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Italy: 2004 Article IV Consultation—Staff Report; Staff Statement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Italy

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2004 Article IV consultation with Italy, the following documents have been released and are included in this package:

- the staff report for the 2004 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on November 10, 2005, with the officials of Italy on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on January 12, 2005. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a staff statement of February 7, 2005 updating information on recent developments.

- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its February 7, 2005 discussion of the staff report that concluded the Article IV consultation.

- a statement by the Executive Director for Italy.

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

Selected Issues Paper

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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ITALY

Staff Report for the 2004 Article IV Consultation

Prepared by Staff Representatives for the 2004 Consultation with Italy

Approved by Alessandro Leipold and Michael Hadjimichael

January 12, 2005

- Article IV discussions were held during October 27–November 10, 2004. The staff—Messrs. Cottarelli, Drummond, Gerson, and Lissovolik (all EUR), Ms. Fedelino (FAD) and Ms. Sgherri (EUR)—met with the Ministers of Economy and Finance, Health, and Productive Activities; the Governor of the Bank of Italy; and other officials, and with representatives from the private sector, research institutions, and labor and business organizations. Mr. Padoan (OED) attended most meetings. Mr. Carstens attended the concluding meetings on November 10.
- The Article IV mission coordinated its work with that of a partially-overlapping FSAP mission.
- The center-right coalition government in power since June 2001 enjoys a large parliamentary majority. Elections are due in 2006.
- Italy has accepted the obligations of Article VIII, Sections 2, 3, and 4, and maintains an exchange system free of restrictions on the making of payments and transfers for current international transactions, except for exchange restrictions maintained for security reasons and which have been notified to the Fund (Appendix I).
- At the conclusion of the last Article IV consultation (on November 7, 2003) Executive Directors noted the need for more determined fiscal consolidation and for structural reforms to raise productivity and employment. For additional information, see http://www.imf.org/external/np/sec/pn/2003/pn03134.htm.

Contents   Page

Executive Summary 3

I. Focus of the Consultation 4

II. Report on the Discussions 5
  A. Cyclical Outlook 5
  B. Growth Trends...9
  C. Fiscal Policy 11
  D. Labor and Product Market Reforms...21
  E. Financial Sector 25
  F. Other Issues 26

III. Staff Appraisal 27

Boxes
1. Response to Key Recommendations of the 2003 Article IV Consultation.............5
2. Competitiveness..7
3. Monetary Conditions 8
4. Pension Reform..15
5. Fiscal Sustainability 17
6. Gap Between the Fiscal Deficit and the Borrowing Requirement.......................20

Tables
1. Selected Economic and Social Indicators 32
2. General Government Accounts, 1999–2005..33
3. Selected Indicators of Vulnerability 34
4. Financial Soundness Indicators 35
5. One-off Fiscal Measures, 2000–05 36
6. Public Sector Debt Sustainability Framework, 1999–2009 37

Appendices
I. Fund Relations 38
II. Statistical Information 40

EXECUTIVE SUMMARY

A cyclical recovery is underway, but its pace is expected to remain moderate, with growth recovering only to potential in 2005. The fiscal situation remains weak, with the deficit close to the SGP ceiling despite substantial one-off measures and with the debt ratio continuing to exceed 100 percent of GDP. Fiscal pressures are likely to rise over the coming years due to population aging, and the staff views as essential a faster pace of fiscal consolidation than planned by the authorities. Labor force participation rates have risen steadily over the last decade, but productivity has been stagnant, underscoring the need for structural reforms to enhance product market competition and improve the business environment.

Improved external sector performance has contributed to a recovery of output growth, but medium-term prospects remain a concern. Staff forecasts growth of 1.7 percent in 2005, in line with consensus forecasts, and below the authorities' forecast of 2.1 percent. The authorities agree that risks are on the downside. Labor market reforms have led to a steady increase in hours worked, but lagging productivity has undermined growth. Potential growth is estimated at 1¾ percent. Raising it will require measures to further increase the employment ratio and boost productivity, which has stagnated in recent years.

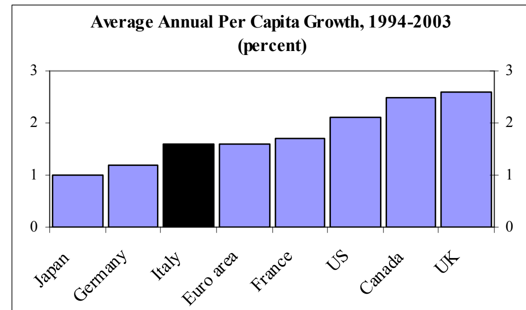
The fiscal adjustment envisaged by the authorities for 2005 is too small, particularly in light of limited progress in fiscal consolidation in recent years. Moreover, it is unlikely to be achieved without further action. Staff and the authorities agreed on the need to eliminate the deficit, phase-out one-off measures, and reduce the tax burden in the coming years, but disagreed on the relative priorities. While the authorities saw a case for making progress in all three areas in 2005, staff argued that deficit-reduction and the elimination of one-off measures should have assumed priority, primarily because tax cuts would have little impact if not seen as sustainable. Moreover, there is a significant risk that the fiscal targets will be overshot in 2005 and the authorities should stand ready to introduce additional measures if necessary.

A lack of competition in key sectors and problems with the business environment were recognized as impediments to investment, innovation and growth. Progress was being made in increasing competition in the energy sector, but in other areas—notably wholesale and retail trade and professional services—opposition by vested interests had blocked reform. Efforts were also underway to enhance Italy's business environment, where lengthy legal proceedings and the high costs of opening and closing businesses were particularly problematic. Passage of a modern bankruptcy law has been delayed further.

The financial system was found to be resilient, but passage of "post-Parmalat" reforms to strengthen securities regulation should be a priority. Banking system profitability is improving, and the first stage of the FSAP assessment of Italy gave a positive assessment of financial sector developments. The staff urged Italy to increase its level of ***official development assistance,*** and called on the authorities to continue to resist pressures for increased trade protection following the elimination of textile export quotas.

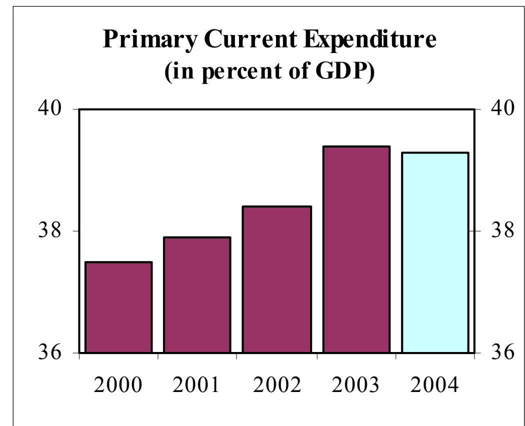
I. FOCUS OF THE CONSULTATION

1. **Slow growth and unresolved fiscal problems have for years been defining features of Italy's economic landscape**. Growth has averaged just 1.7 percent over the last decade. Per capita growth has equaled the euro area average but has lagged that in the United States by half a percent annually and that in Canada and the United Kingdom by a full percentage point. On the fiscal side, Italy's public debt ratio is among the largest in the world, tax and spending ratios are high, and age-related spending will rise significantly over the coming decades.



2. **In previous Article IV consultations the authorities and staff had broadly agreed on the overall strategy to address these problems.** In particular, the authorities' 2001 medium-term program—their first after coming to power—set an ambitious agenda. Sizable cuts in current spending ratios, in the context of pension and other fiscal reforms, were expected to move the fiscal accounts into balance by 2003 while still allowing tax pressure to fall, reducing uncertainty and boosting incentives to invest and work. Together with further labor market liberalization, privatization, and increased product market competition, fiscal consolidation would lead to faster growth, giving rise to a virtuous circle. During Article IV consultations the Fund has strongly supported this agenda.

3. **Unfortunately, policy implementation has fallen well short of targets.** The recent pension reform, which strengthens the reforms introduced since the mid-1990s, is an important fiscal success. However, in the context of an initially unfavorable external environment, lack of consensus within the coalition on where to cut has prevented a downsizing of the public sector, and spending ratios have actually risen. One-off measures, including tax amnesties, have been repeatedly used to stem the rise of the fiscal deficit, which has nevertheless approached 3 percent of GDP in 2004. Some further labor market reforms have been introduced, but product market reform has lagged (see Box 1 for a discussion of progress in implementing last year's Fund recommendations).



4. **The 2004 Consultation revisited the same themes as previous discussions, but political realities have led to some adjustment of the authorities' priorities.** In particular, with general elections scheduled for 2006, delivering on a key electoral promise—cutting taxes—has become a pressing goal for the government. Thus, a key focus of the 2004

Box 1. Response to Key Recommendations of the 2003 Article IV Consultation

Fiscal consolidation: During the 2003 Article IV consultation the Fund recommended reducing the cyclically adjusted (or structural) deficit net of one-off measures by 1 percent of GDP in 2004. The initial budget proposal was close to this target, but the decline currently projected is only 0.4 percent of GDP.

Pension reform: In August 2004, Parliament approved the "framework law" on the pension reform, which the Fund had supported. Legislative decrees to implement the law are expected to be introduced during the next 18 months.

Competition, product market reform, and the business environment: Since last year's Article IV consultation little has been done to address the lack of competition in key sectors or to eliminate bureaucratic hurdles to entrepreneurial activity. *Inter alia*, the reform of the bankruptcy law has been once again delayed.

Labor market reforms: In June 2003, the government approved a draft decree enacting the first part of a "framework law" on employment and the labor market. The 2003 Article IV mission had called for passage of the second half of the reform, but this has not occurred. The statistical authorities have not completed the work on regional price indexes, which rendered moot the staff's proposal that the authorities take the lead in promoting wage decentralization through regional cost of living allowances for public servants.

consultation discussions—and an important area of disagreement between authorities and staff—was the extent to which tax cuts should have priority over fiscal consolidation needs.

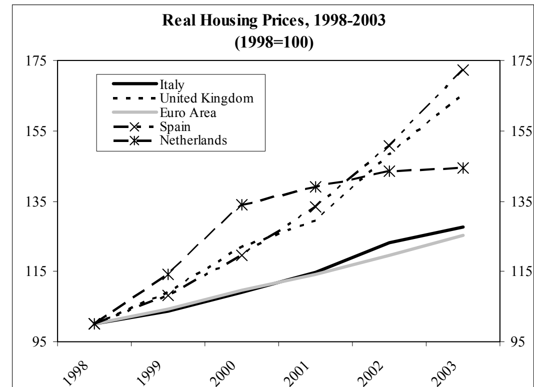
II. Report on the Discussions

A. Cyclical Outlook

5. **In the first three quarters of 2004 real GDP rose by 1.2 percent over the same period of 2003, driven by stronger external demand and investment.**

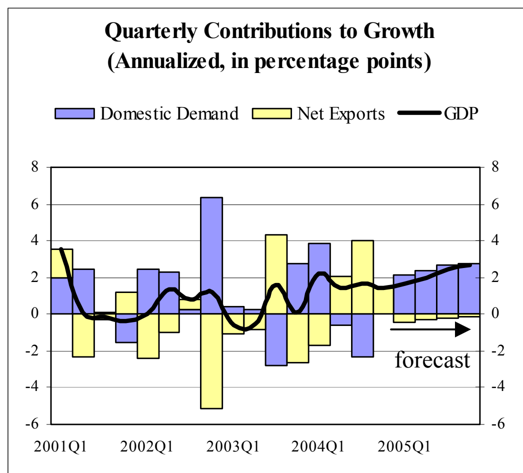
- As exports benefited from the supportive global environment, the external contribution strengthened over the first three quarters of 2004, turning positive in the third quarter on a rolling 12-month basis for the first time since end-2001.

- After falling in 2003 as some tax incentives expired, fixed investment recovered, rising by more than 2 percent in the first three quarters of 2004 over the same period of 2003. Low interest rates and strong increases in house prices continued to favor construction, while improving firm balance sheets and the better external environment boosted equipment investment.



- Private consumption rose by 1.2 percent in the first three quarters of 2004, somewhat less than disposable income.

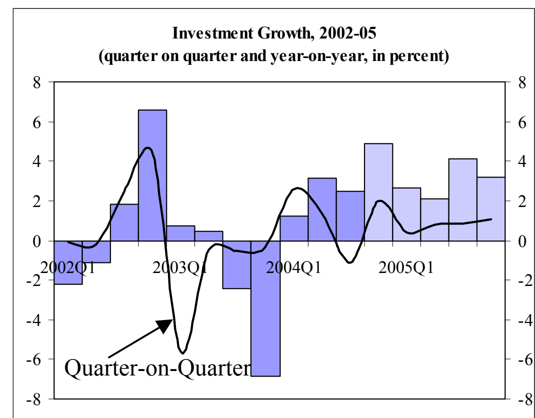
6. **The recovery was expected to take hold but its pace would likely remain moderate**. Staff projects growth of 1.5 percent in 2004 and 1.7 in 2005, broadly in line with EC and OECD forecasts. The authorities project faster growth in 2005 (2.1 percent), reflecting a much stronger forecast for domestic demand growth, arising in part from positive expectations about the impact of tax cuts and structural reforms.



7. **The external environment was seen as the main driver of the recovery.**

- Based on results through the third quarter of 2004, staff now expects a positive net external contribution in 2004–05 on the order of ¾ percent. Nevertheless, concerns about Italy's medium-term external performance remain (Box 2).

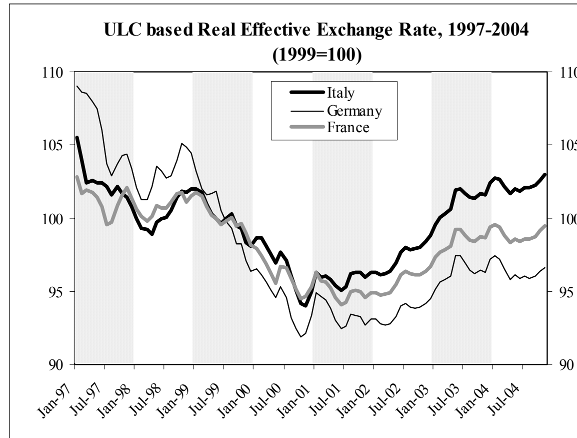
- Private investment was projected to remain solid owing to the favorable external environment, improved firm profit margins as productivity recovered, and stronger balance sheets, in the context of supportive monetary conditions (Box 3), and the rebuilding of inventories (which had fallen in H1 of 2004). The unexpected downturn in fixed investment in the third quarter of 2004 (resulting from a steep fall in transport and possibly also from the impact on confidence of concerns about the sustainabilty of the recovery in Europe), however, underscores the need for caution.

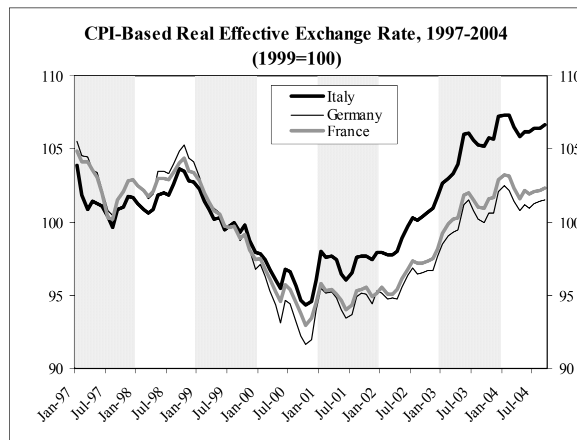


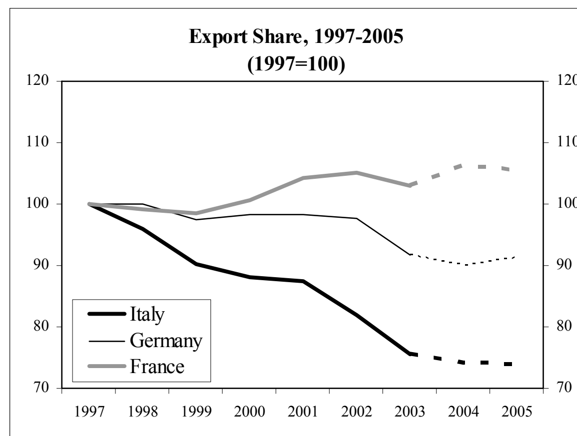
Box 2. Competitiveness

Real exchange rate indicators have appreciated in recent years. Unit labor costs rose particularly rapidly, reflecting poor productivity performance. The authorities, however, stressed that Italy's exports had also suffered from structural changes in world trade: global demand had risen faster for high technology goods where Italy had little market weight, while competition from emerging market manufacturers for traditional Italian exports had intensified.

Underscoring this point, exports of textiles and leather goods, which in 2003 accounted for almost one-sixth of exports, fell by about 4 percent in volume terms during the first half of 2004 compared to the same period of 2003 (also see paragraph 36). In this context, Italy's market shares had performed poorly even vis-à-vis the other large euro-area countries.

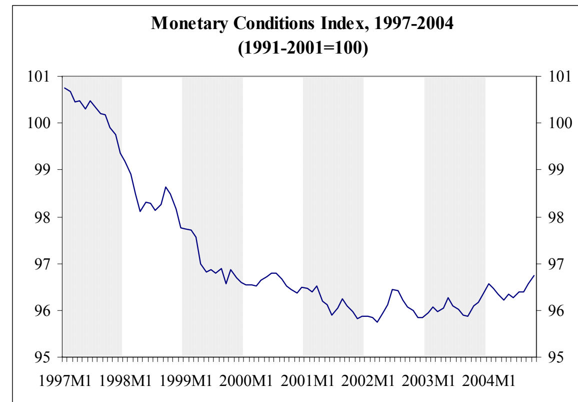




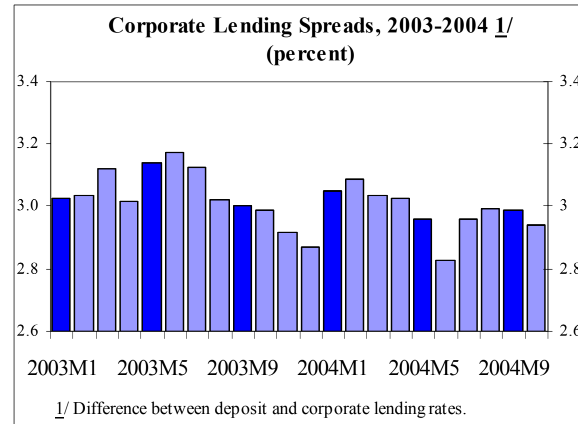


Box 3. Monetary Conditions

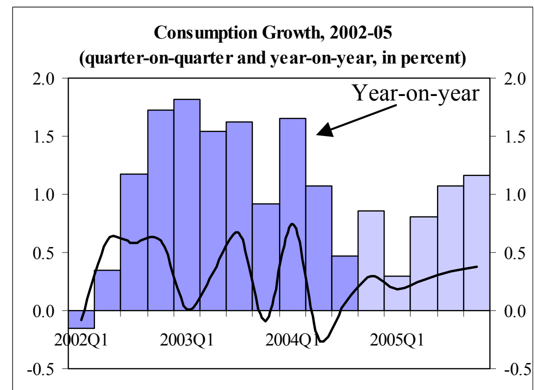
Notwithstanding the euro appreciation, monetary conditions remained relatively accommodative. While overall conditions had tightened fairly steadily since mid-2004, they were still more or less on a par with those at the start of the year, helped by low real interest rates (which were below those prevailing in Germany, for example) and were very accommodative from an historical perspective.



Bank lending to firms had slowed somewhat since mid-2003, and was now growing at a rate close to the euro-area average. Overall, the authorities stated that the behavior of spreads and credit lines suggested that the credit supply had not tightened in the wake of the Parmalat crisis.

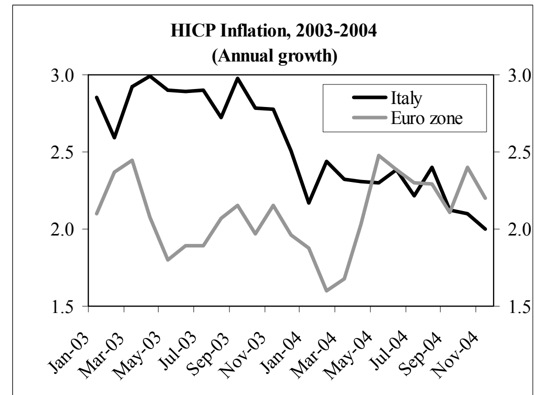


- Consumption fundamentals like employment and real disposable income were holding up relatively well. Stronger household balance sheets—reflecting the aforementioned rise in housing prices—also augured well, though the third quarter 2004 outturn, which featured a second consecutive disappointing result, following a strong first quarter, again points to the need for caution.



8. **The authorities agreed that risks to growth—mainly oil prices and the exchange rate—were on the downside.** Although Italy's energy intensity (total primary energy demand over GDP) was lower than the euro-area average, *oil* intensity was above average, as energy was derived almost entirely from fossil fuels. Staff estimates suggest a $6 per barrel rise in oil prices would lead to an increase in the oil import bill of about 0.3 percent of GDP and reduce growth by about half that much. A stronger euro would pose additional problems for Italian exporters, although it would at least attenuate the impact of high oil prices.

9. **Despite oil price developments, inflation was expected to remain moderate.** The large output gap (estimated by staff and authorities at about 1½ percent of GDP), euro appreciation, and slow pass-through of international oil prices had thus far contained inflation. Twelve-month harmonized inflation had fallen to 2 percent in November, below the euro-area average, and consensus forecasts projected inflation at some 2.2 percent in 2005. With continued moderate wage growth—labor costs per worker had risen by 2.8 percent in the private sector year-on-year in Q2 of 2004—and some cyclical recovery in productivity, staff and authorities agreed that a resurgence of inflation was unlikely.



B. Growth Trends

10. **Italy's poor growth performance over the last decade is largely attributable to total factor productivity developments.** The authorities estimated potential growth at some 1¾ percent, about the same as staff.[1] Over the last decade, labor market reforms had led to a significant increase in hours worked, but total factor productivity had barely risen. Some decline in productivity growth was to be expected—at least transitionally—as firms responded to labor market reforms by shifting to less capital-intensive production methods and as lower-productivity workers entered employment, but the scale and duration of the decline in TFP growth were nonetheless striking, eroding much of the gain from increases in labor over the last decade. Looking ahead—staff concluded—it was important to address not only the

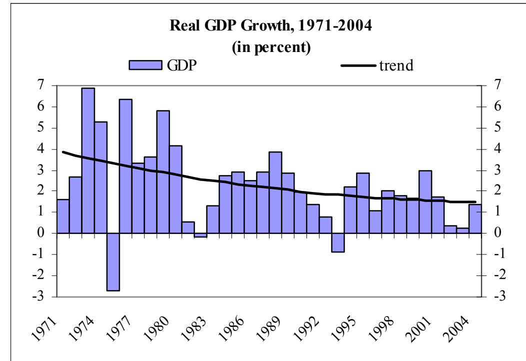
Italy: Contributions to Growth, 1960-2004
(in average annual percentage rate)

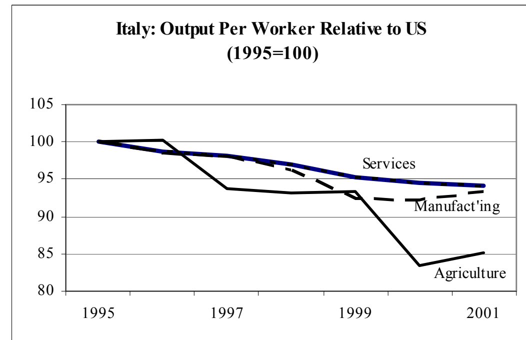
	Labor hours	Capital	TFP	GDP
1960-2004	-0.3	1.3	2.2	3.3
1960-1970	-0.9	1.9	4.8	5.7
1971-1980	-0.5	1.4	2.8	3.6
1981-1990	0.2	0.9	1.2	2.3
1991-2004	0.1	1.1	0.5	1.7

Source: OECD, and staff calculations.

[1] This is based on the traditional production function approach. A Selected Issues paper exploring alternative techniques to isolate cyclical fluctuations from underlying trends in real GDP yields estimates generally consistent with this figure.

factors preventing further employment growth, but also those constraining productivity growth.





11. **Slow growth was generally attributed to a mix of rigidities and resistance to reform.** There were three main themes:

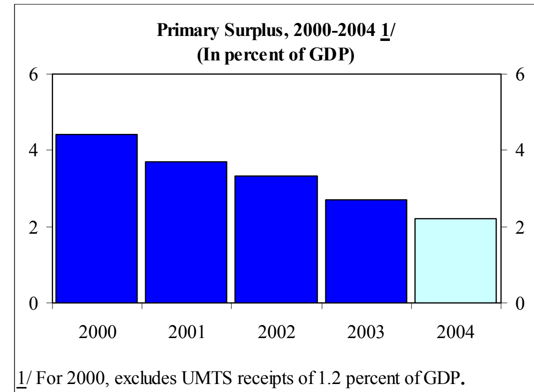
- **Pan-European aspects.** Staff underscored that, as elsewhere in continental Europe, high taxation and uncertainty about fiscal sustainability constrained incentives to innovate, while remaining labor market rigidities slowed firms' responses to structural changes in production processes. As a result, and in contrast to more flexible countries, Europe in general—including Italy—had not fully realized the benefits of the technological revolution of the 1990s.

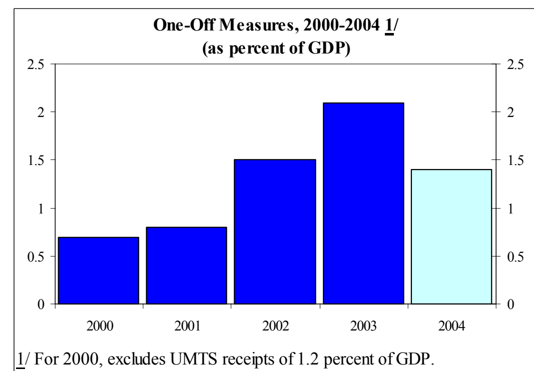
- **Italy-specific factors**. Private sector representatives, academics, and officials pointed to the small size of Italian firms, and associated limited R&D spending; their concentration in low value-added sectors (Box 2 above); the historical weakness of the South; and the faster aging of Italy's population as factors contributing to slow growth. Staff saw some of these factors as symptoms of more general labor and product market rigidities, but recognized that the nature and severity of these deficiencies varied across countries. For example, Italy's labor market rigidities consisted of insufficient wage differentiation and remaining, though reform-reduced, constraints on labor mobility, as well as the high tax wedge. Product market rigidities (including inadequate competition) in some sectors were more severe in Italy than elsewhere. Finally, the legal system was particularly slow and the business climate was generally less favorable than in other advanced economies.

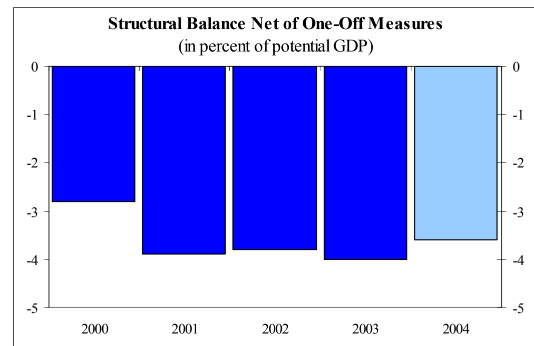
- **Obstacles to reform**. As in many countries, opposition from special interests was an impediment to reform, but the lack of a consensus in favor of change was also notable. Trade unions and some academics disputed the negative effects of high taxes and public spending, pointing to the experience of the Nordic countries. Some government representatives acknowledged that public spending was too high but stressed that this was a European problem, and alleged little could be cut at the margin without a major downsizing of the welfare state, a step public opinion would not support. While such views neglect, for example, the disciplinary aspects of the Nordic welfare states (with their strict enforcement of training, job search, and other eligibility requirements) and the steady rise in primary spending in Italy over the past five years, they nonetheless reflect the fact that a consensus for systemic reforms remains to be achieved.

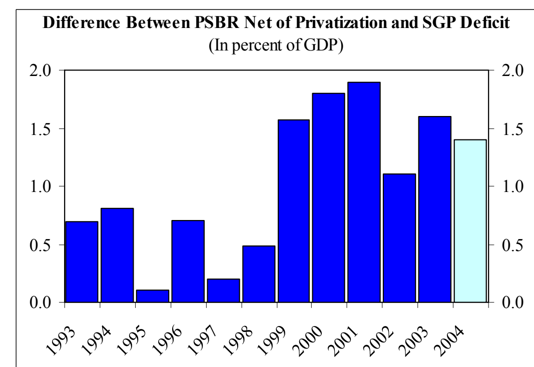
C. Fiscal Policy

12. **Progress in strengthening public finances in 2004 was limited, with recent patterns—missed deficit targets, declining primary surpluses, extensive reliance on one-off measures, and little reduction in the debt ratio—persisting.** Although a mid-year corrective package appears to have been sufficient to keep the deficit below 3 percent of GDP, 2004 was the fourth consecutive year in which the headline deficit exceeded the original budget target. Progress was disappointing by a variety of measures:









- The primary surplus—a key sustainability indicator—is estimated to have fallen to about 2¼ percent of GDP, 3 percent of GDP below the 1995–98 average. Thus, Italy has used the windfall from the drop in the interest burden that followed euro adoption to raise spending rather than to accelerate debt reduction.
- While one-off measures (real estate sales, tax amnesties, and one-off taxes)—which have been used repeatedly in the past to offset rising primary spending and permanent tax cuts—likely fell by more than ½ percent of GDP, they still amounted to almost 1½ percent of GDP.
- As the decline in one-offs is not expected to have been fully offset by permanent measures, the structural deficit net of one-offs is estimated to have declined by less than ½ percent of GDP (remaining more than ½ percent of GDP above its 2000 level). The structural deficit likely actually increased by ¼ percentage point of GDP.
- Finally, the decline in the debt ratio is expected to have again been muted by the large gap between the public sector borrowing requirement (net of privatization) and the SGP deficit, which has averaged more than 1½ percent of GDP since 1999 (see paragraph 20).

13. **The 2005 budget targets only modest reductions in the deficit and one-off measures, in part because of a decision to implement a cut in personal income taxes.**

- The headline and structural deficits are targeted to decline by 0.2 percent of GDP (with the headline deficit at 2.7 percent of GDP). With one-off measures down by 0.4 percentage point of GDP—from 1.4 percent of GDP in 2004 to 1 percent in 2005—the structural deficit net of the latter would fall by 0.6 percent of GDP, to 3.0 percent.

Italy: 2005 Budget and Staff Projections
(in percent of GDP)

	2003	2004	2005	
		Proj.	Budget	Staff
Total Revenues	46.3	45.4	44.6	44.6
Total Expenditures	48.8	48.3	47.3	47.7
Overall Balance	-2.4	-2.9	-2.7	-3.1
Primary Balance	2.9	2.3	2.4	2.0
Memorandum Items				
Structural Balance	-1.9	-2.2	-2.0	-2.4
net of all one-off measures 1/	-4.0	-3.6	-3.0	-3.5
Structural Primary Balance	3.4	2.9	3.1	2.6
net of all one-off measures 1/	1.3	1.5	2.1	1.6
One-off measures 1/	2.1	1.4	1.0	1.0

1/ See Table 5 for breakdown of one-off measures.

- The revenue ratio is targeted to decline by about 0.8 percent of GDP, due both to a decline in the tax ratio and lower capital revenues (the latter arising from the phasing out of tax amnesties). The staff estimates the decline in the tax ratio at about 0.3 percent of GDP. The impact of the tax cut would widen in 2006 by a further 0.2 percent of GDP, and even more if the "solidarity contribution" of 4 percent that applies to the highest-income tax payers is eliminated after 2005, as proposed.[2]
- The spending ratio is targeted to fall by about 1 percent of GDP, largely due to the introduction of a 2 percent cap on the growth of nominal spending (although with some exclusions, notably on social transfers). Health would be subject to an even tighter ceiling, but from a base in 2004 that was inflated by payment of wage arrears. While these cuts are large, they are expected to be achieved primarily by improving spending efficiency, not by cutting entitlements.

14. **Staff argued that a faster improvement than envisaged in the 2005 budget was necessary**. While understanding the need to set politically realistic goals, staff pointed to the fact that the fiscal position was still far from that appropriate for a high-debt country (see paragraph 18), and at the need to make up some of the ground lost through four years of

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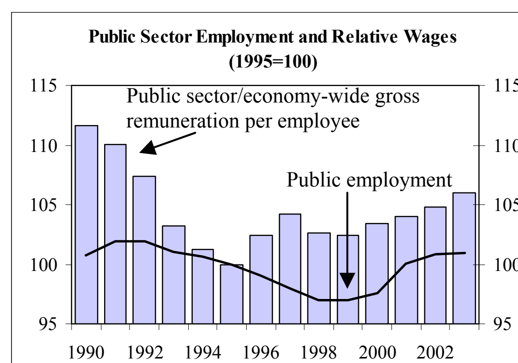
[2] The reform reduces the number of tax brackets from five to three (with a "solidarity contribution" for the highest income taxpayers that, in effect, establishes a fourth bracket) and increases exemption levels for some categories of taxpayers. The reform contains grandfathering provisions ensuring that no taxpayers will be made worse off. The reform also includes some reduction in the corporate tax burden, although this is estimated at only 0.04 percent of GDP.

missed budget targets. Concerns about the fiscal stance had contributed to Standard and Poors downgrading Italian debt earlier in 2004. Moreover, with elections due in 2006, political economy considerations also made 2005 a critical year for fiscal consolidation. Staff emphasized that tax cuts could stimulate the supply side only if they were pursued in the context of sufficient progress in fiscal consolidation and therefore seen as sustainable. The authorities stressed that, the tax cut aside, the contractionary impact of the budget would be larger than implied by the targeted modest decline in the deficit, as replacing one-off measures with permanent ones would have a negative impact on demand. Staff concurred, but underscored that as one-off measures also reduce demand (at least for liquidity constrained agents), replacing them with permanent ones was not equivalent to introducing new measures. More generally, given the cyclical upswing, it was time to quicken the pace of fiscal adjustment.[3]

15. **Moreover, staff viewed the measures taken as likely to be insufficient—by 0.4 percent of GDP, and possibly more—to achieve the announced deficit target:**

- Using the staff's lower growth projection, which was in line with consensus projections, revenues would fall short of the budgeted level by about 0.2 percent of GDP.
- The budget assumed that the state road agency (ANAS) would be transferred out of the public sector, taking about 0.2 percent of GDP in investment expenditures off-budget. ANAS continued to receive sizable transfers to cover its operating deficits (on the order of €0.7 billion annually), which had frustrated previous efforts to classify it as a commercial entity and move it out of the public sector. For 2005, the authorities envisaged replacing lump-sum current transfers with "shadow tolls," where budget transfers would depend on actual traffic. The staff expressed skepticism that this arrangement met the spirit of the classification requirements, as it was primarily an accounting transaction that would not affect the underlying fiscal position.



Altogether, the deficit at unchanged policies was likely to rise to at least 3.1 percent of GDP. An additional area of risk, more difficult to

[3] At the time of the discussions the authorities envisaged a somewhat stronger adjustment in the deficit net of one-off measures (some 0.8 percentage point of GDP), which staff had endorsed, while underscoring the strong risk the fiscal targets would be overshot (paragraph 15). However, part of the targeted improvement was lost when the budget was amended in December to include the tax cut of 0.4 percent of GDP, financed largely through one-off measures.

quantify, related to the effectiveness of the still-untested constraints on spending by regional and local governments, particularly as they were not supported by major cuts in entitlements. Risks were highest for health spending, which had been fully devolved to subnational governments and where past efforts to control expenditure had failed. Staff regretted that more could not be done to contain net spending, including by increasing user fees, cutting transfers to enterprises, and through steps to contain the public sector wage bill, which has grown significantly in recent years due to increases in wages in excess of those in the private sector and in employment.[4]

16. **The authorities believed the risks to the budget outturn were manageable and did not take up the staff's call for additional measures of about ½ percent of GDP.** First, they regarded their revenue projections as conservative, creating some margin in case of slower growth. Second, they felt their proposed treatment of ANAS would be accepted, and stressed that ANAS's new commercial orientation reflected not only changes in financing arrangements but also an increased emphasis on cost containment. Third, though acknowledging that regional and local government spending (especially on health) was an area of risk, they believed new controls—including the ability to nominate a receiver to direct overspending regional governments—would prevent overruns. Staff urged the rapid implementation, in case of need, of the tools to ensure compliance, noting that in the past these had been limited or ineffective. More generally, staff called for prompt action to offset any slippage during budget implementation. The authorities indicated their willingness to introduce measures if needed to ensure compliance with the SGP ceiling.

17. **Turning to the medium term, the new pension reform was a significant step towards easing demographic pressures, but age-related expenditures would still rise substantially.** The reform would raise the effective retirement age starting in 2008, with an important effect on medium-term spending trends (Box 4). This would build on the considerable reforms implemented since the mid-1990s. Nevertheless, population aging was expected to increase annual pension spending by about 2 percent of GDP over the coming decades. Annual health spending would also rise, by some 3 percent of GDP according to (conservative) staff estimates.

[4] The budget does introduce a freeze on hiring for the public sector, but the impact on expenditure will be backloaded, with only a small effect in 2005. Moreover, some sectors are exempted from the freeze.

Box 4. Pension Reform

In August 2004, Parliament approved a framework law offering temporary fiscal incentives to delay retirement and, from 2008, raising the effective retirement age. The reform also furthers the development of a fully-funded private pension system by allowing workers to opt out of the mandatory severance/retirement payment scheme (TFR) and instead direct their contributions to retirement funds, including occupational funds.

The statutory retirement age is 65 for men, but those who have contributed to the system for 35 years are eligible for retirement at 57. In 2008, this minimum age will rise to 60 (61 for the self-employed), with one additional year added in 2010 and 2014. Women with 35 years of contributions would continue to be eligible to retire at 57, but with reduced benefits. Men and women with at least 40 years of contributions will remain able to retire at any age.

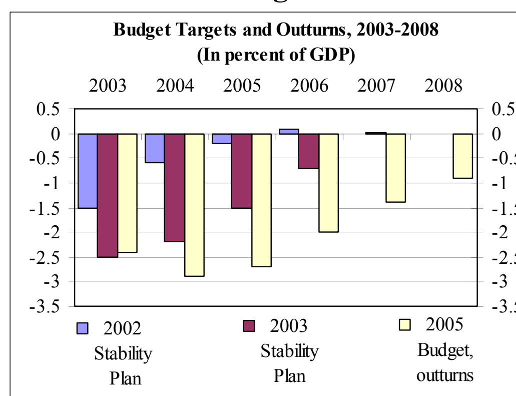
For 2004–07, workers who have met the requirements for retiring at age 57 but opt to defer retirement would pocket (free of income taxes) the corresponding employer's and employee's social security contributions, raising their incomes by about one third. The authorities have prudently estimated that the step would not result in significant savings, with lower pension outlays for workers induced to retire later broadly offset by the costs of foregone contributions from workers who would have deferred retirement anyway. Early data, however, suggested some net saving may arise.

According to the authorities, the long-term financial savings from the reform would peak at about 0.7 percent of GDP by the middle of the 2010s, but would decline gradually to zero by 2040, becoming moderately negative thereafter as longer working lives lead to an increase in average pensions.

18. **Given these pressures, staff saw a need for a rigorous application of the pension reform and for an accelerated pace of fiscal consolidation.** Specifically, the authorities should (i) fully implement the pension reform measures already legislated (including issuing the implementation decrees for the 2004 reform and updating pension replacement rates in line with life expectancy developments every decade, as required by the 1995 reform); and (ii) move to a small fiscal surplus in the coming years, with no one-off measures. Achieving a small surplus by 2009 would imply average annual reductions in the structural deficit net of one-offs of at least ¾ percent of GDP over the next five years, an adjustment pace that did

not seem too demanding for a high debt country. This together with the major privatization efforts envisaged by the government, would over time allow the debt ratio to decline and then stabilize at below 50 percent (Box 5).[5]

19. **However, in contrast to previous years, the medium term targets laid out in the current budget do not contain a commitment to achieve balance, let alone a surplus, within the forecast horizon.** The 2005 budget targeted the deficit to fall only to 0.9 percent of GDP by 2008. Nevertheless, the authorities stated that they remained committed to achieving at least overall balance in the longer term and that the slower pace of adjustment envisioned in the budget reflected a more realistic assessment of what was politically feasible. They also stated that the implementation decrees for the 2004 pension reform would be enacted in 2005, and that the first adjustment of replacement ratios, due in 2005, would not be delayed.



Fiscal Developments and Targets, 2001-08
(in percent of GDP)

	2001	2002	2003	2004 Budget	2004 Est.	2005 Budget	2006 Budget	2007 Budget	2008 Budget
Overall Balance	-2.6	-2.3	-2.4	-2.2	-2.9	-2.7	-2.0	-1.4	-0.9
Structural Balance 1/	-3.1	-2.3	-1.9	-1.7	-2.2	-2.0	-1.5	-1.1	-0.8
Net of One-off Measures 1/ 2/	-3.9	-3.8	-4.0	-2.9	-3.6	-3.0	-1.5	-1.1	-0.8
Borrowing Requirement	4.3	3.5	4.1	...	4.4	4.2	3.9	3.1	3.2
Public Debt	110.6	108.0	106.2	105.0	105.8	104.1	101.9	99.2	98.0

1/ In percent of potential GDP, based on staff estimates of the output gap.
2/ See Table 5 for definition of one-off measures.

[5] In addition to Box 5, the standard debt sustainability template was applied (Table 6). The baseline scenario in the template assumes no change in policies, and thus features a larger deficit (and debt ratio) than the baseline scenario in the Box. The template highlights the sensitivity of the debt ratio to interest rates (although their volatility has likely dropped after euro adoption).

Box 5. Fiscal Sustainability

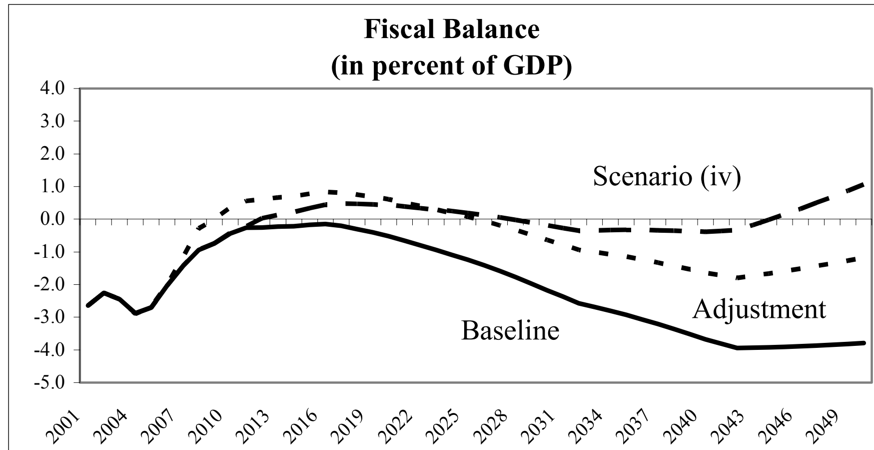
Staff's baseline projection uses, possibly somewhat optimistically given Italy's history of fiscal consolidation, the adjustment path envisaged in the 2005 budget and, thereafter, keeps revenue and non-age-related spending ratios to GDP constant. Health and pension spending reflect the latest ISTAT demographic projections and the pension reforms introduced since the mid-1990s, including in mid-2004. The baseline assumption on health spending (like the authorities') links age-adjusted per capita consumption of health services to growth of GDP per capita. This may underestimate health spending, as health spending has risen faster than GDP in recent years. Labor productivity growth is assumed to rise gradually to 1½ percent annually (from 0.8 percent on average over the last 10 years). The scenario also assumes further gains in the employment ratio (by 5 percentage points over 20 years). These assumptions are more conservative than those in official projections and together result in long-run annual growth of about 1 percent. Along with the application of the provisions of the pension reforms of the last few years, they result in a significant decline in the replacement ratio over the coming decades, which could be difficult to sustain as the share of retirees in the voting population rises.

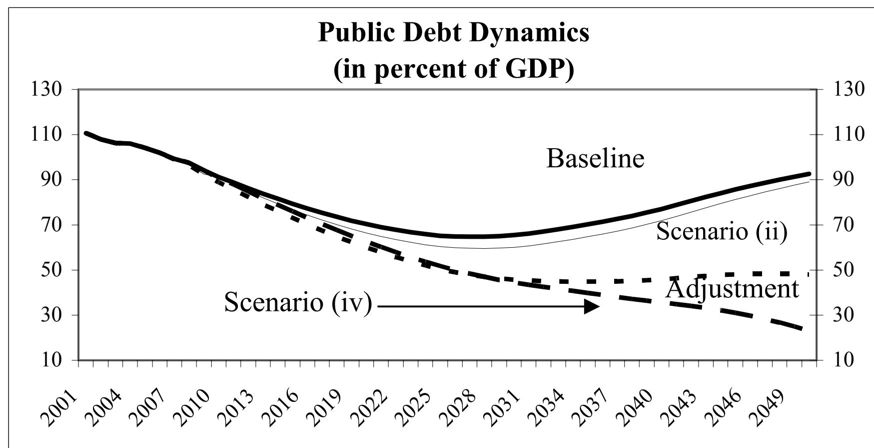
Under the assumptions above, the fiscal deficit would decline through 2010 but rise thereafter, due to increased age-related spending and, later, interest payments. The debt ratio would bottom out in 2025 at about 65 percent and increase thereafter.

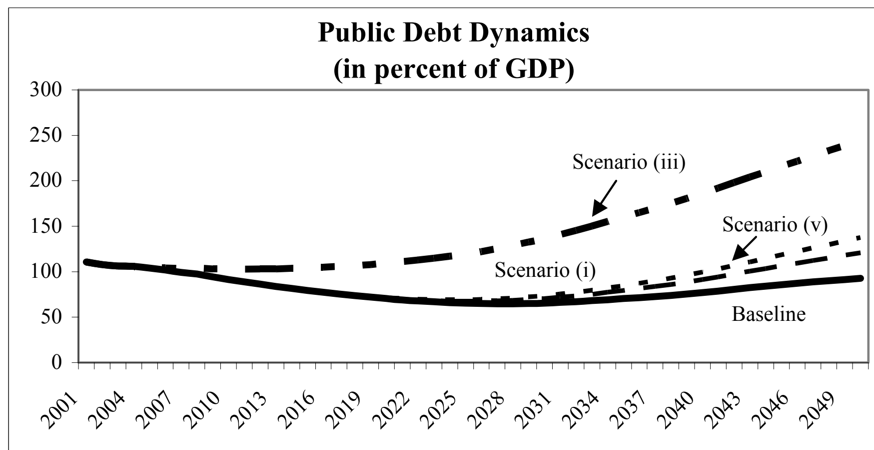
The adjustment scenario features spending cuts sufficient to achieve a small surplus in 2009. Thereafter, taxes and non aging-related spending are held constant as a percent of GDP. Savings on the interest bill allow financing the increase in aging-related spending, with the debt ratio falling to 45 percent by 2035 and then stabilizing.

Stress test scenarios include: (i) slower long-term productivity growth (1¼ percent), which even in the adjustment scenario leads to a rising debt ratio in the long term; (ii) slower population growth (using Eurostat projections, with lower immigration rates), which again leads to upward-trending debt dynamics even in the adjustment scenario; (iii) lack of structural fiscal adjustment over the next four years, leading to a debt/GDP ratio above 200 percent; (iv) a more optimistic productivity growth scenario based on the authorities' assumptions, under which the debt stock falls to 20 percent of GDP by 2050; and (v) failure to implement scheduled adjustments in pension replacement rates in line with life expectancy developments. These results underscore the importance of reforms to increase potential growth and of early action to address fiscal problems, as well as the need for close monitoring given the wide margin of uncertainty.

Box 5. Fiscal Sustainability (continued)







20. **Staff also called for increased fiscal transparency.** One key issue—raised in previous Article IV consultations and recently the subject of a report from the European Commission—was the persistent gap between the SGP-deficit and the borrowing requirement. Efforts had been made to clarify the sources of the discrepancy between the two, but the process was still difficult, and there was no clear economic explanation why some accounting items had grown since 1998 (Box 6). The authorities did not believe that the gap involved any systematic measurement bias. Instead, given the focus of the SGP on the deficit, it was to be expected that operations affecting the borrowing requirement but not the deficit (e.g. accumulation of financial assets, and transfers that were classified below the line under *ESA95*) would rise more rapidly. Be this as it may, understanding the behavior of the borrowing requirement was critical for assessing debt sustainability, and the need for increased transparency in this area was recognized. The need for full transparency in the activities of the institutions promoting public-private partnerships for investment was also agreed. Over the coming years, *Infrastrutture S.p.A.* was expected to finance a growing share of infrastructure spending, which would fall outside the SGP deficit definition. It was essential to provide a clear accounting and economic assessment of any contingent liabilities from its operations.

21. **The authorities' debt reduction strategy features a substantial increase in privatization, although some proposed transactions could pressure future budgets.** Receipts of €100 billion (1.7 percent of cumulative GDP) from below-the-line transactions were planned for 2005-08, starting with about €30 billion (2.1 percent of GDP) in 2005. These figures included sales of equity in state-owned enterprises, the disposal (and possible lease-back) of real estate, securitization of income streams, and other transactions. In addition, the authorities planned above-the-line revenues of €7 billion in 2005, including from the sale of part of the road network: the buyer would be compensated with annual budgetary transfers in lieu of toll payments. The authorities assessed the total value of public sector assets at well above 100 percent of GDP. However, a significant share was controlled by subnational governments, and privatization efforts would therefore depend not only on market conditions but also on the commitment of local and regional governments to reduce the debt burden. Staff noted that some of the proposed transactions—such as sale-leasebacks of real estate and the securitization of income streams—would, like the sale of part of the road network, reduce the debt ratio but increase spending or reduce revenues in the future.

Box 6. Gap Between the Fiscal Deficit and the Borrowing Requirement

Over the period 1999–2003 the annual cash-based borrowing requirement net of privatization receipts (PSBR) exceeded the accrual-based SGP deficit by over 1½ percent of GDP on average. The size of this gap has exacerbated the lingering controversy over consistency of Italy's debt and deficit figures, including a possible underestimation of the latter. Subsequently to the mission, the EC questioned some technical elements of the authorities' SGP deficit calculation, citing the lack of transparency in reconciling the two measures.

The gap broadly reflects differences in three areas: (i) financial transactions affecting the PSBR but not the SGP deficit; (ii) sources of information, with the PSBR compiled by the Bank of Italy differing from that derived from government agencies; and (iii) timing, recording, and valuation rules between cash and accrual accounting.

Difference between PSBR Net of Privatization and SGP Deficit, 1994-2003.
(in percent of GDP)

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	Average 1994-98	Average 1999-2003
Total Difference	0.8	0.1	0.7	0.2	0.5	1.6	1.8	1.9	1.1	1.6	0.5	1.6
Difference in Sources	0.6	0.5	0.7	-0.3	-0.1	0.7	0.4	0.2	0.3	-0.1	0.3	0.3
Impact of Financial Transactions	0.8	0.8	0.8	0.1	0.7	1.4	0.6	0.8	0.6	0.9	0.6	0.9
Cash versus Accrual Accounting	-0.6	-1.2	-0.8	0.4	-0.1	-0.4	0.8	0.9	0.2	0.9	-0.5	0.5

Sources: Bank of Italy, ISTAT, and Ministry of Economy and Finance.

While financial transactions accounted for a large part of the discrepancy over 1994–2003, cash versus accrual accounting explains most of the 1 percent of GDP *increase* in the gap since 1998. Although it was unusual that differences between cash and accrual accounting persistently went in the direction of higher cash deficits, the authorities attributed this to a series of ad hoc factors whose importance varied from year to year: (i) refunds of direct and indirect taxes had accelerated in recent years; (ii) there had been payments of health spending arrears; and (iii) the 2003 tax amnesty lowered the deficit that year, while some cash payments were also delayed to 2004. A persistent delay in the payment of social security contributions of about 0.2 percent of GDP annually—which the authorities argued could be structural—also contributed to the gap.

The authorities provided the mission with clarifications and data on some of the above issues, particularly on taxes and the flows attributed to health spending. At the same time, they noted that regional devolution and some institutional changes (e.g., in the area of pensions) had made the task of adhering to the *ESA95* guidelines very time-consuming, and made "economic" analysis of these discrepancies ever more difficult. Comprehensive health sector data suffered from substantial weaknesses, thereby hindering precise deficit accounting of past debts, but a study group was working to address the issue. Another such group had been created to examine the methodology for social security contributions, in view of the persistent delay in payments.

22. **Progress in implementing constitutionally-mandated fiscal devolution has been slow.** A constitutional reform approved in late 2001 assigned legislative responsibilities across government levels, but designing an implementing framework had proven difficult.[6] Domestic political concerns are by necessity always central to the choice of frameworks, but staff noted that international experience provided some guidance. Specifically, successful implementation depended on transparency and stability of rules and regulations, soundness of monitoring mechanisms, and credibility of enforcement. Improving incentives for compliance would require strengthening coordination of monitoring and enforcement. This would also help ensure ownership of the reform across the political spectrum. The introduction of a pilot program to create a standardized reporting system for cash transactions of government units (SIOPE), to be implemented in 2005, was a step in the right direction, although further efforts to unify accounting standards were needed.

D. Labor and Product Market Reforms

23. **Labor market reforms implemented since the 1990s have continued to pay dividends.** Liberalization of part-time and fixed-term contracts and of the role of employment agencies, pension reforms to discourage early retirement, tax credits for permanent contracts (expired in 2003), and substantial wage moderation had led to sizable increases in the employment ratio and in hours worked. As a result, the unemployment rate had fallen to 8.1 percent in 2004:Q3 (seasonally adjusted), about ¾ percentage point below the euro area average.[7]

24. **Nevertheless, the employment ratio remained the lowest in the euro area, and regional disparities in unemployment rates, while falling, were still substantial.** The authorities agreed that imbalances in unemployment rates could be reduced by greater decentralization of wage bargaining to allow incomes to reflect more closely regional differences in productivity and costs of living. Progress, however, was dependent on the social partners, as there were no legal or regulatory barriers to such arrangements. Employers' representatives indicated their broad support for greater wage differentiation, but

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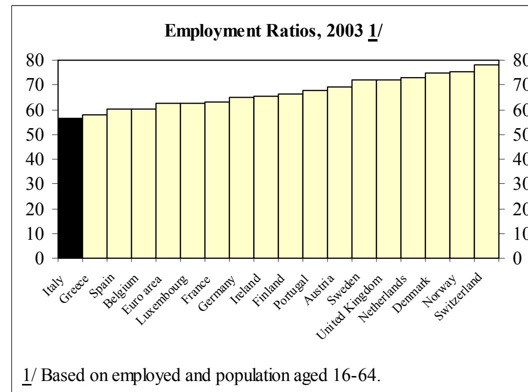
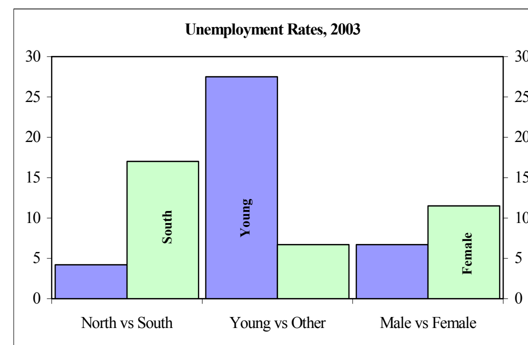
[6] See Chapter V of the Selected Issues paper.

[7] Recent changes to the employment survey to bring it in line with EU norms have resulted in upward revisions to employment and, to a lesser extent, the labor force. Historical time series have been revised backward consistently.

acknowledged that they did not regard it as a priority, partly fearing it would result in higher wages in the North, where most of their membership is located. Some trade unions were considering the merits of increased wage flexibility, but the main one remained against it, arguing the problems of the South lay elsewhere (poor infrastructure and public services). In this context, staff noted that the public sector could facilitate the decentralization process by revising public sector pay scales based on regional cost of living indexes, once these are available. Thanks to recent progress, the OECD calculates that the overall level of employment protection in Italy is slightly below the OECD average, but approval of the second stage of the "Biagi Reform," which was to include some further weakening of employment protection legislation and a redesign of social shock absorbers, could still lead to employment gains. Over the medium term, and as progress in strengthening the fiscal accounts allowed, reductions in the tax wedge—which significantly exceeds the OECD average—would also contribute to further gains in employment.

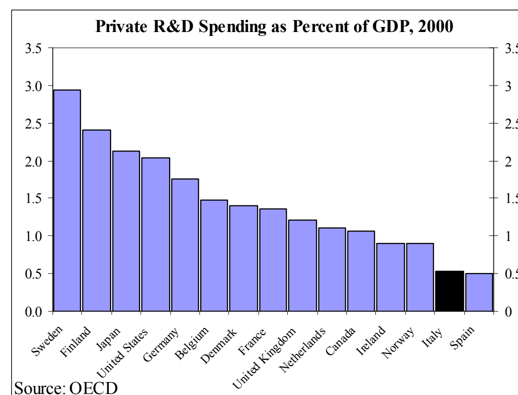


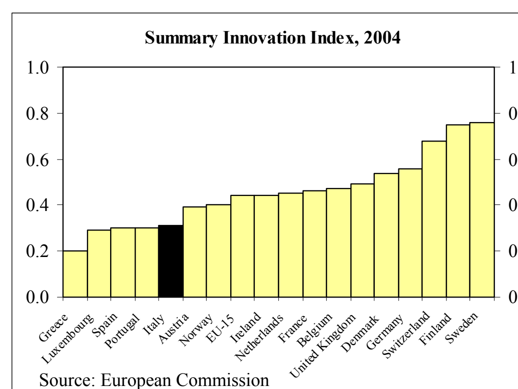
1/ Based on employed and population aged 16-64.



25. **The authorities saw the narrowing of regional disparities in per capita incomes and unemployment rates as a validation of their strategy to promote growth in the South.** The adoption of this strategy, which focuses on enhancing the efficiency of infrastructure investment (including through greater transparency and accountability) and capacity-building at the local government level, had coincided with a narrowing of the per capita income gap between the South and the Center-North, even as regional disparities in other EU members had widened. The rate of new enterprise creation in the South had also outstripped that in the rest of the country over the last several years. Staff welcomed these results, but noted that the improvement remained limited (with South/Center-North relative per capita income rising from about 56 percent in 1995 to 60 percent in 2003). Moreover, employment growth had largely stalled in the South since late 2002, before recovering in the second quarter of 2004 (though unemployment had continued to fall). FDI remained minimal in the South.

26. **Competition in product markets remains problematic, impeding investment, innovation and efficiency.**[8] In key sectors, insufficient competition continues to lead to high prices that are passed on to other firms, hampering their competitiveness and stifling investment. For example, despite Italy's good record in implementing EC regulations on energy policy, a lack of competition had contributed to electricity costs that were 35–40 percent above those in neighboring countries.[9] Barriers to entry established by local governments had impeded competition in wholesale and retail trade. Restrictions applied to the provision of professional services under the guise of consumer protection also resulted in higher costs. By preventing the efficient consolidation of firms, these barriers also discouraged the exploitation of scale economies, risk-taking, and private investment in technology and R&D, which the authorities observed was among the lowest in the OECD.[10] Similarly, Italy's ranking in the EC's 2004 European Summary Innovation Index—a summary of 20 indicators related to knowledge creation and dissemination—was fifth lowest among the EU15.





27. **Efforts were ongoing to increase competition, though with greater success in the energy sector than elsewhere.** Another sizable portion of the electricity company ENEL had been sold in the world's largest privatization in the last two years, and the government was encouraging greater private investment in generation. Prospects for progress in retail trade (among other services) were limited, however, as local governments had so far ignored central government encouragement to liberalize. Although the anti-trust authority had achieved some recent successes, there were concerns about the adequacy of its enforcement

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[8] The 2003 OECD "Economic Survey of Italy" addressed in greater detail many of the issues discussed in this paragraph.

[9] Higher taxes and absence of lower-cost nuclear generation also contribute to high electricity costs.

[10] For evidence on the negative impact on output growth of barriers to firm entry, see Leora Klapper, Luc Laeven and Raghuram Rajan (2004) "Barriers to Entrepreneurship." Available at http://www.hbs.edu/entrepreneurship/conference/papers/klapper.pdf.

powers: little could be done to punish professional associations[11] and—as in much of continental Europe—the authority could not impose criminal penalties.

28. **Recent studies have confirmed problems with Italy's business environment, with negative consequences for investment and growth.** Data compiled by the World Bank showed that the time required to complete the legal processes involved in enforcing contracts is seven times the average for the rest of the euro area.[12] In addition, the costs of opening and closing a business are well-above the euro area average. Surveys compiled by Transparency International report that the perception of corruption in Italy is the second-highest in the euro area; moreover, 41 countries were believed to suffer less from corruption than Italy. And, the World Economic Forum's *Global Competitiveness Report* ranked Italy forty-seventh in the world in terms of the support its business environment gives to growth. Staff noted that the low level of FDI in Italy was also indicative of problems with the business environment. As with competition, Italy's business environment was likely to discourage not only investment but also innovation, firm size expansion, and the entry of new and more efficient firms, thus hampering productivity growth.

Italy--Business Climate

	Italy	€ area avg. 3
Cost of Starting a Business (in pct per capita GDP)	16.2	11.4
Rigidity of Employment Index 1/	50.0	49.0
Legal Framework to Facilitate Lending 2/	3.0	5.7
Time Needed to Enforce Contracts (days)	1390	183
Cost of Foreclosing a Business (pct of estate value)	18.0	6.5

Source: World Bank (2004) *Doing Business Indicators.*
1/ An overall measure that captures hiring and firing costs, plus rigidity of hours worked. Higher numbers indicate a more rigid environment.
2/ Measures how well collateral and bankruptcy laws facilitate lending. Higher numbers denote a more supportive environment for granting credit.
3/ Excluding Italy and, due to lack of data, Luxembourg.

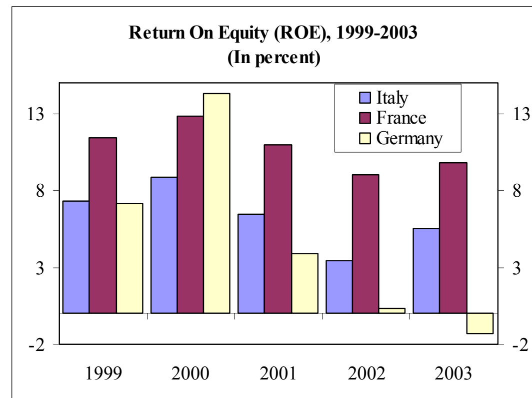
29. **The authorities recognized the shortcomings of the business environment—especially in the South and regarding contract enforcement—but questioned whether investor surveys fully captured the effects of past reforms.** For example, the time needed to open a business had recently been reduced from 22 weeks to 6, while the associated financial costs (though still high by industrial country standards) had fallen by two-thirds over the last several years. The authorities were also reducing red tape, and a large number of "useless" codes had already been phased out. Efforts were ongoing, as well, to address the slowness of the legal system. For example, 12 new corporate tribunals had recently been created. In addition, the authorities were at work on a long-delayed reform of the bankruptcy law. The new law would create a process similar to Chapter 11 in the United States, accelerate firm closure, and—by strengthening lenders' rights—stimulate the flow of credit to small- and medium-sized firms. Staff encouraged the prompt approval of the law, which the authorities had in previous consultations regarded as imminent.

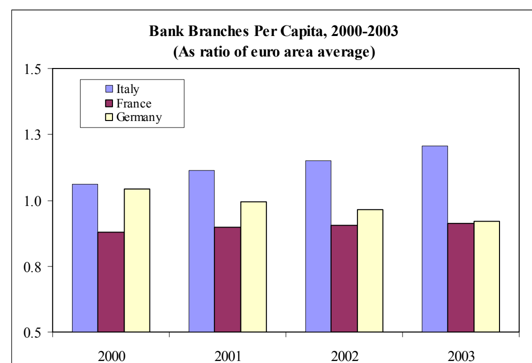
[11] The inability to penalize professional associations arises from the fact that fines are based on turnover, which for most associations is negligible.

[12] A Selected Issues paper examines some of the links between the business environment (including the legal system) and economic performance.

E. Financial Sector

30. **The banking system has evolved substantially in the last 15 years, resulting in greater competition.** The number of banks had fallen by one-third since 1990 due to consolidation, but the number of branches had increased by some 80 percent. In addition, the banking system was now essentially private, while new firms had entered the leasing, factoring and consumer credit markets. Heightened competition was illustrated by falling operational costs, increased productivity, and declining intermediation spreads. Staff observed that competition could be further enhanced through increased involvement of foreign banks, but that—as elsewhere in continental Europe—cross-border mergers and acquisitions have been limited, a fact many analysts had attributed to the opposition of domestic supervisory authorities. In this respect, the authorities expressed concern that Italian banks still faced restrictions in expanding their activities elsewhere.





31. **Indicators of profitability and vulnerability were improving.** Return on equity was expected to rebound to close to 10 percent for the system and to 11 percent for the six largest banking groups. The capital-adequacy ratio, about 11 percent in mid-2004, remained comfortably above the Basel minimum. However, despite a significant improvement in loan quality in recent years, NPL levels remained relatively high.

32. **Market participants expected some restatement of balance sheets with the transition to International Financial Reporting Standards in 2005.** Banks may need to write down the value of nonperforming loans, and some banks were therefore already seeking capital injections. The impact of the introduction of Basel II on bank capital and profits was uncertain, as capital requirements would fall for good clients and rise for bad ones. In principle, the new capital standards could induce banks to reduce lending to smaller enterprises, but some very small firms would qualify for treatment as households under the new rules and thus be subject to more favorable accounting treatment.

33. **Private sector representatives welcomed the stimulus to private retirement savings the recent pension reform would provide.** They agreed the scheme had the potential to increase private saving and accelerate the development of financial instruments to manage longevity and related risks, but expected that at least initially few workers would opt to participate in private plans (other than union-managed occupational funds). The

reform would lead to small increases in costs for firms that had until now been using TRF contributions as a form of inexpensive internal financing. It was expected that the public sector would compensate them for these costs, although the 2005 budget contained no provision to do so.

34. **The authorities had responded to the Parmalat and Cirio scandals by preparing a draft law on savings, but passage had been delayed by political disagreements over some of its provisions.** The authorities had therefore sought to fast-track some elements of the law—those aimed at enhancing the powers of CONSOB (the securities regulator)—by including them in separate legislation incorporating the EU market abuse directive. A number of amendments have been proposed to the remaining elements of the draft savings law—which include the transfer of insurance industry regulation to the Bank of Italy and of responsibility for banking system competition from the Bank to the anti-trust authority—and its timing and final content therefore remained uncertain. Ex post analysis of the Parmalat and Cirio cases suggested that financial intermediaries had sometimes marketed products without ensuring that customers had full information on their risk profiles, and the need to ensure observance of requirements in this area was recognized.

35. **The first of two FSAP missions was completed in early November and gave a positive assessment of financial sector developments.**[13] It found that standards of market regulation and supervision in Italy are comparable with those of other G7 countries; that compliance of securities regulation with the IMF's transparency code is high; and that the securities settlement and clearing systems are safe, sound and efficient. While the mission identified some weaknesses in CONSOB—including a lack of financial resources, insufficient independence from the Ministry of Finance in imposing penalties, and limitations on the sanctions that it can impose—these would be addressed by the draft law on market abuse (see paragraph 34).[14] However, the draft legislation contains no provisions guaranteeing representation of minority shareholders in all listed companies' corporate boards or requiring a majority of independent directors, two measures that, the mission noted, could strengthen corporate governance standards. The second FSAP mission is scheduled for late summer 2005.

F. Other Issues

36. **Recent changes in EU trade policy and developments in the world trading system may significantly affect Italian agricultural and textile producers.** The authorities

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[13] The mission focused on observance of securities markets codes, developing stress testing methodology for banks, investor protection and corporate governance, and the derivative activities of banks.

[14] A Selected Issues paper, based on the work of the FSAP team, reviews Italy's corporate governance system in more detail.

supported the recent revision of the EU's Common Agricultural Policy for so-called Mediterranean products, but looked forward to some rebalancing of the treatment of Mediterranean and Continental products. They were in the process of developing a program with the EC to monitor the effects on Italian firms of the elimination of export quotas under the Multi-Fiber Agreement. Despite anxiety among firms about competition from low-cost producers, the authorities stated that they would resist demands for protection and for implementing safeguard clauses until data from the system could be evaluated. As in the past, they expressed a desire to strengthen protection for intellectual property rights. They hoped detailed modalities for the Doha Round of trade negotiations could be agreed at the next ministerial meeting in December 2005.

37. **Official development assistance rose in 2004—to 0.22 percent of GDP, compared to 0.19 percent in 2003—but remains low.** The authorities intend to increase ODA to 0.33 percent of GDP by 2006, in line with EU commitments. They were also supporting the UK-sponsored initiative to create an International Finance Facility to increase development assistance.

38. **In February the authorities issued a decree implementing the Second European Directive on Anti-Money Laundering/Combating the Financing of Terrorism.** They are participating in working groups on a third decree that would implement some additional recommendations of the Financial Action Task Force, and they are preparing a law to freeze nonfinancial assets of persons related to terrorist groups.

39. **Only limited progress has been made in addressing statistical issues raised in the 2002 ROSC data module report (Appendix II).** Important steps had been taken to strengthen price collection and raise response rates on enterprise surveys, however (see paragraph 20 for a discussion of fiscal data issues).

III. Staff Appraisal

40. **Despite improving near-term prospects, Italy's medium-term outlook remains weak, absent a credible commitment to fiscal consolidation and to significant further reforms.** The fiscal windfall that accompanied euro adoption was used to finance higher current spending, with the deficit now near the Maastricht ceiling—despite substantial one-off measures—and limited progress in lowering public debt. Deficit targets have been missed for four consecutive years, and targets going forward have been revised downward. Fiscal pressures are set to grow as population aging increases spending for health and pensions. The 2004 pension reform has improved the outlook, but much work remains to ensure long-term fiscal solvency. Moreover, deep-seated rigidities in product and labor markets, and the poor business environment, have stifled investment and innovation, and, despite progress, retarded employment growth.

41. **To ensure fiscal sustainability, the budget needs to move to a small surplus over the coming years.** The authorities' assurances that they continue to view overall balance as an appropriate medium-term target are welcome, but this pledge should be accompanied by a

specific timetable. Achieving a small surplus by 2009 while eliminating one-off measures would broadly strike the right balance between the need to make up for past delays and avoiding an excessively abrupt correction. The most recent set of pension reforms is a welcome step toward improving medium-term fiscal prospects. Enacting the legislation necessary to implement the reform during 2005, and application in 2005 of the first of the required adjustments to pension replacement rates in line with changes in life expectancy, would further reduce uncertainty about fiscal sustainability.

42. **The fiscal adjustment envisioned in the 2005 budget falls short of what is needed, in part due to the decision to finance the tax cut largely through one-off measures. Moreover, the budget targets are unlikely to be achieved without further action**. In this light, additional spending cuts should have been adopted, or the tax cuts deferred. Reductions in the tax wedge are important to support medium-term growth, but benefits will be realized only if the cuts are seen as lasting, which requires a sustainable and predictable fiscal environment. The authorities should therefore now be prepared to adopt structural measures in 2005 to at least ensure the target is met. However, should growth be slower than the consensus estimate of 1.7 percent, the automatic stabilizers should be allowed to operate.

43. **While stronger spending cuts would have been warranted, the focus of the budget on reducing the ratio of primary current spending to GDP is welcome.** Any additional measures in 2005 should also target current spending. To maximize the effectiveness of the newly-introduced uniform cap on spending growth for most items, it should be incorporated into a system of multiyear spending reviews to develop and protect budget priorities. In some cases—such as health care—it will also need to be accompanied by changes in entitlements if spending overruns are to be avoided. The proposed increase in privatization receipts over the coming years could improve economic efficiency by putting government assets to more productive use. However, transactions such as the securitization of future income flows, the sale and lease-back of buildings, and the sale of part of the road network will have negative implications for future budgets. The merit of these operations is unclear, and should be assessed transparently.

44. **Fiscal transparency needs to improve**. The large gap between deficits and borrowing requirements should be explored further, focusing on its economic causes. The operations of public entities outside the general government, notably *Infrastrutture S.p.A.*, will also have to be monitored transparently, now that their activities are becoming sizable.

45. **Reforms to accelerate Italy's growth potential are also critical to addressing fiscal weaknesses.** Without a sustained increase in growth, the budget consolidation process will be much harder to manage. The strategy should focus on measures to further reduce labor market rigidities and unlock stagnant productivity.

46. **The improvement in the labor market over the last decade shows that structural reforms do yield results, and need to be continued.** The employment ratio is still low, and regional and demographic disparities in unemployment rates remain large. While only the social partners can agree to decentralize the wage bargaining process to allow a better

alignment of wages with local productivity and costs of living, the government can help start the process by basing public sector wage increases in part on developments in regional price indexes, once they are available. In addition, the second stage of the Biagi Reform—which will help further reduce labor market rigidities—should be approved.

47. **Product market reforms now need to be tackled with the same resolve shown on labor markets.** Additional regulatory reform and further privatization in key network industries like energy can reduce costs and increase competitiveness economy-wide. Strengthening the powers of the anti-trust authority should also be considered. Reforms are particularly needed to address shortcomings in the business environment, which ranks among the least growth-friendly in the OECD. As a first step, the reform of bankruptcy legislation should not be further delayed. Measures are also urgently needed to accelerate other legal processes and further reduce red tape. Progress in this area could contribute to faster reductions in regional income differences, as problems with the business environment are particularly acute in the South. In addition, product market reforms could give additional impetus to labor market reforms, especially where progress is dependent on social partners.

48. **Bank profitability is improving, and financial sector supervision is generally strong, but passage of the post-Parmalat reforms should be a priority.** The draft law on market abuse appropriately gives CONSOB more resources, strengthens its ability to exercise key functions independently, and enhances the sanctions that can be imposed on wrongdoing. Beyond the measures contained in the pending market abuse directive, consideration could also be given to mandating that corporate boards contain a majority of independent directors and to stipulating that they include a representative of minority shareholders.

49. **The authorities should continue to resist pressures for increased trade protection.** They should address worries about the impact on domestic producers of the expiration of textile quotas, as well as their concerns about protecting intellectual property rights, through existing multilateral and regional institutions. Italy's commitment to raise its relatively low ODA is welcome.

50. **Economic statistics have remained broadly adequate for surveillance.** However, in addition to the necessary improvements in fiscal data noted in paragraph 44, faster progress towards addressing the shortcomings noted in the ROSC data module would be welcome.

51. **It is proposed that the next Article IV consultation take place on the standard 12-month cycle.**

Staff Analytical Work on Italy, 2000-04

Fiscal Policy and Entitlement Programs

- Rules-Based Fiscal Policy in France, Germany, Italy and Spain. *Occasional Paper No. 225*
- Pension Reform Issues. *Country Report No. 03/352*
- Social Returns to Education: Evidence from Italian Local Labor Market Areas. *WP/03/165*
- Tax Reform in Italy. *Country Report No. 02/232*
- Redistribution Through Public Employment: The Case of Italy. *IMF Staff Papers, December 2001*.
- Budgetary Transparency for Public Expenditure Control. *WP/01/08*
- Health Care and Its Financing in Italy: Issues and Reform Options. *WP/00/166*
- Italy Fiscal Strategy in a Medium-Term Framework. *Country Report No. 00/82*
- The Evolving Role of Regions in Italy: The Financing and Management of Health Care Services. *Country Report No. 00/82*

Growth and Competitiveness

- Inflation and Competitiveness. *Country Report No. 03/352*
- Regional Convergence in Italy: 1960-2002. *Country Report No. 03/352*
- New Estimates of Potential Output. *Country Report No. 02/232*
- Short-Term Forecasting: Projecting Italian GDP, One Quarter to Two Years Ahead. *WP/01/109*
- Puzzling Out Italy's Growth Performance. *Country Report No. 00/82*
- Seasonality and Capacity—An Application to Italy. *WP/00/80*

Labor Markets

- Regional Wage Differentiations and Wage Bargaining Systems: The Case of Italy. *Country Report No. 02/232*

Financial and Corporate Sectors

- To Buy or Not to Buy? Uncertainty, Irreversibility and Heterogeneous Investment Dynamics in Italian Company Data. *WP/04/104.*
- Italy: Detailed Assessment of Compliance with the Committee for Payment and Settlement Systems (CPSS) Core Principles for Systemically Important Payment Systems. *Country Report No. 04/132*
- Italy: Detailed Assessment of Compliance with the Basel Core Principles for Effective Banking Supervision. *Country Report No. 04/133*

Main Websites for Italian Data

Data in this Staff Report reflect information received by December 31, 2004. More recent data may be obtained directly from the following sources:

National Statistical Office.. http://www.istat.it/

Banca d'Italia.. http://www.bancaditalia.it/

Ministry of Finance.. http://www.tesoro.it/welcome.asp

Information on Italian economic statistics can be found at the Special Data Dissemination Standard website of the IMF..............http://www.imf.org/external/country/ITA/index.htm

Table 1. Italy: Selected Economic and Social Indicators

	1999	2000	2001	2002	2003	2004 1/	2005 1/
Real economy (change in percent)							
Real GDP	1.7	3.0	1.8	0.4	0.3	1.5	1.7
Total domestic demand	3.2	2.3	1.4	1.3	1.2	0.9	1.0
CPI (average index)	1.7	2.6	2.3	2.6	2.8	2.2	2.2
Unemployment rate (in percent)	11.4	10.6	9.5	9.0	8.7	8.3	8.0
Gross national saving (in percent of GDP)	20.3	19.7	19.6	19.4	18.1	18.6	19.3
Gross domestic investment (in percent of GDP)	19.0	19.8	19.7	19.8	19.1	19.7	20.0
Public finance (in percent of GDP)							
General government balance	-1.7	-0.6	-2.6	-2.3	-2.4	-2.9	-3.1
General government structural balance 2/	...	-2.8	-3.9	-3.8	-4.0	-3.6	-3.5
General government debt	115.5	111.2	110.6	108.0	106.2	105.8	104.4
Money and credit (end of year, percent change)							
Private sector credit 3/ 4/	10.2	13.3	7.0	6.2	7.0	7.7	...
National contribution to euro area M3 5/ 6/	2.8	4.7	10.9	10.7	9.5	5.0	...
Interest rates (in percent) 7/							
6-month interbank rate	3.0	4.4	4.3	3.3	2.3	2.2	...
Government bond rate, 10-year	5.7	5.2	5.2	4.3	4.4	3.7	...
Balance of payments (in percent of GDP, unless otherwise noted)							
Trade balance	1.9	1.0	1.6	1.5	0.6	0.7	1.1
Current account balance	0.6	-0.6	-0.1	-0.6	-1.3	-0.9	-0.1
Export of goods and services	25.5	28.3	28.4	27.0	25.4	25.8	26.2
Import of goods and services	23.5	27.3	27.0	26.0	24.9	25.0	24.7
Volume growth (in percent): export of goods and services	0.1	9.7	1.6	-3.4	-3.9	4.3	6.1
import of goods and services	5.6	7.1	0.5	-0.2	-0.6	2.2	3.7
Net imports of crude oil & natural gas (in bln. of U.S. dollars)	13.6	24.4	22.7	21.7	27.7	35.5	36.0
Fund position (as of November 30, 2004)							
Holdings of currency (percent of quota)						65.7	
Holdings of SDRs (percent of allocation)						12.4	
Quota (millions of SDRs)						7,055.5	
Exchange rate							
Exchange rate regime						Participant in euro zone	
Present rate (January 12, 2005)						US$ 1.3122 per euro	
Nominal effective rate (1995=100) 8/	112.4	107.9	109.4	111.9	118.0	119.4	...
Real effective rate (1995=100) 8/ 9/	107.2	102.4	103.0	104.4	109.0	110.8	...
Social indicators							
GDP per capita, in U.S. dollars	2003	25,616					
Population, in millions	2003	57.4					
Population density, inhabitants per square kilometer	2002	196.2					
Income distribution, ratio of income received by top relative to bottom quintiles	2001	5.1					
Life expectancy (years at birth): males	2002	75.0					
females	2002	81.9					
Illiteracy, percent of persons aged 15 and above	2002	1.5					
Gender pay gap, share of female versus male pay, in percent	1995	80.6					
Automobiles per 1000 inhabitants	2000	564.9					
CO2 emissions, in metric tons per capita	2000	7.4					

Sources: Italian authorities; IMF, *International Financial Statistics* ; World Bank, *World Development Indicators* ; Bloomberg; Eurostat; and Fund staff estimates and projections.

1/ Staff estimates and projections, unless otherwise noted.
2/ Structural balances are calculated using the staff's estimates of potential output and exclude one-off measures.
3/ Data for 2004 refer to end-June.
4/ Twelve month credit growth, adjusted for securitizations.
5/ Data for 2004 refer to end-October.
6/ Excludes the currency in circulation held by non-bank private sector.
7/ Data for 2004 refer to end-November.
8/ Data for 2004 refer to end-September.
9/ Based on CPI.

Table 2. Italy: General Government Accounts, 1999–2005
(In percent of GDP)

	1999	2000	2001	2002	2003	2004	2005
						Est.	Proj.
Total revenues	46.6	45.8	45.7	45.3	46.3	45.4	44.6
Direct taxation	15.0	14.6	15.0	14.2	13.6	13.6	13.3
Indirect taxation	15.1	15.0	14.5	14.7	14.5	14.5	14.6
Social contributions	12.7	12.7	12.6	12.8	13.1	13.2	13.1
Other current revenues	3.3	3.0	3.3	3.2	3.2	3.2	3.1
Capital revenues	0.5	0.4	0.3	0.4	1.9	0.9	0.5
Total expenditures	48.4	47.7	48.3	47.6	48.8	48.3	47.7
Current expenditures	44.5	43.9	44.4	44.2	44.7	44.5	44.2
Wages and salaries	10.7	10.6	10.8	10.8	11.0	11.2	11.2
Purchases of goods and services	7.1	7.3	7.7	7.7	7.9	7.6	7.5
Social transfers	17.2	16.8	16.6	17.0	17.2	17.3	17.2
Interest payments	6.7	6.5	6.5	5.8	5.3	5.2	5.1
Capital expenditures	3.9	3.7	3.9	3.4	4.1	3.8	3.5
Of which: asset sales 1/	0.0	-0.1	-0.2	-0.9	-0.2	-0.3	-0.5
Overall balance	-1.7	-1.8	-2.6	-2.3	-2.4	-2.9	-3.1
Primary balance	5.0	4.6	3.9	3.5	2.9	2.3	2.0
Memorandum items:							
Structural overall balance 2/	-1.5	-2.2	-3.1	-2.3	-1.9	-2.2	-2.4
Net of all one-off measures 3/	....	-2.8	-3.9	-3.8	-4.0	-3.6	-3.5
Structural primary balance 2/	5.2	4.3	3.5	3.5	3.4	2.9	2.6
Net of all one-off measures 3/	....	3.7	2.7	2.0	1.3	1.5	1.6
Nominal GDP (in billions of euros)	1,108	1,167	1,219	1,260	1,301	1,354	1,407
Public Debt (in billions of euros)	1,273	1,297	1,348	1,361	1,382	1,432	1,469
Public debt	115.5	111.2	110.6	108.0	106.2	105.8	104.4
Real GDP growth (in percent)	1.7	3.0	1.8	0.4	0.3	1.5	1.7

Sources: ISTAT; Ministry of Economy and Finance, RPP (September 2004) and Fund staff calculations and estimates.

1/ For 2000, excludes UMTS revenues of 1.2 percent of GDP.
2/ In percent of potential GDP.
3/ See Table 5 for definition of one-off measures.

Table 3. Italy: Selected Indicators of Vulnerability 1/

(In percent of GDP, unless otherwise indicated)

	1997	1998	1999	2000	2001	2002	2003	2004	
								Latest Est.	Date
External indicators 1/									
Exports (annual percentage change, in U.S. dollars)	5.2	2.8	1.8	17.8	5.0	-1.7	-3.5	5.2	
Imports (annual percentage change, in U.S. dollars)	11.7	5.2	7.4	25.6	2.4	-1.9	-0.2	5.5	
Terms of trade (annual percentage change)	-1.5	2.0	0.3	-7.2	0.6	2.3	1.3	-0.2	
Current account balance (settlement basis)	2.4	1.5	0.6	-0.6	-0.1	-0.6	-1.3	-0.9	
Capital and financial account balance	-1.5	0.5	-0.6	0.7	-0.2	0.7	1.4	1.1	
Of which : Inward portfolio investment (debt securities, etc.)	6.3	9.3	8.8	5.3	2.7	2.8	4.2	...	
Inward foreign direct investment	0.3	0.2	0.6	1.2	1.4	1.2	1.2	...	
Other investment liabilities (net)	1.2	0.8	3.3	2.5	0.8	-0.5	3.0	...	
Official reserves (in U.S. dollars, billions, end-of-period) 2/	55.7	29.9	22.4	25.6	24.4	28.6	30.4	27.7	Oct
Contribution to euro area M3 (in percent of reserves) 3/	13.6	27.5	29.5	24.9	27.1	30.6	38.8	43.9	Oct
Central Bank foreign liabilities (in U.S. dollars, billions) 2/	1.1	1.0	6.3	0.2	2.2	3.1	0.5	1.0	Sept
Foreign assets of the financial sector (in U.S. dollars, billions)	198.5	225.1	175.4	175.5	152.7	224.5	310.9	...	
Foreign liabilities of the financial sector (in U.S. dollars, billions)	239.2	268.9	248.7	278.1	275.6	315.3	413.5	...	
Official reserves (ratio to average monthly imports) 2/	2.6	1.3	1.0	1.1	1.0	1.1	1.0	...	
Total external debt	59.0	71.1	72.0	82.5	81.5	91.4	94.7	...	
Of which : General government debt	25.4	31.1	29.7	35.2	35.0	42.0	44.2	...	
Total external debt to exports (ratio)	2.2	2.7	2.9	3.0	2.9	3.5	3.8	...	
External investment income payments to exports (in percent)	18.0	19.9	18.8	16.4	15.5	17.6	19.6	...	
Exchange rate (per U.S. dollars, period average)	0.88	0.90	0.94	1.09	1.12	1.06	0.89	0.80	Oct
Financial market indicators									
Public sector debt (Maastricht definition)	120.2	116.4	115.5	111.2	110.6	108.0	106.2	...	
3-month T-bill yield	6.3	4.6	3.0	4.5	4.1	3.3	2.2	2.1	Oct
3-month T-bill yield (real)	4.4	2.6	1.3	1.9	1.4	0.6	-0.6	0.0	Oct
Stock market index (year end)	55	78	96	100	75	58	66	74	Nov
Share prices of financial institutions (year end)	51	79	82	100	71	50	62	67	Nov
Spread of 3-month T-bills with Germany (percentage points, period average)	3.0	1.2	0.1	0.2	0.4	0.3	0.2	0.1	Oct
Financial sector risk indicators 4/									
Foreign exchange loans (in billions of U.S. dollars)	67.1	73.7	45.4	50.0	45.7	43.9	49.1	...	
Share of foreign exchange loans in total lending (percent)	9.4	9.1	5.9	6.1	5.5	4.2	3.7	...	
Deposits in foreign exchange (in billions of U.S. dollars)	24.1	25.8	21.8	22.3	22.1	29.2	...	...	
Share of foreign deposits in total deposits (percent)	3.9	4.0	3.9	4.2	4.1	4.6	...	...	

Sources: Bank of Italy, *Economic Bulletin* and *Statistical Bulletin* ; data provided by the authorities; IMF, *International Financial Statistics* and *Balance of Payments Statistics Yearbook;* and Fund staff estimates and projections.

1/ The interpretation of some indicators is affected by the launch of monetary union in 1999.
2/ Reserves and foreign liabilities refer to the Bank of Italy, both before and after EMU; excluding gold.
3/ Definition of M3 from 1999 onwards excludes currency held by the public.
4/ Data refer to banks, including cooperative and mutual banks.

Table 4. Italy. Financial Soundness Indicators
(In percent unless otherwise noted)

	1999	2000	2001	2002	2003	2004H1
Deposit-taking institutions			*Core set*			
Capital adequacy						
Regulatory capital to risk-weighted assets 1/	10.6	10.1	10.4	11.2	11.4	...
Regulatory Tier I Capital to risk-weighted assets 1/	8.6	7.8	7.8	8.2	8.5	...
Regulatory Tier II Capital to risk-weighted assets 1/	2.4	2.8	3.1	3.3	3.3	...
Asset quality						
Nonperforming loans to total gross loans 2/	9.8	7.8	6.7	6.5	6.6	6.7
Nonperforming loans net of loan loss reserves to Tier I capital 2/	38.9	30.1	26.8	25.0	24.1	22.0
Sectoral distribution of loans to total loans						
General government	7.6	6.4	5.8	5.3	4.7	4.8
Financial corporations	13.0	14.4	14.7	14.6	13.8	12.5
Non-financial corporations and sole proprietorships	59.4	59.3	59.3	59.1	59.6	59.7
Building and construction	7.6	7.0	6.8	6.9	7.2	7.4
Consumer households	20.0	19.9	20.2	21.0	21.9	23.0
Large exposures to capital	80.6	86.7	88.6	81.6	62.4	63.4
Earnings and profitability						
Return on assets	0.6	0.8	0.6	0.5	0.5	...
Return on equity 3/	8.7	11.2	8.6	7.1	7.3	...
Return on equity 4/	9.6	11.5	8.8	6.2	7.2	...
Interest margin to gross income	55.0	52.2	52.3	56.6	55.9	...
Noninterest expenses to gross income	60.6	55.9	55.3	59.8	60.9	...
Liquidity						
Liquid assets to total assets (liquid asset ratio)	10.6	8.2	7.4	5.9	5.5	...
Liquid assets to short-term liabilities	31.6	25.4	21.8	17.3	16.9	...
Sensitivity to market risk						
Duration of assets (weighted average in months and days)	7M 28D	7M 18D	7M 21D	8M 18D	9M 6D	...
Duration of liabilities (weighted average in months and days)	6M 26D	6M 20D	7M 1D	8M 4D	8M 24D	...
Net open position in foreign exchange to capital 1/	4.4	5.7	4.9	3.9	3.6	...
			Encouraged set			
Deposit-taking institutions						
Capital to assets	6.8	6.6	6.8	6.7	6.4	...
Average risk weight (ratio of risk-weighted assets to assets)	0.6	0.7	0.7	0.6	0.6	...
Geographical distribution of loans to total loans						
North	59.3	61.9	62.2	62.3	62.3	62.4
Center	25.2	23.9	24.1	24.1	24.0	23.5
South	15.6	14.2	13.7	13.6	13.7	14.1
Geographical distribution of non-performing loans						
North	34.8	37.0	37.9	40.4	43.0	43.4
Center	26.5	28.0	27.1	27.4	26.5	26.6
South	38.7	35.0	34.9	32.2	30.5	30.0
Gross asset position in financial derivatives to capital	25.6	36.8	50.8	46.7	52.0	...
Gross liability position in financial derivatives to capital	25.1	25.2	37.0	44.8	45.0	...
Trading and fee income to total income	45.0	47.8	47.7	43.5	44.1	...
Personnel expenses to noninterest income	58.4	56.3	54.5	54.6	54.8	...
Spread between reference lending and deposit rates (CDs up to 6 months)						
Household lending (average for new loans)	3.3	3.3	3.4	3.3	3.4	...
Corporate lending (average for new loans)	2.1	2.5	2.2	2.2	2.3	...
Spread between highest and lowest interbank rate 5/	0.0	0.0	0.0	0.0	...	...
Customer deposits to total (non-interbank) loans	107.8	100.3	100.5	103.7	101.1	101.4
Foreign currency-denominated loans to total loans	3.3	3.5	3.2	2.1	1.6	...
Foreign currency-denominated deposits to total deposits	4.1	4.5	4.5	4.7	...	...
Net open position in equities to capital 1/	5.2	5.7	11.4	2.6	3.1	...
Market liquidity						
Average bid-ask spread in the securities market	0.0	0.1	0.0	0.0	...	...
Average daily turnover ratio in the securities market	1.0	0.9	0.9	0.8	...	...
Nonbank financial institutions						
Assets to total financial system assets	37.4	36.9	36.6	34.6	33.9	...
Assets to GDP	92.3	92.5	90.0	85.4	87.5	...
Corporate sector						
Total debt to equity	80.9	76.0	86.7	101.2	106.3	...
Return on equity	9.3	7.3	4.8	...	...	...
Earnings to interest and principal expenses 6/	341.0	265.2	214.3	233.7	...	...
Corporate net foreign exchange exposure to equity	-3.1	-0.4	-2.6	-2.2	...	...
Number of applications for protection from creditors 7/	1,164.0	571.0	605.0	883.0	...	...
Household sector						
Household debt to GDP	19.5	20.4	20.7	21.9	23.4	23.8
Household debt service and principal payments to income	1.7	2.4	2.5	2.3	...	...
Real estate markets						
Real estate prices (1990=100, deflated by CPI)						
Residential	94.2	95.5	100.2	109.0	120.4	...
Commercial	51.0	63.1	...	...	...	...
Residential real estate loans to total loans	9.6	10.3	10.3	12.0	13.8	14.9
Commercial real estate loans to total loans	7.6	7.0	6.8	6.9	7.2	7.4

Source: Bank of Italy and staff estimates.
1/ Based on consolidated data
2/ Nonperforming loans include doubtful loans.
3/ Profit does not include change in the provision for general banking risks
4/ Net earnings include the net change in the fund for general banking risks; capital and reserves are calculated on a 13 month average.
5/ Average overnight rate in December
6/ Earnings to interest expenses
7/ Special administration and private preemptive agreements

Table 5. Italy: One-off Fiscal Measures, 2000-05 1/
(In percent of GDP)

	2000	2001	2002	2003	2004	2005
Total one-off measures	0.7	0.8	1.5	2.1	1.4	1.0
Tax amnesties	0.0	0.0	0.1	1.5	0.7	0.1
Other temporary measures	0.6	0.7	0.5	0.4	0.4	0.3
Asset sales 2/	0.1	0.2	0.9	0.2	0.3	0.5

Sources: Bank of Italy, Ministry of Economy and Finance, and Fund staff calculations.

1/ Includes all nonrecurrent revenue items, in contrast to the official definition which includes only tax amnesties and asset sales.
2/ For 2000, excludes UMTS receipts of 1.2 percent of GDP which, in the text and Table 2, have been excluded from the deficit as well.

Table 6. Italy: Public Sector Debt Sustainability Framework, 1999-2009

	Actual					Projections					
	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
I. Baseline Medium-Term Projections											
Public debt/revenues 1/	247.5	242.8	242.2	238.0	229.2	232.9	233.9	235.5	235.0	237.0	239.4
Public debt/GDP 1/	115.5	111.2	110.6	108.0	**106.2**	**105.8**	**104.4**	**104.1**	**103.8**	**104.7**	**105.7**
Change in public debt/GDP	-0.9	-4.3	-0.6	-2.7	-1.8	-0.4	-1.3	-0.4	-0.2	0.9	1.0
Net debt-creating flows/GDP (5+6)	-1.9	-5.1	-2.1	-1.4	-0.9	-1.2	-0.9	-0.2	-0.3	-0.4	-0.6
Overall deficit, excluding net interest payments/GDP (=primary deficit)	-5.0	-5.8	-3.9	-3.5	-2.9	-2.3	-2.0	-1.1	-1.3	-1.4	-1.7
Revenue and grants/GDP	46.7	45.8	45.7	45.3	46.3	45.4	44.6	44.2	44.2	44.2	44.2
Noninterest expenditure/GDP	41.6	40.0	41.8	41.8	43.5	43.1	42.6	43.1	42.9	42.8	42.4
$((r - \pi) - g(1+\pi))/(1+g+\pi+g\pi))$debt/GDP (8/7) 2/	3.1	0.7	1.8	2.1	2.0	1.1	1.1	0.9	1.0	1.0	1.1
Adjustment factor: $1+g+\pi+g\pi$	1.0	1.1	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
$((r - \pi) - g(1+\pi))$debt/GDP (9+10)	3.2	0.8	1.9	2.2	2.0	1.1	1.1	1.0	1.0	1.1	1.2
$(r - \pi)$ times debt/GDP	5.1	4.3	3.9	2.6	2.3	2.7	3.0	3.1	3.2	3.2	3.3
minus $g(1 + \pi)$ times debt/GDP	-2.0	-3.6	-2.0	-0.4	-0.3	-1.6	-1.8	-2.1	-2.1	-2.1	-2.1
Residual, incl. asset changes, privatization receipts (negative), and valuation changes in externa	1.1	0.8	1.5	-1.3	-0.8	0.8	-0.4	-0.1	0.0	1.3	1.6
Memorandum Items: Key macro and external assumptions											
Nominal GDP (local currency)	1,108	1,167	1,219	1,260	1,301	1,354	1,407	1,465	1,523	1,585	1,648
Real GDP growth (in percent per year)	1.7	3.0	1.8	0.4	0.3	1.5	1.7	2.0	2.0	2.0	2.0
Consumer price index (change, in percent per year)	1.7	2.6	2.3	2.6	2.8	2.2	2.2	2.1	2.0	2.0	2.0
Exchange rate (LC per US dollar)	0.9	1.1	1.1	1.1	0.9	0.8	0.8	0.8	0.8	0.8	0.8
GDP deflator (change, in percent per year)	1.6	2.2	2.7	3.1	2.9	2.5	2.2	2.0	2.0	2.0	2.0
Average interest rate on public debt (percent per year)	6.0	5.9	6.1	5.4	5.1	5.1	5.0	5.0	5.0	5.1	5.2
Average real interest rate (nominal rate minus change in GDP deflator, percent)	4.4	3.8	3.5	2.3	2.1	2.6	2.8	3.0	3.0	3.1	3.2
Growth of revenues (deflated by GDP deflator, in percent per year)	2.1	1.2	1.5	-0.4	2.4	-0.5	-0.4	1.0	2.0	2.0	2.0
Growth of noninterest expenditure (deflated by GDP deflator, in percent per year)	2.6	-1.0	6.3	0.5	4.1	0.7	0.0	3.1	1.7	1.6	1.2
Public sector balance	-1.7	-0.6	-2.6	-2.3	-2.4	-2.9	-3.1	-3.9	-3.8	-3.6	-3.5
Public sector revenue (in percent of GDP)	46.6	45.8	45.7	45.3	46.3	45.4	44.5	44.0	44.0	44.0	44.0
Public sector expenditure (in percent of GDP)	48.4	46.5	48.3	47.6	48.8	48.3	47.7	47.9	47.8	47.7	47.5
II. Stress Tests											
1. If real interest rate, real GDP growth rate, and primary balance (in percent of GDP) in 2005-2009 are at average of past 10 years					**106.2**	**105.8**	**104.3**	**103.1**	**102.0**	**102.1**	**102.6**
2. If real interest rate in 2005 and 2006 is average plus two standard deviations, others at baseline					**106.2**	**105.8**	**110.1**	**115.5**	**115.4**	**116.4**	**117.6**
3. If real GDP growth rate in 2005 and 2006 is average minus two standard deviations, others at baseline					**106.2**	**105.8**	**107.1**	**109.7**	**109.5**	**110.5**	**111.6**
4. If primary balance (in percent of GDP) in 2005 and 2006 is average minus two standard deviations, others at baseline					**106.2**	**105.8**	**104.9**	**104.1**	**103.9**	**104.8**	**105.8**
5. Combination of 2-4 using one standard deviation shocks					**106.2**	**105.8**	**108.8**	**112.3**	**112.1**	**113.1**	**114.2**
6. If debt ratio in 2005 rises by (additional) 10 percent of GDP, others at baseline					**106.2**	**105.8**	**114.4**	**114.2**	**114.0**	**115.0**	**116.1**
Memorandum Items											
Primary deficit (percent of GDP, average of past 10 years)					-4.3	-4.3	-4.3	-4.3	-4.3	-4.3	-4.3
Primary deficit (percent of GDP, standard deviation of past 10 years)					1.4	1.4	1.4	1.4	1.4	1.4	1.4
Real interest rate (nominal rate minus change in GDP deflator, average of past 10 years)					4.9	4.9	4.9	4.9	4.9	4.9	4.9
Real interest rate (nominal rate minus change in GDP deflator, standard deviation of past 10 years)					1.8	1.8	1.8	1.8	1.8	1.8	1.8
Nominal interest rate (average of past 10 years)					8.1	8.1	8.1	8.1	8.1	8.1	8.1
Nominal interest rate (standard deviation of past 10 years)					2.4	2.4	2.4	2.4	2.4	2.4	2.4
Real GDP growth rate (average of past 10 years)					1.7	1.7	1.7	1.7	1.7	1.7	1.7
Real GDP growth rate (standard deviation of past 10 years)					1.2	1.2	1.2	1.2	1.2	1.2	1.2
GDP deflator (average of past 10 years)					3.2	3.2	3.2	3.2	3.2	3.2	3.2
GDP deflator (standard deviation of past 10 years)					1.2	1.2	1.2	1.2	1.2	1.2	1.2

1/ Public sector refers to general government, the underlying scenario after 2005 is no change in policies, and thus the numbers are different from the authorities' baseline and the staffs adjustment scenarios.
2/ Defined as: r = interest rate; π = GDP deflator, growth rate; g = real GDP growth rate.
3/ Real appreciation is approximated by nominal appreciation against US dollar plus increase in domestic GDP deflator.

Italy: Fund Relations
(As of November 30, 2004)

I. **Membership Status**: Joined 3/27/47; Article VIII.

II. **General Resources Account**:	SDR Million	Percent Quota
Quota	7,055.50	100.00
Fund holdings of currency	4,637.14	65.72
Reserve position in Fund	2,418.38	34.28

III. **SDR Department**:	SDR Million	Percent Allocation
Net cumulative allocation	702.40	100.00
Holdings	86.79	12.36

IV. **Outstanding Purchases and Loans**: None

V. **Financial Arrangements**: None

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

	Forthcoming				
	2004	2005	2006	2007	2008
Principal					
Charges/Interest		13.63	13.66	13.66	13.69
Total		13.63	13.66	13.66	13.69

VII. **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.

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). Those exchange restrictions are contained in the following legal instruments:

- Council Regulation (EC) No. 2488/2000 of 10 November 2000, as amended, maintaining a freeze of funds in respect of Mr. Slobadan Milosevic and people associated with him.

- Council Regulation (EC) No. 1763/2004 of 11 October 2004, as amended, imposing certain restrictive measures in support of effective implementation of the mandate of the International Criminal Tribunal for the Former Yugoslavia.

- Council Regulation (EC) No. 2580/2001 of 27 December 2001, as amended, on specific restrictive measures directed against certain persons and entities with a view to combating terrorism.

- Council Regulation (EC) No. 881/2002 of 27 May 2002, as amended, imposing certain restrictive measures directed against certain persons and entities associated with Osama bin Laden, the Taliban and the Al-Qaida network

- Council Regulation (EC) No. 1210/2003 of 7 July 2003, as amended, concerning certain specific restrictions on economic and financial relations with Iraq.

- Council Regulation (EC) No. 314/2004 of 19 February 2004, as amended, concerning certain restrictive measures in respect of Zimbabwe.

- Council Regulation (EC) No. 798/2004 of 26 April 2004, as amended, renewing the restrictive measures in respect of Burma/Myanmar.

- Council Regulation (EC) No. 872/2004 of 29 April 2004, as amended, concerning freezing of funds and economic resources of persons and entities associated with Liberia's former President Taylor.

VIII. **Article IV Consultations**: Italy is on the standard 12-month consultation cycle. The previous consultation discussions took place during July18–23 and October 7–8, 2003, and the staff report (Country Report No. 03/351, 10/23/03) was discussed on November 7, 2003.

IX. **ROSCs**:

Standard Code Assessment	**Date of Issuance**	**Country Report**
Fiscal Transparency	October 9, 2002	No. 02/231
Data	October 18, 2002	No. 02/234

Italy: Statistical Information

Italy's economic database is comprehensive and of generally high quality. Italy has subscribed to the Special Data Dissemination Standard (SDDS) and has posted the metadata for the Dissemination Standards Bulletin Board (DSBB). Data are provided to the Fund in a comprehensive manner (see attached table), and 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 and timeliness and reporting standards of Eurostat and the European Central Bank (ECB), and has adopted the *European System of Accounts 1995* (*ESA95*).

A *Report on the Observance of Standards and Codes (ROSC)—Data Module* (Country Report No. 02/234, 10/18/02) found Italy's macroeconomic statistics to be of generally high quality, but also identified some shortcomings that hindered an accurate and timely analysis of economic and financial developments: (i) no statistical agency had the responsibility to compile and disseminate an integrated, comprehensive statement of government finances, and a troubling difference had emerged between the several distinct measures of government deficit/financing; (ii) source data and/or statistical techniques could be strengthened in several areas, most importantly, by raising response rates on the enterprise surveys used in the national accounts and producer price index, by making price collection for the consumer price index more efficient, and by improving the coverage of cross-border financial transactions that did not go through domestic banks; (iii) balance of payments and government finance statistics could come closer to the internationally accepted methodological guidelines on concepts and definitions, scope, classification and sectorization, and/or valuation; and (iv) resources were under pressure in some parts of the National Institute of Statistics in the face of the statistical requirements of the European Union and the euro area. The ROSC also noted the persistently large gap between the SGP-monitored fiscal deficit and the PSBR net of privatization receipts, a topic that is discussed in detail in the Staff Report (Box 6 and paragraph 20).

Recent steps to improve economic data include: work on the way by ISTAT to calculate regional price levels—expected to be available in 2005; the publication of quarterly data for the general government balance, expenditure, and revenue on an accruals basis (that is, in line with *ESA95*) starting in October 2003; and a new, more detailed labor survey, conducted by professional staff (see footnote 7). The shift to chain-weighted indices for national accounts is expected in March 2005.

Notwithstanding these improvements, weaknesses remain in some areas. In the national accounts, inventory accumulation is derived as a residual and lumped together with the statistical discrepancy: this hampers an analysis of the business cycle. Furthermore, as highlighted by a recent fiscal transparency ROSC mission, the quality and timeliness of some fiscal data, particularly on expenditure by local governments, falls short of the SDDS requirements, notwithstanding some improvements of late.

Italy: Core Statistical Indicators
(As of December 15, 2004)

	Exchange Rates	International Reserves	Central Bank Balance Sheet	Reserve/ Base Money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Government Balance 1/	GDP/ GNP
Date of Latest Observation	12/15/04	10/04	10/04	10/04	10/04	12/15/04	11/04 2/	10/04	9/04	11/04	2004 Q3
Date Received	12/15/04	mid-November	12/01/04	12/01/04	12/01/04	12/15/04	11/30/04	11/24/04	11/24/04	12/01/04	12/10/04
Frequency of Data	Daily	Monthly	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Monthly	Monthly	Quarterly
Frequency of Reporting	Daily	Monthly	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Monthly	Monthly	Quarterly
Source of Update	Reuters, Bloomberg	BoI, IFS	BoI	BoI, IFS	BoI	Reuters, Bloomberg	ISTAT Press Release	ISTAT Press Release	BoI, UIC	Ministry of Economy and Finance	ISTAT Press Release
Mode of Reporting	Electronic	Cable	Internet, Publication	Internet, Publication	Internet, Publication	Electronic	Electronic	Electronic	Publication	Internet, Publication	Electronic
Confiden-tiality	None	Until data off. released	None	None	None	None	None	None	None	None	None
Frequency of Publication	Daily	Monthly	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Monthly	Monthly	Quarterly

Statement by the IMF Staff Representative
February 7, 2005

1. **This statement provides information that has become available since the issuance of the Staff Report**. The new information does not change the thrust of the staff appraisal.

2. **Recent short-term indicators underscore the downside risks to the recovery.** Industrial production fell by a larger-than expected 0.7 percent in November (month-on-month), with production of all categories of goods weakening. Consumer confidence posted its third consecutive monthly decline in January, although the Business Climate Index improved on the strength of rising orders and falling inventories. In addition, a number of forecasters have reduced their 2005 growth projections, with the consensus forecast standing at 1.5 percent in January, slightly below the Staff Report's projection of 1.7 percent and the budget's projection of 2.1 percent. (The staff projection may, however, be subject to revision in the upcoming WEO round). Harmonized consumer prices rose 2.1 percent year-on-year in January, according to preliminary estimates.

3. **On February 2 the European Commission published its assessment of the Italian authorities' 2004 Stability Program Update, raising concerns about fiscal policy.** The Commission found that additional measures could be required to keep the fiscal deficit below 3 percent of GDP this year, due to downside risks to the macroeconomic scenario and to uncertainties about budget implementation. The Commission therefore called on the authorities to take additional measures as necessary to ensure achievement of the 2005 deficit target. In addition, while finding (in contrast to staff) that with full implementation of the budgetary targets and the recent pension reform the debt would be sustainable, the Commission noted the existence of risks to sustainability and thus (in line with staff advice) called for additional consolidation efforts so as to bring the budget "close to balance" by 2008. It also called for close attention to "factors other than net borrowing which contribute to the change in debt levels."

INTERNATIONAL MONETARY FUND
Public Information Notice

EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 05/17
FOR IMMEDIATE RELEASE
February 9, 2005

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Concludes 2004 Article IV Consultation with Italy

On February 7, 2005, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Italy.[1]

Background

A cyclical recovery is underway, with real GDP having risen by 1.2 percent in the first three quarters of 2004 relative to the same period of the previous year, thanks to the favorable external environment and a recovery of investment. Staff forecasts growth of 1.5 percent in 2004 and 1.7 percent in 2005, the latter broadly in line with consensus forecasts but below the official projection of 2.1 percent. Despite the increase in international oil prices in 2004, price pressures are expected to remain moderate, with inflation averaging only about 2¼ percent this year.

A package of corrective measures adopted in mid-2004 is likely to have proven sufficient to keep the fiscal deficit just below 3 percent of GDP last year. Nevertheless, significant reliance on one-off measures and the large gap between the Stability and Growth Pact deficit and the public sector borrowing requirement (net of privatization receipts) remain sources of concern. The 2005 budget targets a small reduction in the headline deficit, to 2.7 percent of GDP, based in part on new measures to control expenditure growth. The budget includes a personal income tax cut of about ½ percent of GDP.

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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. 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.

Labor market reforms and wage moderation have led to a substantial increase in hours worked in recent years, although the employment ratio remains the lowest in the euro area. Stagnant productivity, however, has offset much of the growth impact of improved labor market performance. In this respect, a lack of competition in key sectors and problems with the business environment are widely recognized as impediments to investment, innovation, and growth. Progress has been made in increasing competition in the energy sector, but advances in other areas, and in improving the business environment more generally, have been more limited.

Banking system developments in 2004 were generally positive, with profitability and vulnerability indicators improving. Following the high-profile bankruptcy of Parmalat in December 2003, the authorities introduced a draft law to strengthen securities regulation, but passage of the law has been delayed. In response, the authorities have incorporated some key elements of the reform strengthening the powers and resources of Consob (the securities regulator) in the area of investor protection into a draft law implementing the EU's market abuse directive, which is also under consideration by Parliament.

Executive Board Assessment

Italy's short-term economic prospects are improving, based on a rebound in investment and exports, while inflation remains moderate. However, the economic recovery is likely to be modest, and there are downside risks stemming from high oil prices and the appreciation of the euro. More broadly, Italy's growth potential remains constrained by long-standing supply-side weaknesses and continuing uncertainty over fiscal prospects. Against this background, Directors considered that a key challenge facing Italy is to enhance its growth potential by securing durable fiscal consolidation and pressing ahead with further structural reforms to enhance competition and strengthen the business environment. Progress in these areas will require determined efforts to shape a supportive national consensus.

Directors underlined the importance of a strong and credible medium-term fiscal strategy based on durable adjustment measures to ensure the long-term sustainability of the fiscal accounts. In view of the high public debt burden, they felt that the objective of achieving a small structural fiscal surplus before the end of the decade still remains appropriate, and regretted that the authorities' economic plans had dropped a previous explicit commitment to this effect. They commended the implementation of the pension reform, and called on the authorities to move quickly to finalize supporting legislation and adjust pension replacement rates in line with increases in life expectancy.

While acknowledging that Italy has been able to keep its fiscal deficit below the *Stability and Growth Pact*'s ceiling, Directors noted that this was in large part due to significant reliance on one-off measures. Looking forward, they noted that the fiscal adjustment envisioned in the 2005 budget—with a small decline in the overall deficit and a limited decline in one-off measures—again falls short of what is needed. Moreover, there are risks that the deficit target might be missed in the absence of further action. Directors called on the authorities to be prepared to adopt structural measures over the course of 2005 to ensure that the target is met.

While recognizing the need for reductions in the tax burden over the medium term, Directors believed that the tax cut implemented this year should have been tied to additional structural expenditure cuts or delayed. They also cautioned that fiscal decentralization will need to be accompanied by strengthened coordination among government units, the adoption of transparent and stable rules, and strict monitoring of compliance with these rules in order to avoid a loosening of the fiscal stance.

Directors underscored the need to continue improving the structure of the public finances, and welcomed the government's commitment to eliminate one-off measures by 2006. Given Italy's high tax ratio, Directors emphasized that any additional adjustment should focus on current spending, and welcomed the newly-introduced uniform cap on spending growth as consistent with this objective. They noted that incorporating these spending limits into a system of multi-year spending reviews could help develop and protect budget priorities. Directors supported the authorities' plans to step up privatization efforts. At the same time, they stressed that transactions such as securitization of future income flows, sales and lease-backs of assets, and the sale of parts of the road network might well have negative implications for future budgets and would therefore need to be assessed carefully.

Directors observed that fiscal transparency needs to be improved. The decline in the public debt ratio in recent years has been muted by the large gap between the fiscal deficit and the public sector borrowing requirement net of privatization receipts. They welcomed recent initiatives to clarify the sources of this discrepancy, but underscored the urgency of strengthening these efforts with a view to focusing on the economic causes of the persistently larger borrowing requirement.

Directors were encouraged by the positive results from labor market reforms, including increases in the employment rate and in hours worked. However, the employment ratio is still low, while regional and demographic disparities in unemployment rates remain large. Directors therefore recommended approval of the second stage of the "Biagi" labor market reform bill, which would further reduce rigidities. They also encouraged the social partners to agree to greater decentralization of the wage bargaining process and increased wage flexibility, with some Directors observing that the authorities could contribute to this goal by accelerating the construction of regional cost-of-living indexes and anchoring public sector wage increases to them. Some Directors noted that the implications of wage decentralization for fiscal federalism would need to be taken into consideration. Also, labor market reforms should be accompanied by increased efforts to enhance the quality of the labor force through training and education.

Directors stressed the need to raise Italy's low productivity growth, including through greater competition in product markets and enhancement of the business environment, noting that deep-seated rigidities are hampering competition and impeding innovation, investment, and efficiency. While commending some progress made in the energy sector, Directors called on the authorities to promote competition more forcefully through regulatory reforms, and to address shortcomings in the business environment, including through measures to accelerate legal procedures and to eliminate red tape. In particular, they emphasized the importance of enacting the long-delayed reform of the bankruptcy law.

Directors welcomed the continuing positive trends in Italy's financial sector, as indicated by the first round of the Financial Sector Assessment Program. They noted the increase in bank profitability, which has contributed to improvements in financial vulnerability indicators. A few Directors cautioned, however, that despite substantial progress, non-performing loans remain relatively high, partly reflecting the length of recovery procedures. While observing that financial sector supervision is generally strong, Directors recommended prompt passage of reforms designed to enhance the powers of the securities market regulator. They noted the importance of strengthening corporate governance standards, and welcomed the forthcoming introduction of a legislative package that will address this issue. Directors looked forward to the results of the next round of the Financial Sector Assessment Program.

Directors welcomed the authorities' commitment to increase overseas development assistance to 0.33 percent of GDP by 2006, and encouraged faster progress toward meeting the United Nations' target of 0.7 percent of GNP. Directors encouraged the authorities to continue to resist pressures for increased trade protection, and to monitor the domestic impact of the expiration of textile export quotas.

Directors noted that Italy's statistics are adequate for surveillance. They nevertheless underscored the need to address remaining weaknesses, some of which were identified in the 2002 Report on the Observance of Standards and Codes, and to clarify the reasons for the persistent discrepancy between the fiscal deficit and the borrowing requirement net of privatization revenues.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case.

Italy: Selected Economic Indicators

	2000	2001	2002	2003	2004 1/	2005 1/
Real economy (change in percent)						
GDP	3.0	1.8	0.4	0.3	1.5	1.7
Domestic demand	2.3	1.4	1.3	1.2	0.9	1.0
CPI	2.6	2.3	2.6	2.8	2.2	2.2
Unemployment rate (in percent)	10.6	9.5	9.0	8.7	8.3	8.0
Public finances (general government; in percent of GDP)						
Overall balance	-0.6	-2.6	-2.3	-2.4	-2.9	-3.1
Structural balance 2/	-2.8	-3.9	-3.8	-4.0	-3.6	-3.5
Gross debt	111.2	110.6	108.0	106.2	105.8	104.4
Money and credit (end of year, percent change)						
Private sector credit 3/ 4/	13.3	7.0	6.2	7.0	7.7	...
Contribution to euro-area M3 5/ 6/	4.7	10.9	10.7	9.5	5.0	...
Interest rates (year average) 7/						
Six-month rate on treasury bills	4.4	4.3	3.3	2.3	2.2	...
Government bond rate, ten-year	5.2	5.2	4.3	4.4	3.7	...
Balance of payments (in percent of GDP)						
Trade balance	1.0	1.6	1.5	0.6	0.7	1.1
Current account	-0.6	-0.1	-0.6	-1.3	-0.9	-0.1
Fund position (as of November 30, 2004)						
Holdings of currency (in percent of quota)			65.7			
Holdings of SDRs (in percent of allocation)			12.4			
Quota (in millions of SDRs)			7,055.5			
Exchange rate						
Exchange rate regime			Euro-area member			
Present rate (February 7, 2005)			US$1.2857 per euro			
Exchange rate (change in percent)						
Nominal effective 8/		109.4	111.9	118.0	119.4	...
Real effective (based on unit labor cost) 9/		103.0	104.4	109.0	110.8	...

Sources: Italian authorities; IMF: *International Financial Statistics*; World Bank: *World Development Indicators*; Bloomberg; Eurostat; and IMF Staff estimates and projections.
1/ Staff estimates and projections, unless otherwise noted.
2/ Structural balances are calculated using the staff's estimates of potential output and exclude one-off measures.
3/ Data for 2004 refer to end-June.
4/ Twelve-month credit growth, adjusted for securitizations.
5/ Data for 2004 refer to end-October.
6/ Excludes the currency in circulation held by non-bank private sector.
7/ Data for 2004 refer to end-November.
8/ Data for 2004 refer to end-September.
9/ Based on CPI.

Statement by Pier Carlo Padoan, Executive Director for Italy
February 7, 2005

Italy is a high-debt/low-growth country deeply embedded in a low growth region. In such a demanding environment, where room for maneuver is limited and trade-offs are tight, Italian authorities remain fully committed to pursue fiscal consolidation and structural reforms so as to raise the country's growth potential. Higher, sustained, growth will critically contribute, together with fiscal consolidation, to a sustained reduction of debt.

A number of structural reforms[1] have been introduced over the recent past which are beginning to bear fruits.

A pension reform was introduced in 2004. Developments in the labor market are positive mainly due to the implementation of the first segment of the Biagi reform, which is building on previous reforms. A comprehensive reform of the school system is under way and showing positive results. Steps have been taken to stimulate R&D and an institute was created (Italian Institute of Technology) with a mandate to stimulate research and scientific competition. Several measures have been taken to foster entrepreneurship and to improve the business environment, such as the introduction of a new corporate income tax system and improved access to finance for business, as well as simplification in the judicial procedures for company litigation.

In spite of significant results, notably in labor markets, which have led to a substantial increase in employment, growth remains low. As the staff report notes this is largely the result of the disappointing development of TFP. The evolution of TFP can be interpreted in a number of ways. One possible interpretation is that reforms in other areas are needed to complement those already in place before fruits in terms of growth of the reform strategy can be fully reaped. Of course, as elsewhere, this requires time, political capital to overcome resistance to reform, and the need to face short-term costs.

Pension reform

As stressed by the EU Commission[2], the 2004 July reform goes in the right direction and is in line with the BEPG recommendations for 2003-2005, which require Italy to reduce the long-term transition period to the new contribution-based system. Its implementation starts in 2008, when the tightening of eligibility criteria is scheduled to take effect. These additional measures will produce substantial savings**.** The introduction of more stringent measures only in 2008, aimed at addressing long-term sustainability, will not lead to early retirements. The entitlements will remain unchanged for workers that will mature their rights to a seniority

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[1] Council of the European Union – Annual Report on Structural Reforms 2005.

[2] December 2004 Update of the Stability Program of Italy – An Assessment, European Commission.

pension before January 2008. According to the information available so far, there have been no changes in the projected retirement requests. In the transition phase incentives to increase retirement age will be budget-neutral.

As discussed below, DSA taking into account the 2004 pension reform shows that the debt to GDP ratio declines steadily over the period 2005-2050.

Labor market reforms

Phase one of the Biagi reform is still to be fully implemented. Hence further results should be expected, especially once the employment agency system is fully operational. The second phase covers the reorganization of employment incentives, the reform of the social shock absorber (mainly, the enlargement of the ordinary unemployment benefits), the suspension of Article 18 of the Labor Rights Law, and arbitration in individual labor disputes[3]. The bill is under discussion in Parliament, and not yet scheduled for the final vote. One major obstacle to its approval is the contentious issue of the experimental suspension of Article 18. Another obstacle is the cost of the reform of the unemployment benefits, which is expected to have a substantial impact on the budget (because of the lengthening of the benefit duration and the increase in its level).

The additional flexibility provided by the Biagi Law already in place might further reduce the cost of labor, providing additional incentive to increase the labor-capital ratio. However additional labor market flexibility in the existing labor pool is not the key problem. The main challenge is to increase participation which is, nonetheless, on the rise. The employment rate is at the low end of EU levels but its growth rate in 1998-03 is among the highest in Europe (4.1 percent versus 1.7 percent in EU 25)[4]. The low participation rate is largely the result of low women and elderly participation[5]. However, the rate of growth of women's employment is above the EU average. It increased by 6 percentage points between 1995 and 2003. Pension reforms have increased the participation rate of over 55 by more than 2 percentage points between 2001 and 2003.

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[3] Empirical evidence suggests that the impact of Article 18 on firm size growth is small. See Torrini and Schiavardi "Firm size distribution and employment protection legislation in Italy" Bank of Italy, *Temi di Discussione*, No. 504.

[4] Employment in Europe 2004: Recent trends and prospects - European Commission.

[5] In 2003 the male participation rate of the 25-54 age cohort is 91.5 percent (EU-15 average is 92.4 percent).

Product market reforms are potentially more important but more difficult to implement.[6]

A number of draft laws are in Parliament for the reform of professional services. Main common features include: measures to simplify recognition of new professions; setting minimum and maximum fees only for professional activities bearing on the general interest; possibility for new professions to advertise and inform the general public; improvement in pre-professional training. The “simplification law”, to be approved in 2005, will liberalize business activities at all relevant steps. The “decree on competitiveness”, shortly to be presented by the government, will further slim down red tape for business.

The Energy Sector. Supply and demand.

The diversification of supply should lower electricity costs (10000 MW of combined cycle gas turbine power plants are foreseen for the next 3-4 years). At regional and local levels obtaining authorization for new power plants is difficult mainly due to low public acceptance. The law 55/2003, will introduce a top/down process and compensation mechanisms for populations living close to the power plant, and should speed the authorization procedures.

The merger between the company which holds the electricity network (Terna) and the grid management company (GRTN) to be completed in 2005, and the privatization of the resulting company, will be a further step to liberalize the sector.

In order to facilitate entry of new companies and promote further competition the Energy Authority has recently established rules aimed at: reducing market power and preventing increases in wholesale market prices due to strategic behavior; making existing rules consistent with the planned unification of ownership and management of the transmission grid; and harmonizing the several existing rule sets.

Two decrees aimed at reducing consumption and enhancing energy efficiency were approved in July 2004 and the market has been further opened to all non-domestic consumers, consistently with the EU directive. Starting in January 2005 all non-domestic consumers can buy electricity on the wholesale market.

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[6] As a forthcoming IMF Working Paper shows, while a piecemeal approach to reforms is possible in labor markets, it is usually not possible in product markets. Product markets have to be liberalized in one shot to avoid the formation of dominant positions. See T. Boeri ‘Reforming Labor and Product Markets: Some Lessons from Two Decades of Experiments in Europe’, 2005.

Improving the judicial environment for business

We welcome the selected issues paper, which is in many ways "path breaking" and we encourage staff to apply the same approach to other country cases. We also share the general conclusion that improvement in the "judicial system" could significantly boost growth. A costly and inefficient enforcement system may generate barriers to entry, reducing competition; it might negatively affect the possibility of firms to access financial markets; it may indirectly influence the average size of firms. The excessive length and costs of the Italian bankruptcy procedures also have a negative effect on the turnover of economic activity and hence the re-allocation of resources.

A draft law on bankruptcy reform is under discussion in Parliament, following a major redesign (*maxiemendamento)* approved by the Government in late December 2004. The draft law significantly simplifies the existing procedures.

The operation of the judicial system has been streamlined and updated in 2003 through the introduction of judicial offices specialized in industrial and property rights related to litigation. A special procedure for company litigation was introduced in 2004 to speed up trials. Available evidence shows that, as a result, time needed to settle controversies in these matters has been significantly reduced.

With respect to the analysis by staff we point out the following aspects.

Cross country correlations between quality indicators and GDP do not help to assess whether there is a causal link from institutions to growth; the regressions on "institutions and growth" where *past* growth rates (1985-2003) are regressed on *current* institutional variables are conceptually ambiguous. They are run on the very strong assumption that no relevant changes have occurred in the institutional variables included over the 18-year period. The "long term stability" of some institutional factors should be somehow documented.

The analysis of the determinants of judicial inefficiency as well as the suggested measures take into consideration only the demand-side. They do not fully reflect the breadth of the current debate in Italy on the causes of inefficiencies and on possible reforms. These include supply side issues such us procedural rules and internal organization of courts.

Competitiveness and productive specialization. Escaping path-dependency.

As widely recognized one of the underlying causes of low growth is the persistence of Italy's specialization pattern which is exposed to major shifts in world demand and supply possibly more than in other large industrial countries. Long lasting rigidities make it more difficult to reallocate resources towards new, more dynamic, sectors. However, recent studies highlight the relationship between increased international competition and an increase in productivity of exporting sectors beginning in the nineties[7]. Increased labor market

[7] See M. Bugamelli and A. Rosolia, "Produttivita' e concorrenza estera", Bank of Italy, 2004.

flexibility, as generated by labor market reforms, is useful in this respect. At the same time it could, paradoxically, make the situation worse to the extent that more labor market flexibility favors deepening specialization in the traditional sectors (path dependency) rather than reallocation in new sectors/products, where higher human capital intensity is necessary.

Some improvement can be detected however. While Italy's export market shares in volume terms have declined since 2001, market shares at current prices remained broadly constant (at about 4 percent of world exports), reflecting a higher average unit value of Italian exports. This might signal a quality upgrade in the composition of Italian exports. Exporters of lower quality goods might have suffered from competition from emerging markets while those exporting higher quality goods have kept (or increased) their shares on foreign markets[8]. My authorities firmly believe that increasing international competition in lower quality segments should not be countered through more protection.

Sustained growth in the South would be a major factor in boosting potential output...

In the context of the recent weak economic activity, the Southern regions have shown a remarkable performance vis-à-vis the Center-North, with the GDP over the last eight years recording on average a higher rate of growth—a result which holds also on per capita terms. It is the first time in the whole post-war period that this occurs.

Growth in the South of Italy since the mid-1990s has been driven by increasing fixed gross investment vis-à-vis the Center-North. Reversing a trend observed in the recent decades, it is the first time since the Sixties that capital accumulation in the South of Italy exhibits a favorable dynamic in comparison to the Center-North.

This performance has been underpinned by a steady increase in the share of public investment out of total capital expenditures. Decisions taken by CIPE (Inter-Ministerial Committee for Economic Planning) in 2003 and 2004 are expected to strengthen this trend by providing further resources available for public investment.

…would wage differentiation help?

As staff reiterates, growth and employment in the South could be further boosted by wage differentiation. While we share this general suggestion we would add a number of caveats.

Wage differentials between North and South have been on the rise since the early 1990s.

There are different opinions on how to achieve a wider regional wage differentiation (which is for social partners to implement). On the one hand, a two-tier system such as the current one might work, while controlling the overall wage growth. On the other hand, a fully decentralized system might be more efficient in setting wages closer to the regional

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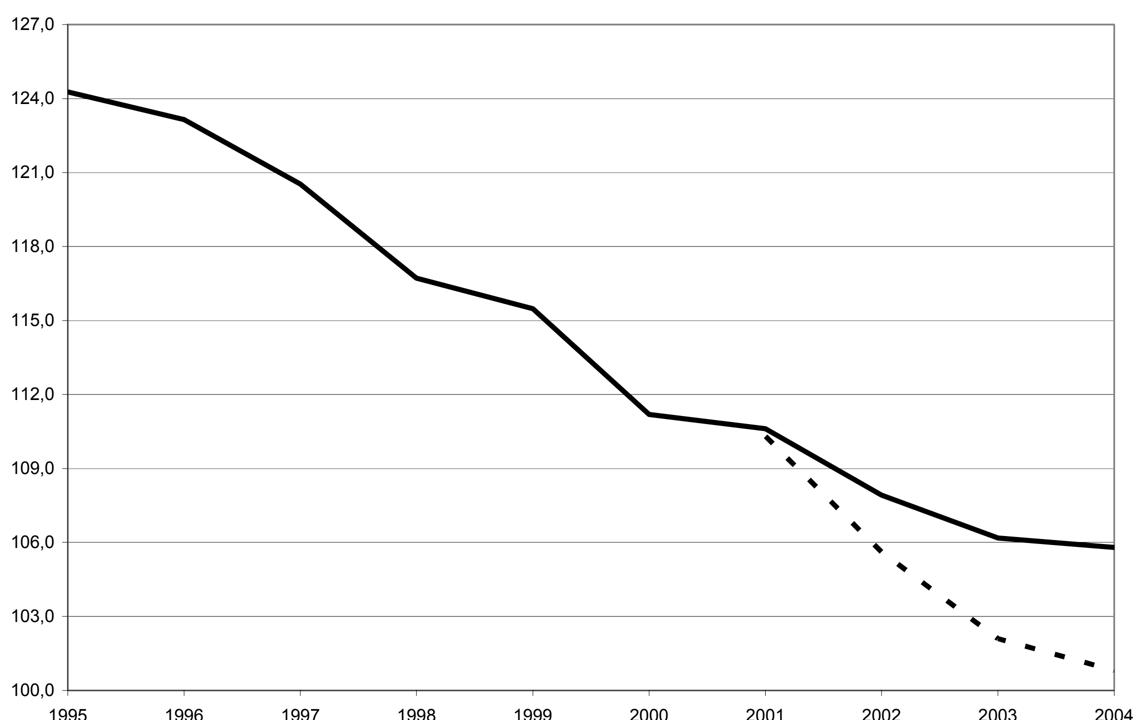
[8]See ICE (Istituto Nazionale per il Commercio Estero), "L'Italia nell'economia internazionale – Rapporto ICE 2003-2004".

equilibrium level. However, such a system might bring about stronger pay rises in the North, potentially hampering competitiveness.

Staff strongly argues in favor of the public sector "leading by example" in setting wages at different levels in different regions. My authorities believe that the implications for fiscal federalism of such a policy should be carefully spelled out before this proposal is implemented.

Italy. Debt-to GDP ratio: actual data and simulation



Debt and growth

Lower growth over the past few years largely accounts for the slow pace in debt reduction. To assess the effect of this slowdown on the debt dynamics, a simple simulation has been carried out for the period 2001-2004, assuming growth at potential (based on Commission estimates[9]) and all other variables unchanged, including the stock-flow adjustment, SFA. Higher growth affects the debt-to-GDP ratio through: i) a smaller numerator, given a smaller nominal deficit for a given cyclically-adjusted balance, ii) a higher denominator, given higher GDP growth. As shown in the figure, in the alternative scenario (dotted line), with growth at potential, the debt-to-GDP ratio would have fallen by 0.3 percentage points more than the

[9] Potential growth calculations are based on actual data for 2001-03 (1.9 percent in 2001, 1.7 percent in 2002 and 1.5 percent in 2003 and 2004), and are thus a lower bound estimate.

historical level in 2001, 2 percent more in 2002, 1.8 percent more in 2003 and 0.9 percent more in 2004. In 2003 the debt-to-GDP ratio would have been at 102.1 percent, 4.1 percentage points lower than in the baseline, and at 100.8 in 2004, 5 percentage points lower than the baseline. The average reduction in the debt to GDP ratio in 2001-04 would have been 2.6 percent, against a 2.3 percent average for 1994-2000.

Debt sustainability analysis

We welcome the DSA analysis. Results presented by staff go a long way towards the standard this chair has always advocated for DSA, including the assessment of the impact of structural reforms. We take it as a compliment from staff that the analysis has been specifically applied to Italy. We expect this approach to be extended to other surveillance exercises.

All the same we do not agree with staff on the underlying hypotheses, which are overly pessimistic. Staff assumes: 1) labor productivity will raise gradually to 1.5 percent annually; 2) limited gains in the participation rate (5 percentage points over 20 years); 3) long-run annual growth of about 1 percent.

In our view staff do not adequately take into account the interactions between demographic trends and labor productivity which typically would take place over such a long time horizon: the marked decline in active population will have a positive effect on productivity through the wage mechanism (also given more flexible labor markets) and the adoption of capital-intensive technologies, while the reduced average number of children per family will increase private and public resources available for human capital accumulation.

Staff underestimate gains in the participation rate, which is historically lower in Italy with respect to the EU average, but that—as mentioned above—has shown an upward trend in the last decade (a one percentage point increase per year), especially as a consequence of the higher female activity rate in the new cohorts.

Italy's Stability Program for 2005 consistently assumes labor productivity growth stable and slightly below 2 percent; participation rate gains by 11 percentage points over the period 2003-2050; and a GDP growth rate above 2 percent between 2005 and 2010 and declining to about 1 percent in the following years.

The 2005 Stability Program sustainability analysis, taking into account the effects of the 2004 pension reform, shows that the debt to GDP ratio declines steadily over the period 2005-2050, drops to below 60 percent in 2018, and turns into a credit in 2042.

According to staff, ageing population is expected to increase Italy's public spending by about 5 percent of GDP in the coming decades. We reject this conjecture: the Ageing Working Group of the EU Economic Policy Committee in its 2003 final report projects that the ageing population will increase public spending by 1.4 percent of GDP between 2005 and 2050 taking into account 4 components (pensions, health care, education and unemployment

benefits). The report stresses that the increase for other EU-15 countries will be much higher, in the range of 3-7 percentage points of GDP in the same period.

Missing targets

The staff report stresses that fiscal targets were missed for four consecutive years. We have assessed the growth impact on fiscal targets in the last four years to see if and to what extent these targets have been missed. To do so we use the methodology, based on the production function[10], that the Commission and EU Member States regularly use to carry on the sensitivity analysis to be included in Stability and Growth Programs as required by the related code of conduct (EFC/ECFIN/404/01).

Initial fiscal targets and growth projections are those included in the updated Stability and Growth program presented to the EU Council in year t-1, which is based on the medium-term financial framework (Documento di Programmazione Economica e Finanziaria, DPEF) approved by the Parliament in July of each fiscal year. Outcomes are those reported in the updated Stability and Growth program presented to the EU Council in year t+1, as the final data for the deficit are formally communicated to EUROSTAT on March 1 of the year following the one to which the target deficit is referred. We should keep in mind that over the last couple of years growth projections were revised downward, at least every 6 months, by all international institutions, while budget targets were set assuming growth projections available at the time when the medium-term financial and economic programs were presented to Parliament.

The table below shows the fiscal targets adjusted for growth changes, as well as the difference between the original deficit targets adjusted for the cycle and the final outcomes for the years 2001-04 and its average (-0.4). Growth changes have significantly affected deficit targets. The amount of the difference (the "miss") has been decreasing over time, positive in 2003, and expected to be close to zero in 2004.

Italy. The impact of growth on fiscal targets

	2001	2002	2003	2004	Average (2001 - 2004)
1. Deficit target	-0.8	-0.5	-1.5	-2.2	
2. Deficit target corrected for growth changes	-1.3	-1.6	-2.9	-2.8	
3. Outcome	-2.6	-2.3	-2.4	-2.9	
4. Difference (3-2)	-1.3	-0.7	0.5	-0.1	-0.4

[10] Decision made by the ECOFIN Council on July 12, 2002.

Stock Flow Adjustment

In the period 1994-2003 the average cumulative value of SFAs for EU countries is 4.2 percent of GDP. At 3.3 percent, Italy stands well below the EU average. As for the period 2000-2003, Italy's cumulative SFAs is 0.3 percent of GDP, the third smallest value among the EU-15, well below both the EU-15 and EU-25 averages (1.8 and 1.7, respectively)[11].

When the SFAs are broken down by component – accumulation of financial assets, valuation effects, and cash-accrual differences – in the period 2000-2003 the average values of the first two components for Italy are negligible. A significant value (1.2 percent of GDP) is instead present for the cash-accrual difference in the recording of revenue and primary expenditure. However, this is largely compensated by the another cash-accrual difference, related to interest payments, which goes in the opposite direction (-0.6 percent of GDP) so that the total of the cash-accrual difference, the third component of the SFAs, stands at 0.5 percent of GDP on average for the period 2000-2003.

Net borrowing and borrowing requirement

A table with the components of the gap between net borrowing and borrowing requirement is reported in Box 6. The Box and the table need some clarifications. They could specify that the borrowing requirement published by the Ministry of Economy and Finance is calculated on the formation side with reference to the Public Sector, while the borrowing requirement published by the Bank of Italy is computed on the financing side with reference to the general government sector. The table could better refer to the sources and methods used to compute the reported figures. In particular it could clarify whether the public sector borrowing requirement series used in the calculations includes the revisions on the post-office accounts which took place in 2004. In this regard, it should be noted that the series regularly published by the Bank of Italy includes such revisions (as well as the usual ordinary statistical revisions), while the Ministry does not publish a complete time series of the borrowing requirement (the *Relazione Trimestrale di Cassa* reports only the most recent years). We are actively working to reduce these discrepancies and an ad-hoc committee was established to this purpose.

Privatizations will continue

Items for privatization will include possible additional ENEL tranches, Alitalia, and the state broadcasting company RAI. "Second level" privatizations will include Terna and Wind by ENEL and SNAM by ENI. The program will also include other assets in addition to equity shares, such as real estate and securitization operations.

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[11] The stock-flow adjustment in the EU member states - European Commission (ECFIN/2004).

S&P Downgrading

Other credit rating agencies did not follow S&P's decision. Actually Moody's reiterated its stable outlook and did not raise any concerns with respect to Italy's budget position. In addition, after that decision, credit spreads on Italian government bonds showed substantial resilience. As investors continued to show robust appetite for Italian bonds, Italy's credit spread continued to improve.

Fiscal adjustment

The Italian authorities continue to be committed to fiscal consolidation. The Minister of the Economy has recently reiterated the commitment to maintain the deficit below the 3 percent limit in 2005.

As staff also recognizes, the composition of adjustment goes in the right direction as one-off measures are being reduced. A 2 percent cap has been imposed on nominal spending with the exclusion of pensions. The positive effects of this measure have already materialized in 2004 outturns as a direct consequence of the law decree of July 2004 (“decreto taglia spese”). In the third quarter of 2004, the general government consumption declined by 4.4 percent. In addition, preliminary data on the 2004 budget shows that the trend of some items are outperforming budget forecast, in particular interest expenditures declined and lottery revenue increased.

As for health spending, further controls on spending procedures by regions have been introduced in the 2005 financial bill including:

a) regions and public health institutions are obliged to define their budgets in line with central government fiscal objectives.

b) throughout the year, if the expenditure profile is not in line with that originally planned, the regions are obliged, according to a strict timeframe included in the aforementioned law, to take additional measures to bring the trend back to its projected path. If the region is reluctant to do so, the central Government can oblige the Governor of the region to take urgently the required measures.

c) the latest revision of the domestic stability pact introduced stricter rules for local authorities to monitor expenditure developments. All local entities, with some differences based on the population size, have to report quarterly to the Ministry of Economy cash and accrual accounts. In the case of overruns, the local government is required to reduce payments in the following quarter. In the case of non-compliance, the following year the local government is not allowed: a) to exceed the previous year's expenditures, b) to recruit new staff, and c) to increase debt.

Tax relief

The Italian government has set as a priority the adoption of tax relief measures, as a way to boost the economy also through a boost to confidence. Tax relief measures included in the 2005 budget, will have an impact on the revenue side of 4261 million euro in 2005, 7186 million for 2006, and 6564 million for 2007. The measures will be fully financed through cuts in expenditures (about 80 percent in 2005, about 50 percent in 2006 and 2007) and increase in revenues, including duties, due to the positive impact of tax relief on disposable income (about 20 percent in 2005 and 50 percent in 2006 and 2007). Even though the share of expenditure cuts tends to decrease in 2006 and 2007, the overall financing is ensured by structural measures.

ANAS

The ANAS Company was privatized in November 2002. However, according to the European accounting rules (ESA 95), to classify the company as a full commercial entity, the operational costs should be progressively financed through market revenues. This target is expected to be reached by the end of 2005, following which ANAS will be considered by EUROSTAT as a full commercial entity and no longer considered part of the public sector.

Infrastrutture Spa

Infrastrutture Spa is a financial intermediary owned by the Cassa Depositi e Prestiti. It has been designed taking into account the positive experience of similar institutions that have served the same purposes in several other large EU member countries. Its main mission is to co-finance PPP infrastructure projects, including those identified by the European Growth Pact endorsed by the European Council on December 2003.

So far, the activities carried out by Infrastrutture Spa have been limited, also due to the delays in implementing the European Growth Pact, in particular its quick-start list of projects. Being a full commercial company, the company follows the related accounting and reporting standard procedures.

Banking sector

As recognized by the staff, the efficiency of the Italian banking sector, now completely privatized, has improved substantially in the last decade: competition has increased, and the cost-income ratio has declined, allowing banks to maintain interest rates in line or below the average of the other EU countries. The six major banks have a ROE of about 13 percent (11 percent for the whole system, in June 2004). The Italian banking sector is one of the most open for foreign shareholders: in the four major Italian banks the share of capital held by foreign banks as members of shareholder agreements is 19.6 percent, well above major Euro area and Anglo-American banks (statistics based on IBCA data). Regarding the impact of Basel II, the empirical analysis (conducted at the international level and by the Italian authorities) shows that the new regime should not have distortional effects on the credit conditions of different classes of companies, including SMEs.

Corporate Governance

As recognized by staff, the Italian legal, regulatory and institutional framework is, overall, adequate. Staff's assessment of the Consob's insufficient independence from the Minister of Finance in imposing penalties is imprecise, since the Minister of Finance has only to check the formal legitimacy of the sanctions. In some areas Italy has one of the most advanced regulations: for instance, that regarding financial reporting and disclosure is one of the most rigorous in Europe; the rotation of the external auditors is compulsory; the recent reform of the Company Law (L.D. 6/2003), in addition to the Italian model (based on the dual system - the Board of Directors and the independent Board of Statutory Auditors), offers companies the possibility to choose between the Anglo-American unitary board and the German "supervisory board". The Preda Code requires an adequate number of independent Non-Executive Directors on the basis of the "comply or explain" rule, as in other European countries.

Very shortly, possibly by the end of February, a legislative package (the "Law on Saving" and the implementation of the Market Abuse Directive), will provide a strong answer to the recent corporate governance problems. The major provisions are: a) for listed companies that at least one member of the Board of Directors should be elected by the minority shareholders; a provision that will put Italy in a leading position on this issue; b) Consob staff should increase substantially, as well as its enforcement power through higher sanctions in cases of misbehavior; c) new measures, once approved, should further reinforce the procedures aimed at reducing potential conflicts of interest within the financial industry.

Fiscal federalism

Fiscal decentralization is ongoing. It is concentrated on constraints on the spending side while there is little change on the revenue side.