.8	49.1	50.4	47.7	48.4	48.2	48.4	49.5
Net open position in foreign exchange to capital	1.2	2.0	0.0	0.3	1.5	1.3	0.3	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	6.5
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	49.8
Gross liability position in financial derivatives to capital	83.2	75.5	71.6	85.8	84.5	41.3	84.6	52.8
Personnel expenses to noninterest expenses	55.7	57.7	55.0	52.8	53.0	54.3	51.7	51.9
Spread between reference lending and deposit rates (basis points)	263.9	284.1	292.1	272.5	243.9	226.2	220.8	218.2
Spread between highest and lowest interbank rates (basis points)	12.4	19.7	9.9	33.6	8.1	5.0	0.9	4.9
Customer deposits to total (noninterbank) loans	67.9	70.5	70.6	75.2	86.1	80.9	70.9	77.6
Foreign-currency-denominated loans to total loans	8.3	8.8	9.5	10.0	9.7	8.6	8.4	7.8
Foreign-currency-denominated liabilities to total liabilities	6.3	6.4	7.1	7.9	7.9	7.3	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. 2019Q2 data are latest available.

2/ Data are from Bank of Italy. 2019Q4 data are latest available.

Annex I. Progress Against IMF Recommendations

2018 Article IV Policy Advice	Actions Since 2018 Article IV	Next Steps
I. Structural Reforms		
Labor Markets		
Decentralize wage bargaining to facilitate the re-alignment of wages with productivity at the firm and regional levels, which in turn will support job creation and lower structural unemployment. 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.	A decree law sought to protect certain groups of (vulnerable) workers, such as those working through digital platforms, those registered in the separate management (*Gestione Separata*) account of INPS, and those hired for community and public works. On ALMPs, the authorities increased staffing at the national employment agency (ANPAL) and in regional employment centers. They also plan to develop electronic platforms to help matching job seekers and employers.	The policy advice provided previously remains germane.
Product Markets		
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.	There has been limited progress in this area.	Remove entry barriers for sectors characterized by high markups, such as professional services. Lower exit barriers and foster consolidation for sectors with a large mass of low productivity firms, such as in retail. Avoid recurrent delays in implementing legislated pro-competition measures, e.g., the liberalization of energy tariffs and local public transport.

2018 Article IV Policy Advice	Actions since 2018 Article IV	Next Steps
Public Administration		
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.	A public administration bill was approved in June 2019, with measures for targeted recruitment, improved digitization, and combating absenteeism. An emergency decree was approved in mid-2019 to speed up public procurement by reversing and/or suspending some provisions in the earlier reform of procurement. The monitoring report on rationalizing local state-owned enterprises was published in mid-2019, indicating limited progress.	Accelerate implementation and effective enforcement of reform initiatives. Publish key performance indicators to track and communicate progress. Implement remaining provisions of the public procurement reform code, while striking a balance between simplifying complex procedures and safeguarding transparency. On the rationalization of local state-owned enterprises, ensure transparent and consistent rules for shareholding divestment. Strengthen the role of the Court of Auditors in enforcement.
Insolvency Reforms		
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.	The new insolvency code was adopted in early 2019. Corrective decrees are being drawn up to address implementation challenges. Pending issuance of secondary legislation, the code is expected to enter into force in August 2020. On civil justice, the government adopted guidelines for the reform aimed at simplifying court procedures and digitizing proceedings.	Implement the new insolvency code in line with best international practice within the targeted timeline. Fold the special insolvency regime for large enterprises into the general insolvency framework. Reform civil procedures to simplify processes and reduce the length of trials.

2018 Article IV Policy Advice	Actions since 2018 Article IV	Next Steps
II. Fiscal Policy		
Fiscal Consolidation		
Adjust the structural primary balance by about 2½ percent of GDP, cumulatively, over 2019–23.	Implementation of the 2019 budget was more prudent than expected, as Italy twice sought to avoid the EU's excessive deficit procedure. The 2019 fiscal stance was slightly expansionary, and the 2020 budget also is modestly expansionary.	Implement a credible medium-term consolidation that targets a small overall surplus by about 2025 and puts debt on a firmly declining path. Establish credibility by legislating upfront pro-growth and inclusive measures.
Improve the Quality of Fiscal Policy		
Cut current primary spending (including pensions), while modernizing the safety net for the poor and raising capital spending.	The 2019 budget introduced a new citizenship income program and an experimental "Quota 100" early retirement rule that added to social spending. The authorities plan to bring public investment gradually back to pre-crisis levels, including through a Green New Deal.	Cut current primary spending. Preserve indexation of retirement age to life expectancy, ensure actuarial fairness including for options to retire early, and adjust pension parameters to secure affordability. Improve the design of the citizenship income program. Raise capital spending and improve the quality of projects.
Lower tax rates on productive factors, shift taxation toward property and consumption, and broaden the tax base.	The 2019 budget lowered the tax rate for the self-employed and small enterprises. The Growth Decree extended fiscal incentives for investment. The 2020 budget cancels planned hikes in VAT and excise rates of 1.3 percent of GDP for 2020; lowers taxes marginally, including on labor income by 0.2 percent of GDP; tackles tax evasion; and extends incentives for investment.	Undertake a comprehensive reform to broaden the tax base, lower statutory tax rates, and help fight evasion. Broaden the tax base by reducing VAT policy gaps and removing other inefficient tax expenditures. Introduce a modern property tax (including on primary residences) by updating the property valuation system to reflect market values. Combat tax evasion through stricter enforcement, while avoiding tax amnesties.

2018 Article IV Policy Advice	Actions since 2018 Article IV	Next Steps
III. Financial Stability		
Accelerate NPL resolution and improve balance sheet health		
Continue intensive supervisory oversight to ensure NPL reduction strategies are ambitious and credible for significant banks and extend it fully to less significant banks (LSIs).	Significant banks agreed with the SSM on ambitious NPL reduction targets. The Bank of Italy requested NPL reduction strategies from LSIs. GACS was extended to support reduction of bad loans. NPL ratios fell significantly in significant institutions (SIs) and LSIs, but remain over twice the EU average, with the share of UTP increasing.	Supervisory emphasis on NPL reduction should continue, with further attention given to provisioning and strategies for UTP loans. The SSM's approach to setting bank-specific expectations for the gradual path to full provisioning of the existing NPL stock should be extended to LSIs with high NPLs. Capital and provisioning in weak banks should be increased. Prudential policies to moderate the sovereign-bank nexus could be considered and phased-in to avoid possible market disruptions.
Enhance banks' profitability, governance and business models		
Deploy assertive supervisory oversight to promote improvements in banks' business models, risk management, and resource allocation. 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.	Business model analysis has been a mandatory component of SREP scores for SIs and is included in the LSI SREP methodology whose roll-out for all LSIs must be completed by 2020. SSM-wide supervisory priorities in 2019 included several aspects of risk management and will include business model sustainability in 2020.	Strong supervisory focus on the viability of business models, governance and cost reduction plans should continue and intensify. Close quickly long-standing legislative gaps in the implementation of the EU fit and proper rules for banks' management.
Undertake rigorous supervisory analysis to ensure that the three new banking groups start with a clean bill of health and are profitable over the long term, including by undertaking an asset quality review (AQR) of all emerging groups, ensuring robust governance and risk management structures, and following up on issues found in remaining smaller banks.	The formation of two new cooperative banking groups has been completed, with the third group opting instead to form an Institutional Protection Scheme (IPS). The assessment of the proposed IPS model is underway by the Bank of Italy, with support from the SSM. The two merged groups were moved under direct ECB/SSM supervision with AQRs and review of their business and operating plans (as an input to the SREP process) scheduled for 2020.	Complete the asset quality reviews for the merged groups and ensure—through intensive and assertive supervisory challenges and by imposing ambitious and credible targets—that the merged groups have sound risk management and realistic and coherent business model assumptions. Similar challenge of cost reduction plans and business models should be undertaken for other banks with unsustainably low levels of profitability. Facilitate further consolidation and restructuring where needed.

2018 Article IV Policy Advice	Actions since 2018 Article IV	Next Steps
Effective use of resolution framework		
Swift recapitalization of problem banks or the timely and effective use of the resolution framework is essential to avoid weaknesses lingering, 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 enforcement of MiFID rules.	The recapitalization—outside of resolution or liquidation - of a medium-sized bank that is supervised directly by the SSM was completed and further restructuring of the bank is planned. Capital was provided by the deposit guarantee scheme (DGS) and one of the cooperative banking groups. A small but regionally important bank was also recapitalized by the DGS, with further capital injections from the DGS and a state-owned bank planned.	Consideration should be given to more escalated corrective measures, using all available tools. Care needs to be taken that the use of special administration does not delay decisive action when needed. Building additional loss absorbing capacity over an appropriate transition period would facilitate orderly resolution or liquidation for LSIs, in particular those for which a resolution strategy is foreseen. The use of the DGS for preventive measures should be avoided as much as possible.

Annex II. External Sector Assessment

Overall Assessment: *The external position in 2019 is broadly in line with the level implied by fundamentals and desirable policies, based on preliminary staff forecasts.* Nonetheless, policies to improve competitiveness are necessary to support growth, reduce high unemployment and public debt, and safeguard the external balance sheet.

Potential Policy Responses: Although the external position is in line with fundamentals, credible medium-term fiscal consolidation is necessary to reduce external vulnerabilities and maintain investor confidence. 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, are also critical to improving competitiveness, boosting potential growth, and reducing vulnerabilities. The elements of this package of policies would likely have offsetting effects on the external current account (CA), as they would boost export competitiveness and investment, while being supportive of overall growth.

Foreign Asset and Liability Position and Trajectory	**Background.** Italy's NIIP reached an estimated -2.5 percent of GDP at end-2019, the highest level since Italy joined the euro. Gross assets and liabilities, however, are estimated at about 159 and 161 percent of GDP, respectively, both about 60 percentage points higher than in 2000. TARGET2 liabilities declined to 25 percent of GDP in 2019 after peaking at 27 percent in 2018, partly reflecting the inflow of reserves to Italian banks following the introduction of tiering by the ECB.[1] Debt securities represent about two-thirds of gross external liabilities, half of which are owed by the public sector. Sustained expected CA surpluses should continue to gradually improve 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, as well as between sovereign debt and the financial system.				
2019 (% GDP)[2]	NIIP: -2.5	Gross Assets: 159.0	Debt Assets: 59.3	Gross Liab.: 161.4	Debt Liab.: 108.6
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 multiyear-high surplus of 2.7 percent of GDP, which could be surpassed in 2019 as weak domestic demand is weighing on imports and, hence, boosting the trade surplus. About two-thirds of the improvement from 2013 to 2017 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 liability payments, related not least to the impact of monetary policy. The positive primary income balance also reflects the higher weight of equity in foreign assets than in liabilities. In terms of saving and investment, the improvement in the CA since 2010 is almost entirely due to the increase in gross national saving, while investment over GDP has remained stagnant. **Assessment.** The cyclically adjusted CA is estimated at 2.6 percent of GDP in 2019, close to the EBA-estimated CA norm of 2.7 percent of GDP. Staff assesses a CA gap in the range of -1.0 to 1.0 percent of GDP. Despite the CA being in line with fundamentals, Italy's sizable and long-standing structural rigidities hamper its ability to improve competitiveness.				
2019 (% GDP)	Actual CA: 2.9	Cycl. Adj. CA: 2.6	EBA CA Norm: 2.7	EBA CA Gap: -0.0	Staff Adj.: 0.0 / Staff CA Gap: 0.0
Real Exchange Rate	**Background.** From 2018 to 2019, the CPI-based and ULC-based REER depreciated by 3.1 and 2.5 percent, respectively, after appreciating by similar amounts in the previous year.[3] Stagnant productivity and rising labor costs 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, which has partially reversed since 2014. **Assessment.** The level and index REER models suggest a modest overvaluation in 2019 of 4.3 percent and 7.0 percent, respectively. This is generally consistent with, but slightly below, the persistent wage-productivity differentials vis-à-vis key partners. It corresponds to a CA gap below the lower end of the staff-assessed CA gap range.[4]				
Capital and Financial Accounts: Flows and Policy Measures	**Background.** Portfolio and other investment inflows typically financed the CA deficits of the past, despite a modest net FDI outflow, without much difficulty. Italy's financial account posted net outflows of 2.9 percent of GDP in 2019, reflecting residents' net purchases of foreign assets. However, portfolio investment shifted from outflows to inflows as foreign investors returned to Italian sovereign debt in mid-2019, with inflows supported further by the ECB's announcement of extended asset purchases. **Assessment.** While supported by ample monetary accommodation by the ECB, Italy remains vulnerable to market volatility, owing to the large refinancing needs of the sovereign and banking sectors as well as the remaining balance sheet weaknesses in some banks.				
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.				

[1] Under tiering, deposits at the ECB below a country-level cap of 6 times the minimum reserves requirement benefit from higher rates. Since Italy was the only country below that threshold, it attracted liquid assets from other euro area banks. This is a one-off effect.

[2] Debt assets and liabilities data are for year 2018.

[3] ULC-based REER data is available up to Q3:2019.

[4] The elasticity of the REER to the CA gap is estimated to be 0.26.

Annex III. Risk Assessment Matrix

Italy: Risk Assessment Matrix and Transmission Channels[1]

Potential Deviations from Baseline

Sources of Risk: Trigger Event (color = relative likelihood)	Sources of Risk: Vulnerabilities	Impact if realized (color = severity)	Policy Response
Sharp rise in risk premia that exposes financial vulnerabilities. An abrupt reassessment of market fundamentals triggers widespread risk-off events that expose financial vulnerabilities that have been building in a period of low interest rates and a search for yield. Risk asset prices fall sharply, leading to significant losses in major financial institutions. Higher risk premia generate debt service and refinancing difficulties; stress on leveraged firms, households, and vulnerable sovereigns; and capital outflows.	**Fiscal:** High public debt and gross financing needs	Widening of sovereign spreads, higher financing costs and concerns over fiscal sustainability could push Italy into a bad equilibrium.	- Undertake credible medium-term fiscal consolidation to achieve a small structural surplus, supported by pro-growth and inclusive measures. - Activate OMT if needed.
	Bailout / Asset		
Strained bank balance sheets amid legacy problems and a weak profitability outlook leads to financial distress in one or more	**Banks:** High NPLs and sovereign exposure Higher funding costs, low profitability Crowding out credit to private sector	Tighter financial conditions, higher debt service and refinancing risks, weakening of bank balance sheets and solvency positions, potential loss of market confidence. Recovery cannot be supported by financial sector.	- Restore market confidence through corrective fiscal and financial policies. - Supervisors should continue to set ambitious targets for reducing NPLs in identified banks. - Reform insolvency to facilitate reduction in NPLs, encourage bank consolidation and better governance to improve profitability, and resolve weak banks in a timely manner. - Faster progress on banking union--clarify backstops.
	Asset quality / Credit crunch		
Weak domestic demand due to low productivity growth and a failure to fully address crisis legacies and undertake structural reforms.	**Real:** - Chronically weak productivity - Large corporate debt overhang	Lower growth potential due to weaker investment and lower employment. Further deterioration in public debt sustainability and private balance sheets.	- Implement and deepen structural reforms to spur investment, productivity and competitiveness, advance rebalancing.
Rising protectionism and retreat from multilateralism. In the near term, escalating and unpredictable protectionist actions and an inoperative WTO dispute resolution framework imperil the global trade system. Additional actions or the threat thereof, including investment restrictions, reduce growth directly and through adverse confidence effects. In the medium term, geopolitical competition, protracted tensions, and fraying consensus about the benefits of globalization leads to further fragmentation, with adverse effects on investment, productivity, growth, and stability.		Reduced flows of trade, capital and labor. Weaker sentiment triggering volatility in financial markets. Negative risks for investment, productivity, and long-term growth.	
Intensified geopolitical tensions and security risks (e.g., due to developments in the Middle East) causes economic and political disruption, disorderly migration, volatile commodity prices, and lower confidence.		Limited integration of asylum seekers could raise unemployment, put pressure on national budgets, and put social cohesion at risk.	- Let automatic stabilizers work to support growth
Coronavirus outbreak causes widespread and prolonged disruptions to economic activity and global spillovers through tourism, supply chains, containment costs, and confidence effects on financial markets and investment.		Falling external demand hurts exports and investment.	- Repair bank and corporate balance sheets to enhance monetary transmission.
Weaker-than-expected global growth. Idiosyncratic factors in the U.S. (Low), Europe (High), China (High), and other large emerging markets (High) feed off each other in a synchronized and prolonged slowdown.			
Large swings in energy prices.		Risks to oil prices are broadly balanced.	
Timely resolution of trade tensions and better-than-anticipated response of demand to declining yields could have a larger positive impact in the short term than currently expected.		Higher growth will bring public debt down and help repair corporate and bank balance sheets.	- Run higher fiscal surpluses to put public debt on a firm downward path. - Implement bold structural reforms.

[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 IV. Debt Sustainability Analysis

A. Public Debt Sustainability Analysis

Italy's public debt is very high. It is projected to remain broadly stable at 130–135 percent of GDP in the medium term, owing to low interest rates. But in the longer term, it is projected to rise because of pension spending pressures. It will rise earlier and faster if adverse shocks materialize. Implementing a structural reform and medium-term fiscal consolidation package is essential to putting debt on a firm downward trajectory and, thus, to securing sustainability.

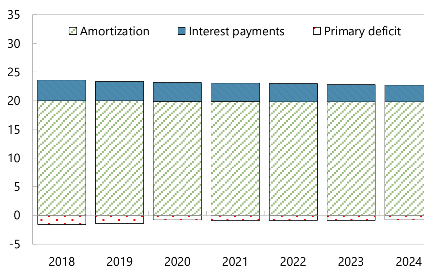
1. Public debt in Italy is very high and an enduring source of vulnerability.

- Debt increased from about 100 percent of GDP in 2007 to 135.7 percent of GDP in 2019.[1] It is the second highest public debt ratio 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 changing interest rates.

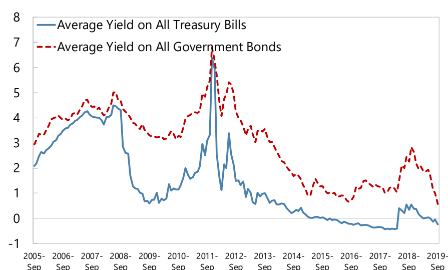
- The ECB's accommodative stance has helped to bring yields down in recent years and its sovereign bond purchasing program has mitigated refinancing risks. Since March 2015, the Eurosystem's net purchases of Italian public debt were €364 billion, compared with gross medium- to long-term bond issuances of about €900 billion, with renewed open-ended purchases since November 2019 further mitigating refinancing risks.

Gross Financing Needs
(Percent of GDP)



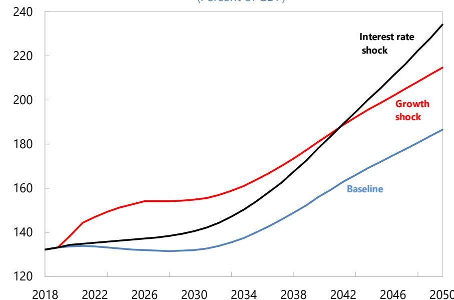
Sources: Bloomberg and IMF staff

Treasury Bills and Government Bond Yields
(percent)



Sources: Haver Analytics

Gross Nominal Public Debt
(Percent of GDP)



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 at 130–135 percent

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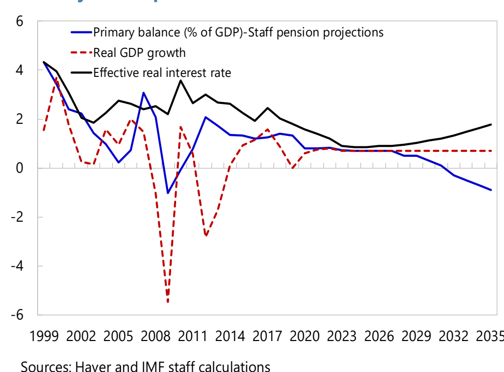
[1] Public debt figures include a recent revision owing to the redefinition of the scope of the general government and to accounting changes for postal saving bonds (BPF). These bonds were assigned to the Ministry of Economy and Finance following the transformation of Cassa Depositi e Prestiti into a joint stock company in 2003. The last BPF series mature in 2033, but holders will have the possibility of delaying the redemption for ten years after expiry. Even though the reclassification does not affect the general government deficit (accrued interest was already included), public debt (including this accounting change) is projected to decrease faster owing to the maturing BPF series, which results in debt declining to the 2019 level by 2021.

of GDP, owing to the historically subdued interest rates. But debt rises in the longer term under staff's projections of pension spending. The assumptions underpinning the baseline are as follows:

- Real GDP growth is projected to average 0.6 percent annually. This rate of growth is higher than what it has been over the past two decades. The GDP deflator is projected to rise from 0.9 percent in 2018 to a steady state of around 1.5 percent over the next few years.[2]

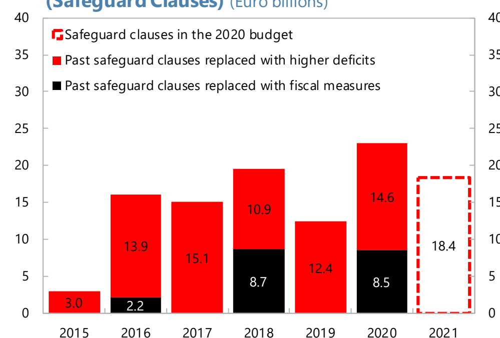


Sources: Haver and IMF staff calculations

- 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 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 ¶32.

- The stock of maturing postal saving bonds (BPF) is included in the debt projections. It is projected to decline sharply from €55 billion in 2019 to about €24 billion in 2025. This contributes to a reduction in the stock of public debt by 3½ percent of GDP during this period. Excluding BPFs, public debt is projected to remain broadly unchanged over the forecast horizon.

- Since the euro area confidence crisis, successive budgets have included safeguard clauses (in the form of future VAT rate increases) to signal commitment to achieving lower deficit targets over the medium term. In practice, however, it has mostly not been activated and the deficit target has been adjusted upward. For 2020, it amounted to about 1.3 percent of GDP and, for 2021, to 1 percent of GDP. Future clauses are excluded from staff's projections.



- Over the medium term, staff projects an effective nominal interest rate of about 2½ percent, or an average interest bill of about 3½ percent of GDP. The marginal cost of borrowing, i.e., at issuance, is projected to decrease to 0.7 percent in 2020 from 1.1 percent in 2018. Spreads vis-à-vis German bunds are assumed to be about 180 basis points through 2023—close to the average of the last ten years. In the longer term,

[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.

the average cost of debt rises gradually as monetary policy normalizes eventually, with the effective nominal interest rate increasing to around 3½ percent by 2035 (2 percent in real terms). This projection is conservative as spreads could rise along with debt under staff's projections of pension spending.

- An effective real interest rate of 2 percent (about 100 basis points lower than the average over 1996–2017), with real GDP growth of ½ percent, implies a debt stabilizing primary balance of about 2 percent of GDP.

Debt Stabilizing Primary Balance
(At 132 percent of GDP)

		Real GDP growth rate (in percent)			
		0.0	0.5	1.0	1.5
Real interest rate (in percent)	1.5	**2.0**	1.3	0.7	0.0
	2.0	2.7	**2.0**	1.3	0.7
	2.5	3.3	2.7	**2.0**	1.3
	3.0	4.0	3.3	2.7	**2.0**

- Privatization proceeds have fallen short of targets in recent years. The authorities expect receipts of 0.2 percent of GDP in 2020, which however, would exceed the cumulative receipts of the past five years. Debt projections, therefore, do not include privatization proceeds.

- Contingent liabilities: Government guarantees amounted to 3.9 percent of GDP at end-2017. Liabilities of government-controlled entities (public corporations) classified outside general government amounted to 52.1 percent of GDP, of which approximately 30 percent of GDP involves deposits and other financial sector activities (source: Eurostat). Government intervention in SOEs has been limited in the past 15 years (below 1 percent of GDP).

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 surveillance countries. However, Italy's projected fiscal stance is subject to significant downside risks. A small overall surplus—translating to sizable and sustained primary surpluses of at least 3 percent of GDP in the medium term and higher thereafter—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 2001–19. However, these were insufficient to ensure debt would not rise.[3]

4. **Materialization of moderate shocks would result in debt rising earlier and faster.** For instance:

- *Standard growth shock*. Real output growth rates are assumed to be lower by one standard deviation for two years starting in 2020, resulting in average growth of -1½ percent in 2020–21. Furthermore, for every 1 percentage point decline in growth, inflation is assumed to decline by 25 bps. The primary balance would decline, reaching -1½ percent of GDP by 2021. Debt increases to about 148 percent of GDP and increases further over the projection period.

- *Interest rate shock*. Spreads could increase further, for instance, prompted by political uncertainty, a re-emergence of concerns about debt sustainability, or policy surprises. A further increase in spreads of 200 bps is assumed (during the 2011–12 episode, spreads rose above 500 bps). Higher borrowing costs are passed on to the real economy, depressing growth by

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

0.4 p.p. for every 100 bps increase in spreads. The implicit average interest rate on debt rises to 3 percent by 2024. Debt increases to around 145 percent of GDP by 2024.

- *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 2020, e.g., from costs to recapitalize the banking system or other contingent fiscal liabilities (as reported by Eurostat). Debt rises to 170 percent of GDP by 2024. Gross financing needs would be significantly higher.

B. External Debt Sustainability Analysis

The external debt sustainability analysis complements the External Sector Assessment (Annex II). Under the baseline scenario, external debt is projected to decline slightly from 121 percent of GDP in 2019 to 119 percent of GDP in 2024, benefiting from continued trade surpluses. In standard shock scenarios, external debt would increase very modestly. However, with more than half of external debt issued by the public sector, external debt sustainability is tightly linked to public debt sustainability. Further strengthening of public and financial sector balance sheets is necessary to lower vulnerabilities and the potential for negative feedback loops between these two sectors.

5. Background. External debt has grown by 40 percentage points since Italy joined the euro, plateauing in 2015 at around 120 percent of GDP. This is about half the euro area weighted average. Over the past 5 years, Italy's net international investment position moved into balance (Annex II). However, more than half of debt liabilities are issued by the public sector—a higher share than in major euro area countries.

6. Assessment. In the baseline, external debt is projected to fall from 121 percent of GDP in 2019 to 119 percent of GDP in 2024, predicated on continued trade surpluses. Standardized shocks are calibrated to ½ standard deviation for growth, interest rates, and the current account. In these scenarios, external debt would inch up slightly by the end of the forecast horizon. The growth shock has the largest impact, leaving external debt modestly higher at 126 percent of GDP. The historical scenario is much less favorable, however, with debt climbing to 158 percent of GDP, as it is based on an average of the past 10 years, which include the global financial and euro area confidence crises. Although standard macroeconomic and external shocks do not threaten external debt sustainability in the medium term, sustainability is ultimately tied to the public debt dynamics, underscoring the need for a package of structural reforms and credible medium-term fiscal consolidation.

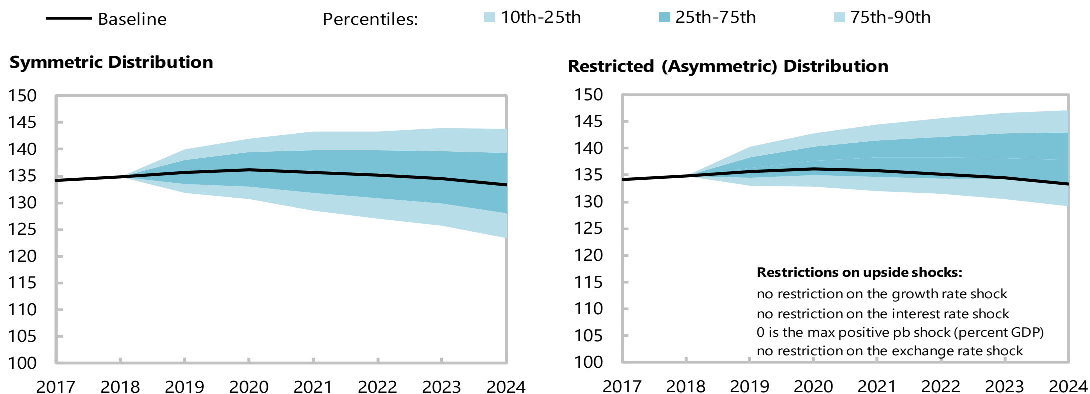
Italy: Public DSA Risk Assessment

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

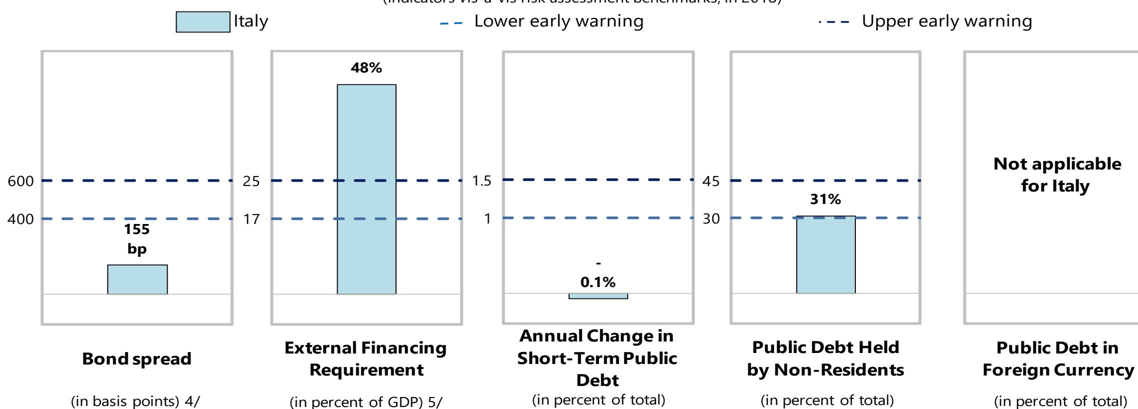
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2018)



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:

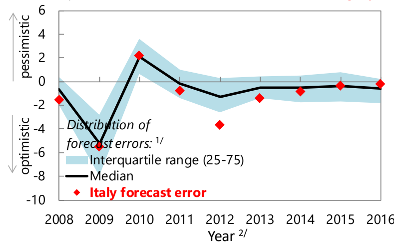
400 and 600 basis points for bond spreads; 17 and 25 percent of GDP for external financing requirement; 1 and 1.5 percent for change in the share of short-term debt; 30 and 45 percent for the public debt held by non-residents.

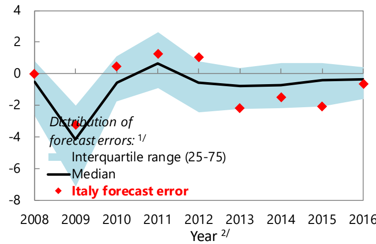
4/ Long-term bond spread over German bonds, an average over the last 3 months, 02-Nov-19 through 31-Jan-20.

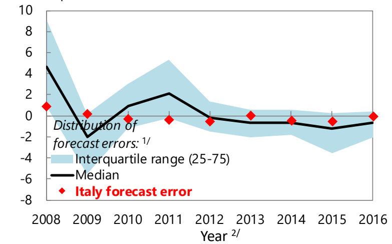
5/ External financing requirement is defined as the sum of current account deficit, amortization of medium and long-term total external debt, and short-term total external debt at the end of previous period.

Italy: Public DSA—Realism of Baseline Assumptions

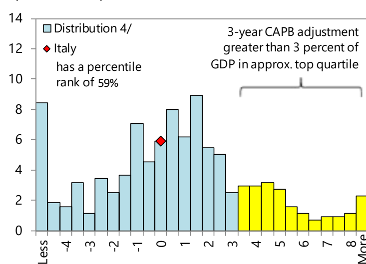
Forecast Track Record, versus all countries

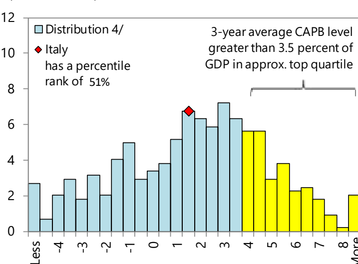




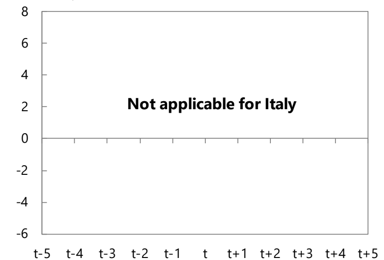


Assessing the Realism of Projected Fiscal Adjustment





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 obervations from 1990 to 2011 for advanced and emerging economies with debt greater than 60 percent of GDP. Percent of sample on vertical axis.

Italy: Public Sector Debt Sustainability Analysis (DSA)

(In percent of GDP unless otherwise indicated)

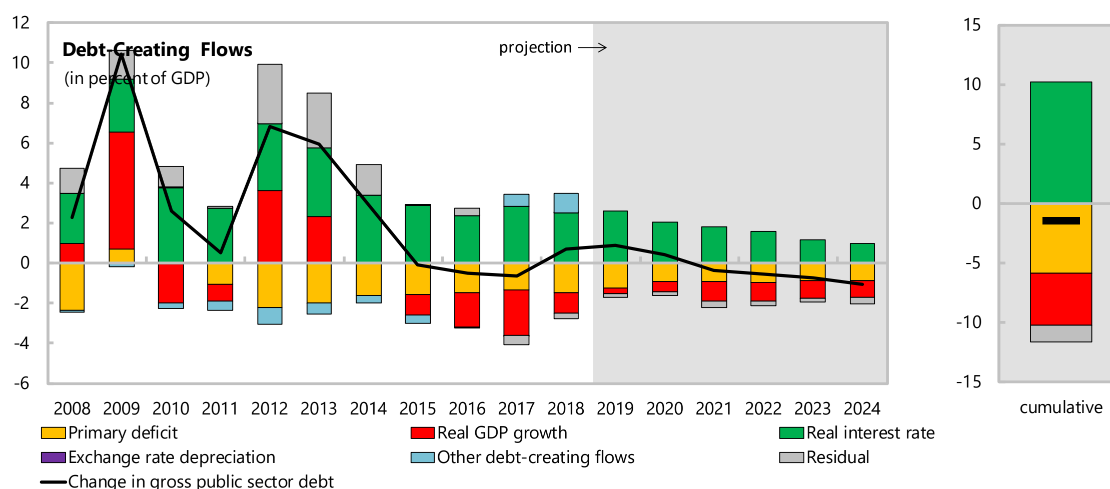
Debt, Economic and Market Indicators [1/]

	Actual			Projections					
	2008-2016 [2/]	2017	2018	2019	2020	2021	2022	2023	2024
Nominal gross public debt	125.1	134.1	134.8	135.7	136.1	135.7	135.2	134.4	133.4
Public gross financing needs	28.1	24.8	22.2	22.1	22.3	22.2	22.1	22.0	21.9
Net public debt	113.9	122.0	122.9	123.9	124.5	124.3	123.9	123.4	122.6
Real GDP growth (in percent)	-0.7	1.7	0.8	0.2	0.4	0.7	0.7	0.6	0.6
Inflation (GDP deflator, in percent)	1.3	0.7	0.9	0.6	1.0	1.0	1.2	1.4	1.5
Nominal GDP growth (in percent)	0.6	2.4	1.7	0.8	1.4	1.8	1.9	2.0	2.1
Effective interest rate (in percent) [4/]	3.8	2.9	2.8	2.5	2.5	2.4	2.4	2.3	2.2

As of January 31, 2020		
Sovereign Spreads		
EMBIG (bp) 3/	137	
5Y CDS (bp)	107	
Ratings	Foreign	Local
Moody's	Baa3	Baa3
S&Ps	BBB	BBB
Fitch	BBB	BBB

Contribution to Changes in Public Debt

	Actual			Projections							
	2008-2016	2017	2018	2019	2020	2021	2022	2023	2024	cumulative	debt-stabilizing primary balance [9/]
Change in gross public sector debt	3.4	-0.7	0.7	0.9	0.4	-0.4	-0.6	-0.8	-1.0	-1.4	
Identified debt-creating flows	2.2	-0.2	1.0	1.1	0.6	-0.1	-0.3	-0.6	-0.7	0.0	
Primary deficit	-1.3	-1.3	-1.5	-1.3	-0.9	-0.9	-0.9	-0.9	-0.9	-5.8	0.2
Primary (noninterest) revenue and gra	46.7	46.2	46.2	46.6	46.6	46.5	46.6	46.6	46.6	279.5	
Primary (noninterest) expenditure	45.4	44.9	44.7	45.3	45.7	45.6	45.6	45.7	45.7	273.7	
Automatic debt dynamics [5/]	3.8	0.6	1.5	2.4	1.5	0.8	0.6	0.3	0.2	5.8	
Interest rate/growth differential [6/]	3.8	0.6	1.5	2.4	1.5	0.8	0.6	0.3	0.2	5.8	
Of which: real interest rate	3.0	2.8	2.5	2.6	2.0	1.8	1.6	1.2	1.0	10.2	
Of which: real GDP growth	0.8	-2.3	-1.0	-0.2	-0.5	-1.0	-0.9	-0.9	-0.8	-4.4	
Exchange rate depreciation [7/]	0.0	0.0	0.0	...	...	...	...	...	...	...	
Other identified debt-creating flows	-0.4	0.6	1.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Privatization Receipts (negative)	-0.2	0.6	0.0	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 Euro	-0.2	0.0	1.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes [8/]	1.3	-0.5	-0.3	-0.2	-0.2	-0.3	-0.3	-0.2	-0.3	-1.4	



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 $[(r - \pi(1+g) - g + ae(1+r)]/(1+g+\pi+g\pi))$ 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 $r - \pi (1+g)$ and the real growth contribution as $-g$.

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

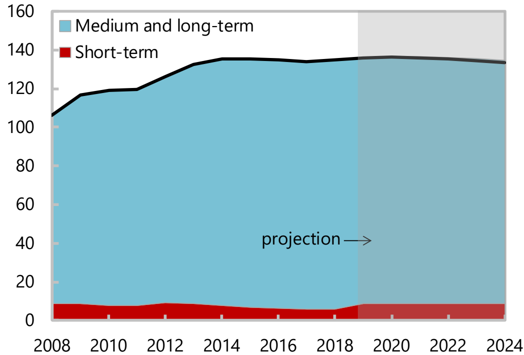
8/ Includes asset changes and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

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.

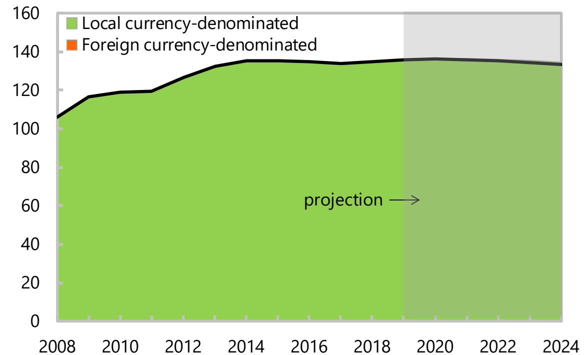
Italy: Public DSA—Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

By Maturity
(in percent of GDP)



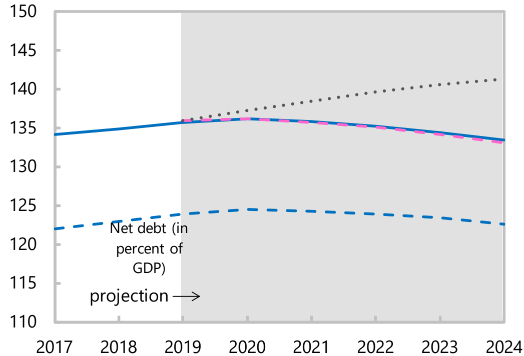
By Currency
(in percent of GDP)



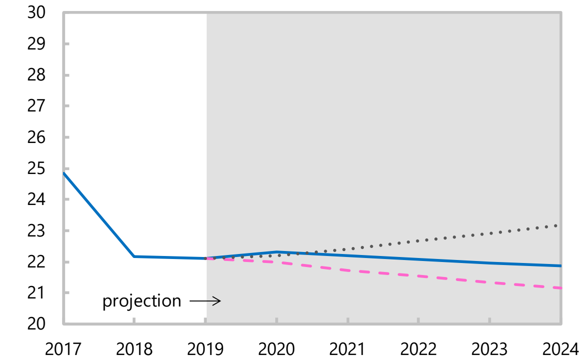
Alternative Scenarios

Baseline · Historical · Constant Primary Balance

Gross Nominal Public Debt
(in percent of GDP)



Public Gross Financing Needs
(in percent of GDP)



Underlying Assumptions
(in percent)

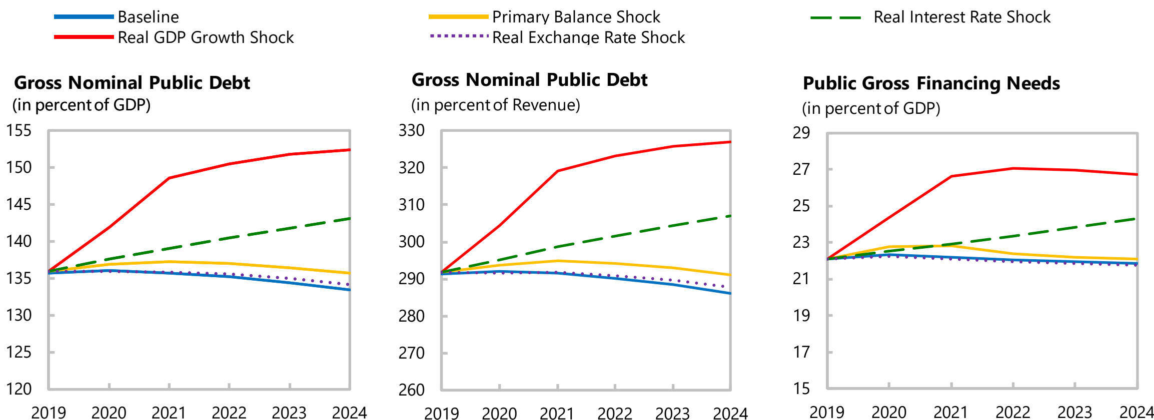
Baseline Scenario	2019	2020	2021	2022	2023	2024
Real GDP growth	0.2	0.4	0.7	0.7	0.6	0.6
Inflation	0.6	1.0	1.0	1.2	1.4	1.5
Primary Balance	1.3	0.9	0.9	0.9	0.9	0.9
Effective interest rate	2.5	2.5	2.4	2.4	2.3	2.2
Constant Primary Balance Scenario						
Real GDP growth	0.2	0.4	0.7	0.7	0.6	0.6
Inflation	0.6	1.0	1.0	1.2	1.4	1.5
Primary Balance	1.3	1.3	1.3	1.3	1.3	1.3
Effective interest rate	2.5	2.5	2.4	2.4	2.3	2.2

Historical Scenario	2019	2020	2021	2022	2023	2024
Real GDP growth	0.2	-0.3	-0.3	-0.3	-0.3	-0.3
Inflation	0.6	1.0	1.0	1.2	1.4	1.5
Primary Balance	1.3	1.2	1.2	1.2	1.2	1.2
Effective interest rate	2.5	2.5	2.6	2.6	2.6	2.6

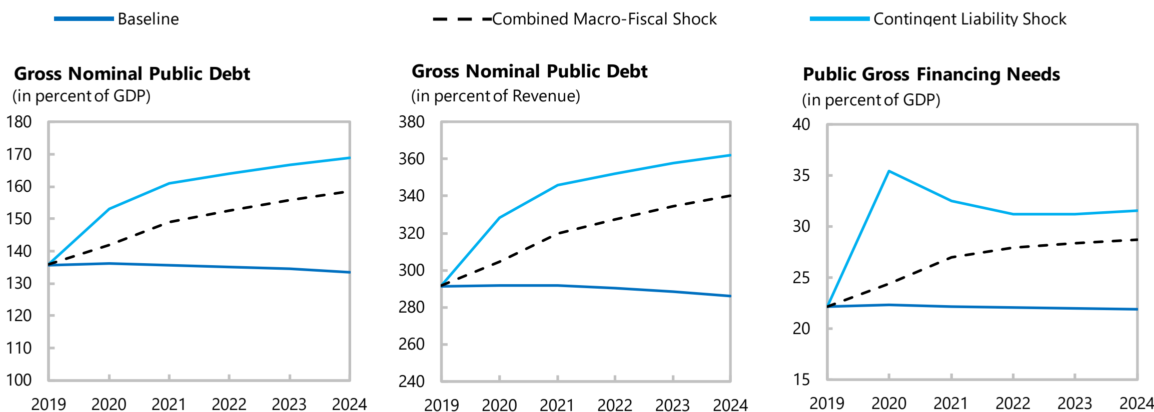
Source: IMF staff.

Italy: Public DSA—Stress Tests

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions

(in percent)

	2019	2020	2021	2022	2023	2024
Primary Balance Shock						
Real GDP growth	0.2	0.4	0.7	0.7	0.6	0.6
Inflation	0.6	1.0	1.0	1.2	1.4	1.5
Primary balance	1.3	0.5	0.5	0.9	0.9	0.9
Effective interest rate	2.5	2.5	2.4	2.4	2.3	2.2
Real Interest Rate Shock						
Real GDP growth	0.2	-0.4	-0.1	-0.1	-0.2	-0.2
Inflation	0.6	1.0	1.0	1.2	1.4	1.5
Primary balance	1.3	0.9	0.9	0.9	0.9	0.9
Effective interest rate	2.5	2.5	2.7	2.8	2.8	2.9
Combined Shock						
Real GDP growth	0.2	-1.9	-1.6	-0.1	-0.2	-0.2
Inflation	0.6	0.4	0.5	1.2	1.4	1.5
Primary balance	1.3	-0.4	-1.5	-1.2	-0.7	-0.4
Effective interest rate	2.5	2.5	2.7	2.8	2.8	2.9

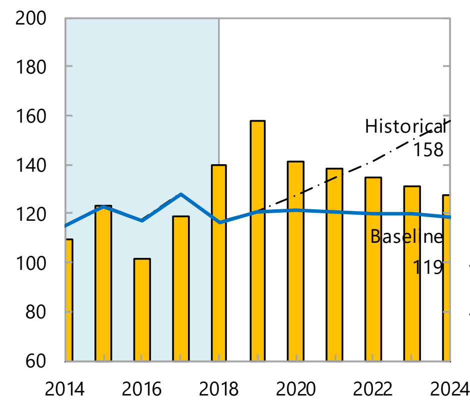
	2019	2020	2021	2022	2023	2024
Real GDP Growth Shock						
Real GDP growth	0.2	-1.9	-1.6	0.7	0.6	0.6
Inflation	0.6	0.4	0.5	1.2	1.4	1.5
Primary balance	1.3	-0.4	-1.5	-1.2	-0.7	-0.4
Effective interest rate	2.5	2.5	2.4	2.4	2.4	2.3
Real Exchange Rate Shock						
Real GDP growth	0.2	0.4	0.7	0.7	0.6	0.6
Inflation	0.6	1.4	1.0	1.2	1.4	1.5
Primary balance	1.3	0.9	0.9	0.9	0.9	0.9
Effective interest rate	2.5	2.5	2.4	2.3	2.3	2.2
Contingent Liability Shock						
Real GDP growth	0.2	-1.9	-1.6	0.7	0.6	0.6
Inflation	0.6	0.4	0.5	1.2	1.4	1.5
Primary balance	1.3	-11.4	0.9	0.9	0.9	0.9
Effective interest rate	2.5	2.6	2.9	2.6	2.5	2.4

Source: IMF staff.

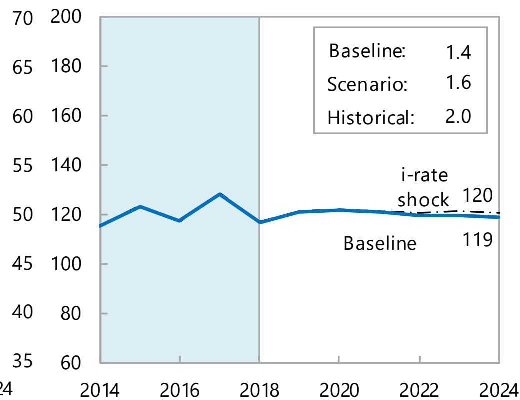
Italy: External Debt Sustainability: Bound Tests 1/ 2/

(External debt in percent of GDP)

Baseline and historical scenarios

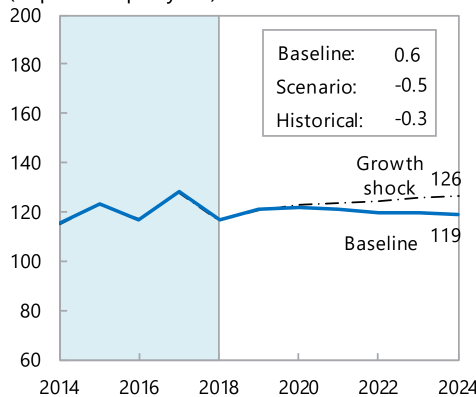


Interest rate shock (in percent)



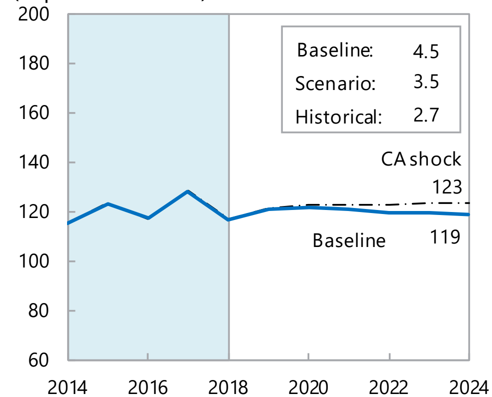
Growth shock

(in percent per year)

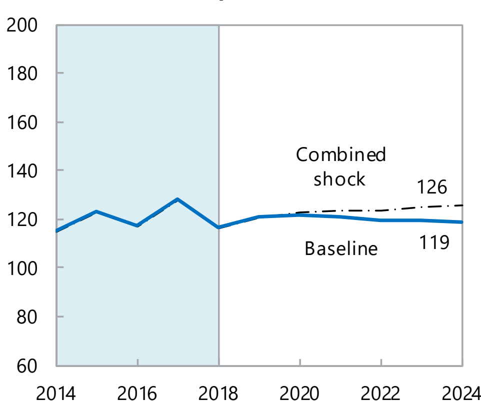


Non-interest current account shock

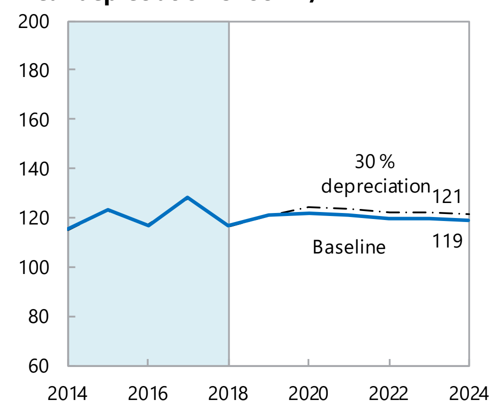
(in percent of GDP)



Combined shock 3/



Real depreciation shock 4/



Sources: International Monetary Fund, Country desk data, and staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.
3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.
4/ One-time real depreciation of 30 percent occurs in 2020.

Italy: External Debt Sustainability Framework, 2014–24

(In percent of GDP unless otherwise indicated)

	Actual							Projections						
	2014	2015	2016	2017	2018			2019	2020	2021	2022	2023	2024	Debt-stabilizing non-interest current account 6/
1 **Baseline: External debt**	115.1	123.1	117.1	128.0	116.5			**120.9**	**121.4**	**120.7**	**119.6**	**119.6**	**118.6**	**-0.8**
2 Change in external debt	-7.5	8.0	-6.0	11.0	-11.6			4.5	0.5	-0.8	-1.1	0.1	-1.1	
3 Identified external debt-creating flows (4+8+9)	-4.1	-3.4	-6.1	-6.5	-4.6			-3.8	-4.0	-4.1	-4.0	-3.8	-3.7	
4 Current account deficit, excluding interest payments	-4.2	-3.6	-4.4	-4.4	-4.1			-4.4	-4.5	-4.4	-4.5	-4.5	-4.6	
5 Deficit in balance of goods and services	-2.9	-3.0	-3.3	-3.0	-2.5			-3.2	-3.2	-3.0	-2.9	-2.8	-2.7	
6 Exports	29.1	29.7	29.3	30.9	31.5			32.3	33.0	33.5	34.1	34.8	35.6	
7 Imports	26.2	26.7	26.0	27.9	29.0			29.1	29.8	30.5	31.2	32.0	32.9	
8 Net non-debt creating capital inflows (negative)	-1.1	-0.6	-0.6	-1.0	0.3			-0.6	-0.4	-0.3	-0.3	-0.2	-0.2	
9 Automatic debt dynamics 1/	1.2	0.9	-1.1	-1.1	-0.8			1.3	1.0	0.6	0.7	1.0	1.1	
10 Contribution from nominal interest rate	2.3	2.2	1.8	1.8	1.5			1.5	1.4	1.5	1.6	1.7	1.8	
11 Contribution from real GDP growth	0.0	-1.1	-1.5	-1.9	-0.9			-0.2	-0.5	-0.9	-0.8	-0.8	-0.7	
12 Contribution from price and exchange rate changes 2/	-1.1	-0.2	-1.4	-0.9	-1.3			...	...	...	...	...	...	
13 Residual, incl. change in gross foreign assets (2-3) 3/	-3.4	11.3	0.1	17.5	-6.9			8.2	4.5	3.4	2.8	3.8	2.6	
External debt-to-exports ratio (in percent)	395.5	414.1	399.0	414.8	369.9			374.2	368.4	360.2	350.2	343.6	333.5	
Gross external financing need (in billions of US dollars) 4/	1024.0	933.8	850.7	975.1	1146.1			1185.8	1117.6	1132.2	1142.3	1151.1	1161.0	
in percent of GDP	47.3	50.8	45.3	49.7	54.9	10-Year	10-Year	59.5	55.3	54.5	53.6	52.7	51.8	
Scenario with key variables at their historical averages 5/								**120.9**	**127.5**	**134.7**	**141.4**	**149.8**	**157.5**	**5.5**
Key Macroeconomic Assumptions Underlying Baseline						Historical Average	Standard Deviation							
Real GDP growth (in percent)	0.0	0.8	1.3	1.7	0.8	-0.3	2.3	0.2	0.4	0.7	0.7	0.6	0.6	
GDP deflator in US dollars (change in percent)	1.0	-15.7	0.9	2.8	5.5	-0.9	6.8	-4.7	1.0	2.1	1.8	1.9	2.0	
Nominal external interest rate (in percent)	1.9	1.6	1.5	1.6	1.2	2.0	0.5	1.2	1.2	1.2	1.3	1.5	1.6	
Growth of exports (US dollar terms, in percent)	2.6	-13.3	0.9	9.9	8.5	0.8	11.8	-2.0	3.4	4.5	4.5	4.6	4.8	
Growth of imports (US dollar terms, in percent)	0.9	-13.5	-0.4	11.8	10.5	-0.2	13.0	-4.1	3.9	5.2	5.0	5.2	5.4	
Current account balance, excluding interest payments	4.2	3.6	4.4	4.4	4.1	2.7	1.9	4.4	4.5	4.4	4.5	4.5	4.6	
Net non-debt creating capital inflows	1.1	0.6	0.6	1.0	-0.3	0.4	0.7	0.6	0.4	0.3	0.3	0.2	0.2	

1/ Derived as [r - g - r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as [-r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock. r increases with an appreciating domestic currency (e > 0) and rising inflation (based on GDP deflator).

3/ For projection, line includes the impact of price and exchange rate changes.

4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

Annex V. Lessons from Two Public Sector Reforms in Italy[1]

1. The reform of the public administration has been a priority for several years. Successive Italian governments have undertaken numerous simplification and modernization initiatives to enhance efficiency. Nevertheless, progress remains limited. This annex summarizes a case study of two reforms since 2016—of local state-owned enterprises and public procurement—to draw lessons for the future.

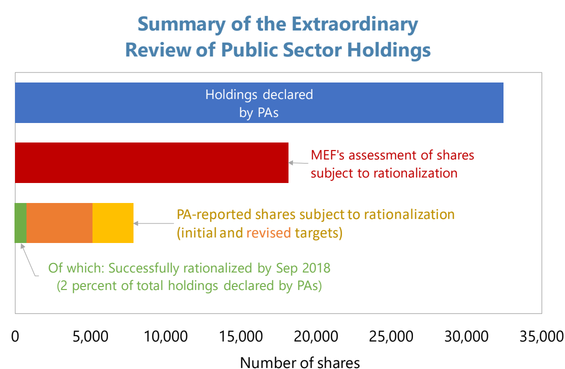
Reforming Local State-Owned Enterprises (SOEs)

2. Prior to 2016, there was no comprehensive or regular review of the large number of local SOEs. The majority of these enterprises are owned by local public administrations (PAs). They employ a sizable number of workers and operate across all sectors of the economy, including professional and business services where barriers to competition are high (OECD, 2019). Concerns have been raised primarily about their nature as providers of public goods or services and their impact on competition and efficiency, rather than any direct budgetary implications. They were often able to obtain service contracts without an open tender and protected from competition; around ⅓ were loss making (Karantounias and Pinelli, 2016).

3. The Consolidated Law on SOEs was enacted in mid-2016 to reduce their number, enhance competition, and increase efficiency. It integrated fragmented laws and defined qualitative and quantitative criteria for the establishment, acquisition, and retaining of shareholding in SOEs. These criteria include that PAs justify a direct link with the institutional goals of the public sector; provide services of general interest, in a cost-effective manner; and be financially sustainable. PAs were mandated with carrying out an *Extraordinary Review* of their shareholdings in 2017, identifying those to be rationalized, and completing the rationalization by September 2018. The law mandated annual progress reviews with a system of sanctions, supervised directly by the Ministry of Economy and Finance and indirectly by the Competition Authority and the Court of Auditors.

4. Notwithstanding good intentions, implementation and enforcement have been weak. The *Extraordinary Review* uncovered holdings of more than 32,000 shares by some 8,200 PAs. Of these holdings, PAs declared that only 7,800 shares would be rationalized, less than ½ of Ministry of Economy and Finance's (MEF's) own assessment. This is in part due to the weakening of the reform criteria—by broader interpretations of the shareholding criteria that were subsequently accommodated as well as by the 2019 Budget Law, which exempted companies that were profitable over the preceding three years. Of all the shares that

Summary of the Extraordinary Review of Public Sector Holdings



Source: The Report on the Results of the Extraordinary Review of Public Sector Holding (2019).

[1] Prepared by Nazim Belhocine and La-Bhus Fah Jirasavetakul (both EUR), based on IMF working paper 20/40.

PAs aim to retain, ⅕ are in loss-making companies, and ⅓ fail the efficiency criteria.[2] Only 750 shares were rationalized successfully by the target deadline of September 2018—just 2 percent of total shareholdings—while for nearly ¾ of the shares identified to be divested, the process has yet to be initiated. Most PAs report difficulties in identifying divestment procedures and reconciling transparency rules with market practices.

Public Procurement

5. A new code was approved in 2016 to improve the efficiency and transparency of public procurement and concessions and to adopt the 2014 EU Directives. The new code set standard time frames and conditions for participation in public tenders, criteria for awarding tenders, legal recourses, and appeal processes. To enhance transparency, the anti-corruption agency (ANAC) was given authority to oversee public procurement and contracts, issue implementation regulations, and establish a register for members of public-tender boards.

6. Improvement in public procurement performance has, however, been slow. Only half of the approximately 60 acts enshrined by the 2016 code and the 2017 amending decree have so far entered into force (PBO, 2019). Italy's public procurement performance still lags other EU countries, with tendering times being one of the longest (EC, 2018). Some PAs have reportedly been waiting for the full implementation of the reform to resume public investment (EC, 2016; 2017). Staff's analysis confirms an adverse impact on public investment of weak procurement performance. Improving Italy's public procurement quality towards the best EU performer is estimated to increase public investment by about 0.4–0.7 percentage points of GDP.

7. Legislative uncertainty remains high. The 2019 Emergency Decree reversed some earlier provisions. While the emergency decree aimed to simplify procedures and speed up public contracts, it came at the cost of transparency and increased complexity. Temporary suspensions of specific regulations of the original code also added uncertainty to the strategic direction of the reform and weakened its effectiveness.

Lessons

8. Although reform intentions were good, follow-up and implementation were lacking. Legislative amendments overturned or, in some cases, weakened, original provisions; regulatory complexity and uncertainties in application limited the impact of the reform; and enforcement mechanisms were weak, including in systematically challenging and sanctioning non-compliant local public administrations (EC, 2019; OECD, 2019; PBO, 2019). Addressing these gaps is essential for Italy to successfully modernize its public sector. The urgency of doing so rises further if other key reforms, such as decentralizing wage bargaining, are deemed infeasible.

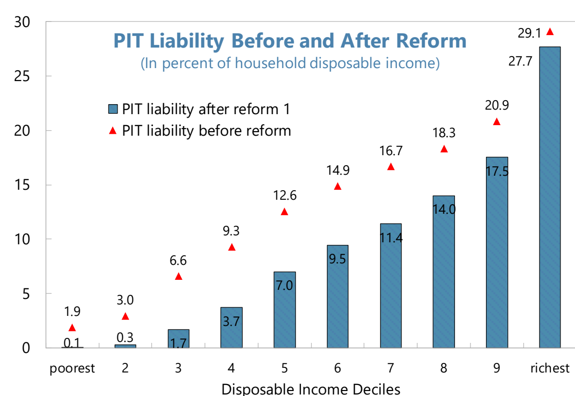
[2] To meet the efficiency criteria (Article 20), companies must (i) not have more directors than employees, (ii) not duplicate the activities of other SOEs, (iii) achieve an average turnover greater than €500,000 in the previous three years; and (iv) not be loss making for four out of the five preceding years.

Annex VI. Toward A Comprehensive Tax Reform for Italy[1]

1. The Italian tax system is complex, imposes high statutory rates on a narrow tax base, and suffers from significant compliance gaps. Multiple and sizable tax expenditures complicate the system and erode the base. To finance increasing public spending with a narrow tax base, statutory tax rates are among the highest in the EU. For instance, the average labor tax wedge is close to 48 percent (EU average is about 42 percent) and the corporate income tax rate is 24 percent (EU average is 21.3 percent). The combination of a complex tax system and high statutory tax rates explains significant compliance gaps, with estimated losses of about 6 percent of GDP.

2. A comprehensive reform—to simplify the system, broaden the base, and lower statutory rates—is proposed and its revenue and distributional implications are assessed using microsimulation techniques. Reform options for the personal income tax (PIT) are simulated to lower the labor tax wedge toward the EU average, a reduction of about 4.5 percent, equivalent to 2 percent of GDP in revenue.[2] To compensate, reform options for the value-added tax (VAT) and the immovable property tax are simulated to achieve an overall revenue-neutral reform. VAT reform involves streamlining the goods subject to reduced rates and lowering the standard rate. Reform of the immovable property tax entails updating valuations to reflect market values of properties.

3. A progressive base-broadening PIT reform lowers the labor tax wedge to the EU average and benefits low- and middle-income households the most. It could comprise: (i) lowering the statutory rate on the first taxable income bracket to 9 percent; (ii) to preserve progressivity, merging the highest two brackets into one bracket for income above €55,000 at 44 percent; (iii) to broaden the tax base, eliminating the National Income Tax Bonus (or €80 bonus), which could also address labor-supply distortions, and the tax credit for building refurbishment and construction, which is relatively costly and benefits wealthy households more. Simulations of the reform increase the disposable income of households in the middle deciles (with incomes between €20,000–€40,000) by 5½ percent, twice as high as the benefit for the wealthiest households. Households with incomes below €20,000 pay virtually no tax. By contrast, simulations of flat or near-flat PIT reform (with two brackets and lower rates) would be exponentially costlier and regressive because higher incomes get the largest tax relief.

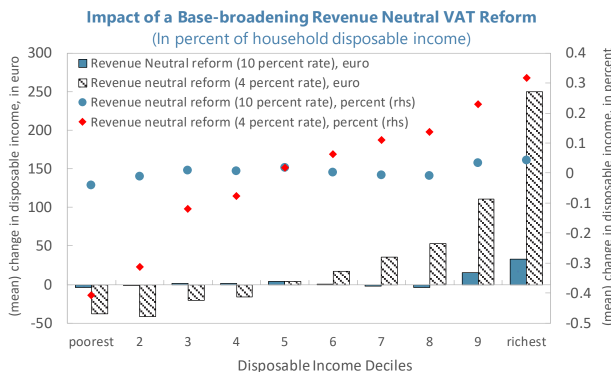


Sources: Authors' calculations based on EUROMOD.

[1] Prepared by Ernesto Crivelli (EUR), based on IMF working paper 20/37.

[2] Studies for European and OECD countries (European Commission, 2006; Arnold and others, 2011; IMF Working Paper 18/59) have found that a 1 percent of GDP shift from labor to property and consumption taxation increases long-term economic growth by 0.2–0.7 percentage points. The magnitude and robustness of the results, however, may vary depending on country sample and period considered (Baiardi and others, 2019).

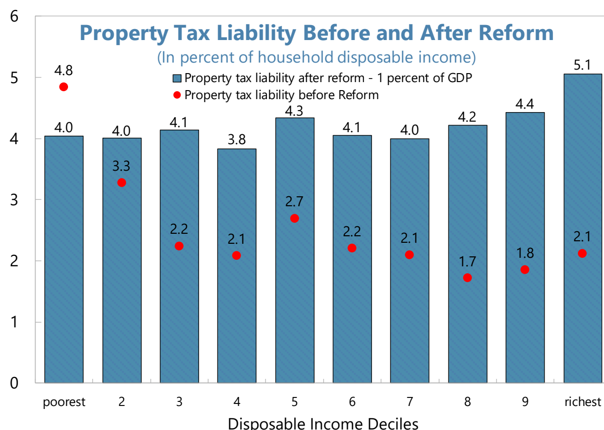
4. A base-broadening VAT reform needs to be designed carefully to limit negative distributional effects. The reduced rate of 4 percent is targeted to categories of goods largely consumed by poorer households. But this is not necessarily the case for the 10 percent rate and some exempted goods. As such, a revenue-neutral VAT reform that eliminates the reduced rate of 10 percent while compensating consumers with a lower standard rate of 18.5 percent is almost neutral in terms of the income distribution.



Note: This chart displays the change in the VAT liability as a result of a revenue-neutral reform, measured as the change in disposable income both in monetary values (euro); and as in percentage of disposable income. The revenue-neutral reform is calibrated assuming that goods and services currently subject to either the reduced rate of 4 percent (or 10 percent) are now subject to the proposed standard rate of 17.5 percent (or 18.5 percent).

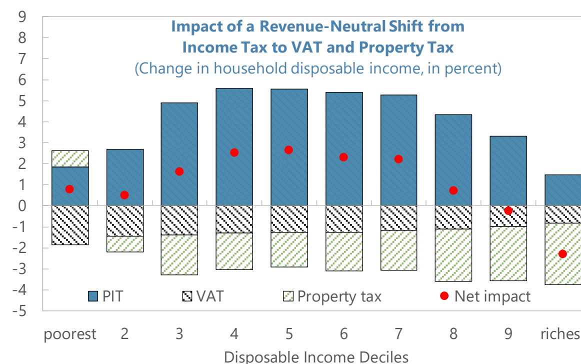
Sources: Authors' calculations based on own micro-simulation model.

5. Updating the property valuation system to reflect market values would address equity concerns and increase revenue collection. Closing the gap between market and taxable values would raise progressivity and revenue collections significantly, allowing for lower tax rates. Simulations suggest that a reform where all properties are subject to a tax rate of 0.55 percent—about half the current rate—would raise 1 percent of GDP in additional revenue while significantly improving the income distribution properties of the tax. Low-income households (in the first two deciles) would be largely unaffected by the reform, whereas the tax liability increases gradually with income.



Sources: Authors' calculations based on EUROMOD.

6. To summarize, a revenue-neutral shift from labor income to consumption and property tax revenue would be growth friendly and inclusive. Simulations of the above-mentioned package, where the cost of a PIT reform is offset with increased VAT and property tax revenue (by 1 percent of GDP each), is less distortionary and, hence, pro-growth and benefits middle-income households the most, while being broadly neutral for low-income households.



Note: This chart displays the change in the tax liability as a result of the proposed reform, measured in percentage of disposable income. The reform is calibrated for a revenue-neutral shift equivalent to 2 percent of GDP in budget revenue from the personal income tax (Reform 1) to VAT (1 percent of GDP) and property tax (1 percent of GDP).

Sources: Authors' calculations based on EUROMOD and own micro-simulation model.

Annex VII. Key FSAP Recommendations

Recommendations	Agency	Time*
Bank supervision and regulation and NPL resolution		
Enhance banks' capital levels, as appropriate, to ensure all banks maintain adequate capital ratios under stress scenarios.	Bank of Italy (BdI), SSM	ST
Consider more timely escalation of corrective measures for weak banks to effect improvement (e.g., in capital levels, operational efficiency, governance) or achieve consolidation or orderly winddowns when needed.	BdI	I
Perform more periodic deep dives and thematic and targeted inspections on key LSI weaknesses such as bank governance, credit risk, and business models.	BdI	ST
Continue scrutinizing banks' credit risk and loan classification and provisioning practices, particularly of UTP portfolios, and challenging progress and ambition of banks' NPL reduction plans.	BdI, SSM	C
Consider extending the SSM approach that sets bank-specific expectations for the gradual path to full provisioning on existing NPL stocks to LSIs with high NPLs with an adequate phase-in period; and update the LSIs' NPL management guidance.	BdI	I
Amend relevant laws to confer BdI and IVASS authority on removal of authorization and winding-up of banks and insurers, respectively.	MEF, MISE	ST
Address gaps in governance regulations of banks and insurance companies by issuing the draft MEF and MISE decrees.	MEF, MISE	I
Macroprudential policies and framework		
Establish a national macroprudential policy authority with a leading role for BdI.	MEF, IVASS, BdI, CONSOB	ST
Incorporate the Systemic Risk Buffer (SyRB) and borrower-based tools into the macroprudential toolkit.	MEF, BdI	ST
Consider implementing prudential policies to moderate the sovereign-bank nexus with an appropriate phase-in period to avoid possible market disruptions.	BdI	MT
Insolvency framework		
Enhance the enforcement and insolvency framework and ensure that courts have sufficient resources and specialization to timely handle insolvency cases.	MoJ, NJC	ST
Reinforcing crisis management and safety nets		
Establish additional loss absorbing capacity to enable greater loss allocation to unsecured and uninsured creditors in resolution and liquidation, notably for LSIs for which a resolution strategy is foreseen; and strictly limit the use of public funds to exceptional events that could undermine system-wide financial stability.	BdI, MEF	ST
Reinforce the DGS by removing active bankers from their boards; assessing the adequacy of funding targets; strengthening backstops; and avoiding the use of DGS resources for failure prevention outside of resolution or liquidation as much as possible, only using it in exceptional cases with strong prospects for successful rehabilitation and restoring long-term viability.	DGS, BdI, MEF	ST

* C = Continuous; I = Immediate (within one year); ST = Short Term (within 1–2 years); MT = Medium Term (within 3–5 years)

INTERNATIONAL MONETARY FUND

ITALY

STAFF REPORT FOR THE 2020 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

February 28, 2020

Prepared By

European Department
(In consultation with other departments)

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FUND RELATIONS

(As of January 28, 2020)

Mission: Rome, Milan, and Frankfurt during January 14–28, 2020. The concluding statement of the mission is available at https://www.imf.org/en/News/Articles/2020/01/29/Italy-Staff-Concluding-Statement-of-the-2019-Article-IV-Mission.

***Staff team*:** Rishi Goyal (head), Ernesto Crivelli, Daniel Garcia-Macia, La-Bhus Fah Jirasavetakul, Natalia Novikova (all EUR), Mark Adams, and Dermot Monaghan (both MCM). May Khamis (MCM, FSAP mission chief) participated in some meetings. Domenico Fanizza and Cristina Quaglierini (both OED) also attended at various times.

***Country interlocutors*:** Finance Minister Gualtieri, Bank of Italy Governor Visco, Labor Minister Catalfo, Cabinet Secretary Fraccaro, parliamentarians, senior government and SSM officials, Anti-Corruption Authority (ANAC), the Competition Authority, the Parliamentary Budget Office (Fiscal Council), the Securities and Exchange Commission (CONSOB), Social Security Institute (INPS), representatives of trade unions (CGIL, CSIL, and UIL), Confederation of Italian Industry (Confindustria), major Italian and international banks, Italian Banking Association (ABI), academics, think tanks, and other private sector analysts.

***Fund relations*:** The previous consultation discussions took place during July 12–26, 2018 and November 6–14, 2018. The associated Executive Board's assessment is available at: https://www.imf.org/en/News/Articles/2019/02/05/pr1931imf-executive-board-concludes-2018-article-iv-consultation-with-italy and the staff report and other mission documents at: https://www.imf.org/en/Publications/CR/Issues/2019/02/06/Italy-2018-Article-IV-Consultation-Press-Release-Staff-Report-and-Statement-by-the-Executive-46579.

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	12,636.36	83.85
Reserve Tranche Position	2,433.75	16.15
Lending to the Fund		
New arrangements to borrow	355.30	
SDR Department:	SDR Million	Percent Allocation
Net cumulative allocation	6,576.11	100.00
Holdings	5,714.61	86.90

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				
	2020	2021	2022	2023	2024
Principal					
Charges/Interest	6.57	6.47	6.48	6.48	6.48
Total	6.57	6.47	6.48	6.48	6.48

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 July 12–26, 2018 and November 6–14, 2018; the staff report (IMF Country Report No. 18/291) was discussed on January 25, 2019.

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
FSAP	March 2020	Forthcoming

Technical Assistance:

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

STATISTICAL ISSUES

(As of January 28, 2020)

I. Assessment of Data Adequacy for Surveillance
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*).
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.
Government Finance Statistics: Annual and quarterly consolidated general government operations and financial balance sheet data are reported, with extensive time series. Component details on Expense (Interest, Grants, etc.) and transactions and stock positions in assets and liabilities by counterparty sector are not available.
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.
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.
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).

II. Data Standards and Quality	
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.	A data ROSC was disseminated in 2002.

Table 1. Italy: Common Indicators Required for Surveillance
(As of January 28, 2020)

	Date of latest observation	Date received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of Publication[7]
Exchange Rates	Jan 2020	Jan 2020	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	Dec 2019	Jan 2020	M	M	M
Reserve/Base Money	Dec 2019	Jan 2020	M	M	M
Broad Money	Dec 2019	Jan 2020	M	M	M
Central Bank Balance Sheet	Dec 2019	Jan 2020	M	M	M
Consolidated Balance Sheet of the Banking System	Nov 2019	Jan 2020	M	M	M
Interest Rates[2]	Jan 2020	Jan 2020	D	D	D
Consumer Price Index	Dec 2019	Jan 2020	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3]—General Government[4]	Q3:2019	Jan 2020	Q	Q	Q
Revenue, Expenditure, Balance and Composition of Financing[3]— Central Government	Nov 2019	Jan 2020	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Nov 2019	Jan 2020	M	M	M
External Current Account Balance	Nov 2019	Jan 2020	M	M	M
Exports and Imports of Goods and Services	Nov 2019	Jan 2020	M	M	M
GDP/GNP	Q3:2019	Dec 2019	Q	Q	Q
Gross External Debt	Q3:2019	Dec 2019	Q	Q	Q
International Investment position[6]	Q3:2019	Dec 2019	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).

Statement by Domenico Fanizza, Executive Director for Italy
March 18, 2020

The ongoing Coronavirus epidemic has created a health emergency in Italy that called for immediate actions by the authorities. ***They are taking all the measures needed to halt the epidemic and to mitigate its impact on the health system, economic activity, and living conditions.*** *The Italian authorities value staff's analyses and recommendations and thank staff for their work. They, however, have: (a) concerns on the specific guidance offered by the FSSA; and (b) reservations on whether the Article IV discussions focused on the relevant policy issues to lift economic growth over the medium term. The FSSA does not consider that the new European regulatory framework has complicated the management of crises affecting small banks. This fact justifies preventive interventions by the private Deposit Guarantee Schemes (DGS) when public confidence is at stake. As regards staff's recommendations on how to raise productivity, the authorities would have liked more attention to: (a) the challenges and opportunities coming from innovation, and the transition toward renewable energy resources; (b) the need to raise both public and private investment; and (c) the urgency of upgrading the education system.*

I. The Coronavirus *(COVID-19)* Epidemic

The COVID-19 epidemic has hit Italy hard. The virus spread quickly from several areas of Northern Italy that were immediately locked down. To limit contagion, mobility across the country has been restricted, public events have been banned and schools and universities have been temporarily closed. To ensure full transparency, civil protection experts and officials provide daily briefings to share all available data on developments with the media and the public.

The fallout of the virus outbreak on Italy's economy will likely be large. At this stage size and duration of the epidemic are highly uncertain as they both depend on several factors, also of external origin. The epidemic has already exerted a major toll on economic activity, particularly in the North of Italy. The impact on GDP will crucially depend on how long the epidemic lasts.

Italy's policy response has been immediate. First, the government made euro 6.3 billion (0.3 per cent of GDP) available to address the emergency and it is now considering additional measures that could bring the overall support package up to a total of euro 25 billion. Actions include support for families, workers and businesses, through enhanced unemployment insurance schemes; temporary tax and debt relief; and provision of liquidity to SMEs that operate below capacity because of the epidemic. Additional measures aim at strengthening the health care system. Smart working is strongly encouraged for civil servants.

As regards the budgetary costs of these measures, the authorities believe they **will have a one-off impact** on public finances, affecting the overall deficit in 2020, but leaving unchanged the structural deficit target as agreed with the European Union. The European Commission supports this approach. **The authorities have committed to resume their efforts on fiscal consolidation** as soon as the disease is defeated, building on the progress achieved in the last year and half.

The authorities strongly believe that a coordinated response is needed to address not only the epidemic but also its economic impact. They are fully aware that the national responses can be successful only if policy makers act quickly both at the regional and global levels.

II. Economic Developments

Last year Italy improved its financial position, despite much weaker-than-expected economic growth and a difficult political climate that kept sovereign spreads high until September, when the new government took office.

- **The overall fiscal deficit declined from 2.2 to 1.6 percent of GDP in 2019**, and the public debt-to-GDP ratio remained at 134.8 of GDP. These figures imply **sizable improvements in the structural balance, primary balance, and structural primary balance as well**.[1] It is worth noting that staff not only had projected the deficit at above 2 percent of GDP, but also had stressed that new social policies could have brought the deficit close to 3 percent of GDP[2]. Finally, the average interest rate on new government debt fell below 1 percent in 2019.
- **The banking system has proved resilient**, with increasing capitalization, declining NPLs, and improved profitability. Moreover, the consolidation process is continuing among both the larger and the smaller banks.
- **The external position of the country remains strong**, with a "close-to-balance" net international investment position, reflecting sizable current account surpluses.
- At 0.3 percent, the growth outcome was, however, disappointing in 2019. Despite record levels of employment, unemployment remains unacceptably high, particularly among the young and in the Southern part of the country. Per-capita income has not recovered to pre-crises levels. **Lifting growth in a lasting manner remains the overarching priority for the Italian authorities**.

III. How to Raise Productivity

The authorities and staff agree that at the root of the disappointing growth performance is low total factor productivity (TFP). **There is also broad agreement that a comprehensive and consistent medium-term plan is much needed to raise productivity**. Political developments over the recent years have not allowed the authorities to build the necessary consensus. The current government intends to redouble its efforts in this direction.

The authorities and staff agree less on the priorities for reform. Staff have long remained convinced that the underlying problems are: (a) a lack of wage flexibility that keeps real wages above

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[1] The primary surplus was 1.7 per cent of GDP in 2019 (national statistical institute's data). We estimate the change in the structural balance and the structural primary balance to be at 0.8 percent and 0.5 per cent of GDP, respectively.

[2] IMF Country Report 19/40.

productivity levels; and (b) an excessively regulated product market. **The authorities are not persuaded that staff have provided compelling evidence in this sense.** They believe that:

- Over the years the **Italian labor market has become substantially more flexible**. In fact, the OECD has provided evidence suggesting that the labor market liberalization may have gone too far, resulting in excessive turnover that makes on-job training harder[3]. More fundamentally, nominal wages have stagnated over the last decade and standard measures of competitiveness have improved. Finally, the emphasis on excessive unit labor costs is not consistent with the recent favorable developments in export market shares.
- **Much has already been done in product-market liberalization**, and therefore further benefits may be limited. Italy's retail sector is already undergoing a deep restructuring, due to changes in purchasing behavior of customers in a context of increased diffusion of e-commerce.

The authorities would have preferred to **focus the discussion on more ambitious measures to increase productivity such as promoting innovation, enhancing investment, and favoring the transition toward renewable energy to reduce carbon emissions**. The authorities plan to focus on investment and education and are determined to exploit the full potential of the European Green Deal to boost productivity. Like other major European economies, Italy faces challenges in adapting its manufacturing-based economy to a quickly changing productive landscape because of innovation and the need to mitigate climate change. At the same time, these demands provide major opportunities to unleash the country's entrepreneurial potential, so to generate new employment and raise per-capita incomes that have stagnated for too long. The authorities' objective is not only raising growth, but also reducing inequalities and addressing pressing social needs. To this aim, they have made the citizenship income operational and strengthened the coordination of local agencies for active labor market policies under the direction of a national agency. This will foster labor market participation and enhance job opportunities for unemployed and discouraged people, while providing support for people in need.

Staff rightly point to the pressing need for a **comprehensive reform of the tax system** that has grown too complex, and places an excessive burden on labor. The new government has already taken steps to lower the **tax wedge** on labor and is committed to prepare a comprehensive tax reform plan to be discussed with stakeholders. The objectives are broadening the tax base, further lowering the tax burden on labor, preserving progressivity, and fostering decarbonization.

IV. Carbon Taxation

Italy has already achieved **all the Lisbon climate and energy objectives for 2020** and is **on track** to achieve the EU-agreed emission reduction targets by 2030.[4] We regret that the staff report does not

[3] OECD Italy's Economic Survey 2019 and OECD Employment Outlook 2019.

[4] Italy is one of the very few countries in Europe to have achieved the Lisbon environmental objectives for 2020: (a) a reduction of 20 percent both in CO_2 emissions and in energy consumption compared to 1990;

acknowledge this achievement explicitly. Moreover, the authorities fail to understand **the rationale for staff proposing a "*uniform carbon tax of €70*"**. In fact, the authorities estimate the implicit tax rate on CO2 emissions already at euro 149 per ton in 2017. It should also be noted that Italy's energy taxation is already among the highest in Europe.

V. Debt Sustainability Analysis (DSA)

Staff dedicate much attention to the DSA. **The authorities believe that the staff's projections of the long-term debt dynamics illustrated in the chart on page 13 are misleading for three main reasons:**

- Staff assume that the "VAT *safeguard clauses*" will not be operational, when in fact they were largely offset by tax and expenditure measures in the budget for 2020. **The authorities are committed to do the same for the foreseeable future**.
- Staff's projections for pension spending inexplicably differ from the authorities'. Moreover, the projections assume a primary surplus of only 1 percent of GDP when the 2019 outturn was 1.7 percent.
- Staff assume a large gap between the real interest rate on government debt and the real rate of growth for a period that implausibly extends to 2050.

VI. Banking Sector Reforms and the Recommendations of the Financial System Stability Assessment (FSSA)

The FSSA rightly highlights that the Italian financial sector has strengthened substantially, despite a difficult context in the aftermath of a double-dip recession. The remarkable improvements in both bank capitalization and asset quality demonstrate the effectiveness of the authorities' supervisory and crisis management approach. The authorities continue to focus on further improving banks' resilience by addressing remaining pockets of vulnerability and building up liability buffers that can help to absorb losses.

The FSAP exercise contains important findings and recommendations, which have already given rise to analyses and projects for change. Yet, the authorities believe that some of the **staff's recommendations do not consider the difficult environment in which supervision has taken place in the last years, mainly as a result of the complex European institutional setting for crisis management for small institutions. We believe that the recommendations are not well-tailored** to the reality of the Italian financial sector; **they overly rely, instead, on, so called, "international best-practices",** as pointed out by a recent IEO report.[5] The authorities, in particular, have issues with the following recommendations:

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and (b) a 17 percent share of energy consumption from renewable sources (Italy's Ministry of Economic Development).

[5] 2019 Report of the IEO on IMF Financial Surveillance recommends: "*The FSAP advice should be fully anchored in the local circumstances and not overly reliant on off-the-shelf "international best practice" more suited in other contexts"*.

- "*Consider more timely escalation of corrective action for problem Less Significant Institutions with persistent weaknesses*". **The authorities believe that corrective measures have been taken as timely and escalated as possible**, once one takes into account: (a) potential financial stability implications; (b) contagion risks; and (c) the shortcomings of the European bank crisis management framework (acknowledged in the Euro Area FSAP). In line with supervisory and crisis management practices adopted internationally, the approach to handle persistently weak banks has been, first, to look for **market solutions,** and then to apply orderly wind-downs, with the aim of minimizing possible systemic risk for financial stability.
- The interventions by the "*Deposit Guarantee Scheme for preventive measures should be avoided as much as possible*". This recommendation **is not supported by sound empirical evidence on the performance of preventive measures**. The authorities stress that, in the absence of an orderly liquidation regime for smaller banks, the DGS preventive interventions constitute a useful tool to handle bank difficulties. These interventions can avoid liquidations that could entail higher overall costs. It should also be noted that **these interventions are explicitly envisaged by the European legislation** and fully consistent with the Core Principles of the International Association of Deposit Insurers. The authorities provided the FSAP team with evidence showing that **Italian DGS' preventive interventions have been broadly successful in restoring banks' viability through private sector solutions** and preserving financial stability.[6]
- Staff are concerned about "*potential misuse of public funds*" in the management of bank crises. The authorities believe these concerns are misplaced because, **under the current European framework, public funds cannot be used even in the presence of a systemic threat to financial stability**—a shortcoming that the Euro Area FSAP has correctly highlighted. **It is surprising that these considerations were not reflected in the staff's assessment**.
- The staff's recommendation to **unilaterally adopt prudential measures against sovereign risks—**without discussing its benefits and costs—**constitutes an unjustifiable endorsement to a party of the ongoing political debate at the EU level.** In fact, the Regulatory Treatment of Sovereign Exposures (RTSE) is the subject of a highly politically charged European debate. Changes to the RTSE are just not viable at this juncture, because they would require both creating a European Safe Asset and establishing a European Deposit Insurance Scheme, which will take time to materialize. **If followed, the staff's recommendation could have an adverse impact on the Euro Area's financial stability.**

[6] Indeed, out of the 57 preventive interventions undertaken by the two DGSs operating in Italy since 1997 (5 by the FITD – *Fondo Interbancario di Tutela dei Depositi*, the main Italian DGS, and 52 by the FGD*, Fondo di Garanzia dei Depositanti del credito cooperativo*, the specific DGS for mutual banks), 45 were successful (2 by the FITD and 43 by the FGD), 9 were not successful (meaning that some years after the preventive intervention a liquidation followed); the remaining 3 (by the FITD) are currently ongoing. These results were neither challenged by the FSAP team nor contrasted with empirical evidence from other countries.