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February 2007
IMF Country Report No. 07/64

Italy: 2006 Article IV Consultation—Staff Report; 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 2006 Article IV consultation with Italy, the following documents have been released and are included in this package:

- the staff report for the 2006 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on November13, 2006, 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 16, 2007. 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 Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its February 7, 2007 discussion of the staff report that concluded the Article IV consultation; and

- a statement by the Executive Director for Italy.

The document listed below has 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.

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.

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International Monetary Fund
Washington, D.C.

INTERNATIONAL MONETARY FUND

ITALY

Staff Report for the 2006 Article IV Consultation

Prepared by Staff Representatives for the 2006 Consultation with Italy

Approved by Michael Deppler and Michael Hadjimichael

January 16, 2007

Executive Summary

Background: The economy is enjoying a broad-based cyclical upswing. Output growth in 2006–07 looks set to be the strongest since 2001. Unemployment is falling, inflation is broadly on a par with the euro-area's, and there are initial signs that structural transformation may be underway. The 2007 budget seems well set to bring the fiscal deficit below 3 percent of GDP, thanks also to stronger-than-expected revenues in 2006. But the politics are difficult: the government's majority is thin and some coalition partners resist market-oriented reforms.

Challenges: Despite progress in several areas, the upswing masks fundamental problems: insufficient domestic competition, still-rigid labor markets, a discouraging business environment, relatively undeveloped capital markets, and unsustainable fiscal accounts. Lax fiscal policy and hesitant structural reform efforts have fostered a prolonged period of anemic productivity, weakening competitiveness, and stagnant growth.

Staff views: The current environment is probably "as good as it gets" for the reforms needed to enhance Italy's growth potential—if not now, when? Although a start has been made—with a set of liberalizing reforms in July 2006 and appreciable deficit reduction over 2006–07—much remains to be done. Main requirements are sustained expenditure-based fiscal consolidation (the 2007 budget relies excessively on higher revenues), supported by modernized budget processes; decisive action to foster domestic competition; a second wave of labor reform; and a deepening of corporate bond and equity markets.

Authorities' views: While broadly agreeing with the staff's analysis, the authorities believe staff underplays recent efforts, given also the political constraints. They see the 2007 budget as an important first step toward medium-term expenditure restraint, and the structural reform process as being on track. On specific policies, the main disagreement is on labor market reform where concerns about nontraditional employment contracts are driving proposals to constrain their use.

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I. BACKGROUND: A PROPITIOUS SETTING FOR ADJUSTMENT AND REFORM

1. **A cyclical upswing is underway.** After four sluggish years, growth recuperated to about 2¼ percent during the first three quarters of 2006 (annualized), as exports finally got some lift from the global expansion, feeding a recovery in fixed investment and employment, and underpinning continued moderate consumption growth. The current pick-up is notably more broad-based and balanced between domestic and foreign sources than the previous aborted recoveries of 2003–04.

2. **But the recovery masks Italy's longer-term low-growth malaise.** Potential growth rates have declined from around 4 percent in the early 1970s to about 1¼ percent currently. Extensive product market regulation and protection, a slow legal system, and a heavy tax burden have all combined to discourage innovation and inhibit restructuring, especially in industry, where the productivity gap relative to France and Germany is striking. Recent reforms of labor contracts have led to a significant increase in employment, but have not translated into higher output due to declining productivity growth. As a result, Italy continues to lose competitiveness. Economic rigidities, along with Italy's historic specialization in products with relatively low value added, contributed to a steady erosion of competitiveness, reflected in a substantial loss of export market share (Box 1).

Annual Labor Productivity Growth by Sector, 2002-05

	Total	Industry 1/	Services
Italy	0.1	-0.1	-0.2
Germany	1.2	3.7	0.3
France	1.0	3.8	0.7

1/ excludes construction

3. **Earlier labor market reforms have led to significant increases in employment.** Employment under new flexible contracts, fostered by the 2003 "Biagi" and earlier laws, has grown briskly, outpacing traditional employment growth and accounting for the bulk of new hires; regularization of immigrants also sustained employment growth. The cheaper flexible contracts helped contain growth of real wage and labor costs, especially in services.[1] The unemployment rate fell to 7 percent by 2006:Q2, but the share of long-term unemployment

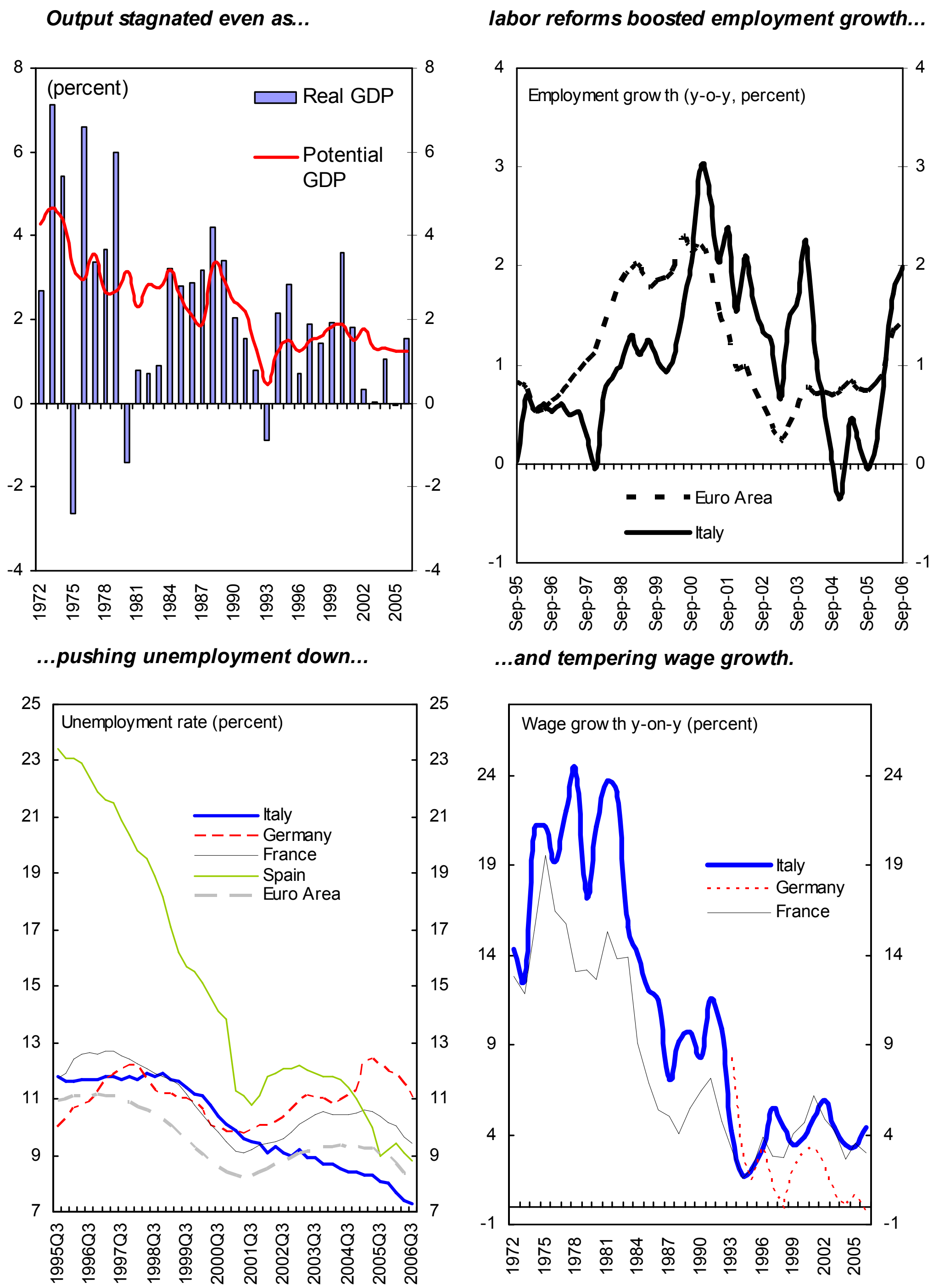
Italy: The Growing Importance of Flexible Employment, 2004-2006

	Levels (thousands)			Growth rates (percent)			Contribution to employment growth (percentage points)
	2004	2005	2006 1/	2005	2006	2004–06	2004–2006
Total employment	**22,438**	**22,651**	**23,187**	**0.9**	**2.4**	**3.3**	
Employees	16,141	16,522	17,015	2.4	3.0	5.4	3.9
percent of total	*72*	*73*	*73*				
Permanent, full time	12,658	12,765	12,937	0.8	1.3	2.2	1.2
percent of total	*56*	*56*	*56*				
Flexible 2/	3,482	3,756	4,078	7.9	8.6	17.1	2.7
percent of total	*16*	*17*	*18*				
Self-employed	6,297	6,129	6,172	-2.7	0.7	-2.0	
percent of total	*28*	*27*	*27*				

Source: Istat
1/ Data for 2006 refer to Q2.
2/ Permanent part-time and all fixed-term contracts.

[1] Estimates indicate that "atypical" contracts (i.e., those other than permanent contracts) reduce labor costs by about 20 percent.

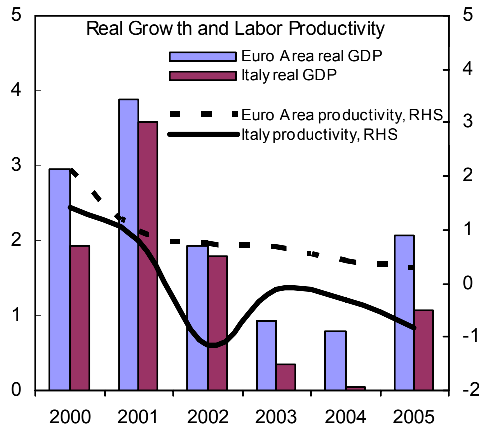
Italian Experience: "Job-rich" Stagnation



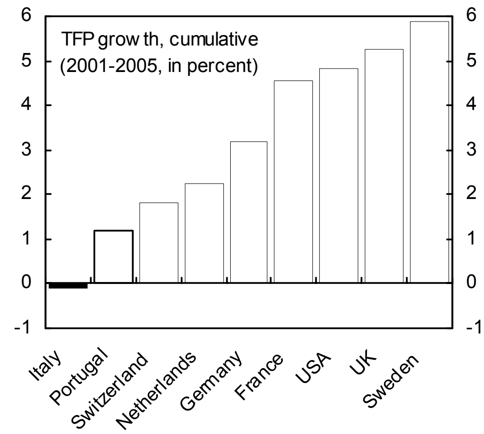
Source: Eurostat, ISTAT, WEO projections.

Low Productivity Growth is a Key Problem

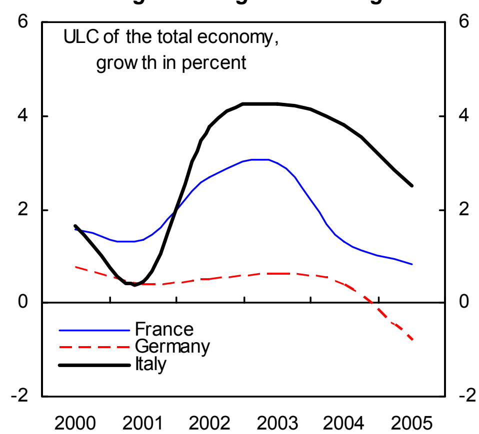
Output growth was disappointing...



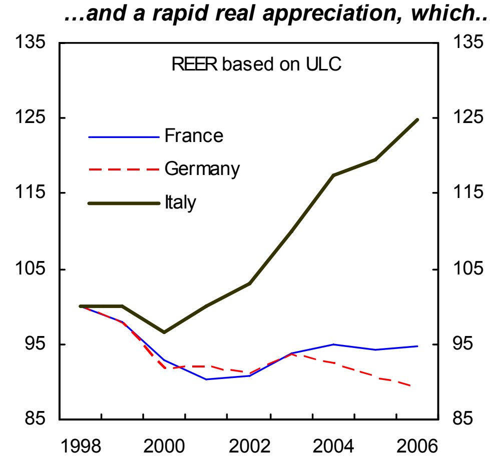
...as productivity fell ...



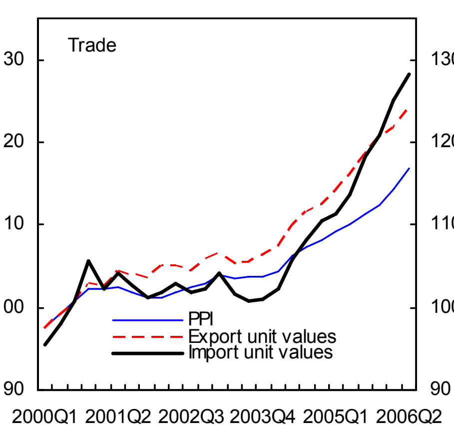
...leading to strong labor cost growth...



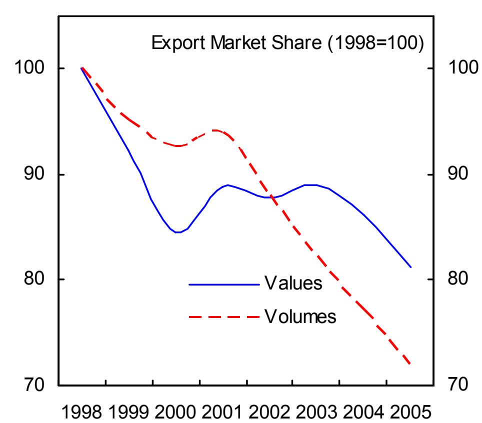
...and a rapid real appreciation, which...



...combined with low competition...



...resulted in a loss of market shares.



Source: Istat, OECD.

(half) has remained unchanged, unemployment among the old and young is still high, and the participation rate has remained at 63 percent since 2003.

Box 1. Italy's Dwindling Competitiveness[1]

Italy has steadily lost export market share since the early 1990s. Based on national accounts data for real exports of goods and services, Italy's market share declined some 38 percent since 1993, versus 2 percent for the euro area as a whole.[2] Constant market share analysis suggests the bulk of Italy's market loss has been due to deteriorating price competitiveness.

Italy: CMS Analysis of Export Changes 1/
(In percent)

	1994–2004
Exports (annual growth rate)	6.4
Contribution	
Word trade effect	8.6
Commodity composition effect	-1.0
Market distribution effect	0.6
Competitiveness	-1.8

Source: IMF staff estimates.
1/ Constant market share analysis based on the commodity composition of exports as of 1994.

A range of indicators points to an appreciable, albeit not large, competitiveness gap versus other euro-area members. Italy's unit labor cost-based real effective exchange rate has appreciated by some 20 percent since 1998—generally considered a benchmark year—and 2005. However, establishing a benchmark year is not without problems and staff used complementary (CPI-based) methodologies to estimate Italy's competitiveness gap at end-2005, including a current account (macroeconomic balance) approach, a reduced-form equilibrium real exchange rate approach using determinants drawn from cross-country panel data analyses (net foreign assets relative to exports, terms of trade, labor productivity, and government consumption), and an external sustainability approach. Though such methodologies have known shortcomings with the results contingent on the assumptions and subject to estimation errors, they suggest a competitiveness gap in the range of 5 to 8 percent.

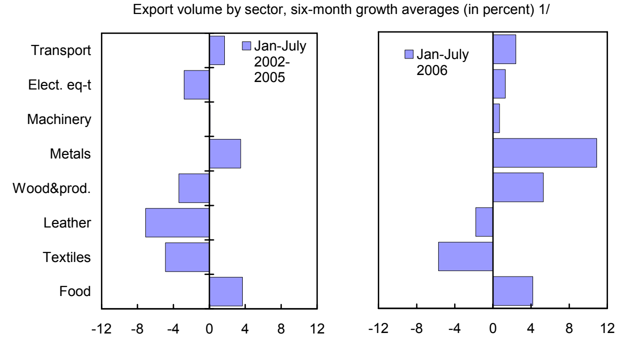
[1] A Selected Issues Paper explores measures of the competitiveness gap.

[2] In value terms, Italy's market share declined by 23 percent in the same period.

4. **There are initial signs of structural transformation.** A recent pick-up in exports in value terms, including in some traditional sectors and in highly competitive emerging markets, suggests that the initial stages of transformation to higher value-added goods may be unfolding. And anecdotal evidence suggests that Italian firms have begun to outsource to enhance their competitiveness, although they remain behind regional competitors in this process.

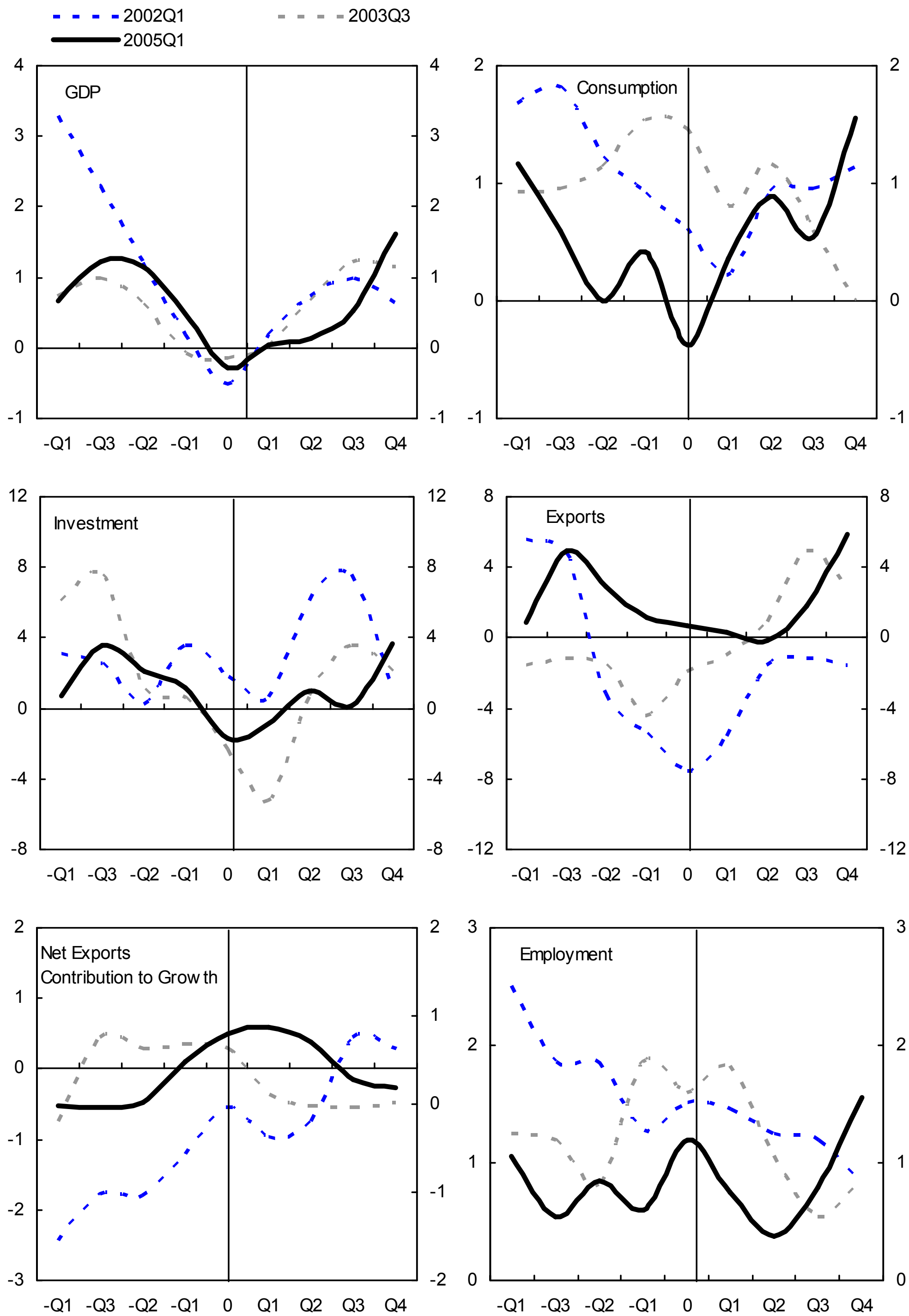
Initial Signs of Recovery in Some Traditional "Made in Italy" Sectors

Export volume by sector, six-month growth averages (in percent) 1/



1/ Normalised by the growth rate of total exports in goods.
Source: ISTAT

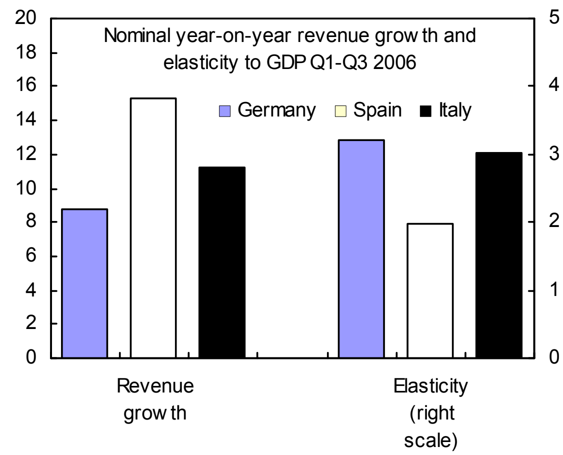
The Anatomy of Recovery: More Balance Among Growth Components 1/



1/ The timing of the quarter "zero" corresponds to the respective troughs of the cyclical upswing episodes, as follows: 2002 - Q1; 2003 - Q3; 2005 - Q1.

Sources: Istat, IMF Staff estimates.

5. **Remarkably strong budget revenues translated into appreciable fiscal overperformance (net of one-offs) in 2006, despite substantial spending overruns.** While the determinants of the revenue buoyancy — observed also in several other EU countries — remain to be fully explained, the increase is broad based and a substantial part seems structural. The authorities speculate that the new government's commitment to eschew tax amnesties and combat tax evasion is enhancing compliance, including on the part of those that have "emerged" as a result of previous pardons.[2] Spending however exceeded the budget target, driven by a persistent upward drift in primary outlays (Box 2).[3] Still, the general government deficit, net of two large one-off operations,[4] is estimated by staff to have declined to 3.0 percent of GDP in 2006 (versus an original budget target of 3½ percent of GDP), implying an appreciable withdrawal of fiscal impulse. The headline deficit, however, is estimated to have risen to 5.0 percent of GDP.



6. **The 2007 budget seems likely to meet the thrust of Italy's EDP obligations.** The budget targets a headline deficit of 2.8 percent of GDP and, in official calculations, a cumulative underlying adjustment of 1½ percent of GDP in 2006–07. In staff's view, even discounting the yield of certain measures, the more favorable base given by the 2006 overperformance should ensure that the headline target is met, although staff's estimate of underlying adjustment is less (some 1 percent of GDP). After rising in both 2005 and 2006 (partly due to the VAT repayments), the public debt/GDP ratio is projected by staff to remain broadly unchanged in 2007, at around 107 percent.

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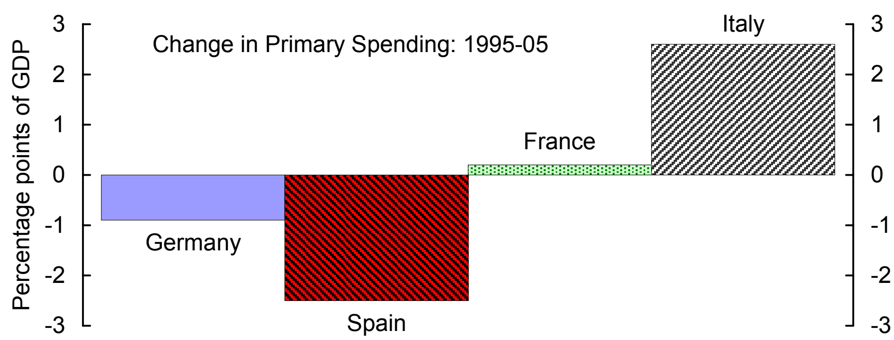
[2] Despite the government's commitment, the 2007 budget does contain a limited amnesty for social security contributions to facilitate the emergence of irregular work situations.

[3] A Selected Issues Paper looks into the structural causes of spending growth.

[4] Namely the European court-mandated refund of VAT collected on the sale of company cars and the government's assumption of railroad-related debt, amounting to some 2 percent of GDP.

Box 2. The Relentless Growth of Primary Spending

Italy's primary spending ratio grew by 2½ percentage points of GDP in 1995–2005, in marked contrast to other large euro-area countries.



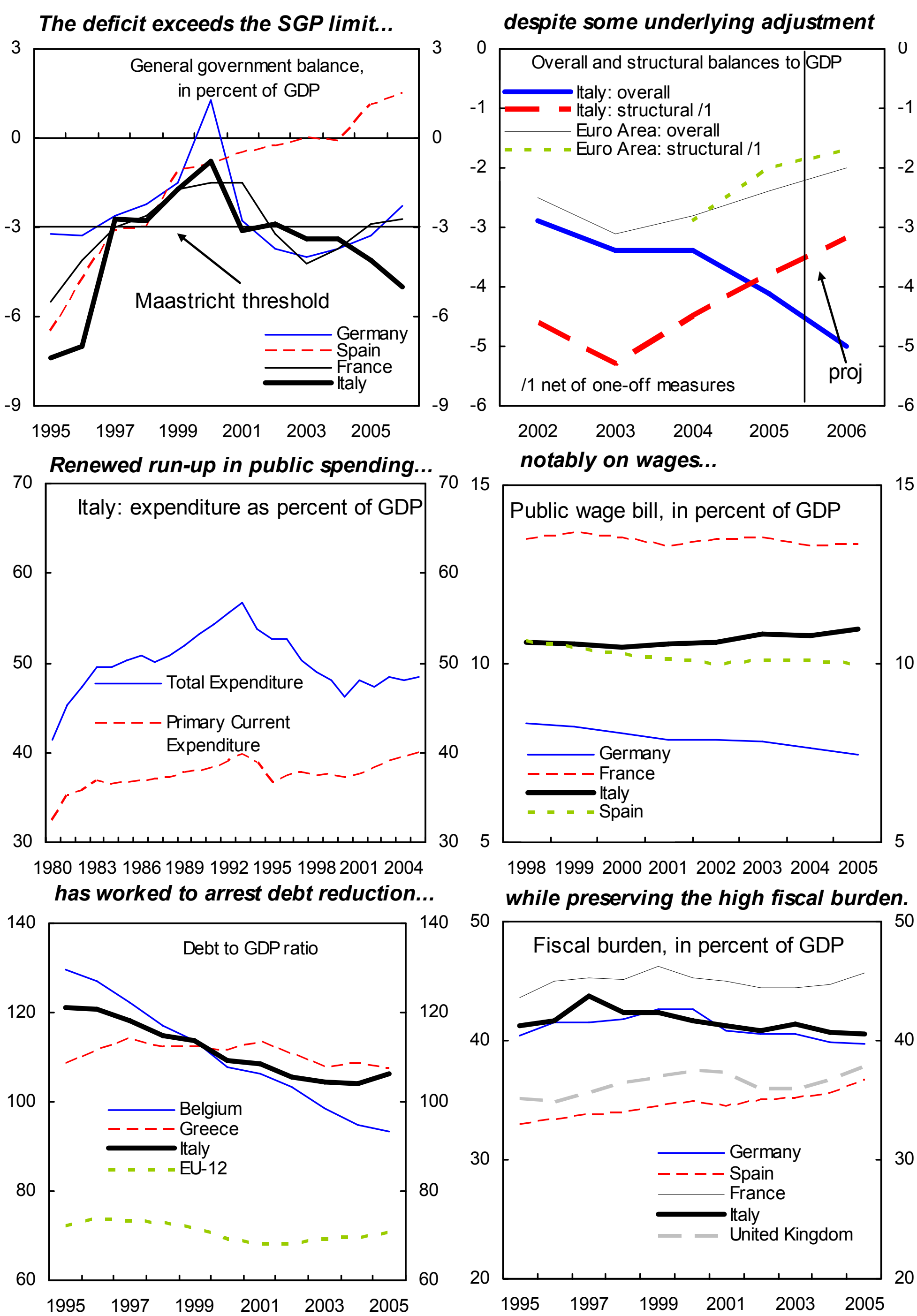
Part of the spending growth appears to stem from euro-area wide convergence in current primary expenditure/GDP ratios, of which there is some evidence. In Italy the initial level of such spending was lower than the euro-area average, though health care spending has now caught up, and the pension and public wage bills are significantly above those of the euro area. Also, the pronounced decline in long-term interest rates over the past decade cut the cost of capital (especially for high-debt countries) and facilitated investment spending.

But the rise in primary spending also reflects missed opportunities from the lower interest bill, combined with Italy-specific policy slippages.

- The large fall in the interest bill in high-debt countries was ultimately used for new spending, rather than deficit reduction.
- Italy incurred significant overruns relative to own-spending targets, explaining much of the deficit slippages in 2001–05.
- With social spending growth contained by pension reforms, other current spending (notably on wages and goods and services) rose rapidly since the late 1990s, partly reflecting the lack of a comprehensive expenditure framework.

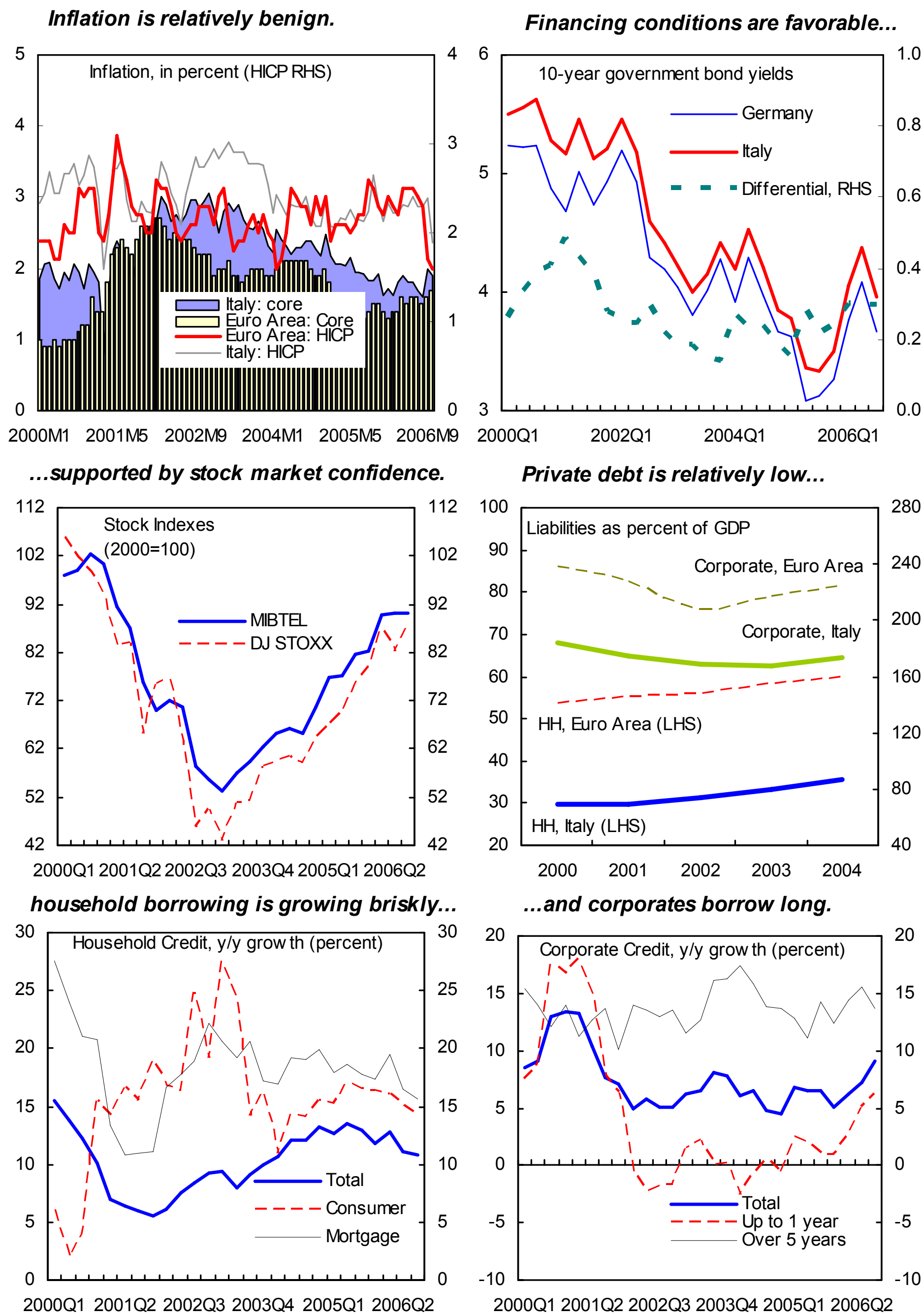
7. **Financial conditions remain sound.** Bank profits have edged up and the quality of their loan portfolio has improved. Household balance sheets remain robust despite double-digit consumer credit growth over the past few years. Household debt, at 34 percent of GDP, is well below the euro-area average. Despite the recent up-tick in servicing costs, delinquency rates are low. Corporate leverage also increased as corporations locked in low interest rates. The October 2006 downgrading of Italian sovereign debt had a minimal impact

Fiscal Imbalances Persist



Source: Eurostat and ISTAT

Monetary and Financial Indicators Remain Favorable



Sources: Eurostat, Istat.

on long-term spreads, which remain—at about 30 basis points relative to German Bunds—somewhat lower than during the period surrounding the April 2006 elections. Continued lengthening in the average public debt maturity has further reduced the sensitivity of debt service to upward interest rate movements.

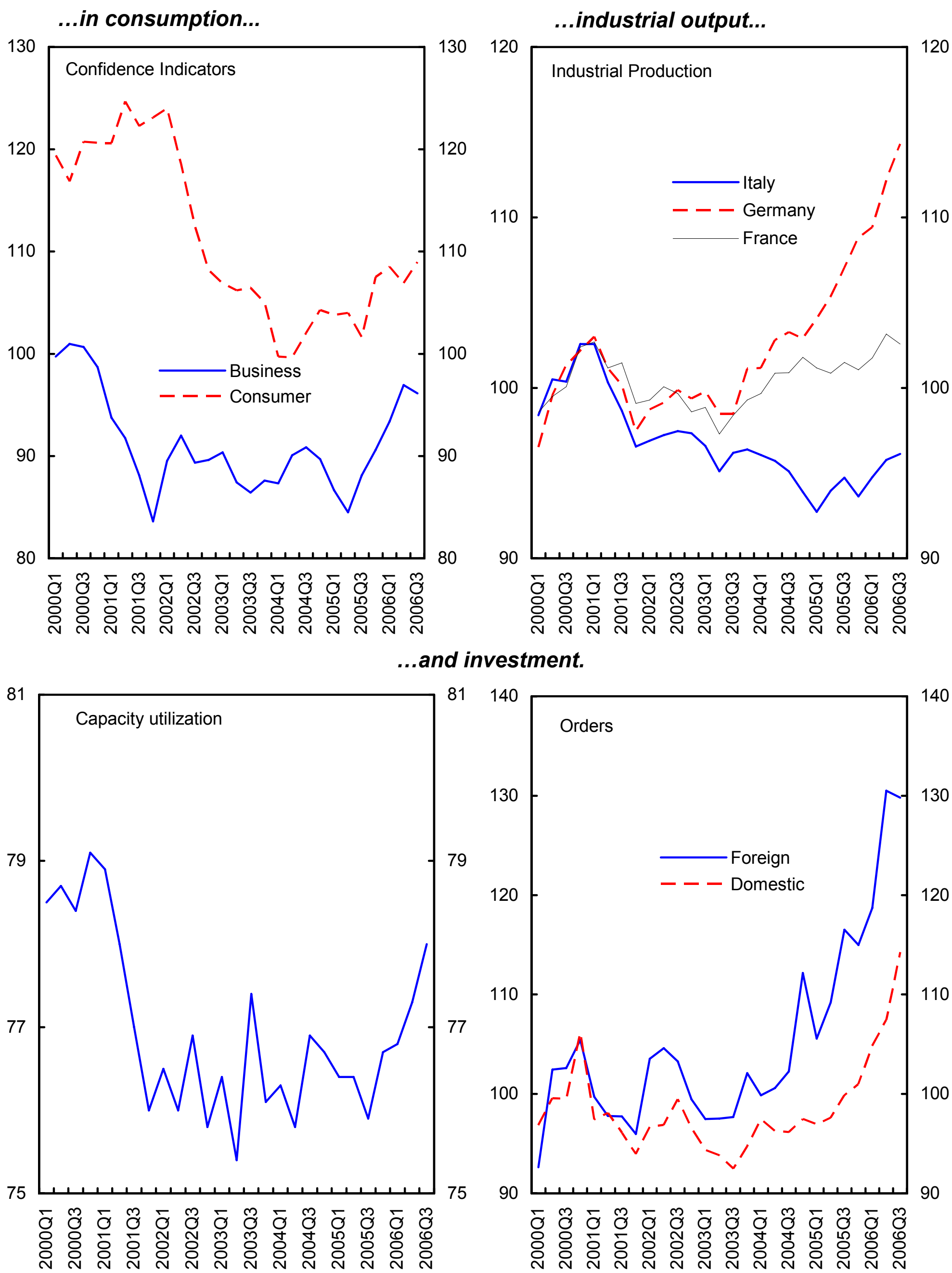
8. **Staff expects growth to slow from 1.7 percent in 2006 to 1.4 percent in 2007.** Continued moderate consumption growth would be supported by increased disposable income, employment gains, and healthy balance sheets. Investment growth seems set to decelerate but remain positive, sustained by domestic and foreign demand, increases in capacity utilization, and favorable financing conditions. The contribution of net exports would again be flat.

9. **The risks to the outlook appear broadly balanced.** The authorities saw slowing partner country growth, including a sharper than expected slowdown in the United States, and an unwinding of global imbalances that entailed euro appreciation as the main downside risks. Staff and other observers also noted the risk of adverse confidence effects provoked by the 2007 budget's reliance on the revenue side. Upside risks stem from the ongoing economic restructuring, which some observers—while recognizing the lack of hard data—view as relatively advanced.

10. **Inflation is set to hover slightly above 2 percent.** Although headline CPI inflation recently edged down to 2 percent thanks to declines in oil prices and base effects, core inflation edged above that of the euro area, to 2 percent. The relatively high level of inflation in Italy suggests that the staff's estimate of economic slack could be overstated, at least in the labor market. Thus, while staff projects wage growth of 3 percent in 2007, the possibility of generous wage increases in the public sector, with a demonstration effect on the private sector, could threaten this outlook.

11. **The politics are difficult.** The recently elected center-left government's parliamentary majority is thin and the coalition comprises a broad spectrum of economic views, ranging from a committed reformist core to parties resistant to market-oriented reform. Although the government has overcome the budget hurdle, this has not been without concessions, and the outlook for fundamental fiscal adjustment and economic reform remains uncertain, with market concerns reflected in the credit ratings downgrades.

High-Frequency Indicators Bode Well for Continued Moderate Growth...



Sources: Istat, ISAE.

12. **Converting the current cyclical upswing into sustained growth and fiscal adjustment will require advancing on a broad front,** stressed in previous Fund advice. Within this overarching theme, the Consultation discussions—the first with the new government—focused on using the start of the government's term and the cyclical upswing to:

- embark on and sustain expenditure-based fiscal consolidation;
- return to growth by stepping up structural reforms;
- further develop the financial system, while maintaining financial stability.

II. Policy Discussions

A. "If not now, when?"

13. **The government has committed to strengthen the fiscal accounts and undertake competition-enhancing reforms, but deeds have not fully kept pace with words.** In staff's view, the 2007 budget puts too little emphasis on expenditure control and—after a promising start—the structural reform process still has to gain momentum and strategic coherence. The authorities contested this view, both in its substance (seeing the 2007 budget as an important first step on the medium-term consolidation path, and the structural reform process as being on track), and in its approach, arguing that the yardstick for assessing the government's action should reflect a pragmatic, tempered balance between what is desirable and what is feasible, with critics (including staff) focusing unrealistically on the former

14. **In staff's view, the current environment is likely to prove "as good as it gets" for needed reforms.** International experience indicates that structural reforms are best enacted early in a government's mandate. Furthermore, a cyclical upturn marked by significant revenue overperformance constitutes a highly supportive setting for fiscal adjustment. While deferring on the assessment of the political constraints, staff shared the approach set out in the government's ambitious medium-term economic program of July 2006—centered on expenditure control in key areas and competition-enhancing reforms—and argued for early action exploiting the window of opportunity now open.

Italy: Fund Policy Recommendations and Implementation

Policy Area	Fund Recommendations	Implementation
Fiscal policy		
Fiscal consolidation	Adopt and begin implementing credible medium-term consolidation plan to achieve overall balance by 2010, relying on targeted measures to contain spending	Near-term deficit reduction is underway, but consolidation to date has relied on revenue increases, across-the-board expenditure cuts, and one-off measures. A medium-term framework remains lacking.
Pension reform	Curtail long-term spending pressure from population aging by reforming the pension system	A series of pension reforms has significantly improved long-term fiscal sustainability, but some key reform elements have not yet been implemented.
Public financial management	Enhance transparency and timeliness of fiscal reporting; modernize budget preparation and execution	Significant progress only on narrowing the historically large stock-flow discrepancy. Budget process remains tortuous and nontransparent, with little accountability for results.
Structural reforms		
Labor market	Build on previous labor market reforms to strengthen unemployment support and relax employment protection	First round of labor market reforms successful, but no action on Fund calls for a second round.
Product market	Pursue comprehensive range of product market reforms to spur competition and growth	Various reforms over the years, yet overall progress has been slow and surveys still point to high levels of regulation and shortcomings in the business environment.
Financial sector	Address structural weaknesses including limited banking market contestability; high operating costs; and undersized corporate bond and equity markets	Appreciable progress, particularly in banking market contestability and other 2005 FSSA recommendations, but further progress needed in enhancing corporate bond and equity markets, and reducing bank costs.

B. Pursuing Sustained Fiscal Consolidation

The 2007 budget

15. **While the likely observance of EDP commitments is a noteworthy achievement, views differed on the headway being made on fundamental expenditure control.** Due to a range of new "pro-growth" and "pro-equity" spending initiatives, the 2007 budget promises no net reduction in spending, and the targeted adjustment comes entirely from an increase in the revenue ratio. While staff acknowledged that the budget contains some first steps to address medium-term spending pressures, it saw these as falling short of realizing the commitment in the government's medium-term economic program of countering these pressures comprehensively in the key areas that account for the bulk of spending—public administration, local authorities, health care, and pensions.

Key Fiscal Indicators, 2005–07
(In percent of GDP) 1/

	2005	2006		2007	
		staff	auth.	staff 2/	budget
Total Revenues	44.4	45.7	45.2	46.3	46.0
Total Expenditures 3/	48.5	48.7	48.8	49.0	48.8
Overall Balance 3/	-4.1	-3.0	-3.6	-2.7	-2.8
Structural Balance 3/	-3.3	-2.4	-3.0	-2.3	-2.3
net of all one-off measures	-3.8	-3.2	-3.7	-2.8	-2.4

1/ Assumes staff's GDP and output gap throughout.
2/ Treats severance benefits contributions (0.4 percent of GDP) as one-off.
3/ For 2006, net of two large one-off operations, which raise the deficit by 2 percent of GDP.

- ***Public administration.*** The budget incorporates plans for reorganizing the public sector, reducing ministerial offices, eliminating duplication, regrouping agencies from a provincial to a regional level, and gradually reducing public employment. The authorities recognized that key to success lies in securing increased mobility in the civil service, which could not be legislated but would be pursued with the trade unions in early 2007. Staff noted that the resulting savings risked being largely offset by relatively generous wage renewals and large-scale conversions of temporary contracts to open-ended employment.

- ***Local authorities.*** A new Domestic Stability Pact replaces expenditure ceilings with explicit deficit targets, and grants local authorities greater taxing leeway, while cutting state transfers. The authorities rebuffed arguments that these measures will mostly operate through higher local taxes, since local authorities could (and should) increase efficiency and cut spending. There was agreement that attaining full-fledged fiscal federalism will require further institutional steps—under preparation—to reconcile local autonomy with fiscal responsibility.

- ***Health care.*** In September 2006, the government signed a potentially promising new "health pact" with the regions, establishing multiyear financing envelopes to increase budgetary certainty, and undertaking various cost–saving initiatives. Regions in breach of their healthcare spending limits and failing to take sufficient corrective measures have been made subject to automatic increases in some regional tax rates (as envisioned in the 2006 budget)—a measure expected to exercise a particularly effective disciplining role in the five affected regions.

- ***Pensions.*** The budget raises contribution rates for the self-employed, but contains no cost-saving measures in this area. Rather, in September 2006, the government signed a Memorandum of Understanding with the trade unions setting out broad principles and a number of potentially constructive commitments (regarding, for example, incentives to lengthen the average working life and links to demographic developments) for additional pension reform by March 2007. Staff stressed that any agreement would need, at the least, to fully preserve the financial impact of already approved reforms[5] and help raise the still very low elderly participation rates, contributing to enhance potential growth. The budget also brings forward steps to promote private pensions savings, originally due to come into effect in 2008.

16. **The authorities argued that the 2007 budget initiated more medium-term spending restraint than generally recognized or than most previous budgets.** They felt that much of the criticism failed to consider some key constraints. First, the difficulty of the inherited situation, in the form of unrealistic spending ceilings, and consequent overruns, in the 2006 budget. And second, the short-term rigidity of spending, and the related fact that longer-term structural reforms are the real key to growth and fiscal sustainability, a process they intend to pursue in 2007. Even so, the authorities argued that appreciable progress was implied on the spending side—arresting the rising trend of current primary spending and broadly stabilizing its ratio to GDP in 2007.

17. **The authorities also noted that many of the revenue items in the budget were worthy initiatives in their own right:**

- A significant portion of the revenue increase was expected to come from measures to reduce tax evasion and avoidance, and which—apart from equity considerations—would yield important efficiency gains and did not involve an increase in tax rates. The authorities have also committed to reduce tax rates in the future in parallel with gains from the proposed measures.

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[5] Two legislated changes to the pension system remain to be implemented: (i) the adjustment of pension replacement rates in line with developments in life expectancy (mandated to take place every ten years under the 1995 "Dini" reform, but not implemented in 2005); and (ii) a step increase in the retirement age for seniority pensions (from 57 to 60), set to occur in 2008 under the "Tremonti-Maroni" reform of 2004.

- The planned unification of tax rates for final withholding on various types of financial income would remove distortions in the tax system.

- The cut in the tax on labor would help enterprise competitiveness.

Thus, rather than constraining medium-term growth prospects, these measures were in the authorities' view likely to enhance economic efficiency and growth potential.

18. **While welcoming measures to broaden the revenue base, staff urged greater reliance on expenditure restraint and enhancing its quality.** Evidence from around the world clearly shows that, to be successful and durable, fiscal adjustment needs to be based on curbing current expenditure, not raising revenue, partly because of the confidence-dampening impact an increase in the tax burden can have[6]—and to allow a concomitant reduction in tax rates, while safeguarding deficit reduction. Also, a higher revenue-to-GDP ratio risks providing leeway for additional spending. Staff noted that there was considerable scope for enhancing the effectiveness and efficiency of individual spending programs—a point shared by the authorities.

19. **Staff took exception to the redirection of workers' severance fund flows being treated as "adjustment."** The budget contains a measure—designed to promote supplementary pension savings—whereby workers' contributions to firm-based severance funds would automatically be directed to a private pension fund (in most cases, an occupational pension fund) in 2007, unless the worker explicitly opts for another pension fund or for continued accumulation of severance funds. In the latter case, and for firms with over 50 employees, contributions (recorded as revenue in the fiscal accounts) would accrue to a special account at the Social Security Institute, to be used to finance public infrastructure. Staff noted that such flows (estimated at 0.4 percent of GDP in 2007) give rise to a liability to provide workers with severance payments in the future, and their diversion to the state would furthermore be costly (as the government is to match not only the previous return on such funds but also compensate enterprises for the loss of cheap financing).

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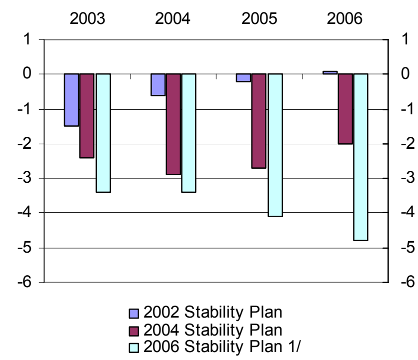
[6] Research in this area has in the event been spearheaded by Italian academics (including Alesina, Perotti, Tabellini and others); for an international overview see, "Experience with Large Fiscal Adjustments," IMF Occasional Paper, No. 246.

Longer-term fiscal sustainability

20. **Achieving long-term sustainability means going beyond EDP targets.** Staff projections show that without deficit reduction beyond that contained in the EDP commitment to bring the deficit below 3 percent of GDP in 2007, public debt will be on an explosive path. By contrast, further consolidation through 2010, along with a modest improvement in productivity growth, would put the debt ratio on a firmly declining trend (Box 3). While the authorities' official Medium-Term Objective—a small overall surplus by 2011—is consistent with that proposed by staff (the same surplus by 2010), a legacy of missed budget targets and persistent failure to undertake expenditure-based fiscal adjustment has severely eroded its credibility.

Deficit Forecasts/Outcomes, 2003-06
(In percent of GDP)



1/ In 2006, excludes impact of railroad debt (0.9 percent of GDP).

21. **The mission called for a multiyear spending framework with clear targets for outer years, backed by structural expenditure-saving measures.** Such measures should be defined soon to be effective before the next budget round, with the aim of bringing the fiscal accounts into balance at least by 2010. Without such measures, Italy's reentry below the Maastricht threshold could be short-lived: indeed, staff projects a deficit of 3.0 percent of GDP in 2008, and official forecasts also see the deficit creeping back up to 2.9 percent of GDP in the absence of further measures. A credible framework to ensure that any revenue overperformance be used for deficit reduction would also help.

22. **The authorities' medium-term plan envisages reducing public debt to below 100 percent of GDP by 2011.** This is to be done essentially by rebuilding the primary surplus—now negative (partly reflecting one-off factors)—to just under 5 percent of GDP by 2011; the medium-term plan does not contain any explicit assumptions about debt reduction via privatization or asset sales. The authorities explained that while sales of public equity and other assets would proceed as and where possible (with some being planned for 2007), they viewed skeptically the feasibility of large-scale operations being studied by the previous government. They furthermore did not wish to nourish any illusion of an "easy" solution beyond the hard work of rebuilding a sufficiently large primary surplus. They nonetheless shared staff's call for continued public divestment and for deep restructuring of several financially distressed public enterprises (Box 4).[7]

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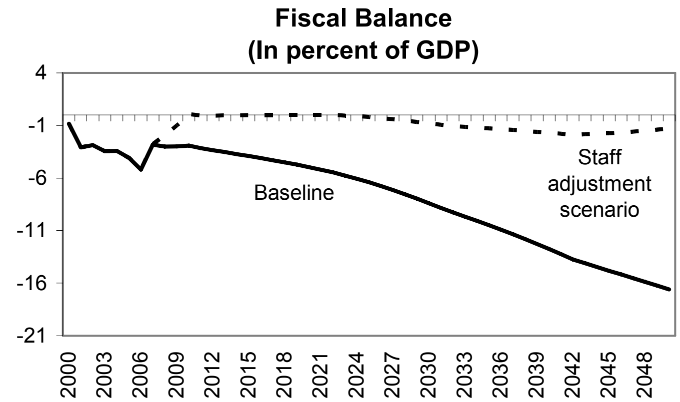
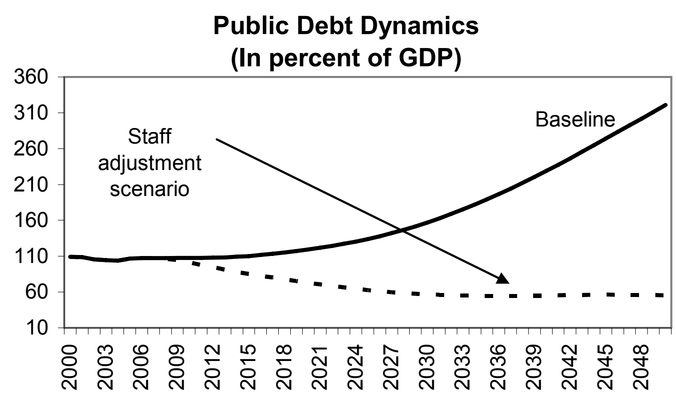
[7] A Selected Issues Paper examines potential fiscal risks arising from two large public enterprises, based on the criteria identified in "Public Investment and Fiscal Policy—Lessons from the Pilot Country Studies," IMF (April, 2005).

Box 3. Fiscal Sustainability—Averting a Debt Explosion

Baseline scenario – debt explosion. The baseline assumes current policies through 2010 and thereafter keeps revenue and non-age-related spending ratios to GDP constant. Age-related spending reflects the authorities' demographic projections and recent pension reforms (part of which remain to be implemented). Given unchanged policies, it assumes only a modest rise in labor productivity growth (to 1¼ percent annually, slightly above the rate achieved over the last few years) and in the employment ratio (by 5 percentage points over the next 20 years). Both assumptions are less optimistic than official projections, and together result in long-run annual real GDP growth of ¾ percent (and per capita GDP growth of slightly under 1 percent). The medium-term TFP growth would slightly lag labor productivity, but its estimation is hampered by significant data uncertainties. In any case, the growth in labor productivity would have to be supported by a combination of fairly modest employment gains and strong gross fixed capital formation. Under these assumptions, the fiscal deficit would decline over the next few years, but would rise thereafter, due to increased aging-related spending and, later, interest payments. The debt ratio would explode to almost 300 percent in 2050. In addition, failure to implement already legislated pension reforms would lead to even more explosive debt dynamics (Table 5).



Adjustment scenario – debt stabilizes below the Maastricht threshold. The staff's adjustment scenario features further structural consolidation of 0.8 percentage point of GDP every year in 2008–10 through spending cuts, reaching a small overall surplus. Assuming current and future structural reforms, productivity growth would increase by ¼ percentage point over the baseline. Interest bill savings would finance higher age-related spending, with the debt ratio falling to around 55 percent by 2035 and then stabilizing. The stark gap between the two scenarios derives from the accumulated difference in the fiscal balance through 2010 and the (upward) impact of (slower) growth on the pension/GDP ratio. These results underscore that achieving debt sustainability depends on both further fiscal consolidation and growth-promoting structural reforms.



Box 4. Fiscal Risks from Italy's Public Enterprises

Italy's once vast public enterprise sector has been significantly reduced over the last two decades. In 1992, 12 of the 20 largest Italian firms (by sales) were state-owned, and the state's holding companies were among the largest employers in the country. Despite being sheltered by legal monopolies and enjoying exclusive state concessions, the vast majority were unprofitable. Enabled by legislative and institutional changes, about 80 major privatizations, totaling some €125 billion, were completed during 1993–2005. Receipts were channeled to the Debt Retirement Fund, created in 1993, significantly reducing public debt.

The state's current portfolio includes holdings in four listed companies and some twenty unlisted companies. The listed companies are performing well, with the notable exception of the airline company Alitalia; their market value was estimated at €32 billion (about 2 percent of GDP) at end-October 2006. Unlisted companies operate in various sectors; the Ministry of Economy and Finance intends to divest the most profitable over the next few years (with an estimated value of about 2 percent of GDP). However, the road company (ANAS) and the railway holding company (FFSS) are running losses financed by state transfers and reserve drawdowns.

These companies' shaky finances pose fiscal risks. Even if the government, according to corporate law, would not be directly responsible for their liabilities in case of default, it is likely that these companies, that jointly employ more than 100,000 workers, would be considered "too big to fail." At the same time, the government has also been transferring risks to these companies, by cutting their capital transfers (deep cuts in the 2006 budget had to be reversed with midyear supplementary allocations when they proved unfeasible). While needed restructuring will take time, early steps to secure timely reporting and enhanced transparency of these companies' operations will be key to any reform effort.

23. **Reform of the tortuous budget process is critical.** This is widely agreed, in good part because of the following considerations:

- The budget's unwieldy "omnibus" presentation, fragmented into thousands of budget forecasting units, and set out in various documents using different aggregations and accounting methods, renders it inaccessible to most and fails to provide a clear picture of government finances even to the initiated.

- These same features—combined with a complex approval process and delays in the availability of some key documents—also render the budget almost impossible to approve in line with the parliamentary schedule, leading to systematic recourse to confidence votes, even by governments with comfortable majorities.

- Budget preparation and execution is focused on legal compliance rather than on efficiency and quality of public services, with a related lack of accountability for results.

Momentum is thus building for budget reform, including a move to performance-based budgeting.[8] Staff also called for improvements in the timeliness of some key budget documents and for greater institutional independence of budget assessments and projections. The authorities are pursuing some initiatives designed to enhance independence of fiscal analysis, largely based on the existing institutional framework.

C. Returning to Growth

Stepping up structural reforms

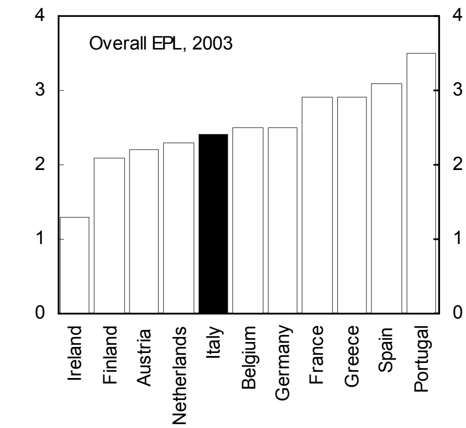
24. **There was agreement on many areas of structural reform needed to address insufficient competition and overregulation, but not on labor markets.** The OECD reports that Italy has the most highly regulated product markets in the EU-15, and various cross-country reviews identify excessive regulation as a continuing problem in key sectors, accounting also for Italy's undersized services sector and high energy prices. In part due to these problems, Italy's ranking in cross-country surveys of the business environment is poor (and worsening). Significant labor market rigidities (notwithstanding important progress) also inhibit growth by slowing labor reallocation. There was agreement that reforms to promote competition and eliminate bureaucratic impediments are thus essential to foster innovation and restore competitiveness. Indeed, these arguments feature prominently in the government's medium-term program, which presents a compelling illustration of the benefits of greater competition for households' budgets and firms' costs (though it is short on details). In labor markets, however, staff and the authorities differed on the appropriate prescriptions on how best to address concerns about "precarious" employment.

25. **After a promising start, the liberalization process has encountered stiff resistance from interest groups.** In July 2006, the government approved a package of measures that liberalized aspects of transportation, professional services, retail trade, and banking and insurance services. Some of the reforms subsequently fell hostage to sectoral opposition, with, for example, protests by taxi drivers leading to maintenance of a key restriction to market access; supermarkets and other nonpharmacy outlets encountering supply difficulties for over-the-counter drugs they are now authorized to sell; and banks seeking means to hinder the effective portability of accounts and by-pass the disposition allowing their free closure. The Antitrust Authority has been proactive in attempting to ensure that such resistance would not dilute the reforms' impact, promptly initiating enquiries into possible anticompetitive behavior, and has availed itself of new powers, including those over competition in the banking sector (previously vested in the Bank of

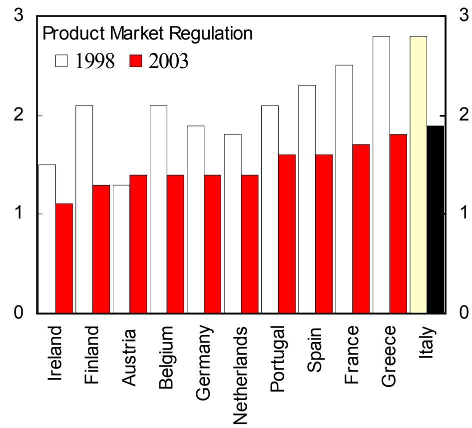
[8] Such changes would be in line with the recommendations of the 2002 ROSC.

Italy's Economy Remains Rigid

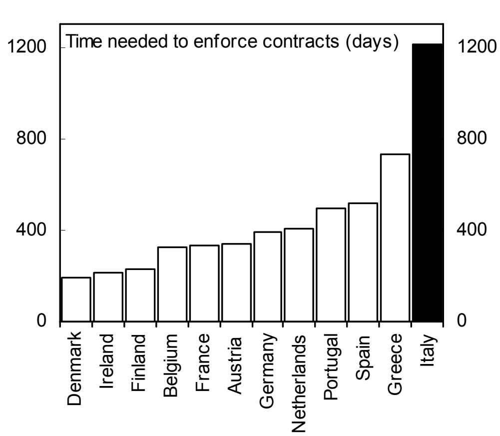
Although employment protection is about average...



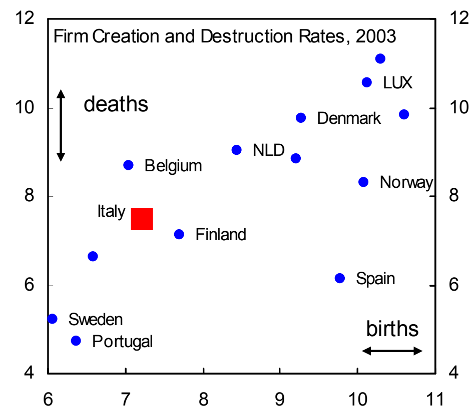
product markets are highly regulated...



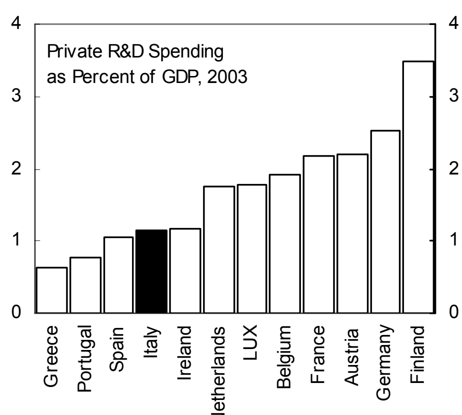
...and business environment is problematic...



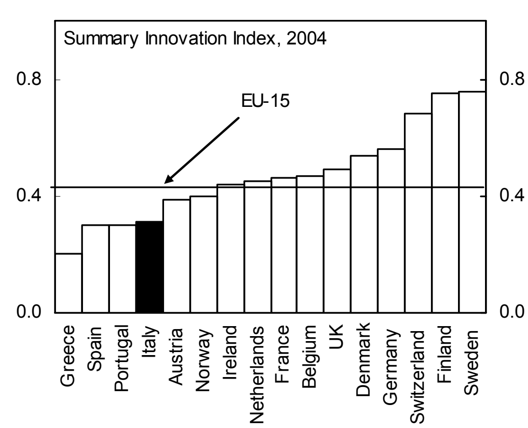
...slowing firm creation...



...R&D investment ...



...and rates of knowledge creation and dissemination.



Source: OECD, EC, Eurostat, ISTAT.

Italy). It also expected the newly introduced "leniency policy" (whereby companies that provide information about a cartel in which they participate could receive immunity from fines) to be a potent instrument—as has been the case in other countries (including the United States).

26. **The government has vowed to persevere with deregulation and liberalization, and a number of draft laws are in the works—but they too face opposition.** The main initiatives concern energy, local public services, class action suits, and professional services. Several of these proposals face opposition—including from within the coalition—and thus an uncertain fate in Parliament. Resistance is particularly strong vis-à-vis initiatives that would open up local utilities to a competitive bidding process (the current practice of direct assignments to municipal companies being a long-standing font of patronage, in addition to a source of inefficiency); the easing of access to the professions; and the introduction of class action lawsuits, where fear of abuses may considerably enfeeble the scope for consumer redress. As to reform sequencing, there was agreement—based also on the July 2006 experience—that a bold stroke, simultaneously affecting economic rents across several markets, could help promote consensus and balance the interests of opposing stakeholders. Staff accordingly encouraged ambitious, broad, and early liberalizing moves. At the same time, given the dispersion of ministerial responsibilities, it saw a need for a strategic view and enhanced coordination in the pursuit of the liberalization agenda.

27. **The government's preoccupation with reducing the precariousness of employment threatens the recent liberalization of labor contracts.** The liberalization of labor contracts in 2002–03 coincided with sharp employment growth, with the growth of "liberalized" employment outpacing that of "traditional" employment. Despite this, the level of temporary contracts in Italy is still comparatively low. There is nonetheless strong pressure (from trade unions and from within the coalition) to take steps to make employment more "stable" and reduce its precariousness. Proposals are still being developed, but are likely to include the suppression of some atypical contracts, limitations on the use and renewal of fixed-term contracts, and other steps to reverse the cost advantages of fixed-term contracts. In contrast, staff reiterated the need to further reduce the still high protection afforded to regular contracts, alongside introducing a well designed unemployment benefit scheme—whose absence underlies concerns about precariousness and inhibits risk-taking and mobility. It noted that simulations in other European countries suggest that, absent reforms affecting the rigidity of regular contracts, the initial employment spurt from liberalizing contracts will eventually fade. While instituting an adequate unemployment safety net is part of the official policy agenda, the authorities firmly ruled out easing dismissal protection, as contrary to the coalition's electoral platform.[9]

[9] At the same time, in policy circles, the Danish "flexicurity" model—far removed from the Italian reality—tends to exercise a somewhat facile appeal. For the difficulties of generalizing this model, see Zhou, Jianping, "Danish for all? Balancing Flexibility with Security: The Flexicurity Model," IMF Country Report No. 06/342.

Further developing the financial system

28. **The new leadership of the Bank of Italy has supported banking sector consolidation, with tangible results.** Shortly after taking office, the new Governor criticized the Italian banking system's "strategic inertia" and made the case for a sustained, market-driven, consolidation effort. In this vein, the Bank of Italy abolished the requirement to notify the supervisory authorities of merger plans even before they are submitted to the board of directors. There has been appreciable movement over the past year: some sizable mergers are underway, including one that would create Europe's third largest bank and, notably, cross-border mergers have also taken place or are being discussed.[10] This process should enhance efficiency in the banking system—where the costs of banking services for customers are still high—and promote growth. The process is also testing the new joint oversight of merger activity by the Bank of Italy and the Antitrust Authority: while there remain some transition issues to resolve, both parties felt that matters were proceeding relatively smoothly. For its part, the Bank of Italy has announced a plan to reorganize its structure and staffing levels over time.

29. **There was agreement that, to support growth and innovation, Italy's financial system needs to further develop its capital markets** (Box 5)**.**[11] The stock, insurance, and corporate bond markets are developing rapidly, but remain undersized. A range of key indicators are below the euro-area average, some considerably: the number of listed companies and the ratio of their total capitalization to GDP; the proportion of private equity investment dedicated to venture capital operations and, even more so, to start-ups; the capacity of small firms with innovative projects to raise funds on the capital markets; and the role of specialized intermediaries and pension funds. The situation is attributable to a range of impediments: bankruptcy and debt recovery procedures remain lengthy; the enforcement of corporate governance provisions has shortcomings; and a history of high tax evasion may compound these problems, as family-owned firms may believe they can more easily avoid the scrutiny of the fiscal authorities if they do not open themselves to outside capital. Against this, the authorities saw potential in their plans for a supplementary pension pillar. Staff concurred, but stressed that—given the complexity of the mechanism for the allocation of workers' severance payment flows—there was a need for a clear educational campaign to allow informed choices. Free and fair competition between classes of asset managers and types of retirement schemes would also be important.

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[10] With consolidation also involving cooperative banks, the Bank of Italy has called for adapting the corporative governance rules of such banks and, in early December, the government announced its intention to revise their voting structure.

[11] A Selected Issues Paper explores links between the financial system and growth.

Box 5. Finance and Growth in Italy

International experience suggests Italy's growth prospects would benefit from further diversifying and deepening its financial system. Not only is financial development in general associated with higher growth, there is also some macro evidence suggesting that industrial countries with financial systems dominated by a particular type of intermediation, especially relationship lending, are less able to seize growth opportunities.[1] The effect is particularly pronounced in countries that have specialized in more traditional industries, such as Italy.

Analysis of Italian micro data supports the tenet that availability of alternative sources of financing is associated with higher productivity and growth. The results, set out in a Selected Issues Paper, hold even when controlling for firm-specific financing decisions and industry-specific effects. In particular:

- Debt financing has a positive marginal effect on firms' future investment, innovation, and revenues. In particular, bond leverage is especially important in high-growth and tech-intensive sectors. And bond debt may mitigate the (generally negative) effect of concentrated ownership.
- Diversification of bank lenders improves a firm's future growth.
- Public equity financing is strongly correlated with high growth and innovation. And firms that decide to list are more likely to operate in high-growth sectors, with high capital requirements and leverage.

Policies that could promote alternative financing sources include measures to: promote bank competition; reduce listing costs; enhance the effectiveness of corporate governance, accounting, and disclosure requirements; further enhance minority shareholder protection; discipline insider dealing reduce the overall administrative burden of doing business; and increase investor and creditor protection. EU-wide initiatives such as Financial Services Action Plan aimed at eliminating the remaining fragmentation in capital markets, offer a useful legal framework. Development of a private pension pillar and further public divestment could also help. While there has been progress across several of these areas in Italy, it remains uneven and insufficient.

[1] See Levine, R., 2005, "Industry Growth and Capital Allocation: Does Having a Market- or Bank-Based System Matter?" in *Governance: An International Perspective,* Vol. 2; pp. 538–71; Elgar, Massachusetts, and IMF, World Economic Outlook, October 2006.

D. Maintaining Financial Stability

30. **The 2005 FSSA found that Italy's financial system was in good health from a stability standpoint, and subsequent developments have been favorable.** In an environment of cyclical strength and only modestly higher interest rates, financial soundness indicators have tended to improve, some rapidly: bank net profits rose by 9.2 percent in 2005, and the nonperforming loan ratio, though still higher than elsewhere in Europe, fell markedly. Capital adequacy ratios have declined marginally, but remain well above the legally required minimum.

31. **Important regulatory reforms are progressing.** A revised Bank of Italy Statute, which, inter alia, establishes fixed terms for all members of the Bank's Directorate and enhances the transparency and collegiality of its decisions, was adopted at end-November 2006. A Code of Ethics was also introduced earlier in the year. Decisions regarding changes to the Bank of Italy's ownership (currently majority-owned by private sector banks) need to be implemented by the government within three years, according to the 2005 Savings law, with the Bank stressing the importance that its independence be fully safeguarded in the process. Progress has also been made on other FSSA recommendations, notably on rules governing the classification of impaired loans (gradually moving to the standard 90-day past due criterion) and regulation of lending to related parties.

32. **Where possible, the Bank of Italy favors replacing detailed rules with supervisory principles and self-regulatory mechanisms.** It views such a shift as allowing market forces to better express themselves, especially in a setting where constant financial innovation can result in the rapid obsolescence of formally rigorous rules. At the same time, it acknowledges that such an approach increases the responsibility of the supervisory authority, requiring it to be fully transparent in accounting for its actions. In this vein, staff suggested issuing regular forward-looking Financial Stability Reports—these could also contribute to much-needed financial education. The Bank was reviewing this possibility, with an eye also on evolving practices elsewhere (including at the Bank of England and the FSA for the United Kingdom) and on avoiding overlap with other analogous reports (e.g., by the ECB).

E. Other Issues

33. **Italy's statistics are broadly adequate for surveillance.** The recent ROSC update reported some improvements, notably on reconciling the discrepancy between the fiscal deficit and the borrowing requirement. Further progress is however needed in the context of developing an integrated presentation of government finance statistics.

34. **Italy's ODA almost doubled in 2005 to 0.29 percent of GNI, but remains well short of the targeted benchmark.** Due to stringent budgetary conditions, ODA is expected to decline in 2006–07, to 0.21 and 0.19 percent of GNI respectively (excluding planned participation in new financing mechanisms such as the International Finance Facility for Immunization).

III. Staff Appraisal

35. **While a start has been made, the current economic recovery and the beginning of a new government's term provide an opportunity for adjustment and reform that Italy can ill afford to miss.** Growth is picking up, some progress has been achieved on the structural reform agenda, and buoyant revenues are helping the fiscal outturn. International experience suggests that reforms are best undertaken early in a legislature's mandate. All in all, the current economic environment is likely to prove "as good as it gets" for fully

implementing the authorities' ambitious medium-term economic plan needed to unshackle Italy's growth potential.

36. **Remarkably strong revenues pushed the 2006 deficit below its original target, but record spending highlights fundamental problems.** The strong revenue performance—at least partly structural—could strengthen the fiscal accounts in the medium term, but only if spending pressures are contained. The ratio of primary current spending to GDP is at its highest level in at least a quarter century. Rebuilding the primary surplus and driving down debt will require addressing the factors that account for this persistent rise in spending.

37. **The 2007 budget seems well set to secure a key objective—reducing the deficit to below 3 percent of GDP—but relies entirely on higher revenues.** The trend of rising primary current expenditure would be arrested (but only just) as envisaged savings will be offset by new expenditure initiatives. The budget contains some initial measures that could, over time, contribute to containing expenditure pressures. But they fall short of addressing comprehensively the structural determinants of such pressures. At the same time, scope for additional spending is created by the transfer of severance fund contributions to the public sector—an accounting measure that does not constitute underlying adjustment. Italy's reentry within the Maastricht deficit limit—itself an important milestone—could thus prove short-lived, with the higher revenue-to-GDP ratio simply fueling the country's relentless public spending machine.

38. **Although a greater emphasis on overall expenditure control in the 2007 budget would have been warranted, some revenue measures are well-founded.** Among these, curbing evasion would help improve equity and eliminate distortions that reduce Italy's growth potential. The commitment to abandon tax amnesties should also encourage better tax compliance, provided it is fully adhered to. The resultant widening of the tax base would, along with durable progress in reducing spending, create scope for further tax reductions, building on the cut in the tax wedge planned for 2007, while safeguarding underlying adjustment.

39. **Structural reforms in priority spending areas should be initiated now so as to make them effective before the next budget round.** Planned discussions on civil service reform should begin promptly, with a view to reducing the relatively high wage bill and enhancing efficiency, including by increasing mobility, essential for the planned territorial reorganization. Domestic Stability Pact revisions that shift from spending to deficit limits are a step forward, but Italy is still far from a fiscally responsible system of federalism. The agreed health pact should be rigorously implemented. A series of pension reforms adopted over the years will—if implemented faithfully—significantly reduce the fiscal costs associated with an aging population. To this end, it is essential that the pension agreement sought by March 2007 fully preserve the financial impact of already legislated reforms.

Finally, several state enterprises need restructuring to put them on a sounder financial footing, reducing another drain on public resources.

40. **The growing interest in reforming budget procedures is well-placed.** Current budget procedures concentrate on legal requirements and financial inputs, but not results; a shift to a program orientation can generate greater efficiency and accountability, both lacking. While reforming budgetary procedures can take years, introducing pilot projects along these lines can help initiate the process. A multiyear spending framework with clear targets for outer years would also facilitate planning. An explicit commitment to use revenue overperformance solely for deficit reduction would also be useful, as would greater institutional independence of budget assessments and projections.

41. **Excessive regulation and protection continue to hamper growth: accelerating competition-enhancing reforms should be a high priority.** Protection results in high prices for consumers and reduced competitiveness: a tax imposed on the majority for the benefit of the few. Measures to promote competition are critical to generate a more dynamic, efficient, and fundamentally fair economy. The liberalizing decrees introduced in the summer of 2006 provided an important initial signal, which should now be followed by appropriately ambitious liberalizing initiatives in the various areas under consideration. Moving forward, the liberalization agenda will need to be pursued within a well-coordinated strategy and with explicit timeframes. Proceeding on a broad front, addressing rigidities in a variety of areas simultaneously, can help promote consensus and a balance across the interests of different stakeholders.

42. **Reforms to labor contracting have been critical to employment growth, and need to be safeguarded and extended.** Notable improvements in Italy's labor market have been made in recent years, resulting in strong employment growth. While fixed-term contracts have been an important path to traditional, open-ended employment for many, concerns have been raised about the precariousness of employment under these schemes. Rather than scale back these reforms—and with them much of the employment gains of recent years—the response should be to develop an adequate safety net, offering better, and appropriately conditional, unemployment support in tandem with further paring employment protection, for Italy to be able to compete in the global economy.

43. **Over time, pension reform can also contribute to growth.** Population aging stands to have a dramatic effect on Italy's growth potential, particularly as participation rates for older individuals remain very low. Reforms that provide incentives to lengthen the average working life, by establishing a closer link between pension contributions and benefits and eliminating rules that bar retirees from working while receiving pensions, would enhance growth potential and allow a higher standard of living for the elderly.

44. **To fully play its role in promoting growth, the financial sector needs to move beyond its heavy reliance on bank intermediation.** Nonbank funding sources, in particular

venture capital, are important for financing new firms. Here, action across a broad front to remove impediments is needed, including measures to improve the enforcement of the legal framework.

45. **Recent developments in the banking sector have been positive.** Financial soundness indicators have generally improved, and credit growth has remained robust. There has been significant progress in implementing the recommendations of the 2005 FSSA: in particular, responsibility for regulating anticompetitive behavior has been transferred to the Antitrust Authority, and the Bank of Italy's Statute has been modified to increase transparency and accountability.

46. **The Bank of Italy's openly encouraging attitude toward bank consolidation is promoting efficiency-enhancing changes.** Signs of greater contestability in the system, including by cross-border players, are encouraging. Greater transparency in banks' interactions with clients will also lead to increased competition in the sector, and the Antitrust Authority's commitment to monitor this carefully is welcome.

47. It is proposed that the next Article IV consultation be held on the standard 12-month cycle.

Table 1. Italy: Summary of Economic Indicators

(Annual percentage change, unless noted otherwise)

	2002	2003	2004	2005	2006 1/	2007 1/
Real GDP	0.3	0.0	1.1	0.0	1.7	1.4
Real domestic demand	1.3	0.9	1.0	0.3	1.7	1.4
Public consumption	2.1	2.0	0.5	1.2	0.6	0.4
Private consumption	0.2	1.0	0.5	0.1	1.6	1.5
Gross fixed investment	4.0	-1.7	2.2	-0.6	2.5	1.9
Stock building 2/	0.0	0.1	-0.1	0.1	0.1	0.1
Net exports 2/	-1.0	-0.8	0.1	-0.3	0.0	0.0
Exports of G&S	-4.0	-2.4	3.0	0.3	4.8	4.2
Imports of G&S	-0.5	0.8	2.5	1.4	4.7	4.0
Current account balance 3/	-0.7	-1.3	-0.9	-1.6	-2.2	-2.1
Resource utilization						
Potential GDP	1.1	1.1	1.3	1.2	1.2	1.2
Output Gap (percent of potential)	0.6	-0.4	-0.6	-1.8	-1.2	-0.9
Natural rate of unemployment (percent)	8.9	8.4	8.0	7.5	6.9	6.8
Employment (percent)	0.9	0.8	3.2	0.7	1.8	1.0
Unemployment rate (percent)	8.6	8.5	8.1	7.7	7.0	6.9
Prices						
GDP deflator	3.4	3.1	2.9	2.1	2.3	2.2
Consumer prices	2.6	2.8	2.3	2.2	2.3	2.2
Fiscal indicators 3/						
General government balance	-2.9	-3.4	-3.4	-4.1	-5.0	-2.7
Public debt ratio	105.5	104.3	103.9	106.6	107.1	106.9
Monetary and financial indicators (end of period)						
Private sector credit 4/	7.8	9.1	6.7	10.1	12.0	...
National contribution to euro area M3 5/	10.7	9.4	5.1	6.3	6.7	...
6-month interbank rate (percent) 6/	3.3	2.3	2.1	2.6	3.8	...
Government bond rate, 10-year (percent) 6/	5.0	4.2	4.3	3.5	4.1	…
Exchange rate regime			Member of EMU			
Euro per U.S. dollar (January 12, 2007)			0.78			
Saving investment balance 3/						
Gross national saving	20.4	19.4	19.8	19.3	19.4	19.9
Public	0.3	-0.8	-0.4	-0.5	0.5	1.4
Private	20.1	20.3	20.1	19.8	19.0	18.5
Gross domestic investment	21.1	20.7	20.7	20.9	21.6	22.0
Gross fixed domestic investment	20.9	20.4	20.6	20.6	21.1	21.5
Public	4.5	4.5	4.2	4.2	6.2	4.5
Private	16.4	15.9	16.3	16.4	14.9	17.0

Source: ISTAT, IMF Staff Projections.

1/ Staff estimates and projections, unless otherwise noted.
2/ Contribution to growth.
3/ In percent of GDP.
4/ Twelve-month domestic credit growth, adjusted for securitizations. 2006 data refer to August.
5/ Excludes currency in circulation held by nonbank private sector. 2006 data refer to November.
6/ Data for 2006 refer to December.

Table 2. Italy: General Government Accounts, 2002–08
(In percent of GDP)

	2002	2003	2004	2005	2006		2007		2008
					staff	auth.	staff	budget	staff
Total revenues	44.5	45.1	44.6	44.4	45.7	45.2	46.3	46.0	46.3
Direct taxation	13.9	13.4	13.3	13.3	14.0	13.9	14.7	14.6	14.7
Indirect taxation	14.3	14.0	14.1	14.2	14.6	14.5	14.5	14.3	14.5
Social contributions 1/	12.5	12.6	12.7	12.9	12.9	12.7	13.5	13.3	13.5
Other current revenues	3.5	3.4	3.6	3.5	3.5	3.5	3.3	3.4	3.3
Capital revenues	0.4	1.7	0.8	0.4	0.7	0.7	0.4	0.4	0.4
Total expenditures	47.4	48.5	48.0	48.5	50.7	50.9	49.0	48.8	49.3
Current expenditures	43.8	44.2	44.1	44.5	44.6	44.6	44.6	44.3	44.8
Wages and salaries	10.6	10.8	10.8	11.0	11.0	11.0	10.8	10.6	10.8
Purchases of goods and services	7.8	7.9	8.1	8.3	8.2	8.2	8.2	7.9	8.1
Social transfers	16.5	16.8	16.9	17.1	17.2	17.2	17.3	17.3	17.4
Interest payments	5.5	5.1	4.7	4.6	4.5	4.6	4.7	4.8	4.8
Capital expenditures 2/	3.6	4.3	3.9	4.0	6.2	6.3	4.5	4.5	4.5
Of which: asset sales	-0.8	-0.2	-0.3	-0.2	-0.1	-0.1	-0.1	-0.1	-0.1
Overall balance	-2.9	-3.4	-3.4	-4.1	-5.0	-5.7	-2.7	-2.8	-3.0
Primary balance	2.7	1.7	1.3	0.4	-0.5	-1.1	2.0	2.0	1.7
Memorandum items:									
Structural overall balance 3/	-3.1	-3.3	-3.1	-3.3	-4.4	-5.1	-2.3	-2.3	-2.6
Net of all one-off measures	-4.6	-5.3	-4.5	-3.8	-3.2	-3.7	-2.8	-2.4	-3.0
Structural primary balance 3/	2.4	1.9	1.6	1.3	0.1	-0.5	2.5	2.5	2.2
Net of all one-off measures	0.9	-0.2	0.2	0.8	1.4	0.8	2.0	2.4	1.8
Public debt /4	105.5	104.3	103.9	106.6	107.1	107.1	106.9	106.9	107.1
One-off/temporary measures (o/w)	1.5	2.1	1.3	0.5	-1.3	-1.4	0.5	0.1	0.4
severance payments revenues	0.0	0.0	0.0	0.0	0.0	0.0	0.4	0.0	0.3
railway debt assumption	0.0	0.0	0.0	0.0	-0.9	-0.9	0.0	0.0	0.0
VAT sentence	0.0	0.0	0.0	0.0	-0.9	-0.9	0.0	0.0	0.0
other one-offs	1.5	2.1	1.3	0.5	0.5	0.4	0.1	0.1	0.1

Sources: ISTAT; Ministry of Economy and Finance, and Fund staff calculations and estimates.

1/ Includes revenue from severance payments contributions (TFR), from 2007 onwards.
2/ In 2006 capital spending is increased by the VAT reimbursement of 1.2 percent of GDP (of which 0.9 percent of GDP relates to prior years) and the assumption of railways-related debt of 0.9 percent of GDP.
3/ In percent of potential GDP, assumes staff's output gap.
4/ For 2007, the "budget" public debt ratio is based on the authorities' nominal GDP.

Table 3. Italy: Financial Soundness Indicators
(In percent, unless otherwise noted)

	2001	2002	2003	2004	2005	2006
Core Set						
Deposit-taking institutions						
Capital adequacy						
Regulatory capital to risk-weighted assets	10.4	11.2	11.4	11.6	10.6	...
Regulatory tier I capital to risk-weighted assets	7.8	8.2	8.5	8.8	8.1	...
Asset quality						
Nonperforming loans						
Share of total gross loans	6.7	6.5	6.7	6.6	5.3	...
Percentage change	-7.8	2.4	7.6	4.7	-12.4	...
Net of provisions, percent of capital	24.4	22.4	21.8	20.9	14.2	...
Sectoral distribution of loans to total loans						
General government	5.8	5.3	4.7	4.5	4.5	4.5
Financial corporations	14.7	14.6	13.8	12.1	11.7	11.5
Nonfinancial corporations and sole proprietorships	59.3	59.0	59.6	59.5	58.8	58.5
Building and construction	6.8	6.9	7.2	7.4	7.7	7.7
Consumer households	20.2	21.0	21.9	23.9	25.0	25.5
Large exposures to capital	88.6	81.6	63.2	51.3	61.7	
Earnings and profitability						
Return on assets	0.59	0.50	0.51	0.65	0.70	...
Return on equity	8.6	7.1	7.4	9.3	...	...
Interest margin to gross income	52.3	56.6	55.4	55.9	...	...
Noninterest expenses to gross income	55.3	59.8	61.0	60.6	...	...
Liquidity						
Liquid assets to total assets (liquid asset ratio)	8.7	7.8	8.6	8.3	7.5	6.8
Liquid assets to short-term liabilities	21.8	17.3	16.9	16.7	18.3	...
Sensitivity to market risk						
Duration of assets	7M21D	8M18D	9M6D	9M29D	10M0D	...
Duration of liabilities	7M1D	8M4D	8M24D	9M14D	9M16D	...
Net open position in foreign exchange to capital	4.9	3.9	3.6	2.4	3.0	...
Encouraged Set						
Deposit-taking institutions						
Capital to assets	6.8	6.7	6.4	6.4	...	...
Average risk weight (ratio of risk-weighted assets to assets)	0.66	0.60	0.57	0.55	...	...
Geographical distribution of loans						
North	62.2	62.2	62.3	62.2	62.0	61.8
Center	24.1	24.1	24.0	23.5	23.5	23.4
South	13.7	13.6	13.7	14.3	14.6	14.7
Geographical distribution of nonperforming loans						
North	38.5	40.2	43.0	43.4	44.2	...
Center	26.7	28.0	26.5	26.5	26.0	...
South	34.7	31.9	30.5	30.2	29.9	...
Gross asset position in financial derivatives to capital	50.8	46.7	52.0	62.8	74.9	...
Gross liability position in financial derivatives to capital	37.0	44.8	45.0	58.1	73.1	...
Trading and fee income to gross income	32.7	32.0	32.7	33.9	36.0	...
Personnel expenses to noninterest expenses	63.4	63.9	64.8	65.7	66.7	...

Source: Bank of Italy, Eurostat, Fund staff calculations.

Table 4. Italy: Selected Indicators of Vulnerability 1/

(In percent of GDP, unless otherwise indicated)

	2001	2002	2003	2004	2005	2006	
						Latest Est.	Date
External indicators 1/							
Exports (annual percentage change, in U.S. dollars)	1.4	3.9	18.0	17.4	6.4	8.1	Jan-07
Imports (annual percentage change, in U.S. dollars)	-0.8	4.8	20.2	18.4	9.4	10.2	Jan-07
Terms of trade (annual percentage change)	1.0	2.3	1.7	0.1	-1.9	1.6	Sep
Current account balance	-0.1	-0.7	-1.3	-0.9	-1.6	-2.2	Jan-07
Capital and financial account balance	-0.2	0.5	1.5	0.8	1.5	2.1	Jan-07
Of which : Inward portfolio investment (debt securities, etc.)	2.6	2.6	4.1	3.4	9.2	...	
Inward foreign direct investment	1.3	1.2	1.1	1.0	1.1	...	
Other investment liabilities (net)	0.8	-0.6	2.4	1.4	4.9	...	
Official reserves (in U.S. dollars, billions, end-of-period) 2/	24.4	28.6	30.4	27.9	25.5	25.7	Aug
Contribution to euro area M3 (in percent of reserves) 3/	25.8	28.4	34.4	43.7	50.7	50.3	Oct
Central Bank foreign liabilities (in U.S. dollars, billions) 2/	2.2	3.1	0.5	0.9	2.0	1.5	Jun
Foreign assets of the financial sector (in U.S. dollars, billions)	152.6	224.5	317.0	389.5	367.7	...	
Foreign liabilities of the financial sector (in U.S. dollars, billions)	280.7	319.7	425.7	497.5	564.8	...	
Official reserves (ratio to average monthly imports) 2/	1.0	1.1	1.0	0.8	0.7	0.6	Aug
Total external debt	79.0	88.3	91.6	90.6	89.0	...	
Of which : General government debt	34.2	40.9	43.3	43.6	42.1	...	
Total external debt to exports (ratio)	2.9	3.4	3.7	3.6	3.4	...	
External investment income payments to exports (in percent)	15.5	17.5	17.8	15.9	16.3	...	
Exchange rate (per U.S. dollars, period average)	1.12	1.06	0.89	0.81	0.80	n.a.	Dec
Financial market indicators							
Public sector debt (Maastricht definition)	108.7	105.5	104.3	103.9	106.6	107.1	Dec
Average T-bill yield	4.1	3.3	2.2	2.1	2.2	3.2	Jan-07
Average T-bill yield, real	1.4	0.6	-0.6	-0.2	0.0	1.0	Jan-07
Stock market index (year end, 2000=100)	75	58	66	78	88	96	Jan-07
Share prices of financial institutions (year end)	71	50	62	58	…	…	…
Spread of 10-year government bond with Germany (basis points, period average)	39	25	18	22	20	28	Jan-07
Financial sector risk indicators 4/							
Foreign exchange loans (in billions of U.S. dollars)	45.7	43.9	48.3	44.4	48.0	51.6	Mar
Share of foreign exchange loans in total lending (percent)	5.5	4.2	3.6	2.9	3.3	3.3	Mar
Deposits in foreign exchange (in billions of U.S. dollars)	22.1	28.0	36.3	38.4	32.9	38.7	Mar
Share of foreign deposits in total deposits (percent)	4.1	4.6	4.3	4.0	3.7	4.1	Mar

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, excluding gold.
3/ Definition of M3 excludes currency held by the public.
4/ Data refer to banks, including cooperative and mutual banks.

Table 5. Italy: Public Sector Debt Sustainability Framework, 2003–50

(In percent of GDP, unless otherwise indicated)

	Actual			Projections								
	2003	2004	2005	2006	2007	2008	2009	2010	2020	2030	2040	2050
				I. Baseline projections								
Public sector debt	104.3	103.9	106.6	107.1	106.9	107.1	107.1	107.0	114.7	147.2	212.7	296.3
Overall balance	-3.4	-3.4	-4.1	-5.0	-2.7	-3.0	-3.0	-2.9	-5.0	-8.4	-12.8	-16.7
Pension spending	13.9	13.9	14.0	14.1	14.1	14.2	14.2	14.4	15.5	16.9	17.8	17.3
Health care spending	6.2	6.5	6.7	6.9	6.8	6.8	6.8	6.8	7.2	7.7	8.1	8.4
Key macroeconomic and fiscal assumptions												
Real GDP growth (in percent)	0.0	1.1	0.0	1.7	1.4	1.4	1.5	1.6	1.0	0.7	0.5	0.8
Real GDP per capita growth (in percent)	-0.8	0.1	-0.8	1.4	1.3	1.3	1.4	1.5	1.0	0.8	0.6	1.1
Labor productivity growth (in percent)	-0.5	0.8	0.5	0.5	0.6	0.7	0.8	0.9	1.2	1.4	1.4	1.3
Employment rate (in percent)	57.5	57.5	57.5	58.5	58.7	59.0	59.2	59.5	61.5	61.7	63.1	63.3
Average nominal interest rate on public debt (in percent)	5.0	4.7	4.5	4.4	4.6	4.6	4.7	4.8	5.1	5.1	5.1	5.1
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	1.9	1.8	2.3	2.1	2.3	2.5	2.6	2.7	3.0	3.0	3.0	3.0
				II. Reform reversals 1/								
Public sector debt	104.3	103.9	106.6	107.1	106.9	107.1	107.3	107.7	124.4	172.7	261.7	373.7
Overall balance	-3.4	-3.4	-4.1	-5.0	-2.7	-3.0	-3.2	-3.4	-6.3	-11.1	-16.5	-21.9
Pension spending	13.9	13.9	14.0	14.1	14.1	14.2	14.4	14.9	16.4	18.4	19.2	18.9
Health care spending	6.2	6.5	6.7	6.9	6.8	6.8	6.8	6.8	7.2	7.7	8.1	8.4
Key macroeconomic and fiscal assumptions												
Real GDP growth (in percent)	0.0	1.1	0.0	1.7	1.4	1.4	1.5	1.6	1.0	0.7	0.5	0.8
Real GDP per capita growth (in percent)	-0.8	0.1	-0.8	1.4	1.3	1.3	1.4	1.5	1.0	0.8	0.6	1.1
Labor productivity growth (in percent)	-0.5	0.8	0.5	0.5	0.6	0.7	0.8	0.9	1.2	1.4	1.4	1.3
Employment rate (in percent)	57.5	57.5	57.5	58.5	58.7	59.0	59.2	59.5	61.5	61.7	63.1	63.3
				III. Staff adjustment scenario								
Public sector debt	104.3	103.9	106.6	107.1	106.9	105.8	103.8	100.7	72.4	56.7	55.4	56.1
Overall balance	-3.4	-3.4	-4.1	-5.0	-2.7	-1.8	-0.9	0.1	0.0	-0.8	-1.7	-1.4
Pension spending	13.9	13.9	14.0	14.1	14.1	14.2	14.2	14.4	15.1	16.2	16.9	16.2
Health care spending	6.2	6.5	6.7	6.9	6.8	6.8	6.8	6.8	7.2	7.7	8.1	8.4
Key macroeconomic and fiscal assumptions												
Real GDP growth (in percent)	0.0	1.1	0.0	1.7	1.4	1.4	1.5	1.6	1.2	0.9	0.7	1.1
Real GDP per capita growth (in percent)	-0.8	0.1	-0.8	1.4	1.3	1.3	1.4	1.5	1.3	1.1	0.9	1.3
Labor productivity growth (in percent)	-0.5	0.8	0.5	0.5	0.6	0.7	0.8	0.9	1.4	1.6	1.6	1.6
Employment rate (in percent)	57.5	57.5	57.5	58.5	58.7	59.0	59.2	59.5	61.5	61.7	63.1	63.3

Sources: ISTAT; Ministry of Economy and Finance, and Fund staff calculations and estimates.

1/ Assumes the baseline, and a scenario in which the 2004 pension reform is reversed and the life-expectancy coefficients are not updated as mandated by the 1995 reform.

INTERNATIONAL MONETARY FUND

ITALY

Staff Report for the 2006 Article IV Consultation—Informational Annexes

Prepared by the European Department

January 16, 2007

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Appendix I. Italy: Fund Relations
(As of November 30, 2006)

Mission: Rome, November 2–13, 2006. The concluding statement of the mission is available at: http://www.imf.org/external/np/ms/2006/111306.htm

Staff team: Messrs. Leipold (Head), Gerson, Lissovolik, Drummond (all EUR), Ms. Fedelino (FAD) and Ms. Ivaschenko (EUR). Mr. Sadun, Executive Director, also participated in most meetings.

Country interlocutors: The Minister of Economy and Finance; the Governor of the Bank of Italy; the Minister of Economic Development; the Minister of Labor; the Minister of Regional Affairs; the Minister of International Trade and European Affairs; the Vice Minister of Finance; the Director General of the Treasury, and other public officials; the Securities and Exchange Commission (CONSOB); the Antitrust Authority; the National Statistics Institute (Istat); the Confederation of Italian Industry (Confindustria); the Economic Analysis Institute (ISAE); the National Association of Insurers (ANIA); the Regional Governors Conference; the Court of Auditors (Corte dei Conti); the Italian Banking Association (ABI); representatives of labor unions; state enterprises, and research centers.

Fund relations: The previous consultation discussions took place during October 19–November 2, 2005. The associated Executive Board's assessment is available at: http://www.imf.org/external/np/sec/pn/2006/pn0613.htm and the staff report and other mission documents at: http://www.imf.org/external/pubs/ft/scr/2006/cr0660.pdf. Italy accepted the obligations under Article VIII and, apart from certain security restrictions, maintains an exchange rate system free of restrictions.

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

I. **Membership Status**: Joined 3/27/1947; Article VIII.

II. **General Resources Account**:	SDR Million	Percent Quota
Quota	7,055.50	100.00
Fund holdings of currency	6,403.47	90.76
Reserve position in Fund	652.08	9.24

III. **SDR Department**:	SDR Million	Percent Allocation
Net cumulative allocation	702.40	100.00
Holdings	180.62	25.72

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				
	2006	2007	2008	2009	2010
Principal					
Charges/Interest		21.12	21.18	21.12	21.12
Total		21.12	21.18	21.12	21.12

VII. **Implementation of HIPC Initiative**: Not applicable.

VIII. **Safeguards Assessments**: Not applicable.

IX. **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).

X. **Article IV Consultations**: Italy is on the standard 12-month consultation cycle.

XI. **ROSCs**:

Standard Code Assessment	**Date of Issuance**	**Country Report**
Fiscal Transparency	October 9, 2002	No. 02/231
Data	October 18, 2002	No. 02/234
FSAP	March 14, 2006	No. 06/112
Data Update	expected February 2006	

Appendix II. Italy: Statistical Information

The economic database is comprehensive, generally of high quality, and adequate for surveillance purposes. The authorities regularly publish a full range of economic and financial data. Italy has subscribed to the Special Data Dissemination Standard (SDDS) and has posted the metadata on the Dissemination Standards Bulletin Board (DSBB), meeting nearly all specifications for coverage, periodicity, timeliness for published data, and the dissemination of advance release calendars. 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*). The shift to chain-weighted indices for national accounts has been largely completed over the course of 2006. Under the Coordinated Compilation Exercise for Financial Soundness Indicators (FSIs) conducted by the Fund, the authorities recently produced a set of indicators broadly consistent with the Fund's FSI Compilation Guide.

The 2002 *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: (i) no statistical agency had the responsibility to compile and disseminate a comprehensive statement of government finances, and a persistent difference had emerged between the SGP-monitored fiscal deficit and the PSBR net of privatization receipts; (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 PPI, making price collection for the CPI more efficient, and improving the coverage of cross-border financial transactions; (iii) balance of payments and government finance statistics should be more closely aligned with 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 (Istat) in the face of the statistical requirements of the European Union and the Euro area.

Many of these shortcomings have been addressed since then, as found by a 2006 ROSC data module update mission (covering the national accounts, CPI and PPI, and government finance statistics (GFS)): (i) Istat has become responsible for disseminating general government statistics; (ii) the benchmark revision of the national accounts was implemented in 2005, updating the benchmark to 2000, revising the calculation and allocation of financial services indirectly measured, introducing chained volume and price measures, and improving many compilation methods; (iii) work is well advanced on implementing random sampling techniques for the CPI collection and the price collection period has been adjusted so it is fully in the reference month; and (iv) the consistency of the constituent parts of the GFS was enhanced through better interagency coordination. Additional improvements include: the publication of quarterly data for the general government balance, expenditure, and revenue on an accruals basis (in line with *ESA95*); a more detailed labor force survey; and progress in reconciling the discrepancy between the cash-based net borrowing requirement and the accrual budget deficit.

Nevertheless, weaknesses remain in some areas. In the quarterly national accounts, changes in inventories are derived residually, along with the statistical discrepancy, thus hampering the business cycle analysis. In PPI, weaknesses remained in the weighting data sources, and there is scope to improve some of the statistical techniques used in the index compilation. The validation process at Istat is constrained by important time lags in assessing the economic nature of transactions and practices that limit revisions to the published aggregates. This may lead to inconsistencies with the GFS component that is under the responsibility of the Bank of Italy. In addition, as highlighted by the fiscal transparency ROSC and the two follow-ups, the quality and timeliness of some fiscal data, particularly on expenditure by local governments, is still in need of improvement.

Italy: Table of Common Indicators Required for Surveillance

(As of December 19, 2006)

	Date of latest observation	Date received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of Publication[6]	Memo Items: Data Quality – Methodological soundness[7]	Memo Items: Data Quality – Accuracy and reliability[8]
Exchange Rates	12/19/06	12/19/06	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	Nov 2006	Dec 2006	M	M	M		
Reserve/Base Money	Nov 2006	Dec 2006	M	M	M	O, O, LO, LO	O, O, O, O, LO
Broad Money	Nov 2006	Dec 2006	M	M	M		
Central Bank Balance Sheet	Sep 2006	Nov 2006	Q	Q	Q		
Consolidated Balance Sheet of the Banking System	Sep 2006	Nov 2006	Q	Q	Q		
Interest Rates[2]	12/19/06	12/19/06	D	D	D		
Consumer Price Index	Nov 2006	Dec 2006	M	M	M	O, O, O, O	LO, O, LO, O, O
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	Nov 2006	Dec 2006	M	M	M	LO, O, LO, O	LO, O, O, O, LO
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	Nov 2006	Dec 2006	M	M	M		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Nov 2006	Dec 2006	M	M	M		
External Current Account Balance	Nov 2006	Dec 2006	M	M	M	O, LO, LO, O	LO, O, LO, O, O
Exports and Imports of Goods and Services	Q3 2006	Dec 2006	Q	Q	Q		
GDP/GNP	Q3 2006	Dec 2006	Q	Q	Q	O, O, O, O	LO, LO, O, O, O
Gross External Debt							

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5] Including currency and maturity composition.
[6] Daily (D); weekly (W); monthly (M); quarterly (Q); annually (A); irregular (I); and not available (NA).
[7] Reflects the assessment provided in the data ROSC (published in October 2002, and based on the findings of the mission that took place during April 2002) for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O); largely observed (LO); largely not observed (LNO); not observed (NO); and not available (NA).
[8] Same as footnote 7, except referring to international standards concerning source data, statistical techniques, assessment and validation of source data, assessment, and revision studies.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL
RELATIONS
DEPARTMENT

Public Information Notice (PIN) No. 07/20
FOR IMMEDIATE RELEASE
February 15, 2007

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

IMF Executive Board Concludes 2006 Article IV Consultation with Italy

On February 7, 2007, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Italy.[1]

Background

The economy is enjoying a broad-based, if comparatively modest, cyclical upswing. Output is estimated to have grown by 1¾ percent in 2006—the strongest pace since the beginning of the decade. Inflation is close to that of the euro area, financial conditions are favorable, unemployment is falling, and the current account deficit is moderate. However, growth—constrained by sluggish potential—is projected to ease to around 1½ percent this year. And despite recovering exports and some initial signs of economic restructuring, medium-term productivity and competitiveness trends remain of concern.

Unexpectedly strong revenues contributed to a better underlying fiscal outturn last year. Net of two large one-off operations, the deficit is estimated to have been well below the original target of 3½ percent of GDP, despite recurrent spending overruns. The 2007 budget will likely achieve the objective of bringing the headline deficit under the key 3 percent of GDP threshold. The public debt ratio, after rising in 2005–06, should broadly stabilize at around 107 percent. The 2007 budget included several structural spending containment initiatives, but some of their key aspects have yet to be finalized.

Some progress has been made on broad-based structural reform. Deregulation of selected services got an initial impetus from a decree adopted last July, and a follow-up liberalization

[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.

package has been approved. However, recent initiatives in labor contracting envision a partial roll-back of earlier liberalizing reforms. Banking sector consolidation and competition have been tangibly boosted, and various reforms to enhance financial sector transparency have progressed. Still, Italy's product and labor markets remain rigid and nonbank financial intermediation is relatively undersized.

Executive Board Assessment

Executive Directors welcomed Italy's economic upturn, noting its broad-based nature, continued employment gains, stable inflation rate, and signs of economic restructuring. At the same time, buoyant revenues are helping the fiscal outturn and progress has been achieved on the structural reform agenda. Directors welcomed the authorities' ambitious medium-term economic plan, and underscored that the opportunity offered by the cyclical upswing and the early phase of the new government's mandate not be missed. New progress in boosting productivity and increasing competition in product and services markets will be needed to sustain good growth performance.

Directors were encouraged by the better-than-anticipated 2006 fiscal outturn, excluding one-off measures. They noted that this mostly reflected stronger revenue buoyancy, a good part of which appears structural. However, primary spending is estimated to have appreciably exceeded the original budget targets, indicating continued expenditure control problems.

Directors considered that the 2007 budget would secure the important milestone of bringing the deficit below 3 percent of GDP. Directors viewed many of the budget's revenue measures as well-founded, especially those combating evasion and widening the tax base. At the same time, while acknowledging some initial expenditure control measures, Directors noted that the planned 2007 adjustment relies heavily on revenues. They accordingly called for rapid progress in structural spending reforms in the key areas of public employment, local government finances, and health care. Safeguarding the financial impact of the already-legislated pension reforms would also be essential. In addition, several state enterprises need restructuring to reduce their drain on public resources. Directors stressed that stronger efforts to control spending in all these areas would be key to rebuilding the primary surplus, driving down debt, and ensuring the durability of Italy's re-entry under the 3 percent of GDP deficit threshold.

Given Italy's aging population and high public debt, Directors cautioned that fiscal consolidation would need to be pursued considerably further for longer-term sustainability to be achieved. To buttress the authorities' medium-term objective of a small overall surplus, Directors encouraged prompt adoption of a multi-year spending framework with clear targets for outer years, backed by explicit expenditure-saving and efficiency-oriented measures. An overhaul of cumbersome budget procedures—including strengthening budgetary governance and introducing an explicit rule assigning revenue overperformance to deficit reduction—would also be helpful. Directors noted that the resulting durable improvements in expenditure control would in due course create scope for tax reduction, while safeguarding fiscal adjustment.

Directors underscored that vigorous pursuit of structural reforms aimed at reducing regulation, increasing competition, and improving the business environment is necessary to raise productivity and growth. In this context, they welcomed recent and planned product market liberalization and competition-enhancing initiatives, and called for accelerated progress across a broad front to garner wide public support, emphasizing the benefits of a well-coordinated strategy and explicit timeframes. While cautioning against any reversal of prior liberalizations of labor contracting, which contributed to buoyant employment growth this past decade, Directors recommended the development of an adequate safety net, with improved unemployment support, to mitigate the effects of the needed greater employment flexibility. They also noted that pension reform, by providing incentives to lengthen the average working life, could support economic growth and welfare.

Directors noted that the financial system remains sound and well supervised, and welcomed recent actions to enhance competition and transparency in financial markets. In particular, the greater contestability observed in the banking sector, reflected in the ongoing consolidation, stands to improve efficiency and the quality of services. Directors also welcomed the significant progress in implementing the recommendations of the 2005 Financial System Stability Assessment. At the same time, Directors underscored that to fully play its role in promoting growth, the financial sector needs to complement its reliance on bank intermediation with a greater role for capital markets. This entails action across a broad front, including measures to improve enforcement of the legal framework.

Directors encouraged the authorities to increase their official development assistance toward the UN target of 0.7 percent of gross national income.

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. The staff report (use the free Adobe Acrobat Reader to view this pdf file) for the 2006 Article IV Consultation with Italy is also available.

Italy: Selected Economic Indicators

	2002	2003	2004	2005	2006 1/
Real economy (change in percent)					
Real GDP	0.3	0.0	1.1	0.0	1.7
Total domestic demand	1.3	0.9	1.0	0.3	1.7
Current account balance (in percent)	-0.7	-1.3	-0.9	-1.6	-2.2
CPI (average)	2.6	2.8	2.3	2.2	2.2
Unemployment rate (in percent)	8.6	8.5	8.1	7.7	7.0
Public finance (in percent of GDP)					
General government balance	-2.9	-3.4	-3.4	-4.1	-5.0
General government debt	105.5	104.3	103.9	106.6	107.1
Monetary and financial indicators					
Private sector credit 2/	7.8	9.1	6.7	10.1	12.0
National contribution to euro area M3 3/	10.7	9.4	5.1	6.3	6.7
6-month interbank rate (percent, end of period) 4/	3.3	2.3	2.1	2.6	3.8
Government bond rate, 10-year (percent)	5.0	4.2	4.3	3.5	4.0
Fund position (as of December 31, 2006)					
Holdings of currency (percent of quota)				90.8	
Holdings of SDRs (percent of allocation)				25.7	
Quota (millions of SDRs)				7,055.5	
Exchange rates					
Exchange rate regime	Member of EMU				
Euro per U.S. dollar (January 31, 2007)			0.77		
Nominal effective rate (2000=100)	101.6	105.8	107.2	107.3	107.8
Real effective rate (2000=100) 5/	104.3	111.4	113.8	112.2	111.9

Sources: Istat; IMF, *International Financial Statistics*; Bloomberg; Eurostat; and Fund staff estimates and projections.

1/ Staff estimates and projections, unless otherwise noted.
2/ Twelve-month credit growth, adjusted for securitizations. 2006 data refer to August.
3/ Excludes currency in circulation held by nonbank private sector. 2006 data refer to November.
4/ Data for 2006 refer to December.
5/ Based on CPI.

Statement by Arrigo Sadun, Executive Director for Italy
February 7, 2007

1. Overview

We wish to thank the staff for engaging in a frank and constructive dialogue with the authorities and for the insightful set of papers on crucial aspects of the Italian economy.

In our opinion recent improvements in economic performance reflect—to a large extent—structural changes initiated long ago. The economic strategy of the new government entails a number of priorities. The primary objective has been the consolidation of fiscal accounts, pursued first with the supplementary budget adopted in the middle of last year and, more recently, with the approval of a very stringent budget for 2007. Both the EU Commission and the Fund agree that these measures are adequate to meet the 2005 EU Council recommendations.[1]

Implementation of the reform agenda is another key priority of economic policy. After the liberalizations enacted last summer, the government has just introduced a second package of sweeping measures to liberalize the product and service markets. Further initiatives are expected shortly concerning the liberalization of the energy sector and local utilities.

Equally important changes have taken place in the financial and banking sectors, including measures to enhance investors' protection, to improve corporate governance, and to strengthen cooperation among financial regulators.

Despite recent improvements, the Italian economy is still facing substantial challenges; fiscal accounts must be consolidated further, regional disparities reduced, the efficiency of public administration enhanced, and productivity and potential growth increased. The authorities are committed to achieving these goals and to supporting the transformations that are reshaping the economy.

2. Economic Outlook

After stagnating in 2005, the GDP rebounded sharply in 2006 thanks to the recovery in domestic demand. The main drivers of the upturn have been private consumption, fueled by rising disposable income and improved confidence, and investment in machinery and

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[1] The 2005 EU Council recommendation calls for a) bringing the deficit to below 3 percent, b) reducing the cyclically-adjusted balance by at least 1.6 percentage points of GDP over two years, and c) restoring an adequate level of primary surplus in the medium term to ensure that the debt ratio declines at a satisfactory pace.

equipment. The contribution of the foreign sector has been limited, as the significant increase in exports was offset by higher imports, particularly in the energy sector. The authorities' growth projections for 2006 and 2007, at 1.6 and 1.3 percent respectively, are broadly in line with those of the Fund. In the period 2008-11, economic growth is expected to accelerate steadily to 1.7 percent.

Strong job creation has been one of the brightest spots of the Italian economy for a number of years. In 2006 employment growth accelerated to 1 percent, bringing the unemployment rate to 6.9 percent, well below the EU average. Despite substantially higher oil prices, inflation has remained under control and in line with the euro-area average. Inflation is expected to ease from last year's 2.2 percent to 2.1 in 2007 and to 1.7 in 2008. The liberalization measures recently adopted will contribute to contain inflationary pressure. Overall, the economic outlook remains favorable, although a slight slowdown is expected this year in line with a similar trend anticipated in other EU countries.

3. Competitiveness

We agree with staff that boosting productivity and promoting wage moderation are critical steps to restore Italy's competitiveness and raise its growth potential. Staff points to the loss of constant-price market shares as symptomatic of the deterioration of the country's competitiveness. Staff analysis suggests that the competitiveness gap between Italy and its major euro-area partners is "appreciable, albeit not large" as estimates range between 5 and 8 percent. In addition, staff argues that Italian firms choose to pass higher production costs onto prices, even at the risk of losing market shares. However, this interpretation understates the major transformation process initiated by Italian industry in the past few years. We note that, measured at current prices, Italy's market shares have remained fairly stable; this suggests that, facing relentless competition, firms have managed to move their production up the value-added ladder, commanding premium prices. The strategy to regain competitiveness in sectors in which the country has a traditional competitive advantage seems to be working. Export performance has improved lately. In 2006 exports increased by a projected 5 percent in real terms—the biggest increase in several years. The recovery was broadly based and also affected some of the country's most traditional sectors.

4. Fiscal Policy

As mentioned above, the first priority of the new government has been to meet the 2005 EU Council Recommendations and to achieve a structurally balanced budget by 2010. The Fund and the EU Commission acknowledge that Italy is well positioned to reach the goal of reducing the deficit-to-GDP ratio to below 3 percent in 2007. According to preliminary estimates it appears that the central government deficit, net of one-offs, may have already declined below the Maastricht threshold last year.

The 2007 Budget: revenue increases and expenditure cuts

The 2007 Budget entails an overall package of about 2.3 percent of the GDP, of which 1.3 percentage points are growth-enhancing measures and 1 percentage point structural budgetary adjustments. The cyclically-adjusted balance, net of one-offs, will be reduced by almost 1.5 percentage points.

While we concur with staff that the 2007 budgetary adjustment relies heavily on the revenue side, their statement that the adjustment stems "entirely from an increase of the revenue ratio" needs some clarification.[2] The revenue increase stems mostly from greater tax compliance and the broadening of the tax base rather than rate hikes. As the authorities are committed to reducing tax evasion and elusion, there is no reason to expect the current revenue surge to be just a temporary phenomenon. Although the top tax brackets have been increased marginally and the rates have been harmonized across various financial instruments in line with the EU standards, the 2007 Budget has also raised tax allowances and subsidies for low-income households. Furthermore, the budget provides for a significant reduction, estimated at about 5 percentage points, in the labor-tax wedge.

Notwithstanding the focus on the revenue side, the 2007 Budget includes structural cuts in current expenditures of about 0.5 percent of GDP. Savings will increase in the coming years as current expenditures will decline by 0.7 percent of GDP both in 2007 and 2008. These structural savings will be achieved through the downsizing and consolidation of several government agencies. A recent agreement between the Central Government and the Regions aims at containing public health expenditures, the major source of overruns in the local government budgets. Incentives will be provided to those administrations that meet the budgetary guidelines, while co-payments have been slightly increased. The strict sanctioning mechanism introduced last year to curb over-spending has been retained.

The domestic stability pact,[3] which excludes healthcare costs, has been further strengthened by setting fiscal targets for the whole budget rather than for individual expenditure categories.

The Second Pillar Pension Scheme

In line with staff recommendations, the government has taken major steps to foster the development of private pension funds. This is critical to boost the entitlements of future generations, for whom the defined contribution system will have its full impact. Future payments to employees' severance accounts will be channeled either into private pension funds or into a State Fund, according to the beneficiary's choice. It is estimated that the State Fund will receive resources amounting to 0.4 percent of GDP in 2007 and to 0.3 percent in the following years. These resources will be used to finance public projects necessary to upgrade the country's infrastructure and enhance growth.

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[2] Staff Report for 2006 Article IV Consultation, paragraph 15.

[3] A set of rules to ensure local Governments' contribution to the national fiscal objectives.

Debt and sustainability
The government is committed to restoring a substantial primary surplus to ensure a satisfactory pace of debt reduction. The objective is to increase the primary surplus steadily until it reaches 5 percent of GDP in 2011. In 2007 the debt-to-GDP ratio will start to fall again and the pace of reduction will accelerate from 2008 onward; according to the December 2006 Stability Program, the debt-to-GDP ratio will dip to below 100 percent in 2010 and to below 60 percent in 2020.

Although Italy has the highest ratio of pension expenditures to GDP among the EU countries, the ratio is expected to increase only marginally from now through 2050, provided that the provisions of previous reforms are implemented. The EU Commission stress tests, using a sustainability gap and required primary balance,[4] indicate that meeting the fiscal targets included in the Stability Program (December 2006 update)[5] will ensure long-run sustainability.

5. Structural Reforms

Enhancing Competition
The recent packages of liberalization include an array of measures to increase competition in the service and product sectors, including telecommunications, transportation, insurance, gasoline distribution networks, and the wholesale natural gas market. Furthermore, steps have been taken to streamline the public administration and remove excessive burdens on business, including much simplified procedures to start new businesses. Additional measures are expected shortly concerning the liberalization of the energy markets and local public utilities. By liberalizing several sectors simultaneously, the government aims to create synergies between the various measures and balance the interests of different stakeholders, thus maximizing public support.

Labor market
Despite several years of slow economic growth, Italy is one of the few EU countries to have enjoyed a robust rate of job creation and a substantial fall in unemployment over the last decade. These results stem from the reforms implemented in the past several years that have increased the flexibility of the labor market and fostered the participation of women.

The new measures planned by the government do not intend to reduce the use of flexible forms of employment, but rather to increase safeguards for non-traditional workers and provide incentives to transform temporary employment into permanent labor contracts. In other words, the authorities' strategy aims to rely on flexible contracts to help workers break into the labor market, and to promote the move to more stable forms of employment. The

[4] For a complete description of the sustainability indicators, see Annex 1 in *European Economy*, April 2006.
[5] http://ec.europa.eu/economy_finance/about/activities/sgp/country/italy_en.htm

authorities concur with staff on the need to develop a well-balanced and strong social safety net, as a pre-condition to further reducing labor rigidities.

6. Banking sector developments and financial regulation

Banking sector

In the last ten years the Italian banking system has undergone a process of intense consolidation, involving approximately 450 banks representing 80 percent of total assets. Several indicators show that the banking system is competitive. Assets held by foreign banks represent 17 percent of the total, a percentage that is higher than in other major European countries. The cost-income ratio is 1 percentage point below the average of the EU area; ROA is in line with the EU average, while ROE is slightly below. There is however room for further improvements, particularly in the area of consumer credit and asset management. Recent initiatives of the Italian Banks' Association (ABI) facilitate price comparability and free portability of current accounts.

Financial stability

For the first half of 2006, all prudential indicators were favorable: both the stock of NPLs and the flows of new NPLs are historically low, while the capital adequacy ratio increased marginally. The system is well positioned to introduce Basel II; the new capital requirements directive was formally implemented in December 2006. The implementation of the Saving Law (2005) improved corporate governance and increased transparency, consumer protection, and coordination among regulators. Consob's resources and sanction power have been increased.

The review of the Bank of Italy's statute, promoted by the Saving Law, has been recently approved. The government is discussing a bill that would allow for the ownership revision of the Bank of Italy to take place within one year, instead of in three years as the Law indicates. However, it must be stressed than even under the current arrangements, there are no conflicts of interest between the supervised entities and the supervisor, due to the presence of several specific legal safeguards. The purpose of the reform is also to preserve the independency of the Bank of Italy, as well as to reduce the number of financial regulators, consolidating the functions of UIC, Isvap, and Covip in the Bank of Italy and Consob.

7. Corporate governance and development of an arm's-length financial market

In Italy, corporate governance is characterized by the role of shareholders' coalitions and ownership concentration. Family-based firms—even large ones—are reluctant to go public, fearing that they may lose control of the business. Moreover, only a few companies are rated, which reduces the possibility of gaining access to international corporate bond markets. So far, the ability to access the capital market, including for foreign investors, has been mitigated by the relatively easy access to other forms of financing. One of the main drawbacks of the above-mentioned corporate structure is a lower firm contestability and greater management insulation from outside pressure. The start-up of a private pension pillar will have relevant positive implications both on institutional investors and the development of the capital market.

In the area of corporate governance, we believe that the regulatory framework is among the most advanced and incorporates the best international practices. For instance, minority shareholders are among the most protected when compared to other industrial countries; the current regulation for takeovers is more stringent than the EU directive; norms on insider trading have been implemented at the most rigorous level of EU guidelines; accounting standards and disclosure are in line with European standards. The recent Bankruptcy Law increased the chances of recovery and rapid restructuring for firms in temporary difficulty and streamlined the procedures for liquidation. Lastly, Italian listing rules and costs are in line with peer European stock exchanges.

There is always room for improvement, but at this stage, we believe that only relatively minor refinements are necessary. In our view the main problems are not in the regulatory framework, but rather in its implementation, due to inefficiencies in the judiciary and administrative systems. The authorities are strongly committed to overcoming these shortcomings.

8. Other Issues

In 2005 the Italian ODA was equal to 0.29 percent of GNI, doubling the 2004 results. While on the basis of current estimates, Italian ODA is expected to decrease in 2006, Italy continues to adhere to the EU commitment to reach an ODA-to-GNI ratio of 0.51 percent (as an individual target) by 2010. The related budget appropriations will gradually increase, taking into account the constraints due to the ongoing budgetary consolidation. The government has planned to carry out a full-fledged reform aimed at boosting the Italian development cooperation.