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Italy: 2008 Article IV Consultation—Staff Report; Staff Supplement; 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 2008 Article IV consultation with Italy, the following documents have been released and are included in this package:

- the staff report for the 2008 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on November 19, 2008, 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 7, 2009. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF;

- a staff supplement of February 2, 2009 updating information on recent developments

- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its February 6, 2009 discussion of the staff report that concluded the Article IV consultation; and

- a statement by the Executive Director for Italy.

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

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INTERNATIONAL MONETARY FUND

ITALY

Staff Report for the 2008 Article IV Consultation

Prepared by Staff Representatives for the 2008 Consultation with Italy

Approved by Ajai Chopra and Martin Mühleisen

January 7, 2009

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I. Staff Appraisal and Executive Summary

1. **The global financial crisis is taking a toll on Italy's economy, compounding its long-standing, home-grown, weaknesses.** Output is projected to contract by about ½ percent in 2008 and 1 percent in 2009, with risks tilted to the downside, linked to a further slowing of global growth and falling consumer confidence. Going forward, the economy's ability to rebound quickly is hampered by rigidities in product and labor markets, a lack of domestic competition, a likely slower pace of industrial restructuring, and weakness of the public finances.

2. **The policy agenda should focus on responding to the global crisis while addressing Italy's longer-term challenges.** Given the exceptional nature of the crisis and its impact on the domestic economy, some carefully tailored near-term counter-cyclical financial and fiscal responses are warranted. But immediate measures should be aligned with the need to respond to Italy's real economic crisis—the relentless decline in productivity. Structural reforms should thus continue to be pursued, and indeed intensified when conditions warrant, aimed at increasing the economy's growth potential and supported by medium-term expenditure-based fiscal consolidation.

3. **While the banking system has proved resilient, further near-term actions are warranted to further strengthen financial stability.** The financial system has weathered the turbulence well, helped by its relatively low risk profile and the authorities' prudent and systematic response to the crisis. But vulnerabilities have risen, related to banks' capitalization, funding, credit quality, profitability, and exposure to Central and Eastern Europe (CEE). To mitigate these vulnerabilities, recent financial sector support measures should be fully and promptly implemented, and additional measures should be considered, including a voluntary government recapitalization scheme. Care should be taken to ensure transparency, minimize market distortions, limit government involvement in banks' decision-making, including via a clear exit strategy, and avoid, to the extent possible, potential spillovers for other countries, especially CEE. Efforts should also continue toward enhancing international regulatory and supervisory coordination.

4. **At the same time, longer-term financial sector goals should be pursued.** Additional measures should be considered which would not only further strengthen financial stability, but would also support the growth-enhancing role of the financial sector in the long run. These could include improving consumer protection, further strengthening the supervisory and regulatory landscape, and enhancing the coordination, efficiency and information sharing among regulators. Efforts should also continue to further spur competition and improve corporate governance in the financial sector.

5. **The budgeted fiscal consolidation for 2009 should be delayed.** The government's innovative three-year fiscal package—which aims for a broadly-balanced budget by 2011 though spending-based measures—provides a good medium-term anchor. But the target deficit of 2.1 percent of GDP for 2009 is no longer in line with the deteriorating macroeconomic environment: staff project the deficit to widen to above 3 percent of GDP. Nonetheless, the recession warrants a counter-cyclical fiscal response, which should be

tailored to Italy's circumstances, especially its high debt. The budgeted cyclically-adjusted consolidation for 2009 (estimated by staff at around 0.3 percent of GDP) should thus be postponed. Timely, temporary, targeted and coordinated measures should be considered, while fully implementing the budget's envisaged reductions in current spending. The fiscal package recently submitted to Parliament, which is likely to imply a broadly neutral fiscal stance for 2009, is generally in line with these considerations. If the growth outlook deteriorates significantly, a somewhat larger stimulus could be considered.

6. **The government should continue to steadfastly improve fiscal frameworks to underpin the medium-term expenditure-based fiscal consolidation.** The authorities have made significant progress in streamlining the budget process, increasing the productivity of public administration, improving the management of public assets, and advancing fiscal federalism. These efforts need to be reinforced and remaining gaps filled. Linkages between the reforms should also be exploited while ensuring consistency with the wider objective of achieving sustainability via expenditure-based consolidation. The opportunity could also be taken to make progress on addressing longer-term fiscal challenges, in particular, reforming the welfare system.

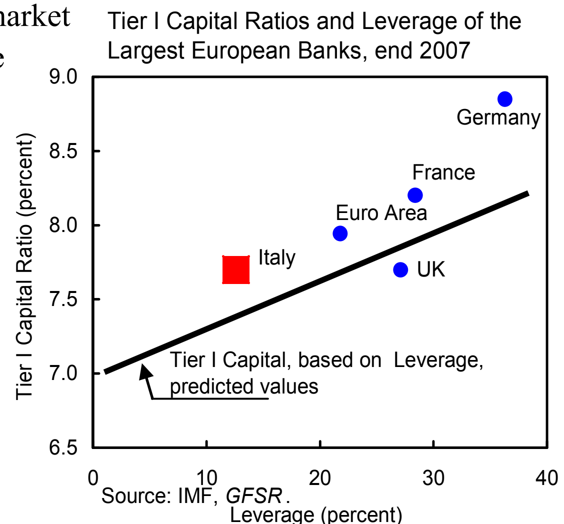
7. **Concerted actions are needed to boost Italy's growth potential.** The structural reform agenda should focus on further liberalizing retail trade and services, continuing deregulation efforts in the energy market, and strengthening the role of competition bodies in formulating policy. A second generation of labor market reforms is required to strengthen the link between wages and productivity, allow wages to better respond to regional differences, and make permanent contracts more flexible. International initiatives should be leveraged to spur reform, while resisting tendencies toward protectionism.

8. **It is proposed that the next Article IV Consultation be held on the regular 12-month cycle.**

II. Context: Weathering the Global Financial Crisis

9. **Italy's financial sector has not avoided the global financial crisis, but has so far withstood the turbulence.** Financial markets were shaken as the international crisis intensified: equity prices plunged, the interbank market froze, corporate issuance dried up, and some large Italian banks came under pressure. Nevertheless, the system as a whole remained solid, and no institution failed or fell short of regulatory requirements. Italian banks' recourse to ECB lending increased but remained commensurate with their asset share in the euro area, and they continued to fund themselves through bond issuance to domestic retail investors—an option unavailable to many European peers—financing robust loan growth up to mid-2008. However,

Tier I Capital Ratios and Leverage of the Largest European Banks, end 2007



Source: IMF, *GFSR*.

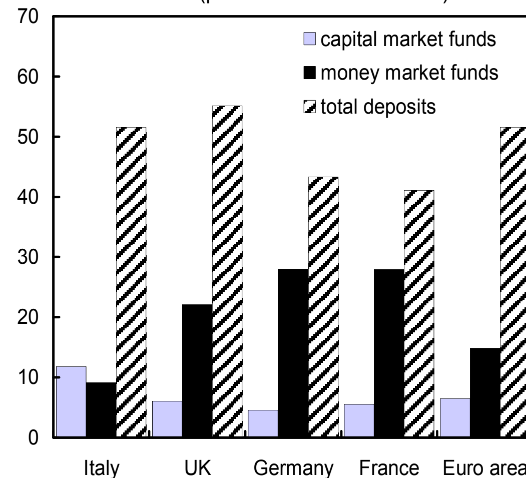
surveys indicate significant tightening ahead (mostly in terms of pricing and lending standards), and household lending has already sharply declined, chiefly for demand reasons. Third-quarter profits for the major banks remained positive, albeit much lower than last year and helped by the application of the new international accounting rules.[1] Bank CDS spreads, while higher, remained below those of other European peers, reflecting their relatively safer risk profile: the traditional, relationship-based banking business model that has supported a broad and stable funding base (composed mainly of retail deposits and bonds), low leverage ratios, a comparatively high-quality traditional asset portfolio with little exposure to "toxic" assets, and relatively low dependence on wholesale interbank funding (Box 1). These factors have been supported by a firm bank regulatory and supervisory environment, strong intervention and resolution frameworks, and pre-existing high levels of depositor protection that exceeds the EU minimum (Annex III).[2]

Bank Losses, Subprime Crisis (USD billions)

Rank, by loss		Writedown and loss	Capital raised
1	Citigroup	55.1	49.1
2	Merrill Lynch	51.8	29.9
3	UBS	44.2	28.3
4	HSBC	27.4	3.9
5	Wachovia	22.5	11
6	Bank of America	21.2	20.7
7	IKB Deutsche	15.3	12.6
39	…		
40	UniCredit	2.6	-
66	…		
	TOTAL, direct	501.4	353

Source: BankScope, Bloomberg

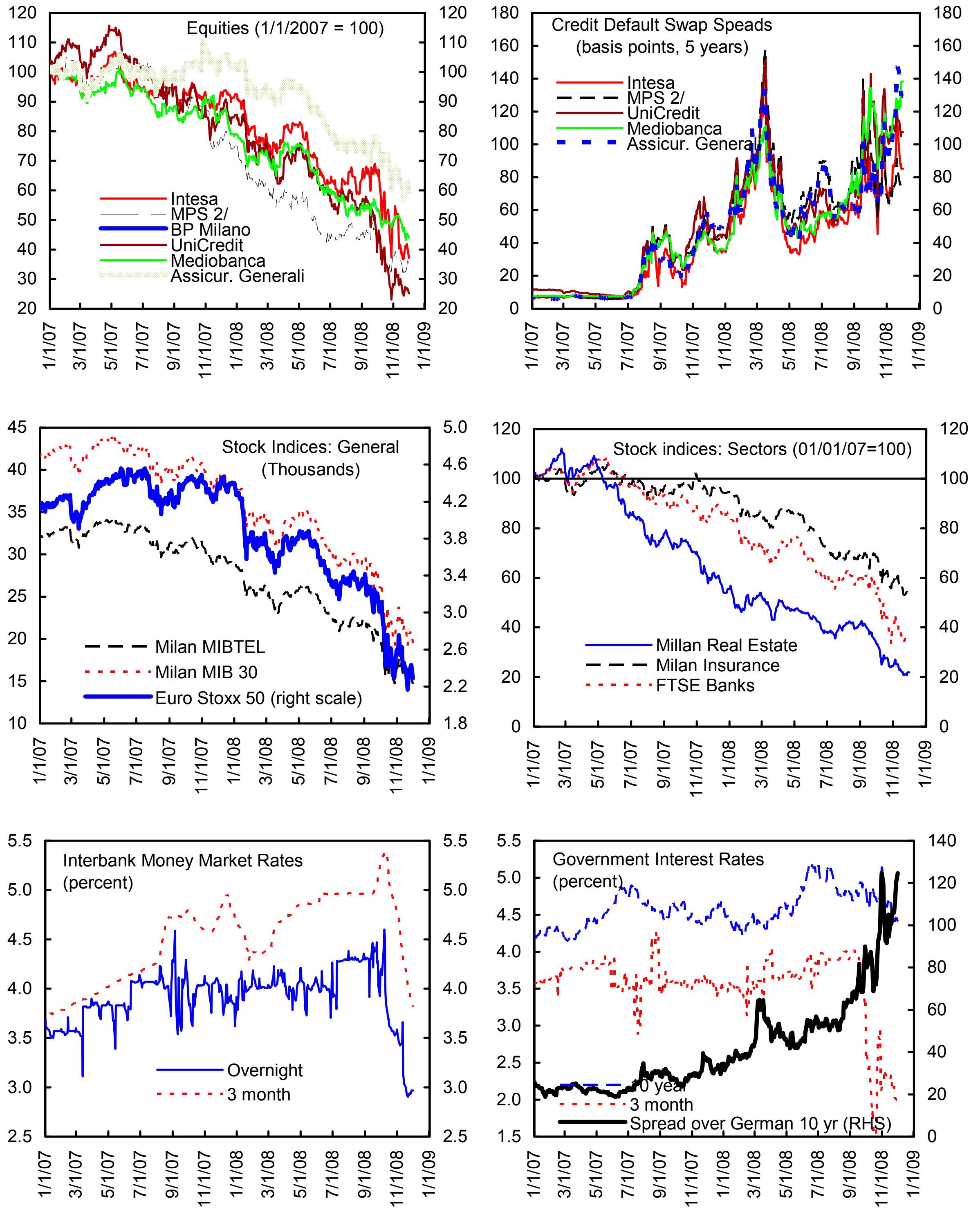
Large European Banks: Funding Composition, 2007 (percent of total liabilities)



[1] The IAS39 rule allows for reclassification of marked-to-market assets as held to maturity. Financial institutions with large securities investments and trading books benefit from the rule the most.

[2] Depositors in all banks incorporated under the Italian law are protected by the two deposit insurance schemes (one for mutual banks and one for all the rest). The deposit insurance is generous compared to other EU countries—at €103,291 per depositor per bank— and has always exceeded the EU-required minimum (recently raised to €50,000).

Figure 1. Financial Indicators 1/

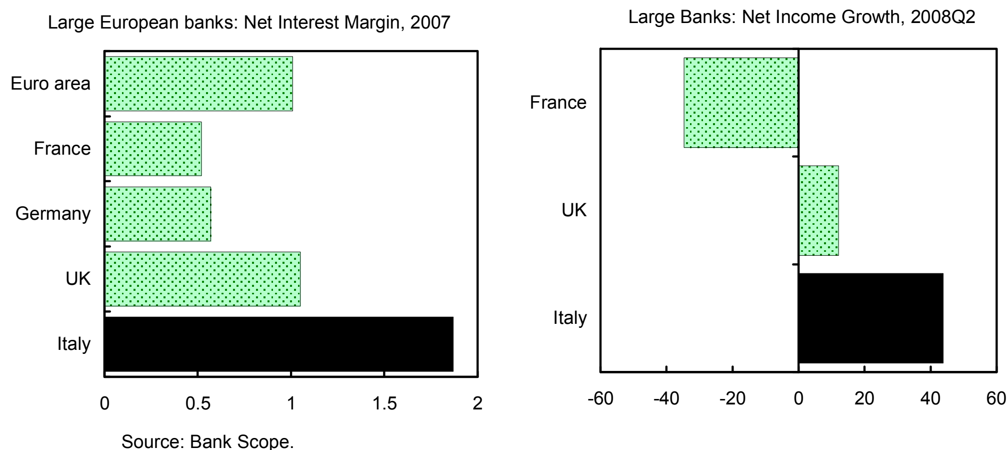


Sources: Thomson Financial/DataStream; and Bloomberg.
1/ The latest observation is as of December 1, 2008.
2/ MPS stands for Monte dei Paschi di Siena.

Box 1. The Relative Resilience of Italian Banks — Some Explanatory Factors

A few factors could explain why banks did not engage in high-risk/high-yield strategies involving structured products, which would have put them more at risk in the current crisis:

- *Financial intermediation is relationship based and dominated by banks*. This, combined with an extensive bank-branch network and a sound deposit-insurance system, helps ensure a solid deposit base and a retail market for other bank liabilities. In addition, most other financial services (i.e. asset-management and insurance) are also channeled via banks' networks. Profits are more stable, which, perhaps, supports safer business strategies. Indeed, even throughout the financial turbulence, and unlike many of their peers, Italian banks managed to sustain a steady pace of income and deposit growth.



Source: Bank Scope.

- *Low (until recently) contestability of the system*, combined with still high net interest margins and retail banking fees, insulated banks from competition, lowering their appetite for risk. Recent evidence indicates that net margins in Italy increased over the past year and that banks have been able to pass the increases in their funding costs onto customers.

- *Growth opportunities elsewhere (until recently)*. Italian banks have rapidly expanded into fast-growing emerging markets, such as new EU member states and Russia, engaging primarily in core banking business. These subsidiaries (until recently) generated double-digit profit growth. However, these exposures are turning into vulnerabilities as the financial crisis takes its toll on the region (see ¶21).

- *Regulatory provisions may have inhibited riskier strategies*. For example, regulatory provisions issued by the Bank of Italy, including those on derivatives, while in line with EU norms and the Basel Accord, have been more stringent than in other countries. The regulation for covered bonds, which has been recently finalized (May 2007), contains strict eligibility requirements as regards capital ratios for issuers and limits on amount of assets allowed to be transferred to an SPV.

- *Past scandals could have reduced banks' appetite for risk-taking*. After corporate fraud scandals with Parmalat and Cirio, banks have been heavily sanctioned by regulators.

10. **The system's resilience has been supported by the authorities' prudent and systematic response.** From the onset of the crisis in 2007, the Bank of Italy (BoI) intensified monitoring and disclosure of banks' risky exposures and communicated the (generally reassuring) results to the markets. Capitalizing on already strong practices, and in line with international recommendations, the BoI also intensified liquidity monitoring (with weekly reporting requirements for the large banks), prudential oversight of risk management and contingency plans of banks, and targeted inspections, and required leading banks to regularly report counterparty risk and stress test more frequently.[3] The high-level interministerial committee on financial stability held frequent ad-hoc meetings, and, as the crisis intensified in September 2008, the securities regulator (Consob) banned short sales. In addition, the government passed two enabling decrees that: (1) allow the government to inject capital into troubled banks on a case-by-case basis, through non-voting preference shares, with conditionality attached; (2) guarantee new bank liabilities; (3) permit the BoI to swap government debt for low-quality bank collateral (for up to €40 bn; operations have already started)—if needed, the Treasury will guarantee the BoI loans; (4) boost the BoI's powers to initiate prompt and early bank resolution to avoid losses; and (5) fully underwrite the deposit guarantee fund. The details of the scheme—especially the pricing of the state capital injections and bank obligations—are awaiting the implementing legislation.

11. **The ensuing global slowdown precipitated the economy's fall into recession.** Output contracted by ½ percent in each of the middle two quarters of 2008. With confidence at its lowest level in over a decade, consumption continued to decline despite still-positive employment gains and substantial easing of inflationary pressures. Gross fixed investment slowed sharply in the first half of 2008, due to pessimism about demand prospects and tighter financing conditions. The contribution of net exports turned firmly negative as partner country demand weakened. The housing market has also been cooling, but less so than in many other European countries, given that house prices had not risen as sharply.[4]

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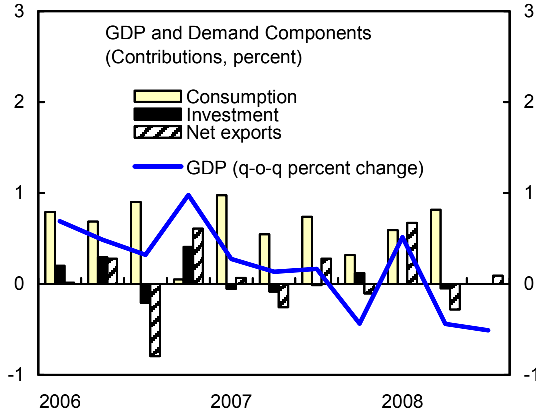
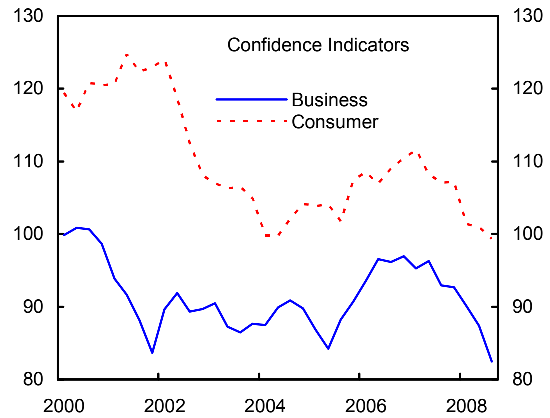
[3] The Bank of Italy, in collaboration with the leading banks, has launched a program of periodic stress tests, using a variety of methods, sensitivity analyses, and scenarios. The results the May exercises (published in the Annual Report) demonstrated that "the system offered a good level of resistance to the scenarios postulated" with regard to credit, interest rate, market and liquidity risks.

[4] See "House Price Developments in Europe: A Comparison" WP 08/211 and BoI Economic Bulletin (Oct. 08).

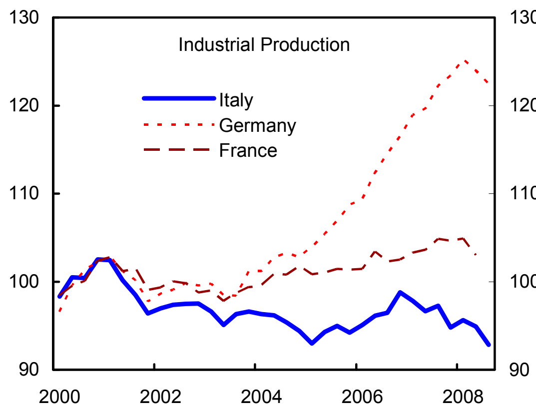
Figure 2. Economic Momentum Has Flagged

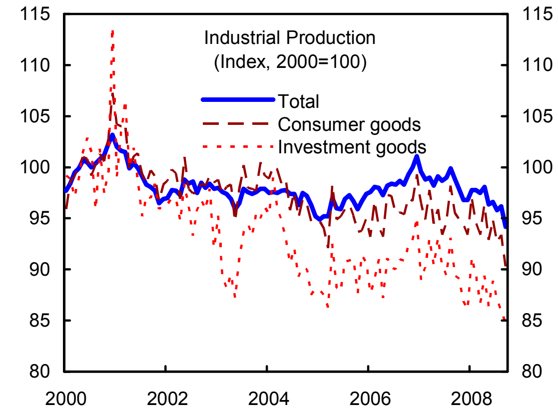
Growth stalled, and indicators point to continuing weakness in consumption ...



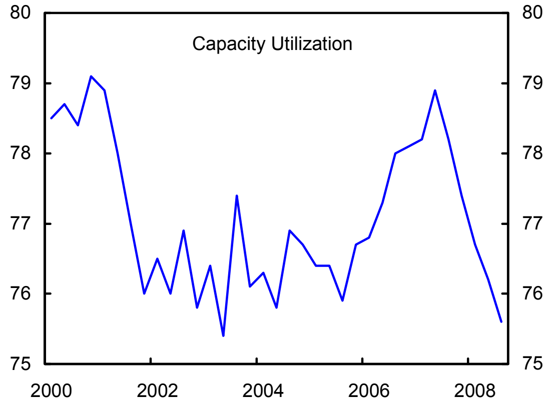


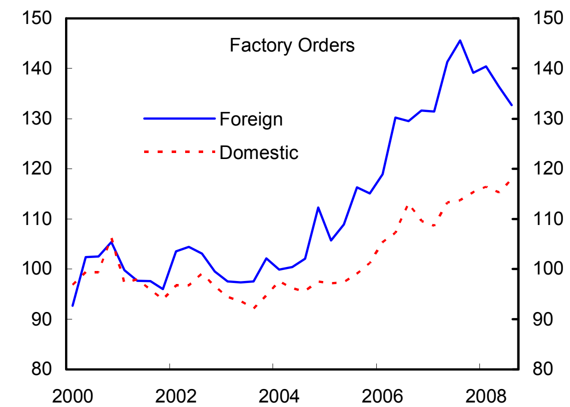
...industrial output...





...and investment.





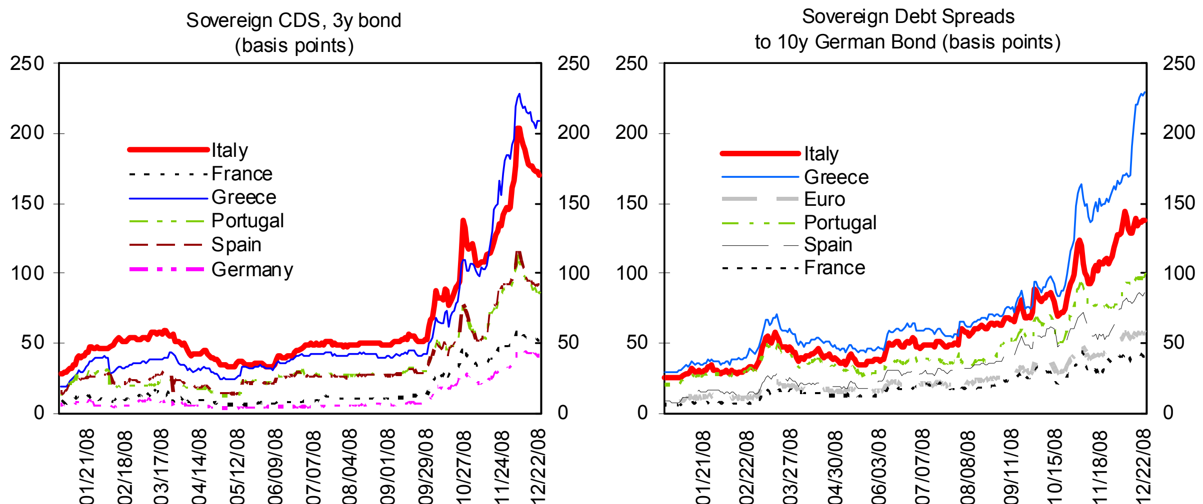
Sources: Istituto Nazionale di Statistica; and ISAE.

12. **The revenue-based fiscal consolidation has come to an end.** The structural fiscal balance improved by 2¾ percent of GDP in 2006–07, mainly due to exceptionally strong revenues, with the overall deficit narrowing to 1.6 percent of GDP in 2007. But, reflecting the expansionary budget, weaker revenues, and some temporary factors, the deficit likely rebounded to 2¾ percent of GDP in 2008, entailing a loosening in structural terms and a higher expenditure ratio, with the primary current spending ratio reaching a record high. The global turmoil and economic weakness have already dented corporate profit taxes. Sovereign 10-year spreads over bunds exceeded 140 bps in December (compared to less than 30 bps a year ago), reflecting greater risk aversion and lower bund yields—overall sovereign yields have, however, fallen (which the authorities have moved quickly to lock in).

Italy: Fiscal Developments: 2005-08
(percent of GDP)

	2005	2006	2007	2008
				est.
Overall Balance	-4.3	-3.4	-1.6	-2.7
Structural Balance 1/	-4.5	-2.9	-1.8	-2.3
Public debt	105.9	106.9	104.1	105.7

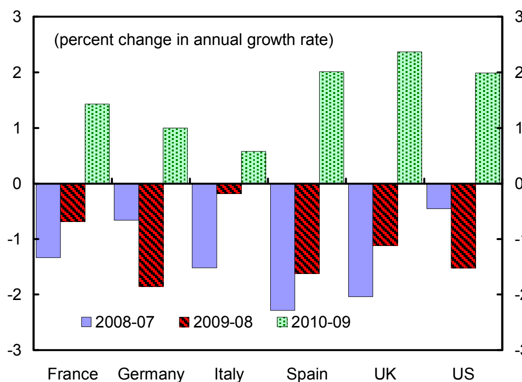
1/ Assumes staff's output gap, and net of one-off measures.



III. Outlook and Risks: Continued Weakness

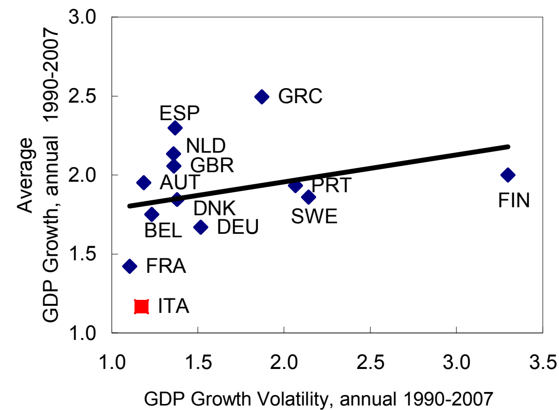
13. **The near-term outlook is bleak.** The global financial crisis has been affecting Italy's real economy mainly through the growth/trade and confidence channels, though the credit channel is likely to prove substantial going forward, and Italy starts from an already relatively weak base (Box 2). Output is projected to fall by about ½ percent in 2008 and 1 percent in 2009, given negative carry-over from the worse-than-expected output declines in Q2 and Q3 2008, weak recent indicators, and expected weaker partner country demand. The projected deterioration in Italy's growth rate between 2008 and 2009 reflects Italy's relatively low level and variance of potential growth, but also some potentially insulating factors: its resilient banking system, low private sector leverage ratios, a less inflated housing market, and the industrial restructuring of recent years.

Projected growth decline in select countries



Source: IMF, WEO.

Italy: Low growth volatility at the cost of low average growth



Source: OECD.

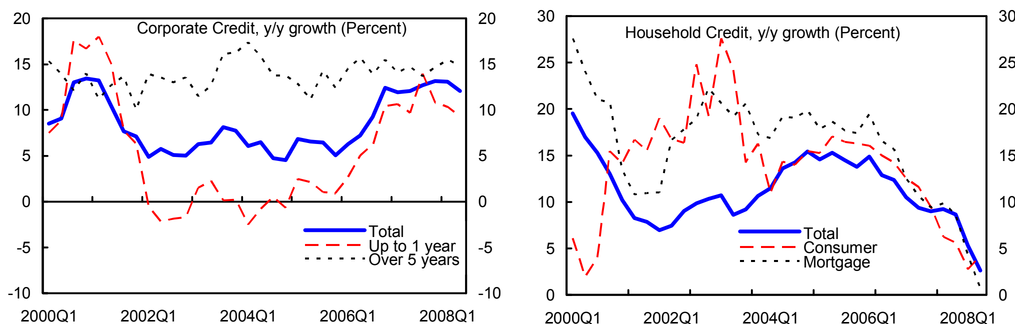
14. **Negative risks dominate the outlook, and the eventual recovery will likely be slow and weak.** Uncertainty about the outlook is exceptionally large. Given the Italian economy's particularly high reliance on exports, downside external risks dominate, stemming from the feedback loop between continuing strains in the global financial system and slowing global economic activity. But domestic risks associated with additional falls in consumer confidence, linked to the deteriorating macroeconomic context and rising uncertainty, are also important. Staff estimate that in the event of a prolonged credit crunch (i.e., decline in loan volumes accompanied by further widening of spreads), investment could decline significantly, resulting in an additional output loss of up to 1 percent a year for two years (Box 2). Going forward, the economy's ability to rebound quickly is hampered by pervasive rigidities, lack of domestic competition, the likely slower pace of industrial restructuring, and the limited scope for a fiscal response. Hence, growth is expected to pick up only modestly in 2010, staying below its already weak potential.

Box 2. Channeling the Financial Turmoil to the Real Economy

The Italian economy has, so far, been mostly affected by the impact of the global financial crisis on partner country demand, with Italy's growth plunging in sync with that of other industrial countries.

- *Investment.* To date, bleak demand prospects at home and (especially) abroad weighed heavily on business confidence and hence investment. At the same time, the direct effect of tighter credit conditions has been more moderate, chiefly due to the fact that Italian firms, on average, rely less on external funding for investment and growth.[1] The slowing economy has eroded the self-funding capacity of firms, but the increase in credit costs to date (over 70 bps) did not affect the pace of credit growth to corporates (though overall corporate borrowing did slow as bond placements have dried up since Q2), with most of the tightening occurring via prices rather than quantities. Staff estimates that, to date, the global downturn subtracted more than 1 percentage point from fixed investment growth, while the contribution of tighter credit conditions has been more recent and limited (about ½ ppt).

Corporate borrowing held up well, but household borrowing slowed sharply.



Sources: Datastream/Thomson Financial; European Comission; and IMF, *IFS* and *WEO*.

- *Consumption.* To date, consumption has been dampened by weak confidence, and, until recently, by eroding disposable incomes due to rising inflation. The direct effect of the financial turbulence on consumption has been moderate due to the negligible wealth effect of housing and generally low recourse to borrowing for consumption purposes. Going forward, employment prospects will continue to define the confidence and consumption outlook. In addition, although households are relatively under-leveraged, debt burdens are rising (from low levels), and household surveys indicate growing concerns about the ability to meet mortgage payments (although delinquency rates are still low).

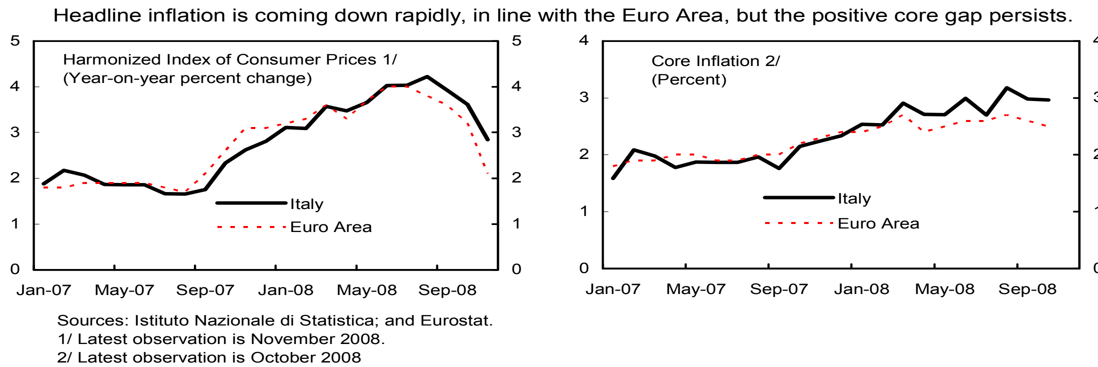
Household debt, selected countries, 2006

	% of GDP	% of DI
Italy (2007)	34	49
Spain	80	140
Euro area	60	…
USA	98	134

Sources: Eurostat, Federal Reserve, IMF

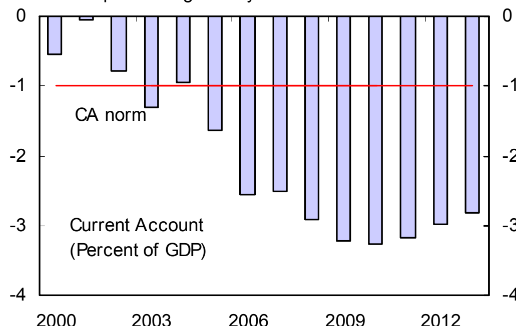
[1] See "Financial Intermediation And Growth in Italy" in *Italy: Country Report No. 07/65*.

15. **Inflation is expected to moderate in line with the slowdown in growth and global commodity prices.** Inflation moderated in November—coming down from a decade high peak—largely due to declining global prices for oil and food. Core inflation, however, remained elevated, and the differential with the euro area widened further, with weak competition in the service sector (especially in domestic trade) likely contributing. As the output gap widens further, inflation is projected to slip well below 2 percent in 2009.



16. **The current account deficit is projected to widen to around 3 percent of GDP in 2008 and further in 2009 and decline only gradually over the medium term.** So far this year, nominal export strength has roughly offset the higher energy import bill, while non-energy imports were subdued. But data for October/November indicate an accelerating contraction in both exports and (to a lesser extent) imports. The trade account is expected to deteriorate slightly in 2008−2010, due to weakened global demand weighing on exports, although imports are also expected to suffer as a result of lower domestic demand. Over the medium term, export growth is expected to gradually pick up as the global economy recovers, while lower import prices would help reduce the trade deficit and, gradually, the current account deficit. The main downside risks are slower partner country growth and a further deterioration of competitiveness.

17. **A modest competitiveness gap persists.** Italy's market share in world trade declined markedly (and more than its peers) since the mid 1990s. Moreover, CPI— and ULC-based real exchange rates point to a continued appreciation that has dampened real exports. Recent staff estimates of the equilibrium real exchange rate based on the CGER methodology support this conclusion, indicating a competitiveness gap of some 8–9 percent.



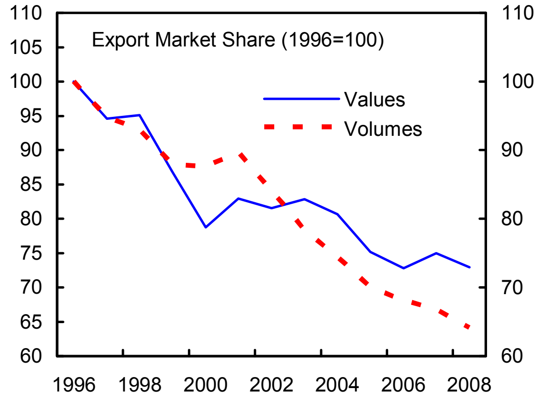
Estimates Applying the CGER Methodology to Italy 1/

	Exchange rate (percent)			Current account (percent of GDP)	
	MB 2/	ERER 3/	ES 4/	2008	2013
France	4.0	6.0	19.0	-3.0	-2.9
Germany	-4.0	2.0	-15.0	7.3	6.5
Italy	9.4	9.4	8.1	-2.9	-2.8

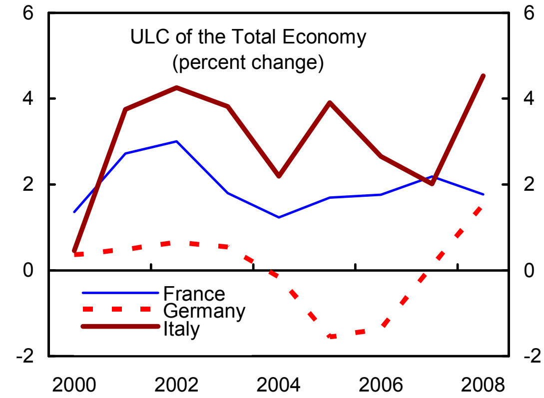
1/ Positive numbers indicate that REER is above equilibrium.
2/ Macroeconomic balance.
3/ Reduced-form equilibrium real exchange rate.
4/ External stability.

Figure 3. Standard Competitiveness Indicators Indicate a Gap

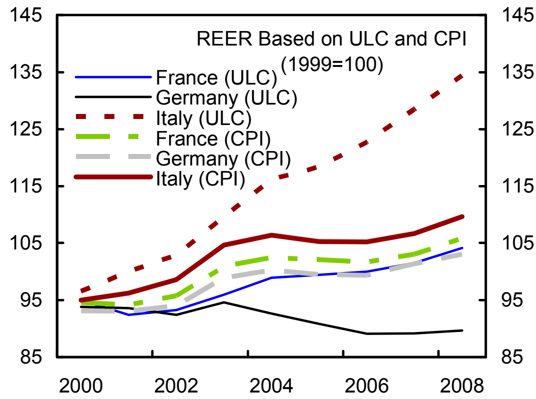
Global market shares have been declining...



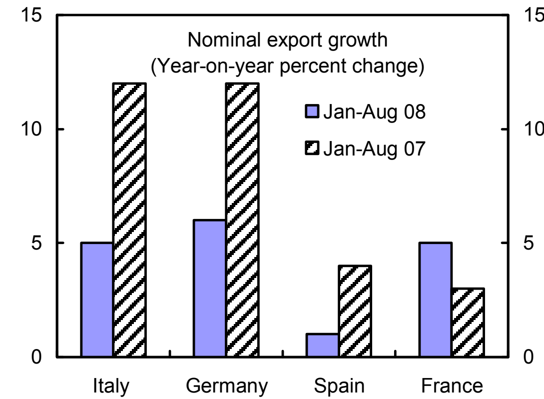
...as labor costs have been relatively high...



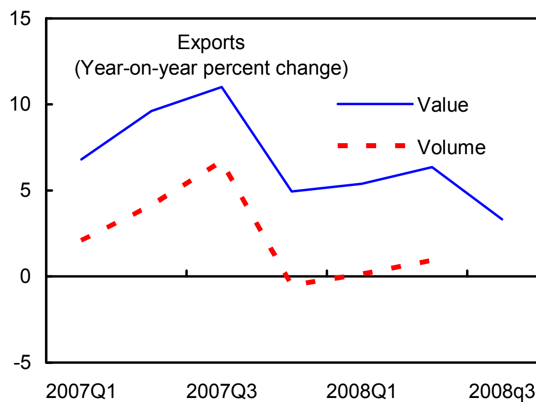
... and the real exchange rate appreciated.



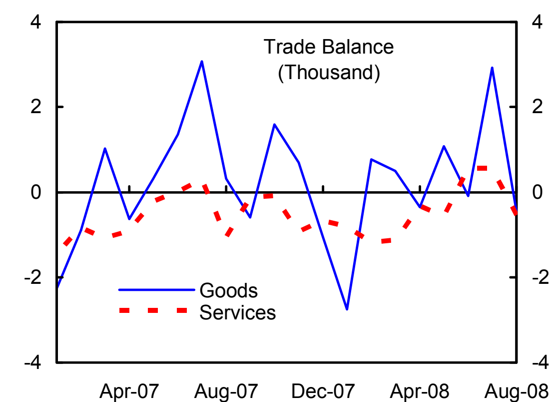
Nominal exports held up relative to peers...



...but the export surge is past its peak...



...with trade balances moving sideways.



Sources: Istat; OECD; Eurostat; Bank of Italy; and IMF staff estimates.

18. **The authorities recognized that the macroeconomic outlook had deteriorated significantly, but views on the severity of the downturn differed.** While the Ministry of Economy and Finance (MEF) has not officially revised its growth projections of 0.1 and 0.5 percent for 2008 and 2009, respectively, which underlie the budget currently in Parliament, there was broad recognition that downside risks were materializing. Nevertheless, they saw a milder downturn than staff, highlighting that Italy's stronger banking system and healthy household balance sheets should help it weather the downturn, and that Italy should benefit more than other countries from the weaker euro and declining energy prices. The BoI's views on the outlook were more negative and similar to staff's. All interlocutors saw negative risks dominating. Although neither the MEF nor the BoI have released revised forecasts, there was a broad agreement with the mission on the inflation outlook.

Italy: Near-Term Outlook, Comparisons

	GDP growth		Inflation	
	2008	2009	2008	2009
IMF (December 3, 2008)	-0.4	-1.0	3.5	1.6
Ministry of Finance (Sept 23, 2008)	0.1	0.5	3.8	2.8
Bank of Italy (July 2008)	0.4	0.4	3.8	2.8
Confindustria (December 16, 2008)	-0.5	-1.3		
European Commission (November 3, 2008)	0.0	0.0		
OECD (November, 2008)	-0.4	-1.0		

Sources: MEF, BoI, Confindustria, EC, OECD, and IMF staff estimates

IV. The Policy Agenda: Responding to the Crisis and Reinforcing Long-Term Goals

19. **Short-term actions are warranted to counter the effects of the global crisis.** The exceptional nature of the crisis and its repercussions for the domestic economy require near-term actions to strengthen financial stability and a countercyclical fiscal response both at the national and international level. But such actions should be tailored to Italy's specific circumstances—especially its high public debt and widening spreads, which constrict the scope for an aggressive fiscal policy response—being mindful of international spillovers.

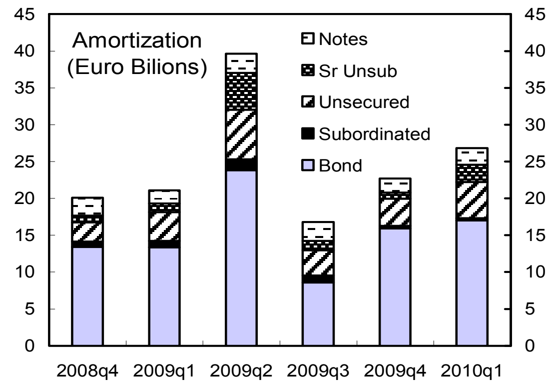
20. **But immediate actions should be aligned with the need for longer-term reforms to address Italy's main challenge— its chronic lack of growth.** Beyond the present cyclical slowdown, the real economic crisis confronting Italy is the decline in productivity over the last decade, which has spawned stagnating incomes, rising unit labor costs, a significant competitiveness gap, and tepid growth. And Italy's large and unproductive public sector—with its poor quality spending, high effective tax burden, and persistent deficits—compounds the problem. The government should thus set short-term measures with longer-term goals in mind, aimed at increasing productivity and ensuring fiscal sustainability.

A. Preserving Financial Soundness

21. **While the financial system remains sound and well supervised, vulnerabilities have risen**. These are mainly related to:

- *Liquidity and funding*: Banks' funding maturity mismatch is rising, given their increasing reliance on relatively shorter-term ECB refinancing and retail bond issues. For a number of large institutions, which are more reliant on wholesale and interbank international market funding, sizeable debt redemptions are coming due in the next 24 months, and although 12-month ahead redemptions are largely pre-funded, some gaps remain. In addition, recourse to the retail bond market could be more limited going forward, as scope for switching away from other investments narrows and the market becomes saturated.

Large redemptions are coming due in 2009-10



Source: Bloomberg.

- *Capital*: While the banking system's capitalization meets regulatory requirements, core Tier I capital in a few large banks has fallen below 6 percent since late 2007. And despite steps taken by large banks to boost capital, including through rights issuance and scrip dividend, markets may view their new ratios as weak compared to many peers elsewhere, especially those that have received government-sponsored recapitalizations. In addition, banks' important shareholders— foundations that hold more than half of the capital of listed banks—may have limited financial capacity to quickly boost banks' capitalization if needed.

Market Perception of the Capital Shortfall and New Core Tier 1: An Example 1/

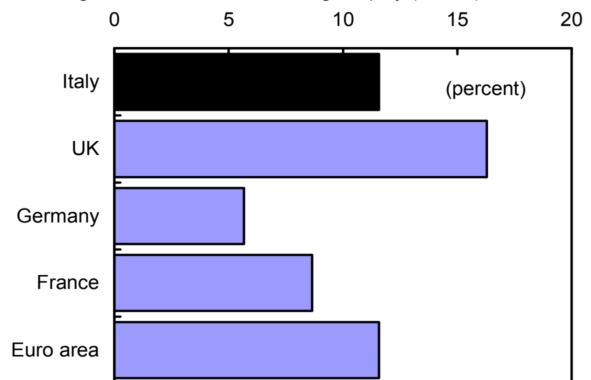
	Capital shortfall (millions of euros)	Core Tier 1
Unicredit	8,138	6.9%
Intesa Sanpaolo	4,728	6.3%
MB	0	10.7%
MPS	2,939	5.4%
BP	1,293	6.0%
UBI	596	7.1%
BPM	94	7.3%
Total	17,788	Italy
Total	16,000	Germany
Total	23,000	France

Source: J.P. Morgan, staff calculations.

1\ Relative to the 8% threshold for Core Tier I Capital. Data as of October 2008.

- *Profitability*. Despite high margins and fees, inefficiencies have led to relatively low profitability even in good times, which is set to decline further as activity flags. As of June, annualized return on equity fell to 10 percent (from 13 percent a year ago) and individual bank financial reports also suggest that some large banks would have registered losses in the third quarter, were it not for the boost to profitability due to the new accounting rule.

Large Banks: Return on Average Equity (ROAE), 2007



Sources: BankScope; and Bloomberg.

- *Regional exposures*. Two large Italian banks are major players in several CEE countries, where unwinding of imbalances is leading to some hard landings.[5] Although banks' overall exposures seem moderate (below 10 percent of consolidated equity) and their lending strategies relatively prudent, most regional subsidiaries previously required funding from the parent, and these requirements could increase if conditions in the host countries deteriorate. In addition, exposures to Western Europe (Germany) have already proven to be a significant negative factor. Profitability is also likely to suffer from such regional exposures.

- *Credit quality*. Households and corporate debt burdens, though low, are increasing, and impaired loans are rising, prompting banks to build up reserves. As the recession deepens and funding costs rise, credit quality is likely to worsen, with small enterprises likely to come under particular pressure.

- *Cross-border regulatory risk*. A number of Italian banks have substantial operations in other European countries, as do foreign banks in Italy. Yet, even in the midst of the crisis, Europe still lacks a well-defined and binding mechanism of cross-border supervision and crisis-resolution and effective information-sharing.

If the financial crisis and credit crunch intensify, so too will these vulnerabilities.

22. **Additional steps to strengthen financial stability, many of which are already in train, could help mitigate these vulnerabilities.** Recent bank support packages need to be fully implemented to shore up confidence, especially by making fully operational the funding guarantee scheme. In addition, a voluntary pre-emptive recapitalization scheme, available to sound banks, could play a useful role in supporting investor confidence and fostering credit growth. The modalities of this scheme should be carefully designed to minimize market distortions and limit government involvement in banks' decision-making (for example, on credit growth), including via a clear exit strategy. In this regard, ensuring full transparency is crucial. Experience in other countries also suggests that: (1) the operation should be on commercial terms, but not unduly expensive in order to increase take-up by banks, encourage private capital raising, and support credit growth; (2) dividend policy should reflect the need to shore up confidence and repay government holdings; and (3) full and quick loss recognition needs to be actively fostered, especially to encourage the re-capitalized banks to minimize credit tightening going forward; and (4) conditionality (for example on lending) should be limited. These principles are also reflected in the recent EU Communiqué (of December 5) on bank recapitalization schemes.

23. **Fostering international coordination is critical.** Italy's advocacy of a more coordinated international approach to crisis resolution and stronger cross-border supervision is welcome. This should be continued, along with Italy's implementation of the international financial reform agenda, including the remaining FSF recommendations and finalizing

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[5] Italian banks account for about 44 percent of banking assets in Croatia, 25 percent in the Slovak Republic, 20 percent in Hungary, and 18 percent in Poland and have exposures in Russia, Ukraine and the Baltics.

implementation of EC Directives (in particular MIFID and the Takeover Directive). The Italian authorities should be mindful of potential spillovers from their bank support actions for other countries, especially in CEE. For example, government recapitalization funds should not be prevented from being used to recapitalize subsidiaries in other countries, if this were deemed an efficient way of supporting the domestic bank.

24. **The agenda for achieving longer-term financial sector goals should continue to be pursued.** Immediate measures aimed at ensuring financial stability should also support the growth-enhancing role of the financial sector in the long run. In particular, the supervisory and regulatory landscape could be further strengthened by: establishing a personal bankruptcy law, which is especially important given the weak growth outlook; intensifying efforts to ensure transparency and consumer protection, as banks become increasingly reliant on bond issuance to retail investors; completing legislative efforts to reduce the number of regulators and improve coordination among them;[6] and finalizing the removal of banks from the ownership of the BoI. The work to enhance the BoI's stress testing to incorporate complex interlinkages across institutions and the macroeconomic environment should also continue. The strides made in recent years to spur competition and improve corporate governance, which appear to positively affect growth, should be preserved and built upon. In addition, other efficiency-enhancing measures, such as the reform of cooperative banks (which could also support financial stability), should not be sidelined.[7]

25. **The authorities broadly agreed with staffs' appraisal of the financial system and main recommendations.** They recognized the growing vulnerabilities in the financial system and the need to fully implement remaining measures to mitigate them; indeed they assured that work was well under way and the remaining legislation would be issued shortly. They also noted that emergency recapitalization scheme has been operational, but no recourse to it has been necessary. On the voluntary bank recapitalization scheme, the BoI and the Treasury saw continued financing of the economy as a main objective of the measure; the BoI favored relatively light conditionality. The authorities stressed the need to ensure close coordination among European countries, especially in the design of the various bank support packages. In this respect, they pointed to the spillover on Italian banks from the global "race to the top" to reach high capitalization ratios, even though the situation of Italian banks was very different. More generally, the MEF pointed out that the financial turmoil has stressed the well-known drawbacks of the European supervisory architecture and has called for an urgent review aimed at introducing effective coordination instruments.

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[6] The so-called "Authorities" law, drafted but not finalized during the previous government's term, envisaged a "twin-peak" model of market regulation and supervision, reducing the number of regulators from four to two (BoI and Consob).

[7] See "Corporate Governance Reforms in the EU: Do They Matter and How?" WP 08/91, and "Reform of Italy's Cooperative Banks" WP 08/78.

B. Providing Short-Run Support While Maintaining Fiscal Sustainability

26. **The government's innovative three-year fiscal package targets significant adjustment in 2009 and a broadly-balanced budget by 2011.** These commitments, in line with Italy's undertakings under the SGP, are positive signs of policy continuity and key steps toward debt sustainability. The adjustment plan is appropriately expenditure-based (though perhaps overly ambitious with respect to reducing investment spending) and targets an increase in the cyclically-adjusted balance of 0.6 percentage points in 2009, with a headline deficit of 2.1 percent of GDP, while the public debt and spending ratios are projected to fall. This plan is based on real growth rising from 0.5 percent in 2009 to 1.2 percent in 2011.

27. **But the near-term fiscal outlook has since sharply deteriorated, in line with the macroeconomic environment.** Staff projects the fiscal deficit in 2009 to be above 3 percent of GDP, mainly due to weaker growth, while the expenditure ratio would rise, even if nominal spending plans are observed. And adjusting for staff's output gap and other minor factors, the cyclically-adjusted balance (and excluding the impact of the package announced on November 28) would increase by 0.3 percent of GDP (and by 0.5 percent of GDP net of one-off measures). In addition, there are risks that tax elasticities could shift adversely during the downturn and expenditure savings would be not be fully realized. The debt ratio will likely rise further, reflecting the gap between the still-high average interest rate on government debt and falling growth rates, a lower primary balance, and possible bank support operations.

28. **Nonetheless, macroeconomic considerations and the need for a coordinated international response argue for delaying the planned structural consolidation in 2009.** While preserving and fully implementing the budget's envisaged reductions in current spending, timely, temporary, targeted and coordinated counter-cyclical measures could lessen the impact of the output decline without significantly undermining fiscal sustainability. As in other countries, the measures could include one-off outlays for vulnerable groups, bringing forward planned maintenance spending, and reductions in government payments delays. In this context, the recent measure limiting interest deductibility for banks could be deferred, and its modalities reconsidered. Public infrastructure spending, especially accelerating existing projects, would support both short-term demand and longer-term growth if implemented rapidly, transparently, and efficiently, with due regard to fiscal risks and using the recommendations of the recent spending review. While policy diversification is important, given uncertainty about the effectiveness of different measures, piecemeal responses should be avoided and a credible path to the MTO maintained. The "anti-crisis" package of fiscal measures recently (after the mission's conclusion) submitted to Parliament is broadly in line with these considerations, implying a broadly neutral fiscal stance for 2009 (Box 3). If the growth outlook deteriorates significantly, a somewhat larger fiscal stimulus could be considered.

29. **Italy, unlike many other advanced countries, is ill-placed to launch a more aggressive fiscal response to counter the effects of the global financial crisis.** With its large debt, spiking spreads over Bunds, and the prospect of debt issuance rising globally, delays in adjustment will likely raise interest costs and undermine confidence. Also, Italy's growth problems stem from low potential, not cyclical, growth, and past relaxations have not proven to be effective.

Box 3. Italy's Recent Fiscal Measures to Counter the Crisis

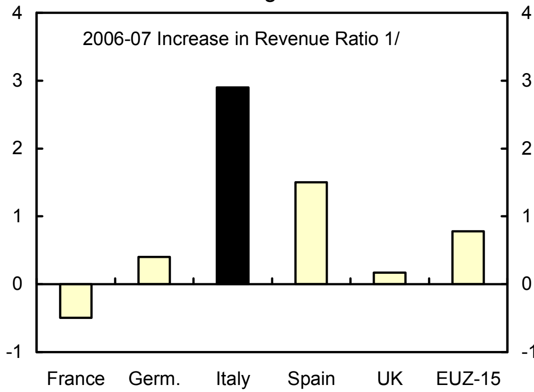
On November 28, the government passed an "anti-crisis" decree that aims to support the flagging economy. The package's gross cost is around ½ percent of GDP, but it aims to be broadly neutral in net terms taking into account offsetting (mainly revenue-raising) measures. But the total economic impact could go beyond the fiscal cost, especially if measures to accelerate investment projects prove to be effective. The main countercyclical measures fall into three broad categories:

- **Support to families/individuals** (the bulk of the fiscal cost of the package)**:** the main measure is a one-off bonus to low-income households. There are also provisions to cap interest rates on mortgages, make additional social payments, cut taxes on productivity bonuses, and limit road tolls and household utility payments.
- **Support to enterprises:** these mainly take the form of "cash-flow" support: postponing the timing of certain tax payments and reducing payment delays by the government. There is another important measure on guaranteeing bank borrowing, with specific targets for financing small and medium-sized enterprises—its modalities are to be clarified in a separate decree.
- **Acceleration of investment:** including appointing special officials to take charge of key projects, with a view to accelerating their implementation, more investment financing for railroads, and additional financing for the main national projects.

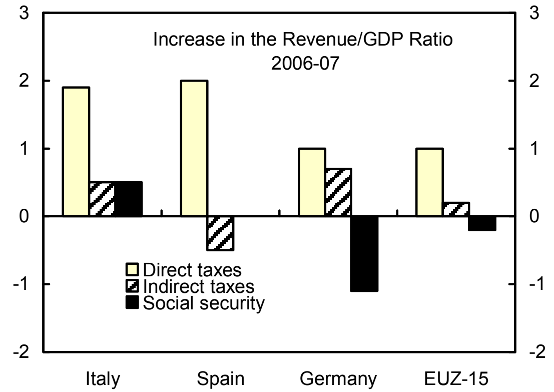
The package — while not perfect — appears to be broadly appropriate for Italy. The likely ex-post fiscal cost of the decree — even assuming some shortfall of offsetting revenue-raising measures in a weak economy — is likely to be 0.2-0.3 percent of GDP, within the available scope for fiscal stimulus, though some further measures could be considered, especially if there are high-quality investment projects being delayed essentially for lack of financing. The key measure (bonus) is timely, temporary, and targeted, although not all measures conform to these principles. The omnibus structure of the "decree-law" offers the dual advantage of immediate effect and "policy diversification" (though perhaps too diversified). At the same time, there would be some flexibility of future implementation in follow-up decrees on specific issues, such as on bank borrowing guarantees. Appropriate implementation — and in particular controlling fiscal risks stemming from bank guarantees and investment projects — will be important to maximize the package's effect on confidence and contain costs.

Figure 4. Revenue Boom No More

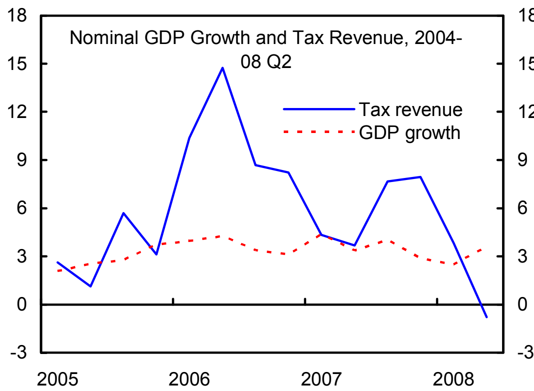
The 2006-07 revenue surge was exceptionally large...



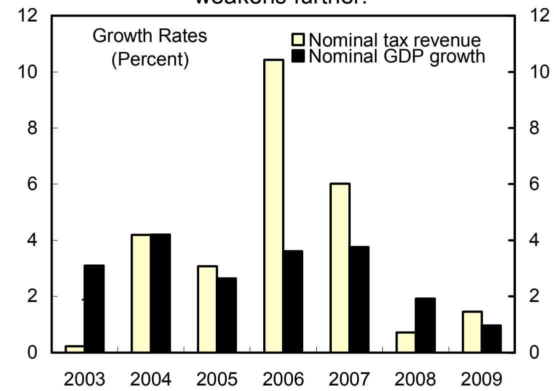
...and broad-based....



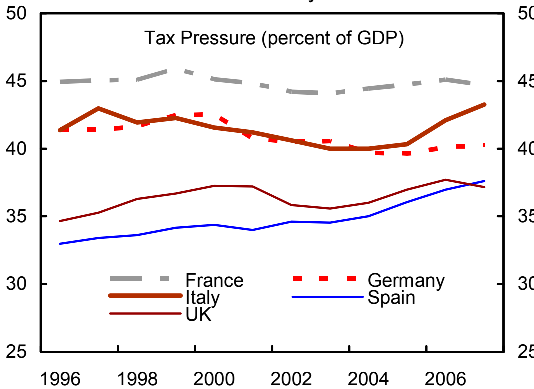
...but revenue growth has started falling...



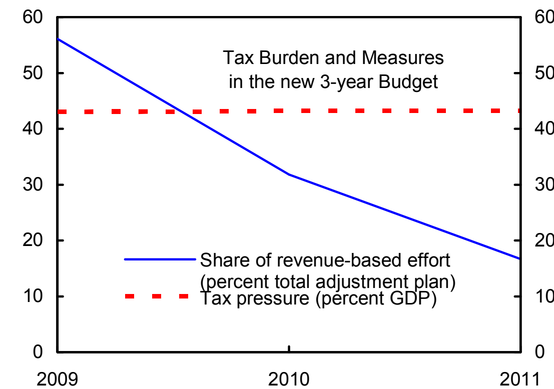
...and is set to remain modest as output weakens further.



With tax pressure already high comparatively and historically...

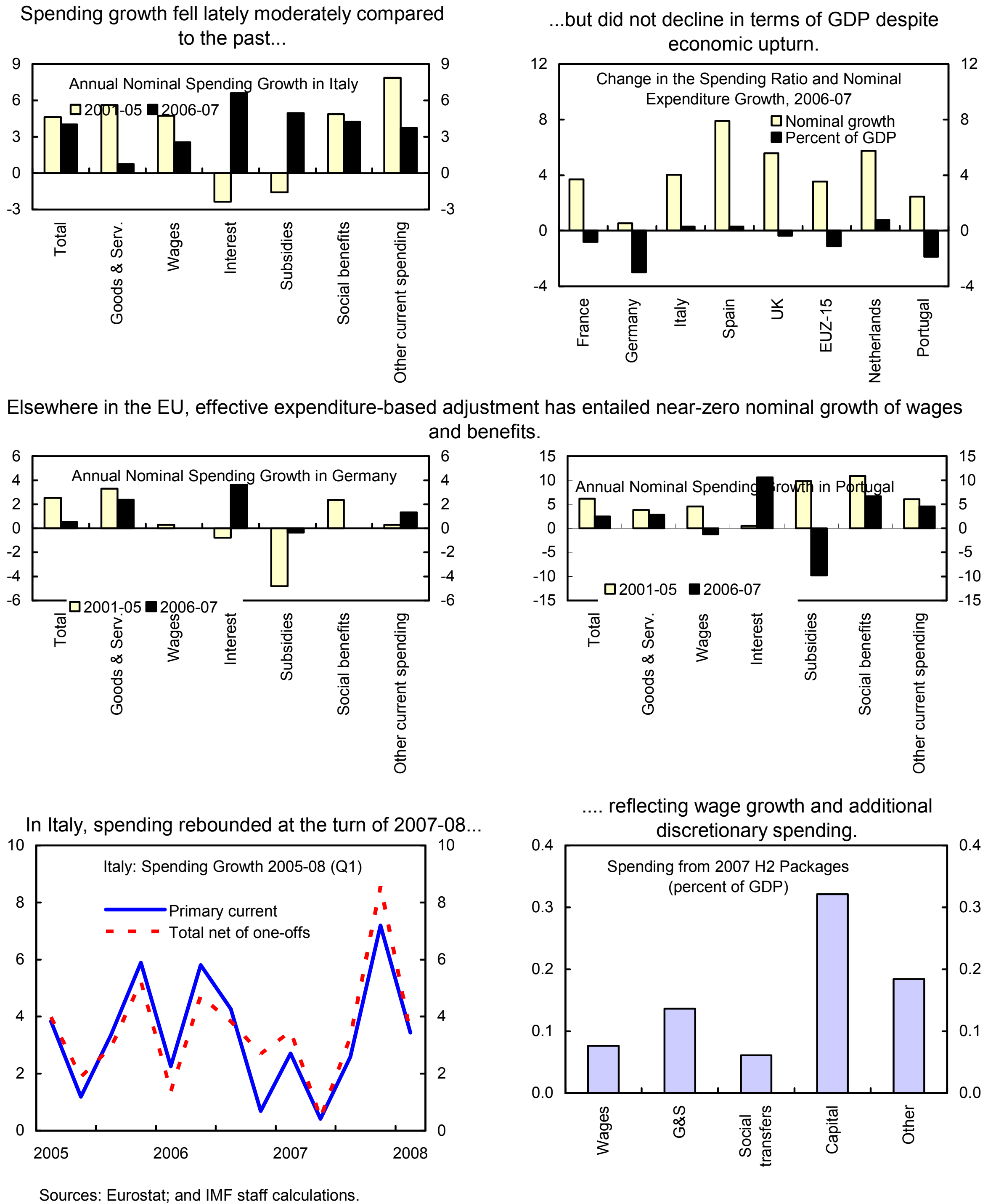


... reliance on revenue increases would be limited.



Sources: Eurostat; and IMF staff calculations.
1/ Percent of GDP

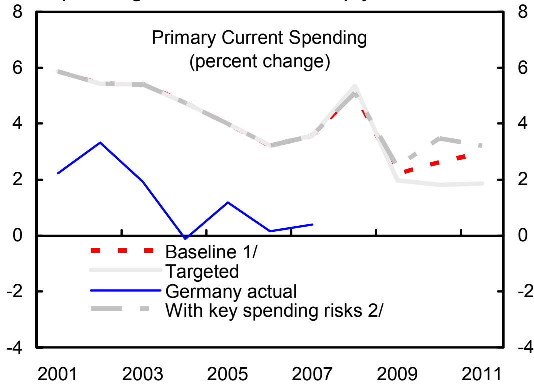
Figure 5. Spending Has Yet to be Reined in



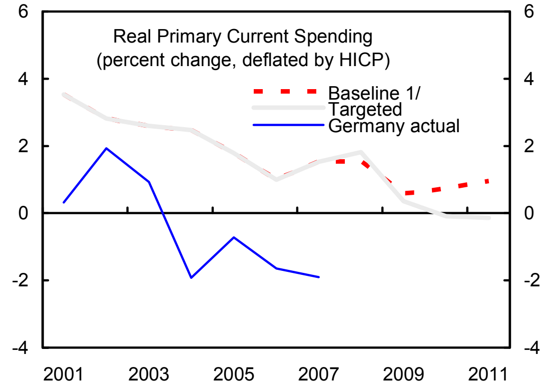
Sources: Eurostat; and IMF staff calculations.

Figure 6. The Medium-Term Budget Appropriately Targets Spending, but Risks Are Significant

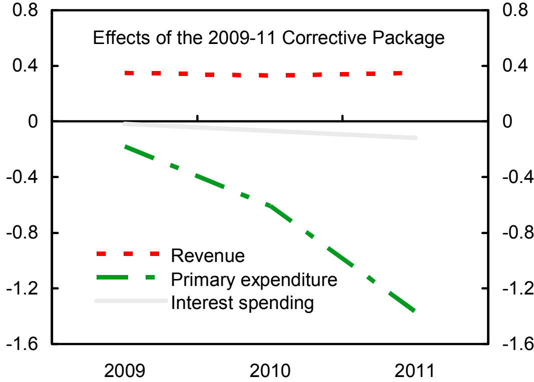
To achieve the government's objectives, spending needs to slow sharply in 2009-11.



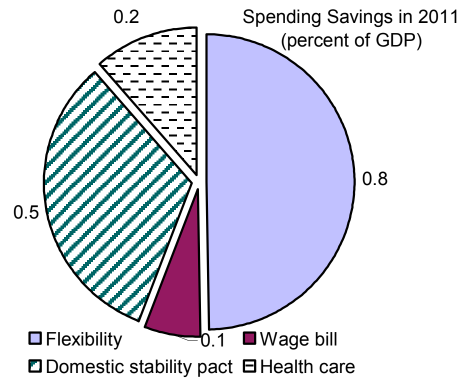
And real spending growth needs to be negative.



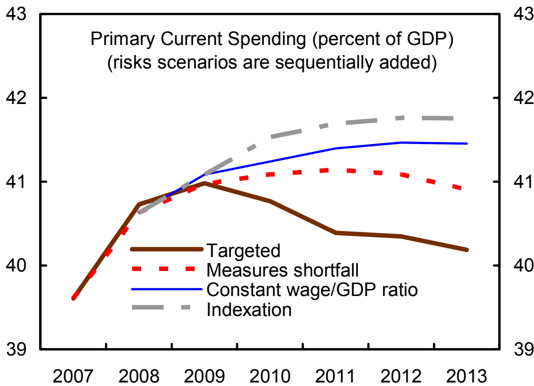
The 3-year spending-curbing package of measures is backloaded ...

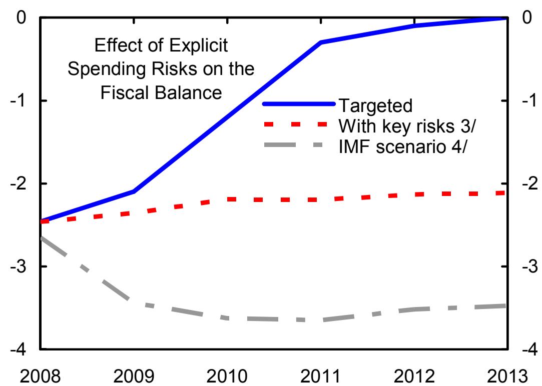


...ultimately relying politically demanding budget reform and federalism.



Explicit expenditure risks may dent progress in deficit reduction.

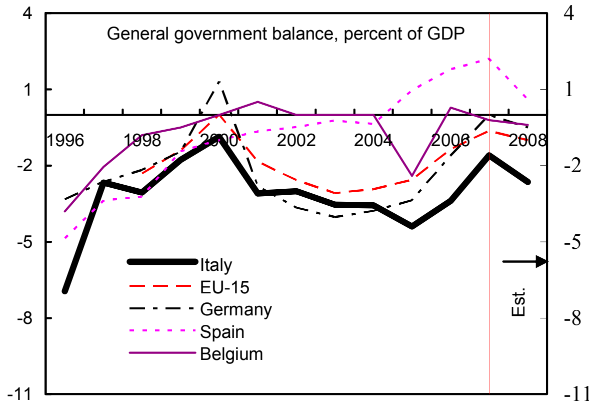




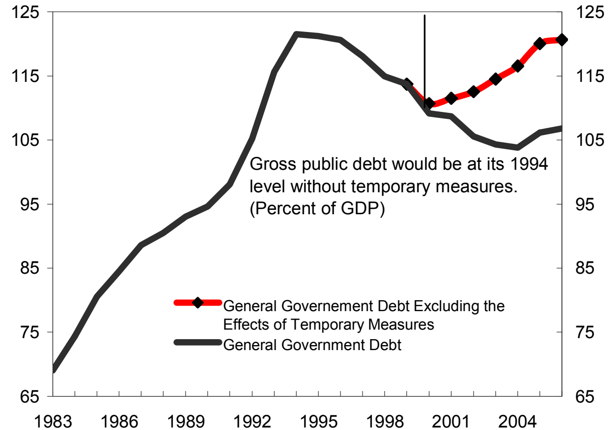
Sources: Eurostat; and IMF staff calculations.
1/ The authorities' "no-measures" ("current legislation") scenario underlying the 2009-11 budget.
2/ Risks from the slippage of spending measures in the 2009-11 package, additional wage bill risk (assuming constant ratio to GDP), and a one-off indexation of wages/pensions to the inflation spike in 2008, on which negotiation is ongoing.
3/ In addition to 2/ assumes slippage in curbing investment spending, the feedback on interest expenditure, and revenue increase generated by additional wage spending.
4/ Assumes constant structural primary balance from 2010 onwards.

Figure 7. Opportunity (Largely) Wasted for Debt Reduction

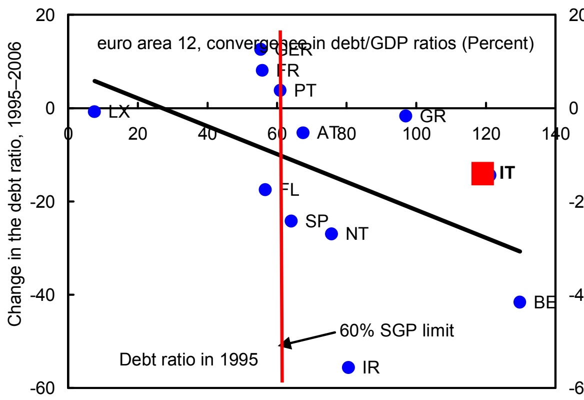
In contrast to others, Italy's consolidation has stopped short of budget balance...

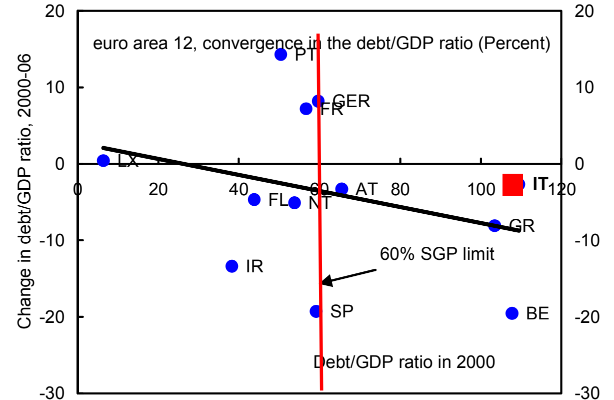


slowing debt reduction, which relied on privatization and other one-offs (that may no longer be available).

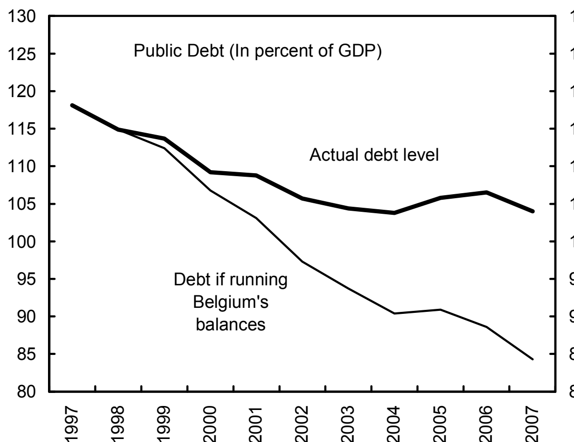


In debt dynamics, Italy has been a nonvirtuous outlier, reducing debt less than other high-debt countries.

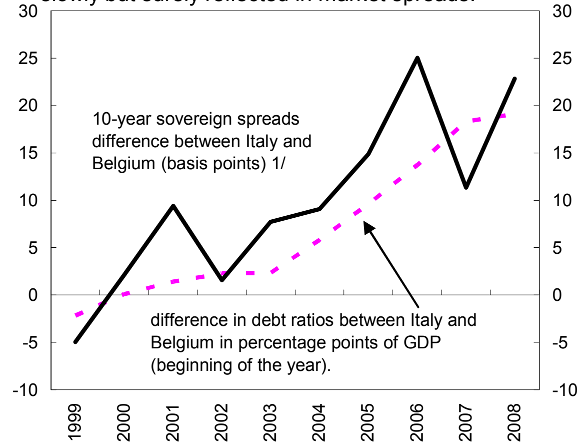




Had Italy run similar budget balances as Belgium, its debt would be close to Belgium's levels...

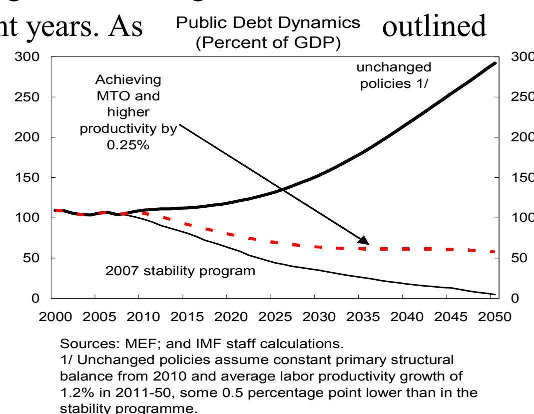


...and Italy's comparative lack of debt reduction has been slowly but surely reflected in market spreads.



Sources: Eurostat; EC, and IMF staff calculations.
1/ Annual average, for 2008, year to date average (through end-September).

30. **The current crisis should not eclipse the need for bolder action to address longer-term fiscal challenges.** Long-term debt sustainability is far from assured, especially if the higher sovereign spreads prove permanent, and hinges on reaching the MTO and achieving productivity growth well above that of recent years. As outlined in the government's recent green paper, further reforms to the welfare system are needed. In particular, legislating additional future increases in the retirement age (especially for women) could tackle Italy's still-comparatively-high pension spending. This could allow for faster debt reduction and/or freeing resources to strengthen Italy's weak social safety net.



Sources: MEF; and IMF staff calculations.
1/ Unchanged policies assume constant primary structural balance from 2010 and average labor productivity growth of 1.2% in 2011-50, some 0.5 percentage point lower than in the stability programme.

31. **Italy's fiscal framework has been improving steadily over time, but insufficiently to fix its fragile public finances.** In particular, the perennial need for consolidation was typically addressed in a piecemeal fashion, often by closing the most visible gaps through "emergency" annual packages that were only partially effective. Efficiency-oriented reforms based on strategically decentralizing the budget process through greater managerial flexibility (initiated in 1997) and fiscal federalism (2001) were repeatedly delayed or scaled back partly to safeguard short-term outcomes. As a result, both the quantity and quality of fiscal adjustment suffered.

32. **The government should build on steps recently taken to improve fiscal frameworks, which are crucial for the viability of the expenditure-based adjustment.** Important actions have already been taken, including: (1) streamlining the budget process and strengthening its medium-term orientation; (2) increasing the productivity of public administration by containing the cost of public employees and implementing a comprehensive plan to reduce the burden of administration; (3) advancing measures to improve cost effectiveness in the education sector, following the recent spending review; and (4) finalizing the draft law on fiscal federalism, currently with Parliament, which aims at increasing the fiscal autonomy and discipline of all levels of government. But these steps need to be built upon to achieve longer-term objectives, including by:

- *Deepening budget system reform*: For next year's medium-term plan, the realism of the baseline projections should be enhanced and fiscal targets should reflect agreements with sub-national governments. Rigidities need to be reduced, including by overhauling the budget law, streamlining legislation related to spending programs, and increasing flexibility in the management of civil servants (Annex I).

- *Pursuing cost-conscious fiscal federalism*: This requires a transparent, formula-based, equalization scheme, a robust and independent regime for monitoring fiscal targets, harmonized accounting, and greater civil service mobility. Given that sub-national

governments need sufficient revenue autonomy at the margin to finance spending preferences or cost overruns, a comprehensive review of property taxation would be useful, especially since the tax on primary residences has recently been eliminated. Should the reform seem set to result in higher costs, bolder offsetting measures could be considered, including streamlining the structure of sub-national governments.

- *Better managing public sector assets*: Care should be taken to ensure that the potential proceeds from sales of public assets do not delay consolidation.[8] Faster progress needs to be made on divestment and minimizing the drain on the public purse, with a focus on enhancing competition. These objectives would be helped by ensuring full transparency of any bank-support operations and government guarantees, and producing timely consolidated accounts for the non-financial public sector.

Transfers to Key Enterprises
(Percent of GDP)

	2005	2006	2007	2008
All budget transfers to all enterprises /1	1.52	1.47	1.91	1.56
Selected public enterprises				
Railroad company (FS)	0.44	0.46	0.53	0.32
Highway company (ANAS)	0.17	0.20	0.17	0.22
Post office	0.05	0.05	0.04	0.07

Source: Combined report on the economy.

1/ Transfers by the central government.

33. **The authorities agreed with the need for some limited temporary measures to address the impact of the crisis, while remaining committed to their adjustment plan.** While agreeing that the worsening macroeconomic conditions warranted some scaling back of planned consolidation, the MEF stressed Italy's relatively limited room for maneuver, especially the high debt burden and the rising spreads, and believed the deficit could still be below the 3 percent limit in 2009. Accelerating investment spending and supporting credit extension were seen as the most effective way of stimulating growth.

34. **Views on prospects for longer-term reforms were mixed**. On pension reform, the MEF pointed to political sensitivities, a potential negative impact on confidence, several reforms of recent years, and risks of implementation delays and reversals, as had occurred with the 2004 reform. Also, the MEF's long-term age-related spending projections for Italy do not indicate any urgency for such reforms. Most interlocutors suggested that reforms to the budget process and fiscal federalism structure would proceed, though admittedly slowly. The MEF is keen to build on the pilot spending review exercise and reduce rigidities in the system, but recognized the medium-term nature of the reform program. Fiscal federalism reforms will be largely dependent on follow-up legislation that is to evolve over the next couple of years. Some interlocutors considered that the forthcoming retirement of many public employees offered a key opportunity to generate cost savings, as did the potential revision of the accounting law.

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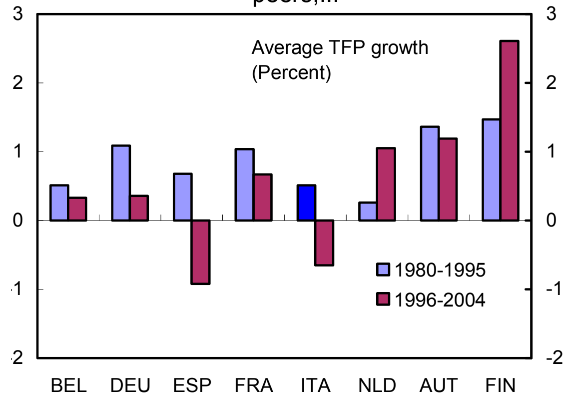
[8] See "Should Italy Sell its Nonfinancial Assets to Reduce Debt?" PDP 08/1.

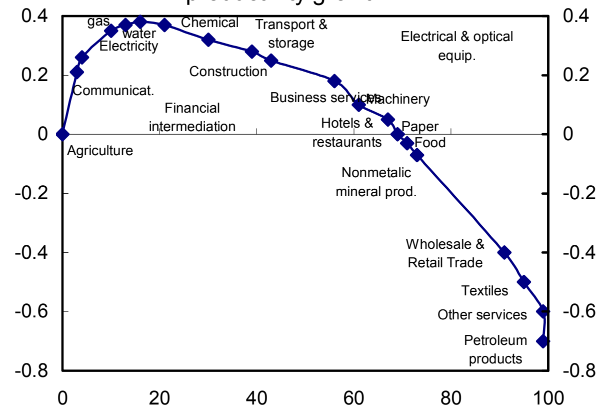
C. Enhancing Competitiveness and Productivity

35. **The real crisis confronting Italy is the chronic lack of growth due to declining productivity.** Italy experienced an unprecedented fall in factor productivity over the last decade, both in manufacturing (from a high level) and services (from a low level), which lies behind the relentless increase in unit labor costs and Italy's falling behind its peers in GDP per-capita terms. This has been linked to a number of structural factors, including: (1) policy and regulatory rigidities limiting competition and hindering the business environment; (2) low efficiency, linked to the preponderance of small and medium-sized enterprises that are unable to exploit fully economies of scale; (3) limited process and product innovation, hindered by labor market rigidities; and (4) outdated specialization patterns, given a production structure (especially in manufacturing) based on traditional low skill products.

TFP growth weakened over time, and compared to peers,...



...with most sectors weighing negatively on productivity growth. 1/



Sources: OECD Product Market Regulation Database; European Commission; and European Central Bank.
1/ The vertical axis shows the cumulative contribution of sectors to TFP growth , while the horizontal axis shows the cumulative value added shares for 1996-2004 (horizontal axis). Sectors are ordered according to their TFP growth rates (with faster growing sectors closer to the origin). The dotted lines indicate the average rate of TFP growth for the entire economy.

36. **Despite recent industrial restructuring and structural reforms, Italy still lags its peers.**

- Recent, but modest, improvements in Italy's micro-based competitiveness indicators reflect a private-sector driven restructuring in sectors already exposed to competition. And although some reallocation toward more dynamic and high-tech sectors occurred, it was slower than in EU peers, with Italy missing out on opportunities to develop its service exports, especially in tourism (Box 4).[9] Thus, while the authorities' policies are promoting domestic stability, and hence the external stability of the union as a whole, productivity and labor utilization need to improve to ensure longer-term stability.

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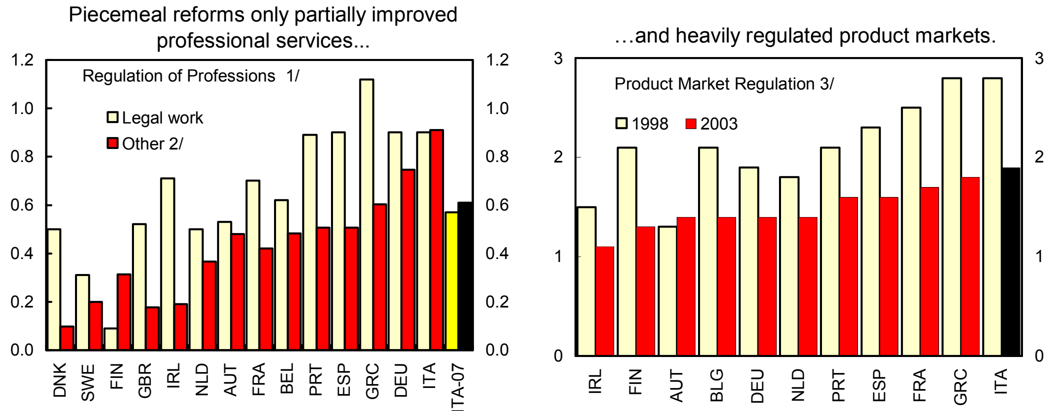
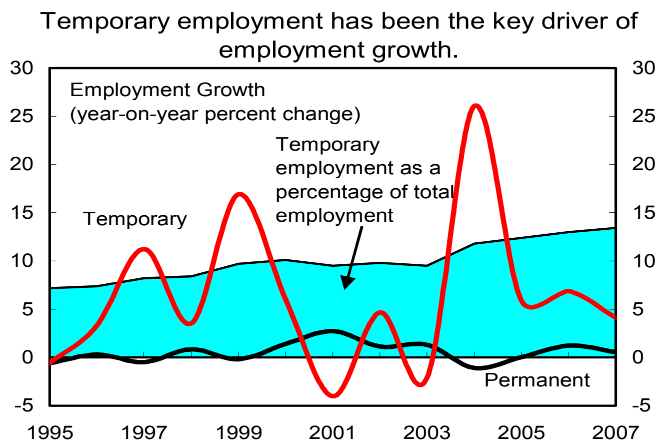
[9] See "Competitiveness in the Southern Euro Area: France, Greece, Italy, Portugal and Spain" WP 08/112.

• Building on progress made in recent years in product and service market liberalization, the government has: (1) passed the local public services bill (albeit falling short of requirements); (2) simplified legislation; (3) implemented a law instituting competition assessments and regulatory impact analysis; and (4) incorporated the Antitrust Authority's recommendations in a competition bill to be discussed by Parliament annually. But the reform momentum appears to have slowed.



Sources: OECD Product Market Regulation Database; European Commission; and European Central Bank.
1/ Preliminary estimates for 2007 before next OECD updates, taking into account the two "Bersani" decrees as calculated by OECD.
2/ Average for accountancy, architectural, and engineering work.
3/ Index 0–6 from least to most restrictive.

• Significant labor market reforms over the past decade have improved employment, labor force participation, and unemployment rates, but Italy's employment-to-population ratio continues to remain among the lowest in the euro area. Moreover, while the deregulation of fixed-and part-term contracts in recent years has improved labor market flexibility, it has also resulted in more "atypical" employment, contributed to stagnant labor productivity, and exposed workers to increased employment risk without commensurate improvements in the social safety net, implying that recent employment gains can be easily reversed.



Source: OECD, Labor Force Statistics, 2007.

Box 4. Is Italy Gaining Competitiveness by Restructuring?[1]

Standard measures indicate that Italy has a modest competitiveness gap. But it is often countered that Italy's exports have been robust in nominal terms, and there is much anecdotal evidence of trade-based firm restructuring in response to the challenges of globalization. Could such restructuring imply that Italy is substantially more competitive than standard indicators suggest?

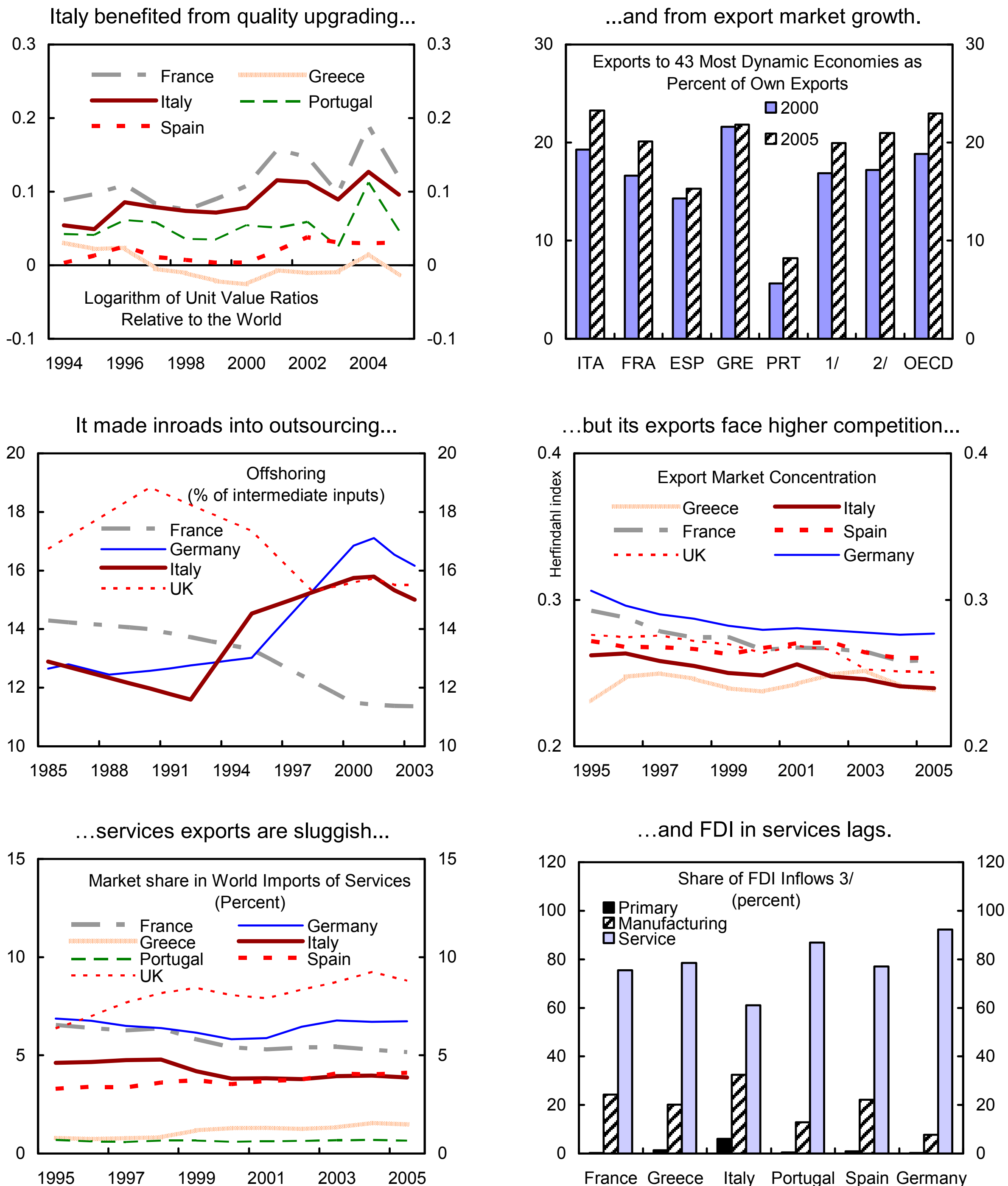
On the positive side, there is evidence of moderate export quality upgrading, proxied by unit value growth (though this is an imperfect proxy also indicative of cost pressures), and some redirection toward dynamic markets and increase in outsourcing. More ambiguously, recent staff analyses indicate that competitive pressure on Italy's exports has been consistently higher than for key EU comparators. While this has been a factor pushing firms to restructure, it also reflects "unfavorable" specialization. Less encouragingly, there are no major positive competitiveness trends emerging from the sluggish services sectors, FDI flows, and the technological content of Italy's exports.

The restructuring may also have much further to go. The intersectoral reallocation of resources away from traditional activities has been limited, and the dynamics of competition from emerging markets have yet to play out, especially as these countries may intensify their upgrading. And while Italy may retain certain niches, a deeper downsizing in some sectors is also a possibility. On balance, export quality improvements are likely to have alleviated some of the competitiveness gap, but not enough to substantially offset the broader structural shortcomings weighing on external performance.

1/ See "Trends in Italy's Nonprice Competitiveness" IMF WP 08/124.

37. **The structural reform agenda should continue to be pursued to boost Italy's growth potential.** Given Italy's history of sluggish liberalization and reform and complex judicial and regulatory system, a comprehensive structural reform strategy remains critical for reviving Italy's growth potential. Piecemeal reforms run the risk of paralysis and reversals, while broad-ranging reforms would produce synergies (Annex II). Building on the progress to date, and rather than allowing it to be eclipsed by the current crisis, the government's reform agenda should continue to be pursued, and indeed expanded when conditions warrant, including by adopting the recommendations of the Antitrust Authority and OECD, focusing on: further liberalizing retail trade and (especially professional) services; continuing deregulation efforts in the energy market, particularly gas; strengthening the role of competition bodies in formulating and influencing policy at an early stage; and eliminating cross-vetoes for infrastructure projects of national interest. The policy agenda and its public acceptance could be strengthened by making greater use of public discussion documents and expert committees (e.g., Australia's Productivity Commission).

Figure 8. Micro-Structural Competitiveness Indicators are Somewhat Less Negative



Sources: Comtrade; UNCTAD; OECD; Eurostat; IMF Balance of Payment Statistics; national authorities; and IMF staff calculations, see WP 08/112.

1/ SEA-5 (Italy, Spain, Portugal, Greece, and France).

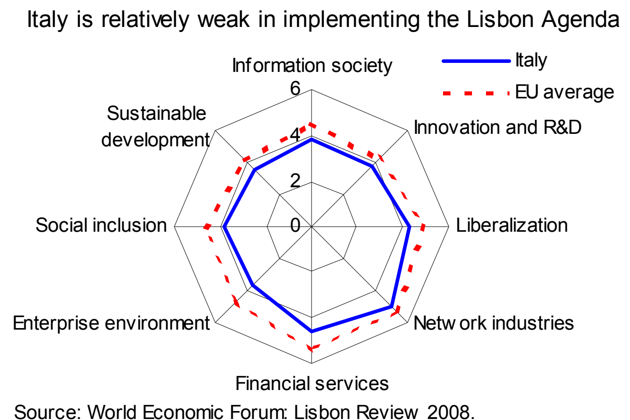
2/ EU-13 (excluding Ireland and Luxembourg).

3/ The data are based on year 1996–2005 for France, 2001–04 for Greece, 1996–2004 for Italy, 1994–2003 for Portugal, 1994–2004 for Spain, and 1996–2005 for Germany.

38. **A second generation of labor market reforms is needed.** Key constraints on labor market performance that should be addressed include: a wage determination mechanism that prevents wages from being more strongly linked to productivity; an inefficient, and unequal, social safety net that prevents sufficient labor reallocation; asymmetric regulation of different contract types that tilts incentives toward atypical employment contracts; and high labor taxation that reduces the incentives for employment creation. Although not well suited as a short-term stimulus measure, broadening and streamlining the social safety net, in particular the unemployment benefit system, could provide some support for the likely increase in redundancies and widen the scope for public acceptance of reducing dismissal restrictions of permanent contracts. Such reform could be financed in part by reducing replacement rates and spending on active labor market policies, and by eliminating piecemeal measures such as tax reductions on overtime/bonus pay which are costly and unlikely to substantially improve outcomes. More generally, any reductions in labor taxation should be broad-based and combined with modifications of the wage bargaining framework that increase the scope for firm-level bargaining. Labor market reform, together with employment and real wages, would also benefit from early product market reforms (Annex II).

39. **International initiatives provide an opportunity to spur structural reform.** The government's new national reform program aligns priorities for the next three years with the revised Lisbon Agenda's objectives. All levels of government should follow through on these plans, working to reduce the large transposition deficit, including by an ambitious transposition of the EU Services Directive by the end-2009 deadline.[10] Also, any tendencies towards protectionism, for example, creating barriers to foreign ownership of Italian firms, are likely to undermine Italy's economic prospects and should be resisted.

Italy is relatively weak in implementing the Lisbon Agenda



Source: World Economic Forum: Lisbon Review 2008.

40. **The authorities broadly agreed with staff's assessment of trends in competitiveness and labor market performance.** They, however, stressed that aggregate indicators do not yet fully capture the effects of the industrial restructuring underway in recent years, reflected in some recent micro-economic evidence on rising variability in profitability, which is also in line with the strong growth in nominal exports and rising export

[10] As the OEDC estimates, Italy could benefit significantly from implementing the Services Directive— trade in services could increase by almost 120 percent, and GDP per capita by over 2 percent as a result (see "Going for Growth", OECD 2008).

unit values. The BoI also pointed to recent, albeit limited, evidence in the micro data of firm turnover and an increase in the average firm size as signs of a higher level of competition. The authorities expected unemployment to rise further, along with slowing, and possibly negative, employment growth. They also agreed on the main shortcomings of labor market institutions, namely, a wage bargaining mechanism that leaves too little scope for firm-level negotiations, and an insufficient social safety net that is uneven across sectors and contract types.

41. **The government considered their structural reform plans adequate and did not see scaling up efforts as a top priority at this time.** The BoI agreed that the structural reform momentum had slowed and that it needs to be revived. The MEF and other interlocutors pointed to the government's commitment to policy continuity and the progress achieved to date. The government expressed doubt as to whether reforming the unemployment system could form part of an immediate crisis response, given the implementation lags and permanent expenditure involved. In line with this view, the government has recently opted for supplementing existing instruments, such as the industry-specific unemployment support schemes ("*cassa integrazione")*, rather than overhauling the welfare system. On wage determination, the government pointed to ongoing tripartite negotiations aimed at increasing the use of firm-level bargaining by linking nationally bargained wages to projected inflation (excluding imported inputs) and reducing taxation on supplemental wages negotiated at the firm level.

Table 1. Summary of Economic Indicators

(Annual percentage change, unless noted otherwise)

	2005	2006	2007	2008 1/	2009 1/	Latest reading (period percentage change, unless noted otherwise)	
Real GDP	0.6	1.8	1.5	-0.4	-1.0	-0.5	2008Q3
Public consumption	1.9	0.8	1.2	0.7	0.4	0.0	2008Q3
Private consumption	0.9	1.1	1.4	-0.3	-0.3	0.1	2008Q3
Gross fixed capital formation	0.7	2.5	1.2	0.1	0.0	-1.9	2008Q3
Final domestic demand	1.1	1.3	1.4	0.0	-0.1	-0.5	
Stock building 2/	-0.2	0.5	-0.1	0.1	-0.4	-0.1	
Net exports 2/	-0.3	0.0	0.1	0.1	0.0	-0.3	2008Q3
Exports of G&S	1.0	6.2	5.0	0.5	0.3	-1.6	2008Q3
Imports of G&S	2.2	5.9	4.4	0.1	0.2	-0.5	2008Q3
Money and credit (end of period, percent change)							
Private sector credit 3/	7.7	11.0	9.8	7.3	...	5.9	Oct-08
National contribution to euro area M3 4/	6.3	7.7	7.6	10.8	...	7.8	Oct-08
Interest rates (in percent, end of period)							
6-month interbank rate 5/	2.6	3.8	4.9	4.3	...	5.2	Nov-08
Government bond rate, 10-year 5/	3.5	4.2	4.7	4.8	…	4.5	Nov-08
Resource utilization							
Potential GDP	1.2	1.3	1.1	0.8	0.7		
Output Gap (% of potential)	-0.8	-0.2	0.2	-0.4	-2.7		
Natural rate of unemployment	7.6	6.8	6.2	6.6	6.7		
Employment	0.7	1.8	1.0	1.3	0.5		
Unemployment rate (%)	7.7	6.8	6.2	6.7	6.9		
Prices							
GDP deflator	2.1	1.7	2.3	2.4	2.0	2.9	2008Q3
Consumer prices	2.2	2.2	2.0	3.5	1.6	4.1	2008Q3
Hourly compensation	4.6	2.9	2.5	5.5	2.2	3.7	2008Q3
Productivity	0.5	0.2	0.4	0.1	0.4	-0.8	2008Q3
Unit labor costs	4.1	2.7	2.1	5.4	1.8	7.5	2008Q3
Fiscal indicators 6/							
Central government balance	-3.8	-2.7	-2.2	-2.7	-3.5		
General government balance	-4.3	-3.4	-1.6	-2.7	-3.4		
Structural balance (in % of potential GDP)	-4.0	-3.3	-1.8	-2.1	-2.0		
Structural balance net of one-offs (in % of potential GDP)	-4.5	-2.9	-1.8	-2.1	-1.6		
Public debt ratio	105.9	106.9	104.1	105.7	108.2		
Exchange rate regime		Member of EMU					
Exchange rate (NC/US$)	1.2	1.3	1.4	1.5	1.5	1.3	Oct-08
Nominal effective rate: CPI based (2000=100)	107.3	107.8	109.9	...	...		
Real effective exchange rate based on							
CPI (2000=100)	112.1	111.8	113.2	...	...		
normalized ULC (2000=100)	132.0	134.0	138.7	145.0	143.7		
External sector 6/							
Current account balance	-1.6	-2.6	-2.5	-2.9	-3.2		
Trade balance	0.0	-0.6	0.1	-0.3	-0.6		
Saving investment balance 6/							
Gross national saving	19.1	19.0	19.0	18.6	19.0		
Public	-0.6	1.3	2.3	1.3	0.7		
Private	19.7	17.7	16.7	17.3	18.3		
Gross domestic investment	20.8	21.5	21.5	21.5	22.3		
Gross fixed domestic investment	20.7	21.0	21.1	21.1	21.4		
Public	4.3	4.2	3.9	4.1	4.1		
Private	16.4	16.8	17.1	17.0	17.2		
Net lending	-1.6	-2.6	-2.5	-2.9	-3.2		

Sources: National Authorities; and IMF staff calculations.

1/ Staff estimates and projections, unless otherwise noted.

2/ Contribution to growth.

3/ Twelve-month credit growth, adjusted for securitizations. 2008 data refer to Sept.

4/ Excludes currency in circulation held by nonbank private sector. 2008 data refer to Sept.

5/ Data for 2008 refer to Sept. on 6-month interbank rate, and Oct. on Government bond rate.

6/ Percent of GDP.

Table 2. Italy: General Government Accounts, 2002-2009
(Percent of GDP)

	2002	2003	2004	2005	2006	2007	2008		2009	
							Staff	Budget	Staff	Budget
Total revenues	44.5	45.1	44.5	44.2	45.9	47.2	47.3	47.6	47.5	48.6
Direct taxation	13.9	13.4	13.3	13.3	14.4	15.2	15.6	15.8	15.7	16.1
Indirect taxation	14.3	14.0	14.0	14.2	14.9	14.7	13.9	14.0	14.0	14.4
Social contributions 1/	12.5	12.6	12.6	12.8	12.8	13.3	13.8	13.8	13.8	14.2
Other current revenues	3.5	3.4	3.6	3.5	3.5	3.6	3.6	3.6	3.6	3.7
Capital revenues	0.4	1.7	0.9	0.4	0.3	0.3	0.4	0.4	0.3	0.3
Total expenditures	47.4	48.6	48.0	48.5	49.3	48.7	49.9	50.1	50.9	50.7
Current expenditures	43.8	44.2	44.0	44.5	44.3	44.6	45.9	46.1	46.8	46.7
Wages and salaries	10.6	10.8	10.8	11.0	11.0	10.7	11.1	11.1	11.3	11.3
Purchases of goods and services	7.8	7.9	8.1	8.3	8.0	7.9	8.1	8.2	8.2	8.1
Social transfers	16.5	16.8	16.9	17.0	17.0	17.3	17.8	17.8	18.3	18.2
Interest payments	5.5	5.1	4.7	4.6	4.6	5.0	5.1	5.2	5.2	5.3
Capital expenditures 2/	3.6	4.3	4.0	4.1	5.0	4.1	4.0	4.0	4.1	4.1
Of which: asset sales	-0.8	-0.2	-0.3	-0.2	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Overall balance	-2.9	-3.5	-3.5	-4.3	-3.4	-1.6	-2.7	-2.5	-3.4	-2.2
Primary balance	2.7	1.6	1.2	0.3	1.3	3.4	2.4	2.6	1.8	3.1
Memorandum items:										
Structural overall balance 3/	-3.2	-3.2	-3.4	-3.9	-3.3	-1.7	-2.1	-2.0	-2.0	-0.7
Net of all one-off measures	-4.7	-5.0	-4.7	-4.5	-2.9	-1.8	-2.3	-2.2	-2.0	-0.7
Structural primary balance 3/	2.3	1.9	1.3	0.7	1.4	3.3	3.0	3.1	3.2	4.5
Net of all one-off measures	0.8	0.2	0.0	0.1	1.8	3.2	2.8	2.9	3.2	4.5
Public debt 4/	105.7	104.4	103.8	105.9	106.9	104.1	105.7	103.7	108.2	102.9
One-off/temporary measures	1.2	1.7	1.3	0.6	-0.4	0.1	0.2	0.2	0.1	0.1

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

1/ Includes revenue from severance payments contributions (TFR), from 2007 onwards.

2/ In 2006 capital spending is increased reflecting the assumption of railways-related debt of 0.9 percent of GDP.

3/ Percent of potential GDP, assumes IMF staff's GDP and output gap.

4/ Budget numbers for public debt are calculated with the authorities' (not staff's) nominal GDP, at which all other numbers are calculated.

Table 3. Italy: Balance of Payments
(Percent of GDP)

	2005	2006	2007	2008	2009	2010	2011	2012	2013
Balance on current account	-1.7	-2.6	-2.5	-2.9	-3.2	-3.3	-3.2	-3.0	-2.8
Balance on goods and services	0.0	-0.7	-0.3	-0.9	-1.2	-1.2	-1.1	-0.9	-0.7
Trade balance	0.0	-0.6	0.1	-0.3	-0.6	-0.6	-0.5	-0.3	-0.2
Exports of goods and services									
Exports of goods f.o.b.	21.0	22.4	23.9	25.4	24.2	24.5	24.7	25.2	25.7
Exports of services	5.0	5.3	5.4	5.7	5.5	5.5	5.6	5.7	5.8
Imports of goods and services									
Imports of goods f.o.b.	20.9	23.1	23.8	25.8	24.8	25.1	25.2	25.5	25.9
Imports of services	5.1	5.4	5.8	6.3	6.0	6.1	6.1	6.2	6.3
Net factor income	-1.0	-0.9	-1.3	-1.3	-1.3	-1.3	-1.3	-1.3	-1.3
Total current transfers, net (IMF)	-0.7	-0.9	-0.9	-0.7	-0.8	-0.8	-0.8	-0.8	-0.8
Balance on capital account	0.1	0.1	0.2	0.1	0.1	0.1	0.1	0.1	0.1
Balance on financial account	1.5	1.7	1.7	2.5	2.7	2.7	2.6	2.4	2.3
Direct investment, net	-1.2	-0.2	-2.4	-0.7	-0.9	-1.1	-1.1	-1.2	-1.0
Portfolio investment, net	3.0	3.0	1.2	1.3	1.5	1.4	1.1	0.7	1.2
Other investment, net	-0.6	-1.1	3.0	1.9	2.2	2.4	2.5	2.9	2.0
Reserve assets (IMF)	0.1	0.0	-0.1	0.0	0.0	0.0	0.0	0.1	0.1
Errors and ommisions	0.1	0.8	0.6	0.3	0.4	0.4	0.5	0.4	0.4
IIP (Billions of Euros)	-51.5	-67.1	-80.0						
Assets	1,629	1,823	1,921						
Liabilities	1,681	1,890	2,001						

Sources: IMF, *World Economic Outlook*; and the national authorities.

Table 4. Italy: Financial Soundness Indicators

(Percent, unless otherwise noted)

	2002	2003	2004	2005	2006	2007	20081/
Core set							
Deposit-taking institutions							
Capital adequacy							
Regulatory capital to risk-weighted assets	11.2	11.4	11.6	10.6	10.7	10.4	10.4
Regulatory tier I capital to risk-weighted assets	8.2	8.5	8.8	8.1	7.8	7.6	7.4
Asset quality							
Nonperforming loans							
Share of total gross loans	6.5	6.7	6.6	5.3	5.1	4.6	4.8
Percentage change	2.4	7.6	4.7	-12.4	-8.7	-3.3	3.6
Net of provisions, percent of capital	22.4	21.8	20.9	14.2	25.3	23.1	23.8
Sectoral distribution of loans to total loans							
General government	5.3	4.7	4.5	4.5	4.5	3.9	3.9
Financial corporations	14.6	13.8	12.1	11.7	11.5	11.2	11.7
Nonfinancial corporations and sole proprietorships	59.0	59.6	59.5	58.8	58.5	59.9	60.0
Building and construction	6.9	7.2	7.4	7.7	7.7	8.1	8.3
Consumer households	21.0	21.9	23.9	25.0	25.5	25.0	24.4
Earnings and profitability							
Return on assets	0.5	0.5	0.6	0.7	0.8	0.8	...
Return on equity 2/	7.1	7.4	9.3	9.7	14.3	12.9	11.5
Interest margin to gross income 2/	56.6	55.4	55.9	54.5	51.9	56.6	62.4
Non-interest expenses to gross income 2/	59.8	61.0	60.6	59.8	59.4	59.8	56.4
Liquidity							
Liquid assets to total assets (liquid asset ratio)	7.8	8.6	8.3	7.5	6.5	5.7	5.3
Encouraged set							
Deposit-taking institutions							
Capital to assets	6.7	6.4	6.4	6.9	4.9	6.4	6.6
Average risk weight (ratio of risk-weighted assets to assets)	0.60	0.57	0.55	0.65	0.66	0.66	0.64
Geographical distribution of loans							
North	62.2	62.3	62.2	62.0	61.8	61.9	61.4
Center	24.1	24.0	23.5	23.5	23.4	23.3	23.9
South	13.6	13.7	14.3	14.6	14.7	14.8	14.6
Geographical distribution of nonperforming loans							
North	40.2	43.0	43.4	44.0	44.6	46.2	...
Center	28.0	26.5	26.5	27.9	27.9	29.4	...
South	31.9	30.5	30.2	28.1	27.5	16.9	...

Sources: Bank of Italy; Eurostat; and IMF staff calculations.

1/ The 2008 data are as of June.

2/ The 2008 data refer to the five largest groups.

Table 5. Italy: Selected Indicators of Vulnerability 1/
(Percent of GDP, unless otherwise indicated)

	2004	2005	2006	2007	2008	
					Est.	Date
External indicators 1/						
Exports (annual percentage change, U.S. dollars)	18.2	5.8	11.7	18.8	18.7	Dec-08
Imports (annual percentage change, U.S. dollars)	17.5	8.9	14.8	17.0	19.6	Dec-08
Terms of trade (annual percentage change)	-0.1	-1.8	-2.9	1.0	-4.8	
Current account balance	-0.9	-1.7	-2.6	-2.5	-2.9	Nov-08
Capital and financial account balance	0.7	1.6	1.8	1.9	2.6	Nov-08
Official reserves (billions of U.S. dollars, end-of-period) 2/	27.9	25.5	25.7	28.4	36.0	Nov-08
Contribution to euro area M3 (percent of reserves) 3/	3523	4090	4381	4261	3430	Nov-08
Central bank foreign liabilities (billions of U.S. dollars) 2/	0.9	2.0	1.3	0.1	0.1	Jun-08
Foreign assets of the financial sector (billions of U.S. dollars)	392.4	369.6	466.0	579.7	...	
Foreign liabilities of the financial sector (billions of U.S. dollars)	497.5	564.8	806.8	1076.6	...	
Official reserves (ratio to average monthly imports) 2/	0.8	0.7	0.6	0.5	0.6	Nov-08
Total external debt	90.4	88.4	104.7	109.3	...	
Of which : General government debt	43.5	41.7	45.9	43.1	...	
Total external debt to exports (ratio)	3.6	3.4	3.8	3.7	...	
External investment income payments to exports (percent)	15.9	16.4	16.8	18.2	...	
Exchange rate (per U.S. dollars, period average)	0.81	0.80	0.80	0.73	0.79	Nov-08
Financial market indicators						
Public sector debt (Maastricht definition)	103.8	105.9	106.9	104.1	105.7	
Average T-bill yield	2.1	2.2	3.2	4.0	2.8	Nov-08
Average T-bill yield, real	-0.2	0.0	1.0	2.0	0.1	Nov-08
Stock market index (year end, 2001=100)	103	118	140	129	49	Nov-08
Share prices of financial institutions (year end, 2001=100)	88	110	133	119	84	Aug-08
Spread of 10-year government bond with Germany (basis points, period average)	3	11	17	17	104	Nov-08
Financial sector risk indicators 4/						
Foreign exchange loans (billions of U.S. dollars)	44.4	48.0	59.9	93.5	97.1	May-08
Share of foreign exchange loans in total lending (percent)	2.9	3.3	3.4	4.2	4.0	May-08
Deposits in foreign exchange (billions of U.S. dollars)	38.4	32.9	45.4	54.2	65.8	Jun-08
Share of foreign deposits in total deposits (percent)	4.0	3.7	4.3	4.4	4.9	Jun-08

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 IMF 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 6. Italy: Public Sector Debt Sustainability Framework, 2003–13

(Percent of GDP, unless otherwise indicated)

	Actual					Projections					
	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
1 Baseline: Public sector debt 1/	104.4	103.8	105.9	106.9	104.1	105.7	108.2	109.7	110.7	111.0	111.1
Of which : foreign-currency denominated	2.2	1.9	1.9	0.7	0.2	0.2	0.2	0.2	0.2	0.2	0.2
2 Change in public sector debt	-1.3	-0.5	2.1	1.0	-2.8	1.6	2.5	1.5	1.0	0.4	0.0
3 Identified debt-creating flows (4+7+12)	0.1	-1.4	1.5	-0.3	-2.4	0.8	2.4	1.3	0.8	0.2	-0.2
4 Primary deficit	-1.6	-1.2	-0.3	-1.3	-3.4	-2.4	-1.8	-1.6	-1.6	-1.7	-1.9
5 Revenue and grants	45.1	44.5	44.2	45.9	47.2	47.3	47.5	47.6	47.6	47.5	47.4
6 Primary (non-interest) expenditure	43.4	43.3	43.9	44.7	43.7	44.9	45.7	46.0	46.0	45.8	45.5
7 Automatic debt dynamics 2/	1.5	0.3	1.9	0.9	1.1	3.1	4.2	3.0	2.4	2.0	1.8
8 Contribution from interest rate/growth differential 3/	1.9	0.5	1.9	0.9	1.1	3.1	4.2	3.0	2.4	2.0	1.8
9 *Of which* : contribution from real interest rate	1.9	2.0	2.5	2.8	2.6	2.7	3.1	3.2	3.1	3.1	3.2
10 *Of which* : contribution from real GDP growth	0.0	-1.5	-0.6	-1.9	-1.5	0.4	1.1	-0.2	-0.6	-1.1	-1.4
11 Contribution from exchange rate depreciation 4/	-0.4	-0.2	0.0	0.0	0.0	...	...	...	...	...	...
12 Other identified debt-creating flows	0.3	-0.5	-0.2	0.0	-0.1	0.2	0.0	-0.1	-0.1	-0.1	-0.1
13 Privatization receipts (negative)	-0.1	-0.6	-0.3	0.0	-0.2	0.0	-0.1	-0.2	-0.2	-0.2	-0.2
14 Recognition of implicit or contingent liabilities 5/	0.4	0.0	0.1	0.0	0.1	0.2	0.1	0.1	0.1	0.1	0.1
15 Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
16 Residual, including asset changes (2–3)	-1.4	0.9	0.6	1.3	-0.3	0.7	0.1	0.2	0.2	0.2	0.2
Public sector debt-to-revenue ratio 1/	231.5	233.3	239.5	232.7	220.8	223.5	228.0	230.5	232.5	233.7	234.2
Gross financing need 6/	29.7	25.6	25.0	23.3	21.1	23.0	24.8	23.4	23.6	23.5	23.5
Billions of U.S. dollars	448.0	443.4	445.5	432.3	443.2	532.0	524.0	507.2	527.1	543.9	563.6
Scenario with key variables at their historical averages 7/						105.7	104.4	103.1	101.7	100.4	99.1
Scenario with no policy change (constant primary balance) in 2008–13						105.7	107.5	108.2	108.3	107.9	107.3
Key macroeconomic and fiscal assumptions underlying baseline											
Real GDP growth (percent)	0.0	1.5	0.6	1.8	1.5	-0.4	-1.0	0.2	0.6	1.0	1.3
Average nominal interest rate on public debt (percent) 8/	5.0	4.7	4.6	4.5	4.8	5.0	5.0	4.9	4.9	4.9	5.0
Average real interest rate (nominal rate minus change in GDP deflator, percent)	1.9	2.1	2.5	2.8	2.6	2.6	2.9	3.0	2.9	2.9	3.0
Nominal appreciation (increase in US dollar value of local currency, percent)	19.7	9.9	0.2	0.8	9.2	...	...	...	...	...	...
Inflation rate (GDP deflator, percent)	3.1	2.6	2.1	1.7	2.3	2.4	2.0	1.9	2.0	2.0	2.0
Growth of real primary spending (deflated by GDP deflator, percent)	3.7	1.1	2.1	3.6	-0.7	2.1	0.8	0.8	0.7	0.5	0.8
Primary deficit	-1.6	-1.2	-0.3	-1.3	-3.4	-2.4	-1.8	-1.6	-1.6	-1.7	-1.9

1/ General government gross debt.

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

3/ The real interest rate contribution is derived from the denominator in footnote 2/ as r - π (1+g) and the real growth contribution as -g.

4/ The exchange rate contribution is derived from the numerator in footnote 2/ as ae(1+r).

5/ Includes only "debiti pregressi" as calculated by the Bank of Italy, but not other implicit or contingent liablities.

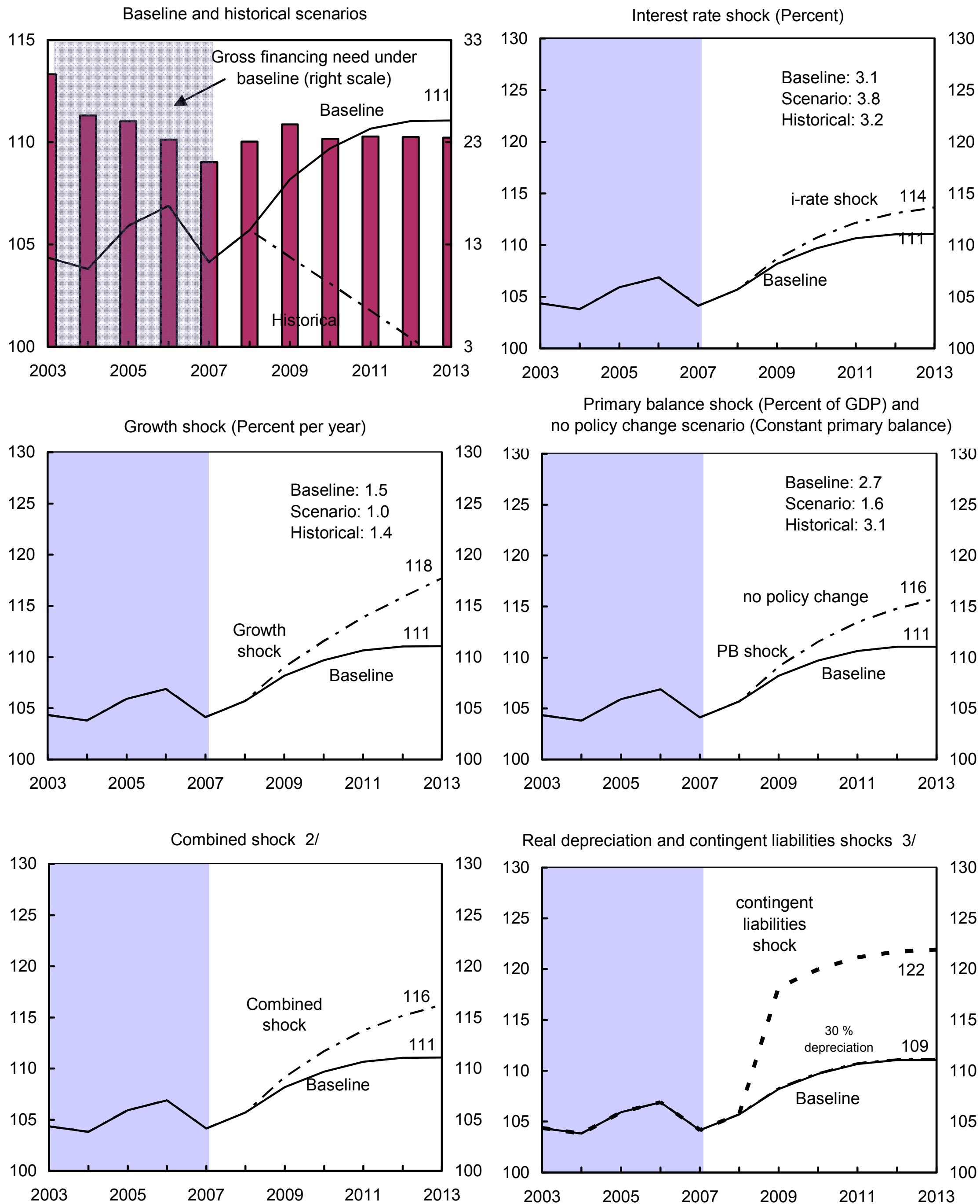
6/ Defined as public sector deficit, plus (estimated) amortization of medium- and long-term public sector debt, plus short-term debt at end of previous period.

7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.

8/ Derived as nominal interest expenditure divided by previous period debt stock.

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

Figure 9. Italy: Public Debt Sustainability: Bound Tests 1/
(Public debt in percent of GDP)



Sources: IMF country desk data and staff estimates.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ Permanent one-fourth standard deviation shocks applied to real interest rate, growth rate, and primary balance.
3/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2007, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

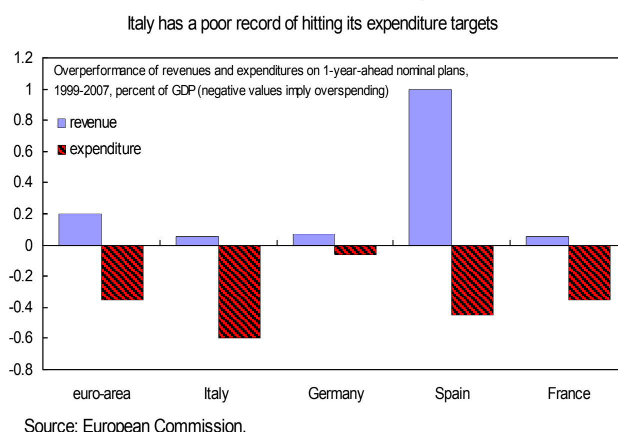
ANNEX I— THE CHALLENGE OF FIXING FISCAL FRAMEWORKS [1]

I. INTRODUCTION

Italy's fiscal frameworks have improved in recent years. The SGP's excessive deficit procedure has been effective in triggering adjustment, while broader EU-led surveillance and the authorities' own efforts have contributed to progress in debt and deficit accounting, central government spending control, the phasing out of one-off measures, and deficit containment under the domestic stability pact. But shortcomings still hamper the attainment of key fiscal goals.

The fiscal position falls well short of the MTO (structural balance). Deficits have been broadly in the 2–4 percent of GDP range, but, unlike in other EU countries, not much lower, partly owing to discretionary relaxations. This has blunted progress in debt reduction and underscores the lack of an effective medium-term budget orientation.

Italy has a poor record of hitting its expenditure targets



Source: European Commission.

Adjustment has been largely revenue-based and hence precarious. Tax hikes proved more effective in delivering "quick" annual adjustment than "across-the-board" spending cuts, which were ineffective or at best short-lived. Indeed, Italy's record of meeting nominal spending plans is weak compared to other large EU countries, especially Germany. Thus, despite significant periodic expenditure cuts, the spending ratio has risen steadily.

Weak budget institutions hamper effective spending-based adjustment. Italy's budget process is fragmented, time-consuming, and legalistic, while lacking transparency and result-orientation. The bulk of budget spending is mandatory/incremental, and governed by a plethora of rigid laws. This leaves marginal scope for employee mobility and resource reallocation, and mid-year spending relaxations often become necessary to avoid arrears. The multi-year spending projections are optimistic, and do not provide certainty of resources to managers.

[1] Prepared by Bogdan Lissovolik and Justin Tyson.

Unsettled intergovernmental rules and remaining data weaknesses hinder broader public sector efficiency. Without a functioning federalism framework, local governments have focused on "incremental" bargaining for central transfers. Ex-post, this tended to generate recurring debts and deficit "surprises," notably in health care. Similarly, many public enterprises continue to depend on sizable transfers. Lack of uniform data— on local government finances and consolidated public enterprise sector—complicates effective fiscal policy responses.

II. Improving Budget Institutions

A. Background

There is a growing desire by, and pressure on, the Italian authorities to improve the cost effectiveness of public spending. The recognized need to reduce the level of public debt, alleviate the tax burden, and enhance the productivity of public sector services requires a budget system that facilitates both the transparent allocation of scarce resources to key priorities and increased efficiency gains from expenditure programs.

However, the budgetary system has displayed weaknesses that stymie the objectives of fiscal consolidation and enhanced expenditure effectiveness. An IMF report in 2007 documented some of the main institutional weaknesses:

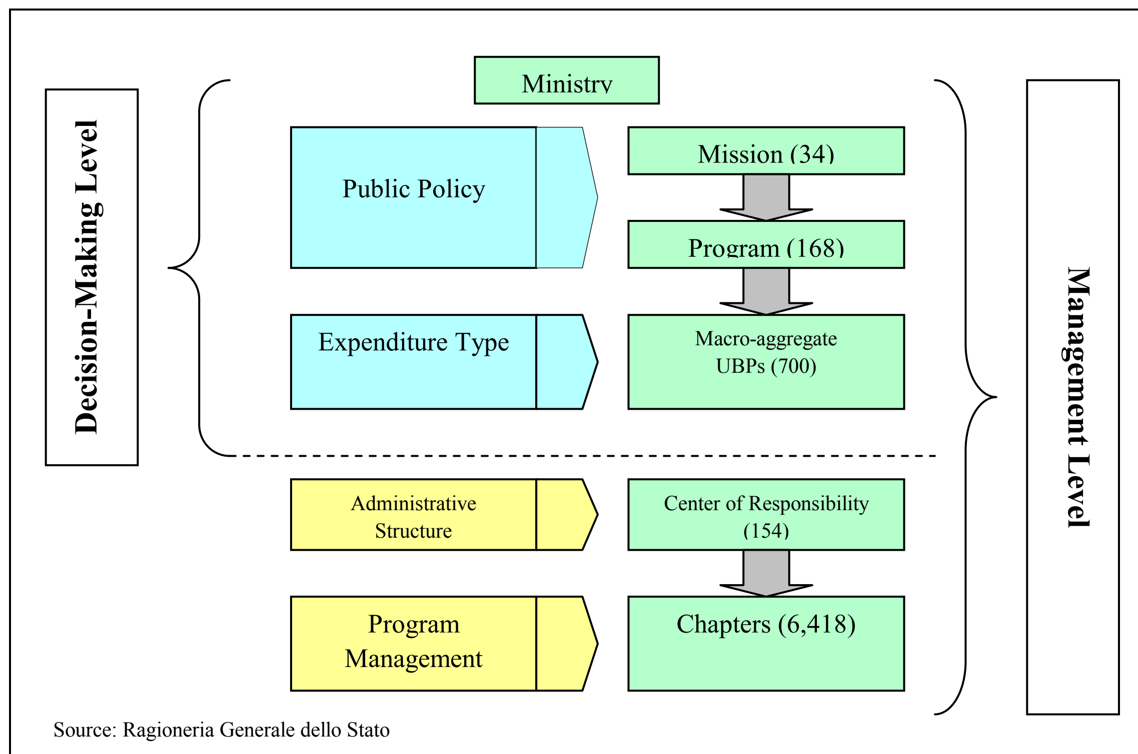
- An "incrementalist" approach to budget formulation. The bulk of public spending was extrapolated annually with marginal changes and without a proper re-examination of the relative value of spending programs and their contribution to government's priorities;
- An excessively fragmented structure of the voted budget, with some 1,500 line items in 2007 that bore no clear relation to the objectives of public spending;
- The lack of a meaningful medium-term orientation in the budget process, with existing forward projections not representing true baseline costs for subsequent budgets;
- A budget approval process in Parliament which allows a proliferation of micro-oriented amendments (about 12,000 presented during the discussion of the 2007 budget);
- Many ex-ante controls on budget execution, constraining budget managers' flexibility in using inputs and fostering a focus on legal compliance, rather than on efficiency;
- A relatively weak information base on the cost of different spending programs, and on their effectiveness in terms of relevant outcomes; and, relatedly,
- Little focus by policy makers on the budget outturn, especially in terms of the results of public spending programs and their cost; and weak accountability for performance.

B. Recent Reforms

Several measures were introduced with the 2008 and the 2009 budgets to address these shortcomings. To reduce the overall size of the public sector while making the public administration more effective, successive governments have implemented important changes to the budget framework, including:

- **Rationalizing the structure of the budget and aligning it with government policy objectives**. A program classification was introduced with 2008 budget and further refined for the 2009 budget; it now includes 34 high level missions and 168 programs, which facilitates consideration of the budget according to government objectives. However, the budget is still voted along more disaggregate line items, or *Unita Previsionale di Base* (UPBs), although these have been reduced from 1,500 to around 700. As required by the 1978 accounting law, these UPBs still represent the basic control unit for budget execution even within the same program (see Figure 1).

Figure 1: New Budget Structure



Source: Ragioneria Generale dello Stato

- **Strengthening the medium-term orientation of the budget**. The 2009–13 medium-term plan, or *Documento di Programmazione Economico-Finanziaria* (DPEF), and subsequent legislation established a binding three-year package of measures that were passed into law. The documents include three-year estimates of the costs of existing policy, broken down by missions and programs.

- **Streamlining the annual budget process and increasing transparency**. Key budget decisions were advanced to June/July (and were anticipated in the DPEF), instead of December. However, to achieve this, a series of "maneuvers" that typically adjust existing revenue and expenditure, authorize new budget proposals, and are the main focus of parliamentary debate in the last months of the year, were passed through the legislature via a confidence vote in the summer, reducing both the length and depth of discussion. The DPEF itself is a more detailed and transparent medium-term strategy document that now explicitly indicates aggregate revenue and expenditure plans.

- **Enhancing managerial flexibility within aggregated programs**. The budget documentation sets spending caps for all missions and programs, and although some additional flexibility is given to transfer resources within programs, this is still confined to a small percentage of expenditure, once "exogenously" driven expenditure is excluded. The basic unit of control remains the UPB. Nonetheless, to meet the aggregate constraints set out in the medium-term adjustment package, line ministries can, for the first time, propose to transfer resources from UPBs in policy areas already defined by legislation (i.e., rigid or mandatory spending) to other priorities.

- **Conducting spending review exercises for selected ministries**. A technical committee established in 2007 undertook a review of cost-effectiveness of public expenditure in five areas: justice, infrastructure, transport, internal affairs, and education. The review was structured more along ministry lines than along programs. Although the final results were reported in mid-2008, both the implementation of the findings and the overall future of the spending review process is unclear. The technical committee was dissolved at the end of the pilot phase, but the General Accounting Department (budget office) intends to continue the exercise and mainstream it into the budget process.

- **Improving the information base on budget execution**. Significant efforts in recent years to implement a computerized system for cash transactions (SIOPE) are starting to bear fruit. This system, which is based on a standardized codification of all cash operations across government levels and agencies, allows real-time monitoring of cash flows. In 2008, the system was rolled out to health and public welfare entities; it now captures 98 percent of public expenditure. The SIOPE should represent a powerful tool for tracking spending.

C. Going Forward

Reducing structural rigidities in the budget will help improve cost-effectiveness. Budget rigidities can reduce economic efficiency by limiting government's ability to reallocate spending in response to changing needs and forcing the brunt of any fiscal retrenchment to

fall on a subset of budget items. In the Italian context, rigidities come from exogenously driven expenditure, which can be divided into two broad categories: (i) mandatory charges (*oneri inderogabili*) where the government has pre-existing obligations, but the exact amount is not predetermined, including pensions, the public sector payroll, and interest payments; and (ii) legislated expenditure (*fattori legislativi*) where specific activities are encumbered by existing legislative prescriptions that specify exact spending requirements. Table 1 shows the implication of these rigidities for a sample program—there is little flexibility for a program manager to reallocate resources. The authorities should thus focus on a set of reforms that begin to tackle these rigidities in the budget framework. Three important steps in this regard are set out below.

Table 1: Example of Rigidities in a Ministry of Communication Program

Ministry of Communication, 2008 Budget (Draft)

Mission: Communication
Program: Radio and Television Broadcasts

UPB 1.1.1	**Operations**	**3,026,787**	**Percent of total**	**Category**
Of which:	Personnel	2,756,971	1.4	Mandatory
	Goods and services	269,186	0.14	Discretionary
UPB 1.1.2	**Interventions**	**154,034,252**	**Percent of total**	**Category**
Of which:		105,648	0.05	Discretionary
		250,000	0.13	Mandatory
	Existing legislation	153,678,604	77.84	Encumbered
	Law 488/1999	*20,658,276*	...	...
	Law 28/2000	*3,329,138*	...	...
	Law388/2000	*21,691,190*	...	...
	Law 448/2001	*20,000,000*	...	...
	Law 289/2002	*5,000,000*	...	...
	Law 350/2003	*27,000,000*	...	...
	Law 311/2004	*1,000,000*	...	...
	Law 296/2006	*10,000,000*	...	...
	Law 296/2006	*45,000,000*	...	...
UPB 1.1.6	**Investments**	**40,356,797**	**Percent of total**	**Category**
		356,797	0.18	Discretionary
	Existing legislation	40,000,000	20.26	Encumbered

Source: Ragioneria Generale dello Stato

- **Overhauling the 1978 budget law to amend the accounting basis and introduce greater control flexibility**. The authorities intend to revise the existing accounting and budget law (law 468/1978); a source of some of the rigidities. They should take the opportunity to redefine UPBs and align them with the new program structure. This will facilitate an eventual move to appropriation and control by programs, once there is confidence in the program design and costing. Nonetheless, the law should still allow the

option of controlling expenditure according to other categories should it be needed, for example, limiting administrative expenditure. The increased flexibility and reduction of ex-ante controls for program managers needs to be accompanied by strengthened ex-post accountability for legal compliance, financial propriety and delivery of results.

- **Rationalizing the body of legislation that encumbers the various spending programs**. Aligning UPBs with programs will not deliver the desired flexibility if expenditure chapters within these programs continue to be encumbered by other pieces of legislation. The authorities should select priority programs and revise the underlying legislation in order to identify opportunities for simplification and rationalization. This will likely require a continuation of the spending review exercise.
- **Increasing the flexibility in the management of civil servants to facilitate geographic and functional mobility**. Improving the effectiveness of public services and also reducing expenditure will require additional flexibility in the management of civil servants. In particular, it is important to move to a framework where line ministries are responsible for delivering policy objectives within a hard budget constraint that includes personnel costs. Increased flexibility in this regard is also important for the objectives set out in the fiscal federalism reforms.

The medium-term orientation of the budget should be enhanced to foster both fiscal discipline and also policy prioritization. For next year's DPEF, the fiscal targets should reflect agreements with subnational governments, effectively bringing forward some of the Domestic Stability Pact negotiations and increasing the credibility of the commitments. However, the authorities could consider setting quantified targets for major areas of spending in the DPEF, or at least making binding the total level of primary spending for the year ahead. This would enhance the role of line ministries and parliament in establishing key budget priorities and trade-offs later in the process. The realism of cost estimates for maintaining existing policy should strengthened by using clearly specified and objectively determined cost drivers (such as the rate of inflation)—these parameters should be agreed for each policy during initial policy discussions and updates should be purely technical exercises. Budget preparation could then focus more transparently on policy changes.

Systematically reviewing expenditure programs for efficiency and effectiveness should become part of the budget process. The pilot spending review exercise highlighted ample policy options to feed into a budgetary debate on cost-effectiveness. The authorities should improve this review process for identifying programs to be eliminated, expanded, initiated, or redesigned to achieve savings. This will require changing the nature of budgetary negotiations to include greater consideration of performance and gradually building up the capacity of the MEF to monitor and evaluate line ministries.

The information base should be improved before moving towards full program budgeting and performance targets. Once there is confidence that the program classification is reasonably satisfactory, the authorities should work to improve the mapping of cost objects to programs on a continuous basis, potentially through an enhancement of existing accounting systems. This reform should precede appropriation by program. In addition, performance measurement of government programs through the design and publication of performance indicators should be developed gradually in collaboration with line ministries before moving to a performance targeting regime; understanding the links between resources and results will take time. The intent to establish a comprehensive database covering financial, output and outcome information is a positive step in this regard.

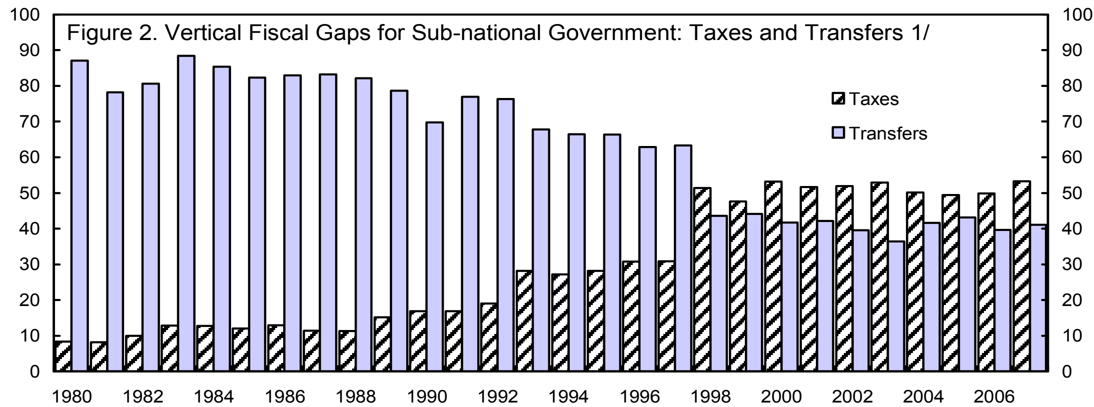
III. Inter-Governmental Fiscal Relationships

A. Background

Italian fiscal federalism is characterized by a significant reliance on transfers.[2] Vertical gaps have narrowed over time, but remain large. In the late 1990s regions were assigned new taxes to replace some of the state transfers, with some flexibility in setting rates, including a new tax on company value added (IRAP) and a surcharge on the national income tax (IRPEF). Horizontal inequities between regions are also significant. The South is more dependent than the North and has a lower margin of flexibility to increase own revenue.

The authorities are undertaking reforms to increase the accountability of sub-national governments and further align revenue powers with spending responsibilities. After changes to the Constitution in 2001 that envisioned further devolution of taxation and spending, there were a number of aborted attempts to advance the reform, and the situation remains unsettled. Sub-national revenue assignments, on aggregate, cover roughly half of current expenses, making regional and local government dependent on central transfers (sub-national governments can also borrow for investment). This in turn reduces the incentives to raise own revenue and complicates budget stability. The draft law approved by the Council of Ministers on October 3, 2008, sets out to gradually replace sub-national dependence on central transfers with own source revenues or a greater share in national taxes.

[2] Italy consists of five special status regions (which are significant beneficiaries of net resource flows regardless of per capita income); 15 ordinary regions; 109 provinces; and upwards of 8,000 municipalities.



Sources: ISTAT; and IMF staff calculations.
1/ Computed as share of taxes/ transfers over total recurrent expenditure for sub-national government.

B. Determining Expenditure Needs

Current Situation

Over the last few decades many spending assignments have been devolved to lower levels of government, in line with the principles of subsidiarity. The central government is left with exclusive competence in areas such as foreign policy; national security; macroeconomic policy; income redistribution; tax collection; constitutional matters; and setting public service standards. Health makes up the bulk of regional spending, with some capital transfers for economic development. Lower levels of government are responsible for road maintenance; school construction; environment; waste and sewage; some health services; management of employment services; and subsidies. Some areas, such as energy distribution are shared between levels. Costs (and thus transfers) are determined based on historical spending.

The Constitutional Court has tried to resolve conflicts in areas of duplication, but some conflicts remain. The court ruled that in areas of overlapping competency the central government should legislate fundamental principles, while the regions undertake financing and administrative functions. Nonetheless, anomalies remain and despite the stipulations of the Constitution, education continues to be financed and provided by the center. Rigid central wage setting has limited the ability of lower levels to manage the cost of devolution.

Reform Proposals

The major change envisaged on spending is to move away from costing sub-national public services based on historical costs in favor of benchmark, or standard, costs. The reform would apply mainly to regional spending in areas where the central government has responsibility for setting national service standards, *Livelli Essenziali di Assistenza* (LEA), such as health, education, and social assistance. Similarly, standard costs will be developed

for delivery of local transport services across the country. For local governments (municipalities and provinces) spending on fundamental functions[3] will be determined on a per capita basis, estimated using historical trends, and adjusted for demographic, geographic, social and economic features. A transition time of up to five years is envisaged.

International Experience

Systems of benchmarking, or formula funding, to enable local agencies to deliver 'standard' packages of services are increasingly widespread (Smith, 2007). The standard is often interpreted as the national average level of services, given a locality's social, economic and geographical circumstances. The standard can be defined in terms of expenditure levels, service levels or outcomes. The aim of the benchmark is to determine the local agency's 'spending need'. One of the best known systems is diagnosis-related groups (DRGs) in health, now used in Regional Health Enterprises in Italy. Benchmarks are typically adjusted to reflect differences in service complexity.

Moving Forward

The move towards standard costs is welcome, but a balance needs to be attained between a simple and complex, micro-analytical and data intensive approaches. A simple approach, for example based on a high-performing region, runs the risk of being rejected as unrepresentative, while an overly complex system may need to be continuously redefined.[4] Two broad categories of formula funding mechanism can be identified: case payments based on actual output, which generally give local agencies the incentive to increase output and efficiency; and capitation methods based on estimates of output that emphasize the 'fair funding' principle of giving the local agency the means to deliver some standard of service, with few incentives to secure the desired results. The former are more aligned with performance budgeting, but the latter are less demanding of administrative data and audit requirements. Some combination of the two mechanisms may be appropriate. The system will also need to define what happens in the eventuality of the state redefining or updating the LEA, as the funding of the spending assignments in this category is guaranteed.

Should high costs materialize, bolder offsetting reforms could be considered, including streamlining the structure of subnational governments. To set the context for this exercise, the authorities should review public service "delivery chains"—the role of various levels of government in expenditure areas, from policy formulation, through defining

[3] "Fundamental functions" have not yet been defined.

[4] See Häkkinen and Joumard (2007) for an analysis of several benchmarking approaches in the health sector and, articles by Mapelli (2008) and Muraro (2008) for a discussion of issues in determining standard costs.

standards, to service delivery. Where possible, duplication of spending competencies and civil service posts should be rationalized, and mechanisms to enhance coordination and information sharing should be established.

C. Revenue Assignments

Current Situation

Sub-national revenue assignments cover about half of current expenses. There are few genuinely autonomous sub-national taxes; most are shared taxes, which for ordinary regions count as transfers, surcharges on national taxes, or have the base controlled by the center. Tax autonomy has been generally increasing over time. The main locally based tax for regions is the IRAP (see table 2), which appears to be a relatively efficient tax with a low standard rate and a wide base. The local property tax (ICI) was the main own revenue source for municipal level government, but was abolished in May 2008 for primary residences. The center has also interfered with the bases of other sub-national taxes.

Reform Proposals

Regions are to have sufficient own revenue resources and sharing in national taxes to cover assigned tasks. Decentralized entities will have three main revenue sources: (i) own taxes, i.e. instituted with local legislation; (ii) derived taxes i.e. instituted by national legislation, but with some local discretion to set rates and relief; and (iii) national tax sharing arrangements for IRPEF and national VAT (IVA). For regions, these taxes will gradually replace the IRAP, which covers most health expenditure.

Tax sharing will be based on the principle of "territoriality"[5] and could lead to large pro-capita variations in resources across regions. However, the main base intended for sharing among the regions is the national VAT, which due to its more even distribution across regions will require smaller transfers to equalize revenue capacity than other bases. A disadvantage of relying heavily on the VAT is the low ownership of the tax given the center's role in setting the base and rate.

[5] Taken to mean revenue will be attributed to the locality where the tax base is e.g. the destination principle for consumption taxes.

Table 2: Tax Autonomy of Sub-national Governments, 2006

Tax	Weight 1/	Margin of autonomy
Region		
IRAP	52.2	Tax rate can vary between 3.25 and 5.25 percent
Surcharge on IRPEF	8.3	Rate can vary between 0.9 and 1.4 percent
Automobile taxes	6.9	Variable by 10 percent relative to previous year
Tax share special regions	30.7	None: Fixed rates
Province		
Tax on auto insurance	46.7	None: Fixed tax
Transcription tax	28.3	Freely set up to 20 percent
Surcharge on electricity	16.7	Variable within given range
Municipality		
Local property tax	58.9	Tax rate variable between 4 and 7 per thousand
Tax on solid waste disposal	20.2	
Surcharge on IRPEF	7.7	Freely set up to 0.5 percent

Source: Banca d'Italia with Istat data.

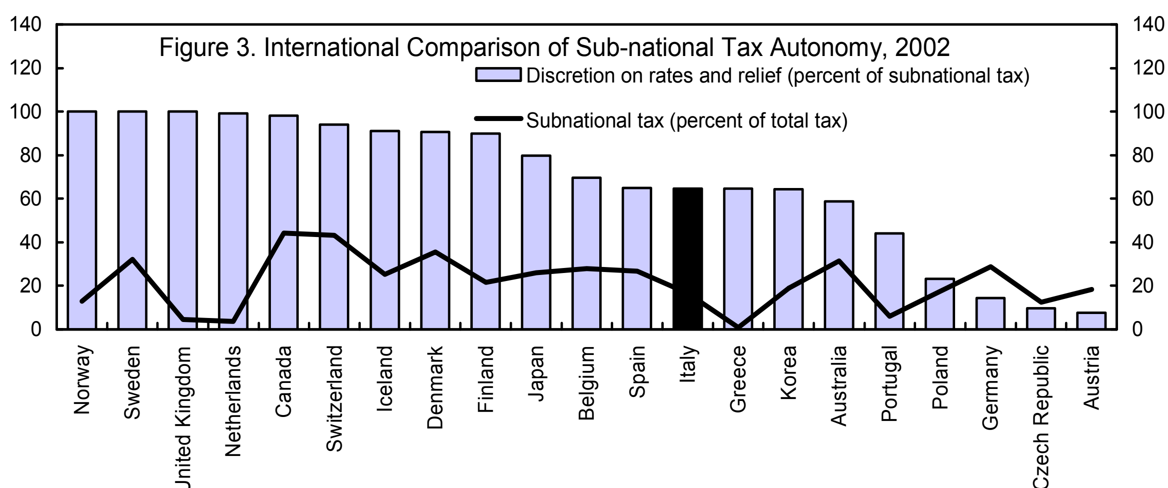
1/ Percent of tax revenue; weights for each level do not add up to 100 because of omitted minor taxes.

Whether sub-national governments will have enough flexibility to guarantee autonomy in expenditure choices remains unclear. The ability to institute new own taxes is constrained by a provision forbidding taxation of the same base by different levels of government. Moreover, the existing flexibility to vary rates (e.g. on the IRAP) has not been utilized, except as a centrally imposed sanction for cost overruns and for industrial policy. The law also seeks to eliminate interference with tax bases that belong to other levels of government, although the recent decision to eliminate the local property tax on primary residences goes against that intent.

Tax assignments will be calculated according to the nature of the expenditure they will finance, but will not be earmarked. For example, mandatory regional spending, i.e., where the center sets basic standards (LEA), is to be covered by own revenue sources (calculated at uniform rates), national tax sharing arrangements for IRPEF and national VAT (IVA). An equalization fund will ensure that all regions can finance services at the required standard (see below). Other regional expenditure will be covered by surcharges on the IRPEF.

International Experience

There is broad agreement in the literature that a degree of tax autonomy is warranted for an effective decentralized system (Ambrosanio and Bordignon, 2006). A variety of reasons are put forward for tax autonomy: (i) to be able to cater to local preferences; (ii) to foster yardstick competition whereby citizens distinguish good and bad policy choices; and (iii) to harden budget constraints and instill discipline, as sub-national governments have greater flexibility at the margin to deal with expenditure increases. Tax autonomy varies across countries; Italy is slightly below average, both in terms of percentage of taxes allocated to lower levels of government and the discretion to set rates and relief (Figure 3).



Source: OECD, Blochliger (2006).

The properties of different taxes and tax bases can make them more, or less, apt for different levels of government. National governments often retain taxes with strong cyclical components, such as personal and corporate income taxes. Central governments also frequently retain control of the base and rates for VAT to avoid the complexity and inefficiencies that might arise from sub-national discretion over these taxes. Nonetheless, an advantage of allocating consumption taxes to sub-national government (often through tax sharing arrangements) is that the base is more evenly distributed than income taxes. Sub-national tax assignments should: (i) allow taxpayers to see the benefit of contributing i.e., be linked to service provision; (ii) not distort resource allocation; (iii) not exacerbate vertical and horizontal imbalances; and (iv) should be easily administered and enforced. Whether mobility of the base is an important consideration depends on whether one values a degree of horizontal tax competition to keep governments efficient. Property taxes are one of the best sources of local revenue. Surcharges for sub-national governments on personal income tax have the advantage of being simple and transparent, but are subject to horizontal inequity. Tax sharing arrangements are common, but give no marginal autonomy. Excise taxes are well suited to sub-national government, if applied according to a destination principle.

Moving Forward

Local entities need enough revenue flexibility at the margin to increase the level/quality of public service provision and/or be responsible for any cost overruns. With the gradual elimination of the IRAP, which represents over 50 percent of regional tax revenue, an alternative tax controlled by the region needs to be identified. The flexibility of sub-national government to vary surcharges rates for IRPEF will need to be increased accompanied, as envisaged, by a reduction in the central rate.

The reform is an opportunity to undertake a comprehensive review of property taxation. The abolition of the ICI on primary residences should be reconsidered, or accompanied by alternative sources of property taxation, as this tax fulfils the desirable criteria for sub-national revenue and represents an important local tax in many countries.

D. Equalization Scheme

Current Situation

Most grants are untied and are considered mandatory from a central government budgeting viewpoint. Equalization grants to cover vertical fiscal imbalances go from the center to both regional and local governments; there are additional grants from regional governments to local authorities within their jurisdiction. Expenditure for special programs, such as regional projects, is financed by EU grants and national cofinancing arrangements.

However, the overall result of the equalization system is a soft budget constraint on sub-national governments. These transfers are fixed *ex-ante* when the budgets for all levels of government are determined; these are largely based on the previous year's spending. The equalization is calculated largely in terms of spending levels; own revenue is deducted from permissible spending to determine the transfer level, with the attendant disincentives for local tax efforts. Moreover, at the end of year grants can be "topped up" to cover unforeseen deficits. This is especially true for health and transport expenditure. The rules for these late adjustments are not clear and appear to be influenced by relative bargaining power.

Reform Proposals

The proposal is to move from a system of equalization based on spending, towards equalization based on revenue capacities and expenditure needs. Expenditure estimates based on historical spending are to be phased out in favor of standard costs for certain mandated functions. Ordinary grants are to be replaced by tax revenues, leaving only equalization grants and special purpose grants for central (and EU) policy objectives.

Regional equalization transfers are to be calibrated according to category of devolved expenditure:

1. **For LEA mandated expenditure, a vertical equalization fund will financed by sharing the VAT base**. In the first round, a share of VAT collected in each region will be calculated at a rate that is sufficient to fully cover LEA functions (estimated according standard costs) in at least one region, after subtracting the region's share in IRPEF and own

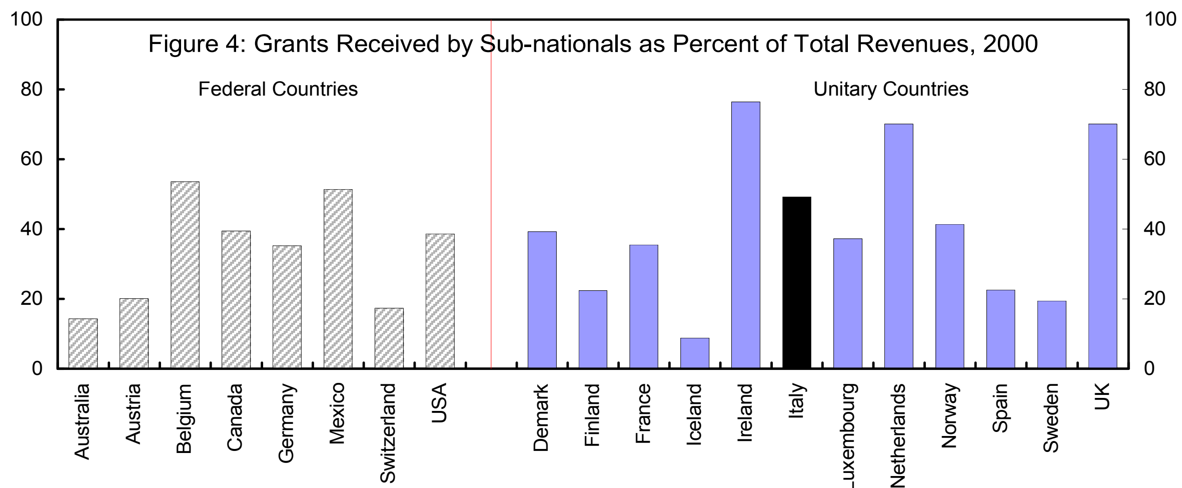
revenues.[6] In a second round, an additional share of VAT is calculated at a rate that is sufficient to fully cover LEA expenditure in all other regions, after subtracting their share in the IRPEF, own revenues, and VAT shares based on the first round calculations.

2. **For non-LEA expenditure**, **a horizontal equalization fund will financed by surcharges on the IRPEF.** Transfers will be determined by equalizing only revenue capacity against a standard calculated using an average IRPEF surcharge rate. Regions that have above (below) average IRPEF per capita contribute (draw from) the fund.

In a break with the past, regions will have greater responsibility for managing the equalization funds for the provinces and municipalities under their jurisdiction. Equalization needs will be calculated as the difference between some standard cost per capita for recurrent expenses and a standard value for own revenue sources and national tax shares.

International Experience

Italy's overall dependence on transfers is not unusual in OECD context (Figure 4). Grants reflect a variety of objectives from a reduction of vertical and horizontal fiscal imbalances, through implementation of national standards in public services, to fostering national priorities and enhancing local expenditure efficiency.



Source: OECD, Revenue Statistics, 2003

[6] There are clearly different solutions to this based on the share of IRPEF that is decided.

The academic literature points to the reduction of transfer dependence as a way to reduce free riding and moral hazard, and instill better budget discipline. Studies have shown that excessive grant dependence is associated with weaker budget discipline at the sub-national level e.g. Germany (Rodden, 2006) and also weaker economic performance e.g., Austria (Blochlieger, 2007). Equalization schemes have to be carefully designed to avoid disincentives to develop local revenues and incentives to inflate expenditure needs. Equalization based on both revenue capacities and also expenditure needs addresses the abstraction from differential costs of services associated with a revenue only approach and also the incentive problems and possible inefficiencies associated with an expenditure needs only approach (Ahmad and Searle, 2006).

Moving Forward

The equalization fund for national standards of public service provision should be based on transparent formulae and rules that can be easily monitored. Discretionary choices by recipient levels to increase service levels should be financed by own resources. The current system of ex-post bargaining should be eliminated and hard budget constraints imposed. In addition, the government should consider setting the equalization at below 100 percent for non-LEA functions to incentivize own revenue effort.

This will require that the equalization scheme be treated as a "closed loop"; the inflows to the equalization fund (e.g. VAT share) should be fixed *ex-ante* in the budget cycle, preferably for three years in the DPEF, in order to reduce the discretionary influence of the center, harden the budget constraint and more closely mirror a horizontal equalization scheme. This share could be reviewed every three years or so and would be less prone to expenditure drift.[7] This arrangement would be equivalent to imposing a balanced operating budget requirement, after equalization grants, on all sub-nationals in the DSP.

The equalization scheme should be implemented and enforced by an autonomous agency free from bargaining. Transparent formulae and independent monitoring will increase transparency and reduce discretionality. The formulation of the Permanent Conference on Public Finance[8] to determine the mechanics, and monitor the operation, of the equalization scheme will be a positive step if it is allowed to operate based on pre-established rules and not political bargaining. This agency should meet at the start of the budget cycle.

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[7] Or the share for the outer year in the medium-term projection could be revised annually.

[8] The Conference will be composed of representatives from all levels of government.

E. Fiscal Discipline and Stability

Current Situation

The main vehicle for imposing fiscal discipline on lower levels of government is the Domestic Stability Pact (DSP). The aim of the DSP was to set a fiscal path for all levels of government that was consistent with the commitments made in the Stability and Growth pact (SGP). The DSP contains a set of fiscal targets, a monitoring mechanism and a system of sanctions. The DSP is set within the context of the annual budget law, after consultation with the lower levels. A pact for health spending is separately negotiated.

However, the DSP has shown certain weaknesses. Shortcomings include a lack of consistency with the SGP targets, periodic amendments to the rules and targets, varying coverage and sensitivity to cyclical conditions (Fedelino, 2005). Although compliance with the DSP has improved in recent years, the health sector is particularly problematic as it is outside the coverage of the DSP and subject to significant cost overruns.

Reform Proposals

The current proposals for fiscal federalism are geared towards engendering greater responsibility for fiscal outcomes to lower levels of government. The exact mechanism for enforcing discipline within the new federal framework has not been defined. However, the proposals on fiscal federalism should be considered alongside the recent move to establish binding three-year adjustment packages consistent with longer-term fiscal objectives and that were anticipated as part of the 2009−13 DPEF. Sharing the deficit target across levels of government is easier if accounting practices are harmonized, as the authorities are planning to do.

International Experience

Evidence of the impact of fiscal federalism on overall budget discipline and macro-stability is inconclusive. Some studies find that federal institutional arrangements are associated with an increased tendency toward macroeconomic fragility, volatility and crises (e.g. Wibbels, 2000). Others find that the dangers of fiscal decentralization for fiscal stabilization have been exaggerated, at least for OECD countries (Thornton and Mati, 2007), or that sub-national tiers play a positive role in fiscal consolidation cycles (Darby, Muscatelli and Roy, 2005).

Different countries have availed themselves of a range of instruments to limit the risks to fiscal discipline. These can divided into four broad categories: administrative controls; centrally-imposed rules; formalized cooperation; and market discipline. Pure market approaches have the benefit of freeing the center from the complication of monitoring local

authorities, but are effective only if the central government can commit not to bail out sub-national governments. The US and Canada earned this credibility by resisting pressure to provide loans to states in financial trouble in the 1830s and 1840s (Spilimbergo, 2005).

Moving Forward

Italy should endeavor to ensure that the federalism reforms are budget neutral at a general government level. As Italy moves towards additional revenue autonomy for sub-national governments, the consequent changes to the rates/shares that regions can command from VAT and income tax need to be reflected in an offset at the central level, if the tax burden is not to rise. This will also send an important signal of the center's commitment to fiscal stability.

The DSP should be revised to have comprehensive coverage and also provide stable, and credible, fiscal objectives for all levels of government. These should ideally target a zero operating budget balance after equalization grants, according to a harmonized definition, that are fully consistent with the multi-year adjustments set out in the DPEF. For next year's DPEF, the fiscal targets should reflect agreements with subnational governments, effectively bringing forward some of the DSP negotiations.

A credible system of sanctions should be established for budget indiscipline, perhaps combined with a no-bailout clause for local government (although the center will need to earn its credibility). Enforcement mechanisms should be transparent and non-discretionary, with enforcement responsibilities delegated, whenever possible, to autonomous agencies and courts.

F. Complementary Reforms

Fiscal federal arrangements will depend on complementary reforms in other areas.

- **Budget processes and systems need to be harmonized across levels of government**. The review of "delivery chains" should be integrated with the spending review exercise undertaken as part of the budget system reform. Shared or overlapping services should be examined to reduce, where possible, duplication of spending competencies and civil service posts. Likewise, the budget policies and spending reforms envisaged at the central level to improve efficiency need to be cascaded down to, and coordinated with, local levels if spending is to become more effective.

- **Reducing overlaps in expenditure competencies will rely, in many instances, on increased flexibility in the public labor market**. Establishing sound benchmark costs, and the related equalization scheme, will require high-quality data. Data should be comparable across regions and units of government, and which is frequently updated. Some of this data

could be sourced to an independent authority, but much will also depend on a modern and consistent accounting system across different levels of government. The refinement of program classification at the center of government will need to be coordinated with other levels. Ensuring high-quality data should precede the other reforms that establish expenditure and revenue quantities.

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ANNEX II—REFORMING ITALY'S LABOR MARKET[1]

I. INTRODUCTION

The Italian labor market has improved markedly over the past decade, but important challenges remain. The social safety net while high for some worker groups, is virtually nonexistent for others; the extent of employment protection varies substantially across worker groups; and the aggregate wage distribution is too compressed. As one of the consequences, a rising share of workers faces high employment risk but little income insurance. The existing wage bargaining system exacerbates these disparities: nationally bargained wages are less binding in the North, but too high for South, and the lack of a sufficient social safety net, particularly for those in the South, prevents sufficient spatial mobility to more quickly reduce regional disparities.

This annex provides an overview of the institutional landscape of Italy's labor market and recent labor market outcomes from a cross-country perspective. It argues that addressing Italy's labor market underperformance requires a comprehensive view of the labor market, recognizing the importance of avoiding further partial measures that exacerbate existing inequities, and also recognizing that product and labor markets interact in important ways. While not all shortcomings of the labor market can be addressed simultaneously, empirical evidence points to the need for careful sequencing, and combination, of selected reforms. Simulations suggests that proper design can also reduce the (fiscal) costs of reform.

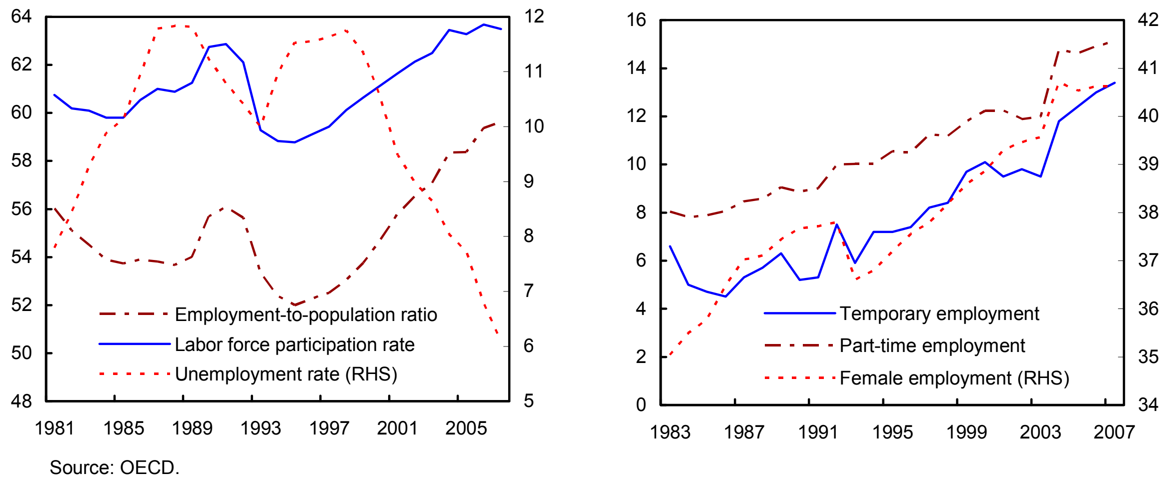
II. BACKGROUND

Starting in the mid-1990s, both labor force participation and employment increased substantially, and with cumulative employment growth almost twice the increase in the labor force, the unemployment rate declined sharply, to 6.1 in 2007, just over half the rate in 1995 (Figure 1, left panel). Reform efforts, such as the 1997 Treu measures and the 2003 Biagi reforms, contributed to the growth in aggregate employment, but their focus on reform "at the margin" also led to an increasing dualism of the labor market.

Much of the employment gains since 1995 were in temporary and part-time employment. Between 1995 and 2007, the share of temporary employment increased from 7.2 percent to 12.4 percent, and the share of part-time employment from 10.5 percent to over 15 percent (Figure 1, right panel). In absolute terms, the number of workers in temporary

[1] Prepared by Martin Schindler.

Figure 1. Recent Labor Market Trends in Italy



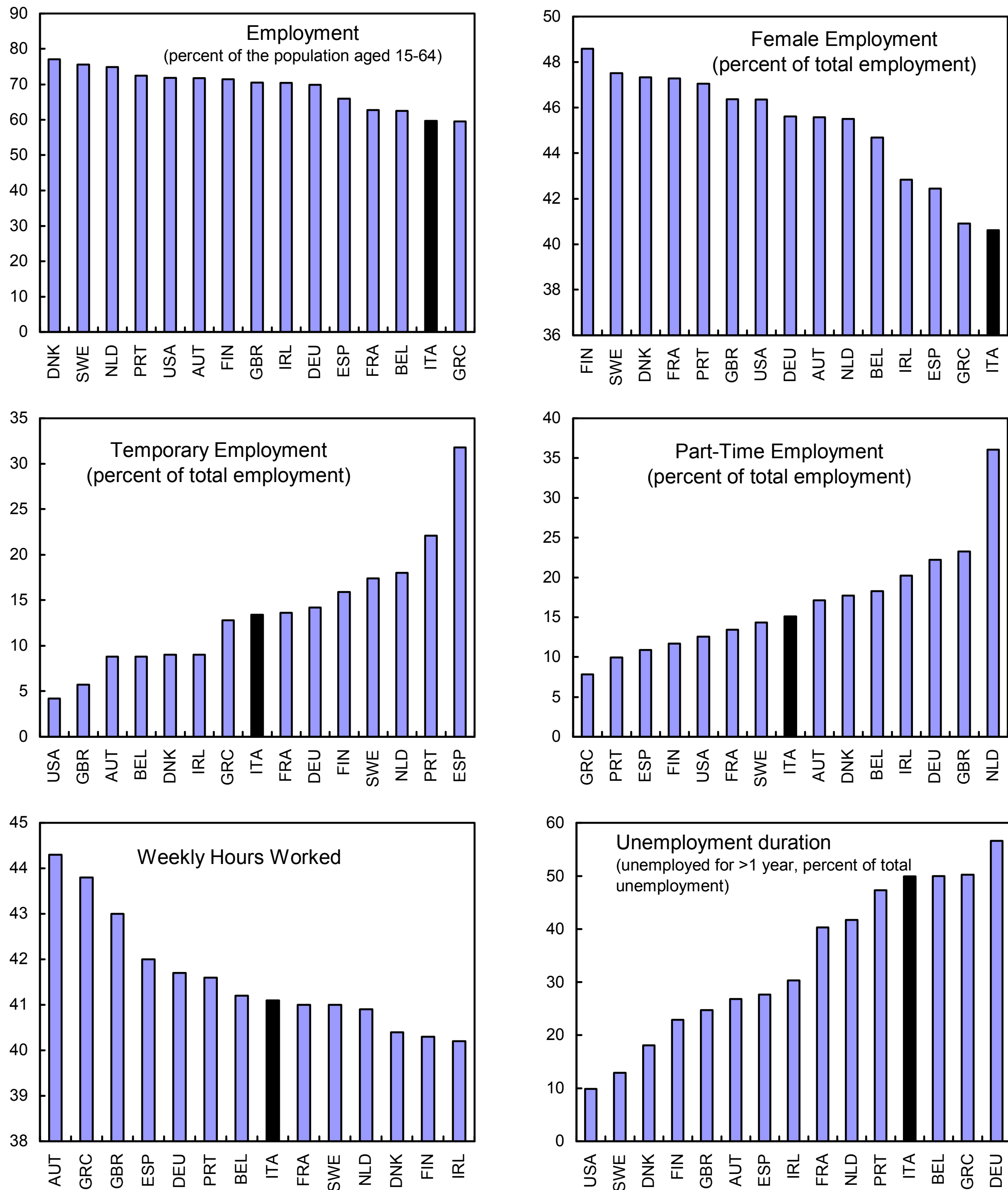
work arrangements more than doubled during that time, while permanent employment increased by only 7 percent. While less dramatic, a similar gap was observed for part-time employment, which increased by 65 percent during the time period, compared to 9 percent cumulative growth in full-time employment. The jump in part-time employment in 2004 had the positive side-effect of benefiting female employment, which increased by over one percentage point that year (as a share of total employment).

In spite of recent improvements, important weaknesses remain in the Italian labor market. Employment growth exhibits signs of a slowdown, and the level of employment, as a share of the working-age population, is still substantially smaller than in most other European countries. Hours worked are at about the EU average and thus do not compensate for Italy's low employment share. And while the increased use in temporary and part-time employment, also now roughly at the EU average, has provided increased flexibility, it may also have displaced growth in permanent employment and contributed to stalling productivity growth. In spite of recent employment growth, unemployed workers still take a long time to find work—nearly 50 percent of the unemployed have been out of work for more than one year, substantially above the EU average. Stagnant labor productivity and continued earnings growth have led to a substantial increase in unit labor costs.

III. Regulatory Framework

Assessing the possible sources of Italy's labor market performance requires a nuanced and comprehensive view. Simple consideration of OECD labor market indicators presents a puzzle. Along many dimensions of the regulatory framework, Italy ranks broadly mid-field,

Figure 2. Italy's Labor Market Outcomes in Cross-Country Comparison, 2007 1/

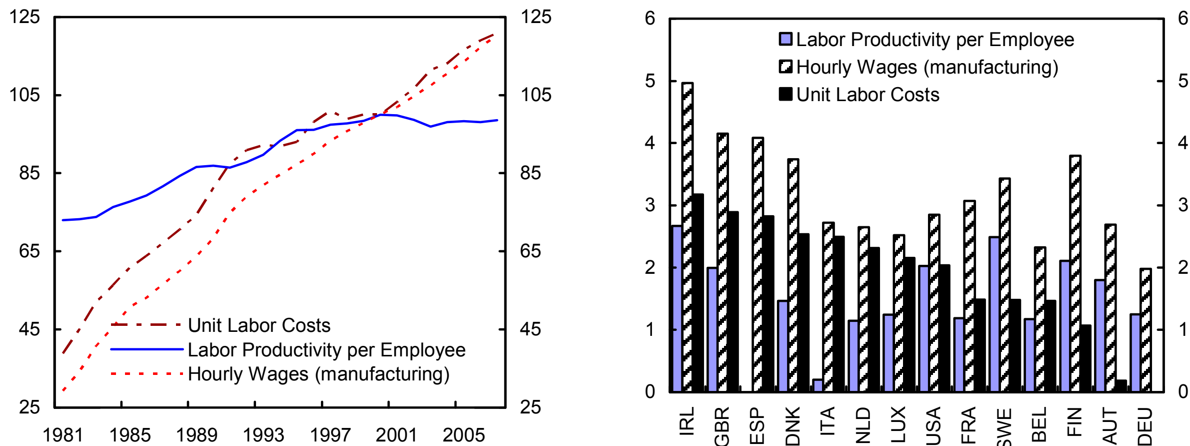


Source: OECD.
1/ All data are for 2007 or latest year available.

and on some dimensions Italy actually appears less regulated than the EU average. Yet, labor market outcomes are among the worst in the EU.[2] To gain a better understanding of this apparent disconnect between labor market policies and outcomes, it is necessary to (1) consider the interactions of different labor market regulations, rather than considering specific margins in isolation, and (2) also take into account spillover-effects between regulations in the labor market and those in others, especially product markets.

Low productivity is the main source of high, and rising, unit labor costs. Average wage growth has been relatively moderate in Italy: for example, manufacturing earnings grew over the past decade at an average annual rate of 2.6 percent, below the average rate of over 3.2 percent in other EU15 countries. The tax wedge, i.e., the combined tax burden of employer and employee deductions relative to total labor cost, is also not out of line: for example, Italy's tax wedge for married individual with two children and average income, is 33.7 percent, below the EU average of 34.2 percent. Thus, comparatively high labor costs are in large part due to low productivity.

Figure 3. Earnings, Productivity and Competitiveness 1/



Source: OECD.
1/ 2000=100 (left panel); cross-country data are average annual growth rates during 1995-2006.

Productivity is held down by asymmetries in labor institutions and their inability to reflect regional differences. Among the key hindrances of an efficient labor utilization and allocation are a rigid wage bargaining mechanism; inefficiencies and inequities in the unemployment insurance (UI) system; and asymmetric employment protection regulations (EPL). More specifically:

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[2] *De jure* indicators may not capture the full extent of the regulations' *de facto* impact. For example, based on survey data, the World Economic Forum's recent competitiveness report ranks Italy 49th among 134 countries and near the bottom on most labor-market related indicators.

- *Collective wage bargaining*—About 60 percent of workers are covered Italy's collective bargaining agreements (Box 1), high by European comparison, and the effective coverage is even higher. However, the nature of the two-tier system leaves little scope for many firms, specifically for small enterprises and many in the South, to engage in firm-level negotiations. As a result, a predominance of nationally negotiated wages over those at the firm level exacerbate regional differences in economic development.
- *Unemployment insurance*—The Italian UI system is complex, and uneven. While ordinary UI benefits are initially relatively high, with a net replacement rate of 60 percent, they drop to zero after 8 months (12 months for workers aged over 50), and complex eligibility rules imply that only few unemployed individuals actually receive such UI benefits (Demekas, 1995).[3] By contrast, wage supplementation funds (*cassa integrazione guadagni*, or CIG) can be substantially more generous, both in terms of level and duration, but are limited to workers on certain contracts and those from participating firms (mostly large firms in the North). The lack of a sufficient social safety net inhibits an efficient worker reallocation, both regionally and in terms of skill mismatches.
- *Employment protection*–Past reforms have substantially reduced restrictions on fixed term and part-time employment arrangements, from among the highest in Europe in the mid-1980s to about the EU15 average in 2003, but have left restrictions on regular employment unchanged (see Figure 4). Although permanent EPL appear comparatively low according to the OECD indicators, market participants and academics alike recognize permanent employment as substantially protected.[4] The asymmetric deregulation has tilted incentives for job creation toward "atypical" contracts, resulting in increased employment risk for an increasing fraction of the labor force (and particularly those with the least access to social insurance) and contributing to worsening productivity trends.[5]

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[3] In 2005, 2.3 percent of the labor force received UI benefits, about a third the rate in other EU countries. Reasons include that receipt of UI benefits in Italy includes an income-test of family members (see de Neubourg et al., 2007); it also has minimum requirements regarding work and contribution histories.

[4] For example, Art. 18 in Law 300/1970 (*statuto dei lavoratori*) protects workers against dismissal without (narrowly defined) just cause, making it difficult for firms to lay off individual workers without risking substantial penalties; protection against collective dismissals is among the highest in OECD countries; and the survey data cited in footnote 2 illustrates the high *perceived* rigidity of Italy's labor market.

[5] The asymmetric liberalization of temporary EPL, and the increased use of temporary contracts, is likely to have impacted productivity, among other things, because their time-limited nature reduces incentives for human capital investments and temporary employment creation tends to be in low-skill areas. Also, the still high protection of permanent contracts maintained the difficulty of laying off non-productive workers on permanent contracts. The overall result has been a bias towards less-productive employment. However, from a pure accounting perspective, the entry of low-skilled workers is likely to have contributed to the decline in measured productivity, thus overstating the actual loss of competitiveness (see Codogno, 2008).

Box 1. Key Reforms of the Italian Labor Market

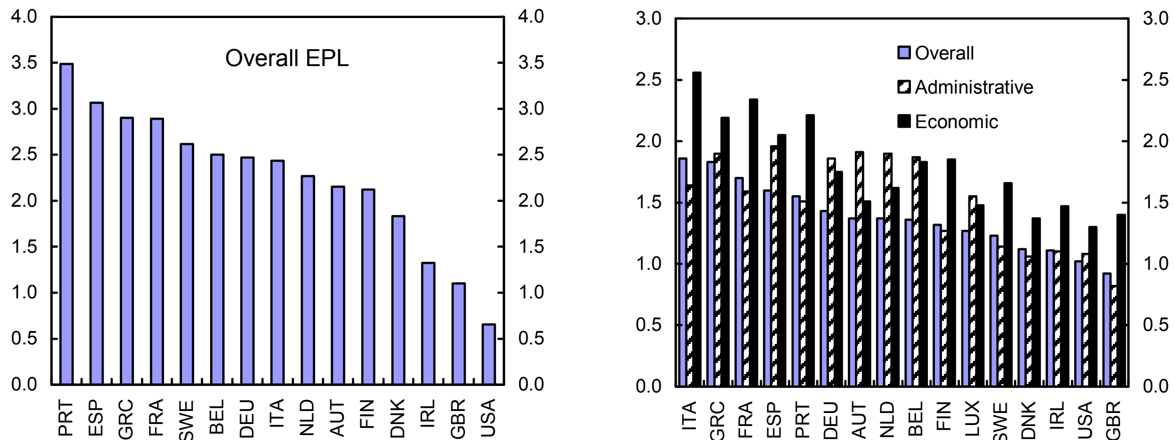
Over the past two decades, Italy's labor market has undergone substantial reform. Adverse macroeconomic conditions, including an unemployment rate that exceeded 12 percent during the late 1980s, and Italy's envisaged entry into the EMU in 1999, resulted in several reform measures (*patti sociali*) starting in the early 1990s. Key among them were the social pact of 1993 which included the incomes policy arrangement and which laid down the foundations of the industrial relations and collective bargaining framework currently still in practice; and the Treu measures in 1997 and Biagi reforms in 2003, both aimed at improving labor market flexibility.

The collective bargaining structure laid out in the 1993 social pact postulates a two-tier bargaining structure: (1) collective bargaining at the national (sectoral) level, to determine the terms and conditions of employment (renegotiated every four years) and basic wage guarantees (*minimi tabellari*, renegotiated every two years); and (2) bargaining at the second (regional or firm) level, allowing the bargaining partners to supplement national contracts (valid for four years). Second-level bargaining is optional, and, importantly, wages can not be reduced below those negotiated in the *minimi tabellari*. Thus, although second-level bargaining in principle provides flexibility for better wage-productivity links, the wage floor imposed by the *minimi tabellari* limits the use of second-level bargaining.[6]

While the 1993 social pact provided a broad bargaining framework between the social partners, the Treu measures in 1997 (Law 197/1997), named after then-Labor Minister Tiziano Treu' were the first legislative measures aimed specifically at increasing the employment rate, particularly in the South, and overall labor market flexibility. The Treu law aimed at increased flexibility via labor market reform "at the margin," mainly by introducing temporary contracts and providing incentives for part-time work. Another law in the same year (Law 469/1993) on the privatization and decentralization of job centers abolished the principle of a public monopoly on employment services. Efforts to increase labor market flexibility were taken forward with the 2003 Biagi reform (Law 30/2003), named after the late Marco Biagi, advisor on labor market reform under the 2001−2006 Berlusconi government. This reform further deregulated the use of atypical work arrangements, such as temporary agency work (staff-leasing) and part-time work, and introduced new forms of atypical work arrangements such as on-call jobs (*lavoro intermittente*), job sharing and occasional work (*lavoro a progetto*).

[6] Although Italy does not have a statutory minimum wage, collectively agreed wages impose a *de facto* wage floor even for workers not covered by collective bargaining—the Italian constitution contains a clause on the right to fair wages (sec. 36), and in determining the level of the fair wage, Italian labor courts have consistently taken the *minimi tabellari* as guiding parameters.

Figure 4. Employment protection and product market regulation, 2003 1/

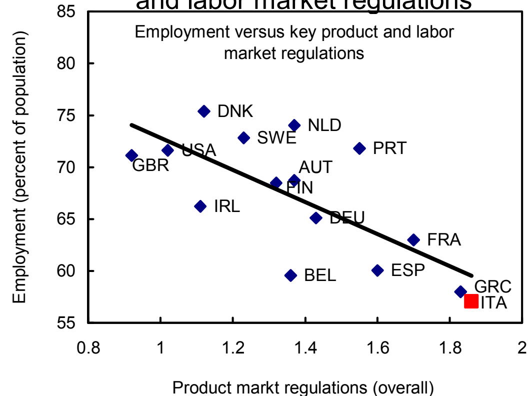


Source: OECD

1/ Overall EPL includes restrictions on permanent and temporary jobs as well as regarding collective dismissals. Administrative regulations include administrative burdens on startups and regulatory and administrative opacity; economic regulations pertain to those of the economic structure and competition; the overall index is an aggregate of the subindices.

Product market regulations are high and have affected labor market outcomes. In 2003, Italy ranked among the countries in the EU with the most regulated product markets (Figure 4). Italy's high score is driven mostly by regulations of the economic structure and competition. Consistent with the theoretical and empirical research (Box 2), which cites a lack of product market competition as an important constraint on employment growth, simple correlations between employment and product market regulation paint a strong, negative relationship between the two, with Italy at the extreme end of this relationship (Figure 5).

Figure 5. Employment versus key product and labor market regulations



Source: OECD

IV. Lessons and Directions for Reform

The details of Italy's labor market institutions are important. Among the key lessons from the overview of Italy's labor market institutions is that the problems are not excessive average wage growth, but a bargaining system that provides insufficient differentiation, leading to wage outcomes that are too restrictive for some subsets of the economy; they are not an excessively generous UI system (as, arguably, in some other European countries), but one that is too low on average, and too uneven, missing those worker groups that most need it; and while employment protection is too high overall, it is specifically its asymmetry that causes additional distortions.

Important lessons from the experiences of successful reformers can be adapted to the Italian case. Several lessons stand out :

- *A labor market reform agenda should address inefficiencies in product markets.* Successful reformers have typically also deregulated product markets, in line with a broad academic literature (Box 2). Given that Italy's product market is among the most regulated in Europe, this lesson is of particular importance. Moreover, product market deregulation is typically less costly (fiscally), and more competitive product markets can also pave facilitate subsequent labor market reform. Thus, product market deregulation should be a top priority in Italy.

- *Reforms should not be piecemeal.* Labor market reforms should be implemented in packages that avoid unintended consequences. Italy's reform history itself provides numerous examples of piecemeal reforms, such as the asymmetric liberalization of temporary employment, partial tax reductions, and expansion of the CIG scheme.[7] More specifically:

  a. An extended use of second-level bargaining is crucial to obtain a more flexible and differentiated wage structure.[8] Reductions in labor taxes may be necessary to provide additional flexibility, but these should be broad-based, rather than partial, and should be implemented only with commitments of unions to moderate wage demands at the national level so as to broaden the scope for wage supplements at the firm-level, while ensuring that tax cuts benefit both workers and firms.

  b. A further EPL reduction, and equalization across employment types, should be combined with a reform of the UI system, including a broadening of coverage and lengthening of duration.[9] That is, increased employment risk should be buffered by improved income insurance.[10]

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[7] Recent measures to reduce taxes at the margin, such as the reduction of taxation on overtime/bonus pay, affect average costs of employment (and thus job creation) only marginally, disproportionately benefit those in permanent employment, and have the potential to result in substantial fiscal costs. Italy's government has also recently committed additional funds to the CIG scheme, thus further exacerbating existing inequities in the social safety net (see also Boeri and Garibaldi, 2008).

[8] Increased wage flexibility would allow firms to adjust to idiosyncratic economic conditions, and could also help mitigate Italy's regional discrepancies, especially given relatively limited internal migration.

[9] See also Boeri and Garibaldi's (2008) policy proposal which underscores the need for a universal, and unified, UI system. In terms of financing, their proposal notes that such UI reform should have an "experience-rating" component, whereby firms with higher worker turnover would pay higher taxes.

[10] Although UI can create disincentive effects by raising reservation wages, Acemoglu and Shimer (2000) note that (moderate) UI may also increase labor productivity by encouraging workers to seek more productive jobs (and firms to create them). With incomplete insurance markets, social insurance can also raise economic welfare, although Rogerson and Schindler (2002) caution that the details of such insurance are crucial.

Box 2. Product Market Regulations and the Labor Market

Product market regulations[11] have been found to be negatively correlated with employment (see, e.g., Boeri et al., 2000, and Figure 5). A possible channel for this relationship is that in a monopolistic market structure, firms set prices at a markup over marginal cost, thus reducing the equilibrium quantity of output. Increased competition then tends to result in a lower equilibrium price, higher output and, all else equal, higher employment.

The effects of product market deregulation on labor market outcomes depend, among other things, on the size of labor market distortions. More specifically, in labor markets with strong unions, wages are elevated over the marginal product of labor because unions extract a share of the (monopolistic) firms' rents. Because product market deregulations reduces firms' rents, it also reduces workers' wage premium, and so the scope for employment effects of product market deregulation is larger in labor markets where unions are strong. The empirical evidence is broadly consistent with these predictions (see Fiori et al., 2007).

Although product market deregulation may, as a consequence, reduce union power and nominal wage gains, Blanchard and Giavazzi (2003) argue that higher aggregate employment and real wages, due to more competition and thus lower prices, will benefit the average worker. In addition, reduced union power may also facilitate future labor market reform. Fiori et al. (2007) provide empirical support for the model's key predictions. The theoretical and empirical results suggest that in the presence of both rigid product and labor markets, reforming the product market first may likely have a large payoff and could also facilitate subsequent labor market reform.[12] Lastly, while the average worker will benefit from deregulation, some worker groups may not. As Blanchard and Giavazzi (2003) point out, political economy considerations may call for combining reforms in ways that help compensate some losers from reform—these considerations are consistent with the experiences of successful labor market reformers (Annett, 2007) and they also inform the directions for Italian reform outlined in this annex.

Appropriate design, and sequencing, of reforms can mitigate fiscal constraints. Labor market reforms can be costly in the short run, while positive employment effects may only be felt in the medium term. Sequencing reforms appropriately by initiating product market

[11] Following the OECD, product market regulations are those that "reduce the intensity of competition in […] the product market" (Conway et al., 2005, p. 3). These regulations can, however, take many shapes; the OECD's database on product market regulations contains measures ranging from the *administrative burden on startups* to the *size of the public enterprise sector* to *regulatory and administrative opacity*.

[12] However, the debate on the optimal product-labor market sequencing is ongoing; For example, Berger and Danninger (2006) find that simultaneous deregulation may have the largest employment impact.

reforms first can provide substantial employment gains at little to no cost (Box 2).[13] But even within the set of possible labor market reforms, careful design can reduce the costliness of such measures.

Model-based simulations suggest that different reform combinations can have significantly diverging medium-term outcomes. For example, simulations by the author based on a labor market matching model (similar to that in Mortensen and Pissarides, 1994) suggest that while cuts in labor taxation unambiguously raise employment, they are generally not self-financing and can result in substantial medium-term fiscal costs unless combined with other measures, such as reduced wage demands. Translated to the case of Italy, where fiscal constraints are especially relevant, this means that while broad-based reductions in labor costs are important for improving labor market outcomes, such measures are likely to be costly from a fiscal perspective unless combined with a more flexible wage bargaining structure than is currently in place.

[13] Based on case studies for Denmark, the Netherlands, Ireland and the UK, Annett (2007) finds that employment gains associated with labor market reform were greater in the presence of liberalized product markets, consistent with the sequencing results summarized in Box 2.

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ANNEX III— ITALY'S BANK CRISIS-MANAGEMENT FRAMEWORK[1]

The system of crisis management and prevention rests on three pillars: the crisis procedures framework, the deposit insurance scheme, and the liquidity and lender of last resort facilities. All three functions are either executed or controlled by the BoI, eliminating coordination and information-sharing inefficiencies. The BoI's track record in terms of efficiency and speed of reaction to individual bank failures is good, with no loss of deposits and bank runs recorded at least since the inception of the deposit insurance scheme in 1987.

Bank Resolution Procedures

The legal framework (The Banking Law of 1993) for the liquidation or restructuring of single credit institutions is well-defined, with the BoI playing a key role in it. The law gives the BoI powers to activate a broad range of measures graduated according to the seriousness of the situation in a problem bank. The most recent Government Decree Law 155 of October 9, 2008, further amended the bank resolution framework to include the case of a "severe crisis" with potential systemic effects (including liquidity) as a trigger for the initiation of the special administration, even when serious losses or violations are not ascertained. Capital injections by the state would apply in this case as well, with the BoI in charge of deciding.[2]

All measures can be broadly divided into two groups: crisis-prevention and crisis-resolution. Preventive measures are not formally included in the prompt corrective-action framework, and the choice of the course of action is at sole discretion of the BoI.

- Preventive measures include letters (leaving it up to the bank to develop specific measures), circulars, regulatory actions (measures imposed by the BoI), and administrative sanctions (in the event of non-compliance).
- Resolution measures include placing the bank into special administration (BoI-led rehabilitation) or compulsory administrative liquidation (BoI-led bankruptcy procedure). Both measures apply to banking groups as well, with an umbrella principle—if the parent is in trouble, the parent may be placed under special administration and, if necessary to manage the crisis of the group, all distressed member companies may be placed under the same special regime.

The BoI has the powers to fine the bank managers. The grounds for intervention are extensive.

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[1] Prepared by Iryna Ivaschenko.

[2] The Decree Law 155 of October, entitled "Urgent measures to guarantee the stability of the credit system and the continued flow of credit to firms and consumers in the current state of crisis in world financial markets."

Crisis-prevention	
Regular inspections	
When necessary, the BoI convenes the bank's governing bodies to examine the situation and suggest measures. Then, the BoI sends a letter to the bank's governing body indicating the problem and proposed remedial measures (e.g., increase profitability).	The troubled bank is required to develop an action program with an implementation timetable.
The BoI can order a bank's board to be convened and propose adoption of actions. The BoI may impose more stringent regulatory requirements on a bank (as regards capital adequacy, risk limitation, eligible equity holding, internal organization, control mechanisms, etc.) Or	The bank must comply with the requirements within a certain time period.
If the bank violates supervisory rules, the BoI can impose pecuniary administrative sanctions on the board members or responsible employees. If there are violations of regulatory requirements or management irregularities, the BoI can prohibit a bank from engaging in new activities or order to close the branches.	
Crisis-resolution	
In more serious cases, crisis procedures can be initiated. The BoI can submit the proposal to the Ministry of Economy to place the bank under "***special administration***" (SA)—a procedure for bank rehabilitation. The BoI appoints special administrators and an oversight committee who replace the management and auditors, take over running the bank, and exercise all functions of administration and control. The aim is to evaluate the situation and find corrective measures. In an emergency, the BoI can arrange directly for special administrators to take over the provisional management for up to two months. If self-rehabilitation is not deemed possible there is market resolution (bank is taken over by other institutions). If violations are especially serious or the crisis is not reversible for exceptionally serious capital losses, there is ***compulsory administrative liquidation*** (CAL), a procedure equivalent to the bankruptcy of a commercial enterprise. If CAL is proposed, the BoI (Supervision Department) prepares the measures necessary to liquidate, including procedures to take the bank out of the national and international payment system, monetary system, and the payout of deposit insurance. The BoI coordinates with the deposit insurance schemes. After the Minister approves the proposal, the BoI appoints a special body to liquidate the bank. The payout of deposit insurance almost never occurred, as the way out is generally a transfer of assets and liabilities to another bank, preserving the continuity of business and the protection of all creditors. Neither SA or CAL prevents the BoI from imposing penalties on a bank's governing bodies. As of October 9 The scope for application of the **procedures for special administration and provisional management of banks** (Article 70 ff. of the Consolidated Law on Banking) is extended to cases of severe crisis, including liquidity crisis, that could jeopardize the stability of the financial system.	

Deposit Insurance Scheme

Depositors in all banks incorporated under the Italian law, with the exception of mutual banks, are protected by the Interbank Deposit Protection Fund (*Fondo Interbancario di Tutela dei Depositi*, or FITD).[3] The mutual banks are protected under a separate scheme, the Mutual Banks Depositor Protection Fund (MBDPF). There is no private co-insurance scheme.

The FIDT is generous compared to the other countries and has exceeded the EU-required minimum, recently raised to €50,000. The FITD provides €103,291 per depositor per bank, and deposits are protected irrespective of currency.

The BoI has full legislative powers in supervising and coordinating the activities of deposit protection funds. All interventions of the FIDT must be authorized by the BoI, and the choice of intervention is determined by the "least-cost" principle. The scheme can be used to pay off depositors, cover the shortfall between assets and liabilities in case of a transfer of a failing bank to a third party, or provide support interventions (i.e. guarantees), which can be initiated only if bank is placed under SA.

The FIDT is funded by bank contributions, ex-post, and risk-adjusted according to the size of the deposit base covered and risk profile of the bank portfolio.

The FIDT does not have supervisory powers. However, it monitors the financial ratios of its members and, in case of non-compliance (with FIDT's guidelines on risk profile and unpaid contributions), it can impose four types of sanctions: suspending voting rights, removing a bank's representative; imposing pecuniary sanctions; and excluding the member from the FIDT.

Since its creation, the FIDT was activated only six times, and has been under the strict surveillance by the BoI.

The Decree Law of October 9, 2008, empowered the Ministry of Economy and Finance to issue a state guarantee to back up the DI schemes.

[3] FIDT was established in 1987 as a voluntary consortium. In 1996, the FIDT was incorporated into the legal system by the Legislative Decree No. 659, implementing the EU Directive 94/19/EU and participation in FIDT was made mandatory. As of June 2007, the FIDT was covering about euro 395 bn of deposits in 297 institutions. The MBDPF protects depositors of about 460 mutual banks, and covers much smaller amount of deposits (euro 35 bn).

Liquidity and Lender of Last Resort (LOLR)

The system-wide liquidity is provide by the ECB via open market operations and standing facilities. Standing facilities allow a broad range of institutions discreet access against a broad range of collateral. However, in some cases, access to (uncollateralised) LOLR is needed.

LOLR facilities and decisions in EU rest with national authorities, hence the BoI. In case of insolvency, the government guarantees the BoI's liquidity support. In addition, as by the recent Decree 155 (October 9, 2008), in the event of severe liquidity crises, the government guarantees the loans granted by the BoI to Italian banks and the branches of foreign banks. The BoI had no specific LOLR line open as of November 2008.

In implementing the measures stated in Decree Law 157 (13 October, 2008), the BoI adopted measures to strengthen the liquidity support for Italian banks. For the matters falling within its competence, it contributes to the implementation of the Eurosystem's credit operations, which, following the changes introduced by the ECB on 8 October 2008, allow the demand for liquidity to be met for unlimited amounts at the fixed rate of 3.75 per cent. The BoI has decided to:

1. reduce from €1,000,000 to €500,000, with immediate effect, the minimum threshold for loans to be eligible for refinancing operations, without prejudice to the right to make further adjustments in accordance with the guidelines laid down by the ECB
2. activate a new facility for temporary swaps between government securities held by the BoI and assets held by Italian banks. The transactions will be renewable, have a maturity of one month and be remunerated with a fee of 1 per cent on an annual basis.

   Banks will be able to swap debt instruments in various currencies and with a rating lower than that of eligible collateral with the ECB. The operations started on October 16, will be carried out twice a week and the facility's total amount can reach €40 bn.

INTERNATIONAL MONETARY FUND

ITALY

Staff Report for the 2008 Article IV Consultation—Informational Annex

Prepared by Staff Representatives for the 2008 Consultation with Italy

Approved by Ajai Chopra and Martin Mühleisen

January 7, 2009

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ANNEX I. ITALY: FUND RELATIONS

(As of November 30, 2008)

Mission: Rome, November 6–19, 2008. The concluding statement of the mission is available at: http://www.imf.org/external/np/ms/2008/111908.htm.

Staff team: J. Daniel (Head), I. Ivaschenko, B. Lissovolik, D. Velculescu (all EUR), J. Tyson (FAD) and M. Schindler (RES). Mr. Sadun, Executive Director, also participated.

Country interlocutors: Senior officials from the Ministry of Economy and Finance, the Bank of Italy, the Ministry of Economic Development, the Ministry of European Affairs, the Ministry of Labor, Health and Social Affairs, the Ministry of Legislative Simplification; the Ministry for Public Administration and Innovation; Parliamentary Budget committees; major Italian banks; rating agencies; banking analysts; 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 Italian Banking Association (ABI); the Italian Association for Consumer Credit and Mortgages (ASSOFIN); representatives of labor unions; and research centers.

Fund relations: The previous consultation discussions took place during November 2−13, 2006. The associated Executive Board's assessment is available at: http://www.imf.org/external/np/sec/pn/2007/pn0720.htm and the staff report and other mission documents at: http://www.imf.org/external/pubs/ft/scr/2007/cr0764.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 3/27/47; Article VIII.

II. **General Resources Account**:	SDR Million	Percent Quota
Quota	7,055.50	100.00
Fund holdings of currency	6,130.61	86.89
Reserve position in Fund	924.90	13.11

III. **SDR Department**:	SDR Million	Percent Allocation
Net cumulative allocation	702.40	100.00
Holdings	163.26	23.24

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				
	2008	2009	2010	2011	2012
Principal					
Charges/Interest		5.80	5.66	5.66	5.66
Total		5.80	5.66	5.66	5.66

VII. **Exchange Rate Arrangement**: Italy entered the final stage of European Economic and Monetary Union on January 1, 1999, at a rate of 1,936.27 Italian lire per 1 euro.

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

VIII. **Article IV Consultations**: Italy is on the standard 12-month consultation cycle. The previous consultation discussions took place during November 2–13, 2006, and the staff report (Country Report No. 07/64, 02/15/07) was discussed on February 7, 2007.

IX. **ROSCs**:

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

ANNEX II. ITALY: STATISTICAL INFORMATION

Data provision is adequate for surveillance. Italy's economic database is comprehensive and of generally high quality. Italy has subscribed to the Special Data Dissemination Standard (SDDS) and has posted the metadata on the Dissemination Standards Bulletin Board (DSBB). Data are provided to the Fund in a comprehensive manner (see attached table). The authorities regularly publish a full range of economic and financial data, as well as a calendar of dates for the main statistical releases. Italy is also subject to the statistical requirements and timeliness and reporting standards of Eurostat and the European Central Bank (ECB), and has adopted the *European System of Accounts 1995* (*ESA95*). The shift to chain-weighted indices for national accounts has been largely completed over the course of 2006.

A *Report on the Observance of Standards and Codes (ROSC)—Data Module* (Country Report No. 02/234, 10/18/02) found Italy's macroeconomic statistics to be of generally high quality, but also identified some shortcomings that hindered an accurate and timely analysis of economic and financial developments: (i) no statistical agency had the responsibility to compile and disseminate 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 (discussed in detail in the 2004 Staff Report); (ii) source data and/or statistical techniques could be strengthened in several areas, most importantly, by raising response rates on the enterprise surveys used in the national accounts and producer price index, making price collection for the consumer price index more efficient, and improving the coverage of cross-border financial transactions; (iii) balance of payments and government finance statistics could be closer 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 EU and the Euro area.

Recent steps to improve economic data include: the introduction in 2005 of the regional price indices by Istat; the publication of quarterly data for the general government balance, expenditure, and revenue on an accruals basis along with a financial balance sheet (in line with *ESA95* and *GFSM 2001*) starting in October 2003; and more detailed labor survey, conducted by professional staff. Progress has also been made in reconciling the discrepancy between the cash-based net borrowing requirement and the accrual budget deficit, and working groups— consisting of representatives of the BoI, MEF (which also publishes cash-based data on the central government in *GFSM 2001* format), and Istat—meet regularly to look at different aspects of the reconciliation. While some differences still exist between the two measures, these are now accounted for more comprehensively and speedily (see the 2005 Fiscal ROSC Update Report for details).

Notwithstanding these improvements, weaknesses remain in some areas. In the national accounts, changes in inventories are derived as a residual and lumped together with the statistical discrepancy thus hampering the economic analysis. Furthermore, 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. Istat's resources remain insufficient and lower than European peers.

Italy: Table of Common Indicators Required for Surveillance

(As of December 16, 2008)

	Date of latest observation	Date received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of Publication[7]	Memo Items:	
						Data Quality – Methodo-logical soundness[8]	Data Quality – Accuracy and reliability[9]
Exchange Rates	Nov 2008	Dec 2008	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	Oct 2008	Dec 2008	M	M	M		
Reserve/Base Money	Nov 2007	Dec 2007	M	M	M	O,O,LO,LO	O,O,O,O,LO
Broad Money	Nov 2007	Dec 2007	M	M	M		
Central Bank Balance Sheet	Nov 2008	Dec 2008	Q	Q	Q		
Consolidated Balance Sheet of the Banking System	Nov 2008	Dec 2008	Q	Q	Q		
Interest Rates[2]	Nov 2008	Dec 2008	D	D	D		
Consumer Price Index	Oct 2008	Nov 2008	M	M	M	O,O,O,O	LO,O,LO,O, O
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	Q2 2008	Nov 2008	M	M	M	LO,O,LO,O	LO,O,O,O,L O
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	Aug 2008	Nov 2008	M	M	M		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Nov 2007	Dec 2007	M	M	M		
External Current Account Balance	Q4 2007	Jun 2008	M	M	M	O,LO,LO,O	LO,O,LO,O
Exports and Imports of Goods and Services	Q4 2007	Jun 2008	Q	Q	Q		
GDP/GNP	Q3 2008	Dec 2008	Q	Q	Q	O,O,O,O	LO,LO,O,O, O
Gross External Debt							
International Investment position[6]	2007	Dec 2008					

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5] Including currency and maturity composition.
[6] Includes external gross financial asset and liability positions vis a vis nonresidents.
[7] Daily (D); weekly (W); monthly (M); quarterly (Q); annually (A); irregular (I); and not available (NA).
[8] Reflects the assessment provided in the data ROSC or the Substantive Update 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).[9] 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

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Staff Report for the 2008 Article IV Consultation with Italy

Supplementary Information

Prepared by the European Department

Approved by Ajai Chopra and Tamim Bayoumi

February 2, 2009

This supplement provides information that has become available since the staff report was issued. The new information does not alter the thrust of the staff appraisal.

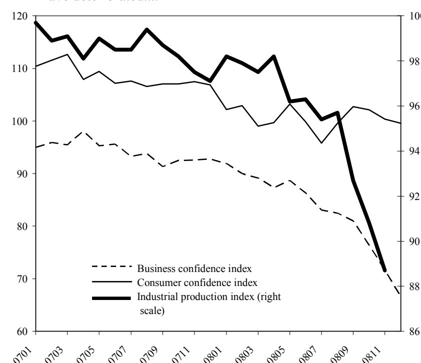
1. **Recent global and domestic indicators have deteriorated, prompting a significant downward revision to staff projections.** As global growth faded, Italy's exports slumped, business confidence fell to historical lows, industrial production and orders continued falling in November, and, despite lower inflation (2.2 percent year-on-year in December), consumer confidence weakened further. Coupled with recent downward revisions to partner country growth and world trade, staff now project GDP to decline by 2.1 percent in 2009 and by 0.1 percent in 2010 with the risks to this projection, mainly relating to the global outlook, remaining tilted to the downside. The forecast for 2009 is similar to that made by the Bank of Italy and the European Commission in mid-January (-2 percent), but staff envisage a more gradual recovery thereafter. Staff project inflation to fall to 1.2 percent in 2009, and remain under 2 percent in 2010, reflecting weaker international commodity prices and the significant output gap.

Italy: Revised Growth Outlook

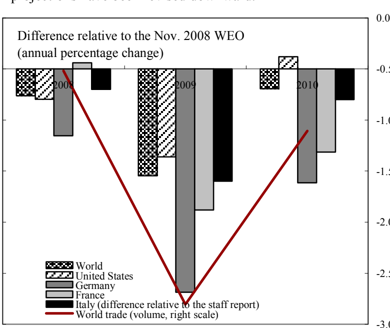
	GDP growth (in percent)		
	2008	2009	2010
IMF (January 26, 2009)	-0.6	-2.1	-0.1
Revisions from staff report	*-0.2*	*-1.1*	*-0.3*
Bank of Italy (January 14, 2009)	-0.6	-2.0	0.5
European Commission (January 19, 2009)	-0.6	-2.0	0.3

Sources: BoI, and IMF staff estimates

Recent indicators of confidence and industrial production have deteriorated....



....while advanced country growth and world trade projections have been revised downward.



Source: Haver, and IMF January 2009 WEO

2. **The fiscal position is set to weaken commensurately**. On the back of deteriorating cyclical conditions, revenues continued to flag in December, and staff now project the 2009 fiscal deficit to widen to 3.9 percent of GDP—including the effects of the recent anti-crisis package approved by Parliament at end-January, 2009—as automatic stabilizers operate. The public debt ratio is forecast to rise to 109.4 percent of GDP. Risks to the fiscal balance remain to the downside, reflecting not only the risks to growth, but also that revenue elasticities may shift adversely. In line with other high-debt Euro area sovereigns, 10-year spreads over German bunds remained elevated (around 140 basis points at end-January).

Estimates of Italy's anti-crisis package costs
(in percent of GDP)

	2009	2010
Expenditure increases (o/w)	0.24	0.12
Infrastructure investment	0.04	0.07
Safety nets	0.17	0.02
Mortgages	0.02	0.00
Revenue reductions (o/w)	0.12	0.08
PIT	0.03	0.01
Indirect tax reductions	0.01	0.00
CIT/depreciation	0.07	0.07
Total cost (gross)	0.36	0.20
contractionary measures 1/	0.15	0.11
Total cost (net) 1/	0.21	0.09

1/ Staff estimate.

3. **Financial market strains have persisted, and sovereign risk indicators remain elevated**. While CDS spreads for the largest banks edged down by some 20 to 40 basis points during the past month, equity valuations remained at historical lows. Italy’s voluntary bank recapitalization scheme for sound banks has been approved by the European Commission but has not yet been promulgated.

Table 1. Summary of Economic Indicators
(Annual percentage change, unless noted otherwise)

	2005	2006	2007	2008 1/	2009 1/	Latest reading (period percentage change, unless noted otherwise)	
Real GDP	0.6	1.8	1.5	-0.6	-2.1	-0.5	2008Q3
Public consumption	1.9	0.8	1.2	1.0	0.9	0.0	2008Q3
Private consumption	0.9	1.1	1.4	-0.4	-0.4	0.1	2008Q3
Gross fixed capital formation	0.7	2.5	1.2	-1.9	-7.8	-1.9	2008Q3
Final domestic demand	1.1	1.3	1.4	-0.4	-1.7	-0.5	
Stock building 2/	-0.2	0.5	-0.1	0.3	0.6	-0.1	
Net exports 2/	-0.3	0.0	0.1	0.3	-0.3	-0.3	2008Q3
Exports of G&S	1.0	6.2	5.0	-1.3	-3.2	-1.6	2008Q3
Imports of G&S	2.2	5.9	4.4	-2.4	-2.3	-0.5	2008Q3
Money and credit (end of period, percent change)							
Private sector credit 3/	7.7	11.0	9.8	7.3	...	5.9	Oct-08
National contribution to euro area M3 4/	6.3	7.7	7.6	10.8	...	7.8	Oct-08
Interest rates (in percent, end of period)							
6-month interbank rate 5/	2.6	3.8	4.9	4.3	...	4.3	Nov-08
Government bond rate, 10-year 5/	3.5	4.2	4.7	4.7	…	4.7	Dec-08
Resource utilization							
Potential GDP	1.2	1.3	1.1	0.6	0.5		
Output Gap (% of potential)	-0.8	-0.2	0.2	-0.9	-3.4		
Natural rate of unemployment	7.6	6.8	6.1	6.6	7.1		
Employment	0.7	1.8	1.0	0.3	0.1		
Unemployment rate (%)	7.7	6.8	6.1	6.8	7.3		
Prices							
GDP deflator	2.1	1.7	2.3	3.1	2.3	2.9	2008Q3
Consumer prices	2.2	2.2	2.0	3.5	1.2	4.1	2008Q3
Manufacturing							
Hourly compensation	4.6	2.9	2.5	5.5	1.7	3.7	2008Q3
Productivity	0.5	0.2	0.4	-0.9	-1.0	-0.8	2008Q3
Unit labor costs	4.1	2.7	2.1	6.4	2.7	7.5	2008Q3
Fiscal indicators 6/							
General government balance	-4.2	-3.4	-1.6	-2.7	-3.9		
Structural balance (in % of potential GDP)	-4.0	-3.3	-1.8	-2.2	-2.1		
Public debt ratio	105.8	106.9	104.1	105.6	109.4		
Exchange rate regime			Member of EMU				
Exchange rate (NC/US$)	1.2	1.3	1.4	1.5	1.5	1.3	Oct-08
Nominal effective rate: CPI based (2000=100)	107.3	107.8	109.9	...	...		
Real effective exchange rate based on							
CPI (2000=100)	112.1	111.8	113.2	...	...		
normalized ULC (2000=100)	132.0	134.0	138.7	145.0	143.7		
External sector 6/							
Current account balance	-1.7	-2.6	-2.5	-2.4	-2.0		
Trade balance	0.0	-0.7	0.1	0.1	0.4		
Saving investment balance 6/							
Gross national saving	19.1	18.9	19.0	19.1	18.6		
Public	-0.6	1.3	2.3	1.0	-0.2		
Private	19.7	17.6	16.7	18.2	18.8		
Gross domestic investment	20.8	21.5	21.5	21.5	20.6		
Gross fixed domestic investment	20.7	21.0	21.1	20.5	19.3		
Public	4.3	4.2	3.9	4.1	4.1		
Private	16.4	16.8	17.1	16.4	15.2		
Net lending	-1.7	-2.6	-2.5	-2.4	-2.0		

Sources: National Authorities; and IMF staff calculations.

1/ Staff estimates and projections, unless otherwise noted.

2/ Contribution to growth.

3/ Twelve-month credit growth, adjusted for securitizations. 2008 data refer to Sept.

4/ Excludes currency in circulation held by nonbank private sector. 2008 data refer to Sept.

5/ Data for 2008 refer to Nov. on 6-month interbank rate, and Dec on Government bond rate.

6/ Percent of GDP.

Table 2. Italy: General Government Accounts, 2002-2009
(Percent of GDP)

	2002	2003	2004	2005	2006	2007	2008		2009	
							Staff	Budget	Staff	Budget
Total revenues	44.5	45.1	44.5	44.2	45.9	47.2	47.0	47.3	47.2	48.7
Direct taxation	13.9	13.4	13.3	13.3	14.4	15.2	15.5	15.7	15.6	16.1
Indirect taxation	14.3	14.0	14.0	14.2	14.9	14.7	13.9	13.9	13.9	14.4
Social contributions 1/	12.5	12.6	12.6	12.8	12.8	13.3	13.7	13.7	13.8	14.2
Other current revenues	3.5	3.4	3.6	3.5	3.5	3.6	3.5	3.6	3.5	3.7
Capital revenues	0.4	1.7	0.9	0.4	0.3	0.3	0.4	0.4	0.3	0.3
Total expenditures	47.4	48.6	48.0	48.5	49.3	48.7	49.7	49.8	51.1	50.8
Current expenditures	43.8	44.2	44.0	44.5	44.3	44.6	45.7	45.8	47.1	46.8
Wages and salaries	10.6	10.8	10.8	11.0	11.0	10.7	11.1	11.1	11.4	11.3
Purchases of goods and services	7.8	7.9	8.1	8.3	8.0	7.9	8.1	8.1	8.3	8.1
Social transfers	16.5	16.8	16.9	17.0	17.0	17.3	17.7	17.7	18.4	18.2
Interest payments	5.5	5.1	4.7	4.6	4.6	5.0	5.1	5.2	5.2	5.3
Capital expenditures 2/	3.6	4.3	4.0	4.1	5.0	4.1	4.0	4.0	4.1	4.1
Of which: asset sales	-0.8	-0.2	-0.3	-0.2	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Overall balance	-2.9	-3.5	-3.5	-4.3	-3.4	-1.6	-2.7	-2.5	-3.9	-2.2
Primary balance	2.7	1.6	1.2	0.3	1.3	3.4	2.4	2.6	1.3	3.1
Memorandum items:										
Structural overall balance 3/	-3.2	-3.2	-3.4	-3.9	-3.3	-1.7	-2.2	-2.0	-2.1	-0.3
Net of all one-off measures	-4.7	-5.0	-4.7	-4.5	-2.9	-1.8	-2.4	-2.2	-2.1	-0.4
Structural primary balance 3/	2.3	1.9	1.3	0.7	1.4	3.3	2.9	3.0	3.2	4.9
Net of all one-off measures	0.8	0.2	0.0	0.1	1.8	3.2	2.7	2.8	3.1	4.9
Public debt 4/	105.7	104.4	103.8	105.9	106.9	104.1	105.6	103.7	109.4	102.9
One-off/temporary measures	1.2	1.7	1.3	0.6	-0.4	0.1	0.2	0.2	0.1	0.1

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

1/ Includes revenue from severance payments contributions (TFR), from 2007 onwards.

2/ In 2006 capital spending is increased reflecting the assumption of railways-related debt of 0.9 percent of GDP.

3/ Percent of potential GDP, assumes IMF staff's GDP and output gap.

4/ Budget numbers for public debt are calculated with the authorities' (not staff's) nominal GDP, at which all other numbers are calculated.

Table 3. Italy: Balance of Payments
(Percent of GDP)

	2005	2006	2007	2008	2009	2010	2011	2012	2013
Balance on current account	-1.7	-2.6	-2.5	-2.4	-2.0	-2.0	-2.0	-1.8	-1.7
Balance on goods and services	0.0	-0.8	-0.4	-0.4	0.1	0.1	0.1	0.3	0.4
Trade balance	0.0	-0.7	0.1	0.1	0.4	0.4	0.5	0.6	0.7
Exports of goods and services									
Exports of goods f.o.b.	21.0	22.5	23.9	25.1	22.9	23.0	23.4	24.0	24.5
Exports of services	5.0	5.3	5.3	5.7	5.2	5.2	5.3	5.4	5.5
Imports of goods and services									
Imports of goods f.o.b.	20.9	23.2	23.8	25.1	22.5	22.6	22.9	23.4	23.8
Imports of services	5.1	5.4	5.8	6.1	5.5	5.5	5.6	5.7	5.8
Net factor income	-1.0	-0.9	-1.3	-1.3	-1.3	-1.3	-1.3	-1.3	-1.3
Total current transfers, net (IMF)	-0.7	-0.9	-0.9	-0.7	-0.8	-0.8	-0.8	-0.8	-0.8
Balance on capital account	0.1	0.1	0.2	0.1	0.1	0.1	0.1	0.1	0.1
Balance on financial account	1.5	1.7	1.7	2.0	1.5	1.5	1.3	1.2	1.2
Direct investment, net	-1.2	-0.2	-2.4	-0.7	-0.9	-1.1	-1.1	-1.2	-1.0
Portfolio investment, net	3.0	3.0	1.2	1.3	1.5	1.4	1.1	0.7	1.2
Other investment, net	-0.6	-1.1	3.0	1.4	0.9	1.1	1.3	1.8	0.8
Reserve assets (IMF)	0.1	0.0	-0.1	0.0	0.0	0.0	0.0	0.1	0.1
Errors and ommisions	0.1	0.8	0.6	0.3	0.4	0.4	0.5	0.4	0.4
IIP (Billions of Euros)	-51.5	-670.8	-81.1						
Assets	1629.2	18230.1	1920.4						
Liabilities	1680.7	18900.9	2001.5						

Sources: IMF; WEO; and the authorities.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 09/16
FOR IMMEDIATE RELEASE
February 6, 2009

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

IMF Executive Board Concludes 2008 Article IV Consultation with Italy

On February 6, 2009, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Italy.[1]

Background

The economy has entered into recession, as the global financial crisis and ensuing slowdown intensified. Output is projected to contract by 0.6 percent in 2008 and 2.1 percent in 2009, with risks tilted to the downside. Inflation has moderated, in line with the euro area, and is expected to decline further in 2009 as the output gap increases. The current account deficit is projected to moderate to 2.4 percent of GDP in 2008 and 2 percent of GDP in 2009 and then gradually narrow over the medium term, as external demand and exports pick up. The economy's recovery, however, is likely to be slow and weak, reflecting underlying structural rigidities, lack of domestic competition, and the limited scope for a fiscal response.

The financial system has weathered the global turbulence, although vulnerabilities have increased. While banks came under pressure, the system as a whole remained solid, and no institution failed or fell short of regulatory requirements. The system's resilience reflects its relatively safer risk profile, which was supported by a firm regulatory and supervisory environment, strong intervention and resolution frameworks, and pre-existing high levels of depositor protection. However, vulnerabilities have risen, related to banks' capitalization, funding, credit quality, profitability, and exposure to Central and Eastern Europe (CEE).

[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.

The revenue-based fiscal consolidation has come to an end. The structural fiscal balance improved by 2¾ percent of GDP in 2006-07, mainly due to exceptionally strong revenues, with the overall deficit narrowing to 1.6 percent of GDP in 2007. But, reflecting the expansionary budget, weaker revenues, and some temporary factors, the deficit likely rebounded to 2¾ percent of GDP in 2008, entailing a loosening in structural terms and a higher expenditure ratio, with the primary current spending ratio reaching a record high. The fiscal deficit is likely to widen to around 3.9 percent of GDP in 2009, due to the deteriorating macroeconomic environment. Debt will start rising again, reaching 109 percent of GDP in 2009.

Executive Board Assessment

The Executive Directors noted that, in line with the rest of the euro area, Italy is being severely affected by the worsening economic environment, although its financial sector has remained relatively resilient. The economic recession is deepening, and, while a gradual recovery is expected in 2010, the possibility of a prolonged downturn cannot be ruled out. Against this backdrop, Directors welcomed the authorities' focus on prudent and comprehensive measures to strengthen financial stability and on temporary and targeted fiscal measures, while remaining committed to fiscal sustainability. They underscored the need to implement these measures promptly. At the same time, the authorities should step up implementation of their long-run structural reform agenda to enhance the economy's growth potential.

Directors supported the authorities' actions to strengthen financial system stability and reduce vulnerabilities through intensified monitoring and prudential oversight. They looked forward to the implementation of the recently announced voluntary government recapitalization scheme, while stressing the need for minimizing potential negative spillovers for other countries. Directors commended Italy's advocacy of enhanced international regulatory and supervisory coordination.

Directors supported the government's anti-crisis fiscal package. The package takes into account the limited room for fiscal stimulus, and focuses on temporary, targeted, and timely measures, as well as on accelerating public investment projects. Directors in general saw little scope for further stimulus, but a few noted that a somewhat larger stimulus could be considered if the growth outlook deteriorates further. Although a delay in structural consolidation is warranted for 2009, it will nevertheless be important to carry out the envisaged reductions in current spending to underpin fiscal sustainability. In this vein, Directors welcomed that the authorities remain committed to attaining fiscal balance in the medium term.

Directors welcomed the progress made in improving Italy's fiscal frameworks. The 2009 budget process has been streamlined and its medium-term orientation strengthened. Efforts are under way to increase the productivity of public administration and improve the management of public assets. Implementation of the fiscal federalism reform will increase fiscal autonomy and discipline at all levels of government. Directors encouraged the authorities to build on these efforts, by filling the remaining gaps, and following through on plans to tackle longer-term fiscal challenges, in particular reforming the welfare system.

Directors underscored the importance of reducing regulation, increasing competition, and improving the business environment to raise Italy's productivity and growth potential. They welcomed recent measures to enhance competition in local public services, simplify legislation, and institute competition assessments and regulatory impact analyses. Directors called on the authorities to further liberalize retail trade and services, continue deregulation in the energy market, and strengthen the role of competition bodies. A comprehensive package could help reinvigorate the reform effort by reaping synergies and raising popular support.

Directors noted the strides made in the past decade to boost employment. They encouraged a second generation of labor market reforms to strengthen the link between wages and productivity, allow wages to better respond to regional differences, and make permanent contracts more flexible, in tandem with efforts to enhance the social safety net. Directors pointed to the benefits that would accrue from concerted efforts to attain the EU Lisbon Agenda objectives, and urged the authorities to resist protectionist pressures.

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 2008 Article IV Consultation with Italy is also available.

Summary of Economic Indicators

(Annual percentage change, unless noted otherwise)

	2005	2006	2007	2008 1/	2009 1/	Latest reading (period percentage change, unless noted otherwise)	
Real GDP	0.6	1.8	1.5	-0.6	-2.1	-0.5	2008Q3
Public consumption	1.9	0.8	1.2	1.0	0.9	0.0	2008Q3
Private consumption	0.9	1.1	1.4	-0.4	-0.4	0.1	2008Q3
Gross fixed capital formation	0.7	2.5	1.2	-1.9	-7.8	-1.9	2008Q3
Final domestic demand	1.1	1.3	1.4	-0.4	-1.7	-0.5	
Stock building 2/	-0.2	0.5	-0.1	0.3	0.6	-0.1	
Net exports 2/	-0.3	0.0	0.1	0.3	-0.3	-0.3	2008Q3
Exports of G&S	1.0	6.2	5.0	-1.3	-3.2	-1.6	2008Q3
Imports of G&S	2.2	5.9	4.4	-2.4	-2.3	-0.5	2008Q3
Money and credit (end of period, percent change)							
Private sector credit 3/	7.7	11.0	9.8	7.3	...	5.9	Oct-08
National contribution to euro area M3 4/	6.3	7.7	7.6	10.8	...	7.8	Oct-08
Interest rates (in percent, end of period)							
6-month interbank rate 5/	2.6	3.8	4.9	4.3	...	4.3	Nov-08
Government bond rate, 10-year 5/	3.5	4.2	4.7	4.7	…	4.7	Dec-08
Resource utilization							
Potential GDP	1.2	1.3	1.1	0.6	0.5		
Output Gap (% of potential)	-0.8	-0.2	0.2	-0.9	-3.4		
Natural rate of unemployment	7.6	6.8	6.1	6.6	7.1		
Employment	0.7	1.8	1.0	0.3	0.1		
Unemployment rate (%)	7.7	6.8	6.1	6.8	7.3		
Prices							
GDP deflator	2.1	1.7	2.3	3.1	2.3	2.9	2008Q3
Consumer prices	2.2	2.2	2.0	3.5	1.2	4.1	2008Q3
Manufacturing							
Hourly compensation	4.6	2.9	2.5	5.5	1.7	3.7	2008Q3
Productivity	0.5	0.2	0.4	-0.9	-1.0	-0.8	2008Q3
Unit labor costs	4.1	2.7	2.1	6.4	2.7	7.5	2008Q3
Fiscal indicators 6/							
General government balance	-4.2	-3.4	-1.6	-2.7	-3.9		
Structural balance (in % of potential GDP)	-4.0	-3.3	-1.8	-2.2	-2.1		
Public debt ratio	105.8	106.9	104.1	105.6	109.4		
Exchange rate regime							
Exchange rate (NC/US$)	1.2	1.3	1.4	1.5	1.5	1.3	Oct-08
Nominal effective rate: CPI based (2000=100)	107.3	107.8	109.9	...	...		
Real effective exchange rate based on							
CPI (2000=100)	112.1	111.8	113.2	...	...		
normalized ULC (2000=100)	132.0	134.0	138.7	145.0	143.7		
External sector 6/							
Current account balance	-1.7	-2.6	-2.5	-2.4	-2.0		
Trade balance	0.0	-0.7	0.1	0.1	0.4		
Saving investment balance 6/							
Gross national saving	19.1	18.9	19.0	19.1	18.6		
Public	-0.6	1.3	2.3	1.0	-0.2		
Private	19.7	17.6	16.7	18.2	18.8		
Gross domestic investment	20.8	21.5	21.5	21.5	20.6		
Gross fixed domestic investment	20.7	21.0	21.1	20.5	19.3		
Public	4.3	4.2	3.9	4.1	4.1		
Private	16.4	16.8	17.1	16.4	15.2		
Net lending	-1.7	-2.6	-2.5	-2.4	-2.0		

Sources: National Authorities; and IMF staff calculations.
1/ Staff estimates and projections, unless otherwise noted.
2/ Contribution to growth.
3/ Twelve-month credit growth, adjusted for securitizations. 2008 data refer to Sept.
4/ Excludes currency in circulation held by nonbank private sector. 2008 data refer to Sept.
5/ Data for 2008 refer to Nov. on 6-month interbank rate, and Dec on Government bond rate.
6/ Percent of GDP.

Statement by Arrigo Sadun, Executive Director for Italy
February 6, 2009

We wish to thank staff for its open, constructive, and comprehensive dialogue established with the authorities. Staff's effort in grasping the complexities of the Italian economy deserves praise; all the more so, as it is not always easy to distinguish between structural issues and the impact of the current global crisis. The results of this effort are well reflected in the report, which provides an updated, in-depth analysis of the Italian economy.

Overview

The worst global recession of the last seventy years is taking its toll on the Italian economy; however, as it has remained largely immune from the housing boom and excessive financial leveraging that had propelled unsustainable growth rates in other counties in the previous years, Italy now has been able to avoid the most severe effects of the financial crisis. Furthermore, the impact of the financial market turmoil has been mitigated by prudent banking practices and the relatively low level of indebtedness of households and firms. The corporate sector is dominated by a very large number of small and medium-sized firms that rely more on self-financing rather than on capital markets, while the traditional bank-client relationship mitigates the effects of credit rationing.

The authorities have already locked-in to a relatively tight budget for 2009 last summer, ahead of the economic downturn, and anchored it to a three-year fiscal framework (2009-2011) aimed at reaching a balanced-budget by 2011. Although the deepening of the recession has led to the adoption of several measures to soften the blow, these have been designed to limit their impact on the budget. These efforts have had a positive impact on the markets as the spread between the yields on Italian and German 10-year government bonds, although still elevated, have declined from their recent peaks.

In addition to the difficulties caused by the global recession, the Italian economy faces a number of long-term challenges. Accordingly, the authorities are committed to reducing the high level of public debt as well as to implementing further structural reforms that will raise productivity and growth potential.

Economic Outlook

Following a 0.6 percent decline in 2008, the staff projects a further 2.1 percent contraction in Italy's GDP in 2009. This projection is roughly in line with those by the Bank of Italy and the European Commission. The government will shortly issue its revised forecasts, taking into consideration the most recent developments, including a greater-than-expected decline in private consumption and investment. Staff projects a small negative growth in 2010. This scenario is in contrast with the assumption of a generalized upturn of the global economy and with the most recent forecasts for the Italian economy issued by the European Commission and Bank of Italy, both of which project a recovery in 2010. The authorities believe that a number of factors will limit the duration of the recession: real disposable income will be sustained by low inflation (particularly lower energy prices); corporate and household balance sheets appear relatively solid. Finally, consumption should be less affected than in

other countries by the negative wealth effect stemming from the downturn in the housing market, but also because its lower reliance on credit.

After several years of robust job creation, employment growth declined in 2008 although it remained positive. Unemployment is anticipated to increase in 2009, but will remain well below the European average. The 2008 surge in inflation, triggered by higher energy and other commodities spikes, is receding fast and is expected to continue to do so in 2009. The current account deficit is expected to decline, thanks to a surplus in the trade balance; this, in turn, reflects the improvement in the terms of trade.

Although the authorities fully expect a very difficult environment throughout 2009, they believe that the avoidance of excessive imbalances in the previous cycle makes the Italian economy relatively less exposed to downside risks, and this will facilitate the recovery when the global economy turns the corner.

Fiscal Policy

Last June the European Council abrogated the excessive deficit procedure against Italy, as the deficit ratio had declined to 1.6 percent in 2007, the best performance since 2000 and well below the 3 percent threshold of the Maastricht Treaty. The improvement reflected strong revenue increases as well as firmer control of expenditure growth. Staff estimates that the deficit reached 2.7 percent in 2008, due to weaker revenue and a more expansionary budget. In order to strengthen the fiscal stance, the Italian authorities have adopted a number of significant changes in the budgetary process, including a 3-year budgetary-framework that is aimed at reaching a balanced budget by 2011. The fiscal strategy is based on the containment of public expenditures across the board and at all levels of government. An adequate level of resources for social services will be guaranteed by increasing the efficiency of other public sector activities. A comprehensive reform of the public administration has been launched in the framework of the 2009 budget. A crucial element of this reform is to link wage increases and productivity.

The high level of public debt severely limits the authorities' scope for fiscal stimulus. Thus, the measures recently adopted have been targeted to address specific issues, such as supporting low-income households, and are largely based on the mobilization of funds already included in investment plans. Accordingly, the authorities do not expect any significant impact on the budget. The measures entail high multiplicator effects and are designed to be temporary. Therefore, the overall deterioration of fiscal balances in 2009 can be considered almost entirely cyclical, as it depends on GDP dynamics and automatic stabilizers.

The momentum to improve the fiscal framework has not slackened. The spending review pilot project, initiated with the Fund's technical support, has been completed and a report covering five key areas of the public sector (justice, infrastructure, transports, internal affairs, and education) has been issued. The budget office, in cooperation with line ministers, is now responsible for selecting priority programs, reviewing their underlying legislation and identifying opportunities for reducing spending and improving efficiency.

Fiscal discipline of local governments has increased markedly in recent years. The Domestic Stability Pact has helped bring local public finances under control. In the past, the health care system, managed at the regional level, has been a traditional source of overspending. However, with the introduction of the so-called "health-care pact" in 2006, which provides

stringent budgetary limits, expenditure trends have improved noticeably. The fiscal federalism reform, already approved by the Senate, will provide a more coherent framework to establish areas of responsibilities and allocation of resources at all levels of government. The authorities consider an expedited implementation of the reform a top priority.

The Banking System

The Italian banking system has so far suffered less than others from the impact of the crisis. As noted by staff, the system remains solid; no institution has failed since the outbreak of the crisis, nor has fallen short of regulatory requirements. The resilience of the banking system reflects a business model based on prudent lending, as well as on retail funding rather than on wholesale capital markets.

Its resilience also stems from a solid regulatory and supervisory environment and strong intervention and resolution frameworks. Box 1 in the staff report mentions a number of factors that have prevented Italian banks from pursuing more risky strategies, such as the extensive bank-branch network and, more generally, the banks' funding policies. While in line with EU norms and the Basel Accord, regulatory provisions, including those on derivatives, securitizations, liquidity monitoring, limits on the use of hybrid capital, and exposures to SPVs, have long been particularly stringent.

The Italian authorities' response to the financial crisis has been prudent and systematic since its outbreak. Following the intensification of global financial instability, in October 2008 the authorities adopted measures to preserve the stability of the financial system, protect savers, and maintain adequate levels of bank liquidity and capitalization. These actions have recently been supplemented by additional measures designed to strengthen the system's overall ability to finance economic activity.

The Ministry of Economy and Finance has been authorized to participate in the recapitalization of banks whose capital levels have been deemed insufficient by the Bank of Italy. Moreover, to support bank lending, the Ministry can subscribe financial instruments issued by sound listed Italian banks that qualify as regulatory capital support. Furthermore, in the event of a severe liquidity crisis, the Italian Treasury is authorized to guarantee the emergency loans granted by the Bank of Italy to Italian banks and to the branches of foreign banks operating in Italy.

Further measures to sustain bank liquidity and foster funding have been adopted in a coordinated effort with the other euro-area countries. For example, the Ministry of Economy and Finance can issue state guarantees for Italian banks' new liabilities with maturity between three months and five years. Additional measures adopted by the Bank of Italy include the activation of a new facility that allows banks to temporary exchange their assets for government securities held by the Bank of Italy itself.

The crisis resolution framework has been further strengthened through the extension of the procedures for special administration and provisional management of banks to cases of "severe crises", including liquidity crises, which could jeopardize the stability of the financial system.

Structural Reforms

Low productivity growth coupled with steady increases in unit labor costs are at the basis of Italy's competitive gap and slow growth potential. Despite the disappointing performance of the Italian economy in the past few years, there are growing signs that a widespread restructuring of the Italian industry is underway. Even in traditional sectors such as textiles and leather goods, Italian firms have managed to move toward higher value-added goods, and have improved the quality of their exports. This is confirmed by the fact that although Italy's world market shares have declined if measured at constant-price, they have remained relatively stable at current prices. These findings are also in line with the latest data on the Trade Performance Index, developed by the International Trade Centre of UNCTAD/WTO, which ranks Italy very high in terms of competitiveness in several sectors of world trade.

The authorities are committed to continue pursuing the reform agenda to boost Italy's growth potential. The National Reform Programmme, submitted to the EU Commission last November in the framework of the Lisbon's Agenda, envisages specific measures to be implemented before 2010 concerning the liberalization of products and services markets. Building on the recently approved measures for the electricity sector and local public services, the authorities seek to promote greater competition in other sectors. The modernization of the public administration, programmed as part of the 2009 budget, will boost the efficiency of the public sector. Finally, investment in infrastructures and research and development will be accelerated.

A series of reforms launched in the past several years have increased labor market mobility and led to substantial job creation. Although the unemployment rate remains well below the European average, the recession is putting stress on the labor market. Accordingly, the social safety net has been strengthened with additional funding for the unemployment protection scheme ("*cassa integrazione*"). Moreover, the social partners have started to implement some changes in the collective bargaining process, increasing wage flexibility and strengthening the linkage to productivity growth. Specifically, basic wage rates will be negotiated at the national level taking into consideration the expected rate of inflation (excluding energy prices). Wage increases tied to productivity gains will be determined through decentralized negotiations.