July 2011
IMF Country Report No. 11/173

Italy—Staff Report for the 2011 Article IV Consultation; Informational Annex; Public Information Notice; Statement by the Staff Representative; and Statement by the Executive Director for Italy.

The following documents have been released and are included in this package:

- The staff report, prepared by a staff team of the IMF, following discussions that ended on May 11, 2011 with the officials of the Italy on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on June 20, 2011. 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 Supplement to the Staff Report—Informational Annex
- A Public Information Notice
- A statement by the Staff Representative on Italy
- A statement by the Executive Director for Italy

The document(s) listed below will be separately released.

Selected Issues Paper

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

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INTERNATIONAL MONETARY FUND

ITALY

Staff Report for the 2011 Article IV Consultation

Prepared by the Staff Representatives for the 2011 Article IV Consultation with Italy
(In consultation with other departments)

Approved by Juha Kähkönen and Tamim Bayoumi

June 20, 2011

Executive Summary

Background: A modest export-driven recovery is underway. Growth is expected to remain constrained by long-term structural bottlenecks. Public debt grew to 119 percent of GDP by end-2010. Fiscal consolidation is proceeding. The authorities aim at reducing the fiscal deficit to close to zero in 2014. The recently announced recapitalizations strengthened banks. Bank and sovereign spreads have increased on the wake of euro area debt crisis. Structural reforms have stalled with the exception of fiscal federalism and pension reform.

Challenges: Fiscal consolidation relies on across-the-board cuts which are difficult to sustain and do not address the roots of public expenditure inefficiency. Measures to achieve consolidation in 2013–14 (about €20 billion per year or 2.3 percent of GDP cumulatively) remain to be specified. Enterprises are highly indebted. Potential growth is constrained by structural factors, including regional disparities, a heavy and distortive tax burden, public sector inefficiencies, high business and service regulations, labor market duality, and low education attainment.

Staff's views: Fiscal consolidation is a prerequisite for sustainable growth. It should be achieved by rationalizing public expenditure and reducing tax evasion. But only sustained growth will reduce the burden of public debt. Increasing potential growth should be the main policy goal. Comprehensive structural reforms in the areas of labor and product markets and public administration should be promptly implemented.

Authorities' views: The authorities agree on the need of an expenditure-based fiscal consolidation and of reviving growth. However, they consider that North-South require different approaches regarding structural reforms. They consider tax reform, fiscal federalism, and reducing the bureaucratic burden key for growth.

Mission team: A. Spilimbergo (head), L. Lusinyan, H. Morsy, E. Zoli (all EUR), L. Eyraud (FAD). A. Borges (EUR) joined the mission for the concluding meetings.

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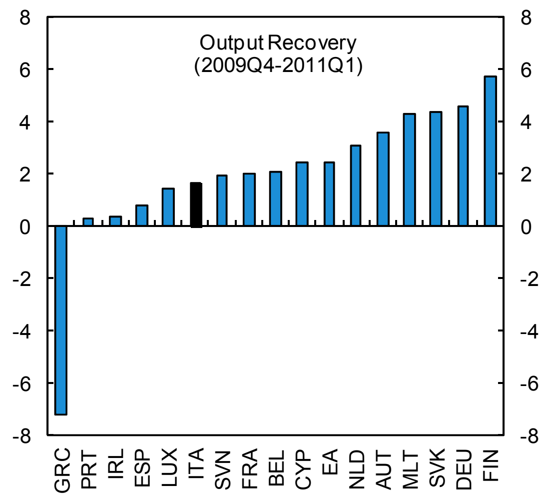
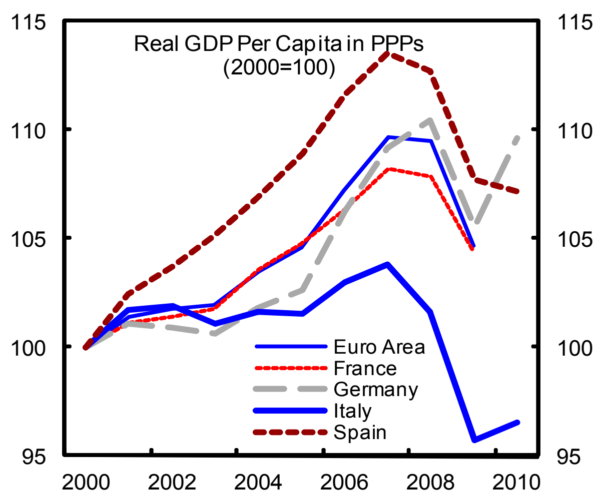
I. Context: Existing Weaknesses Constrain The Recovery

A. The Global Crisis Left a Difficult Legacy

1. **Italy suffered one of the largest output contractions in the euro area during the global financial crisis and is experiencing one of the slowest recoveries**. The downturn started earlier and lasted longer than in most of the euro area (EA) countries. It was exacerbated by the economy's long-standing structural problems and reliance on international trade. Per capita GDP and productivity in 2010 were lower than in 2000, with Italy experiencing the largest per capita GDP contraction among OECD member countries over a decade. The level of output in 2015 is projected to be around 10 percent lower than the pre-crisis historical trend (1990–2004).



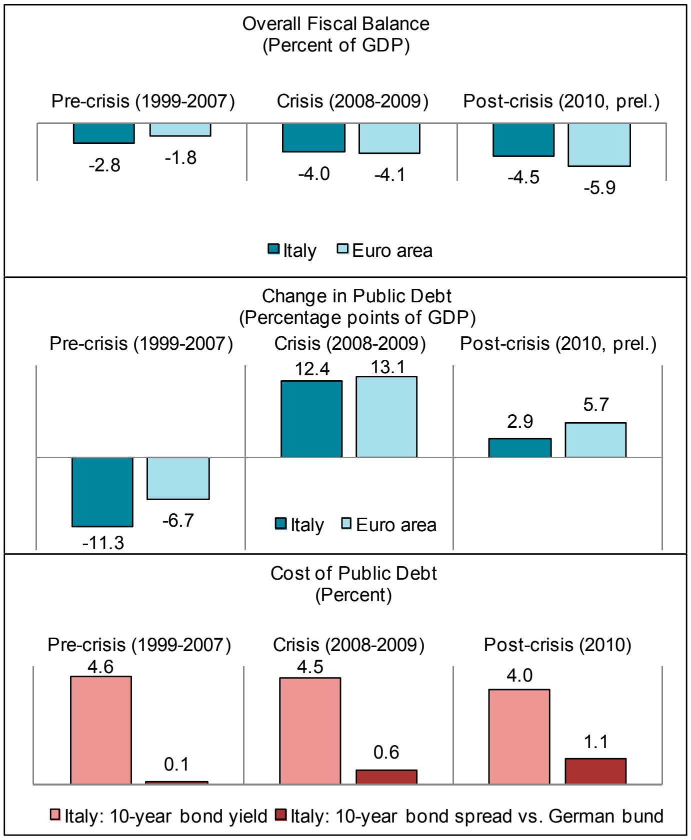
Sources: WEO; and IMF staff calculations.



Sources: OECD; WEO; Haver; and IMF staff calculations.

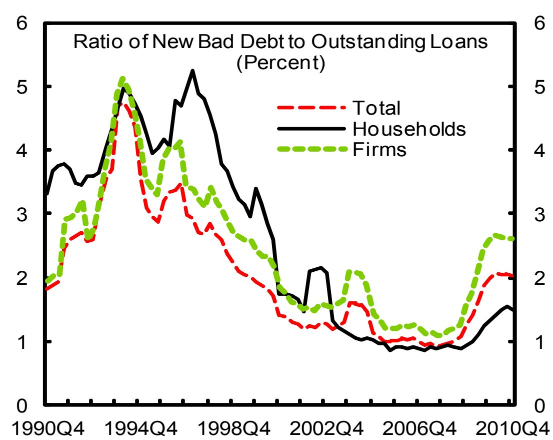
2. **Despite the modest discretionary fiscal stimulus, public finances weakened.** Constrained by the lack of fiscal space, the stimulus packages were modest. Still, the deterioration in public finances during the crisis was comparable to that of the EA average. At end-2010, Italy's public debt stood at 119 percent of GDP. The 10-year bond yield spread vis-à-vis Germany, increased substantially over 2008–2010, reaching levels last seen in 1997, reflecting concerns over public sector financing needs—over €400 billion or about one-quarter of Italy's GDP on average in 2009–2011.

The State of Public Finances Before, During, and After the Global Crisis



Sources: WEO; Bloomberg; and IMF staff estimates.

3. **During the global financial crisis, Italy's banks proved resilient, but asset quality and profitability weakened.** While banks did not suffer large losses, thanks to a traditional business model and a sound supervisory framework, overall bad debt almost doubled in 2009–2010. Credit quality, though, worsened less than during the severe 1992–1993 recession, thanks to lower interest rates and advances in banks' credit risk management.

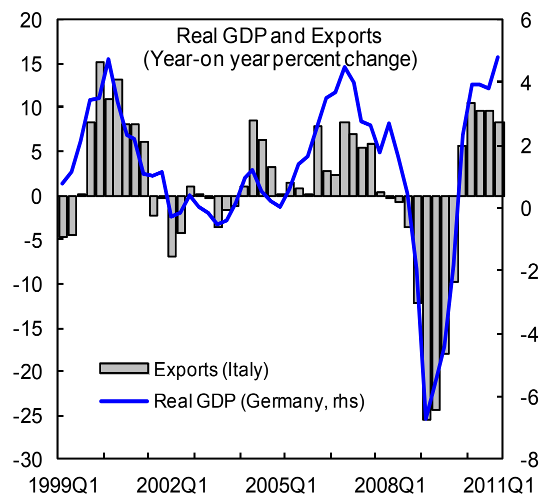


Source: Bank of Italy
1/ Data are seasonally adjusted and annualized.

B. Weak Recovery and New Challenges

Real economy: export-led recovery

4. **A modest export-led recovery is under way.** The economy grew by 1.3 percent year-on-year in 2010, less than the EA average of 1.7 percent, and by 0.1 percent quarter-on-quarter in Q1 2011, compared to an EA average of 0.8. External demand, supported by the depreciation of the euro and the economic rebound in Germany, drove the recovery. Domestic demand was weak. Household spending remained cautious on the back of rising unemployment, declining real disposable income, and lingering uncertainty on growth prospect. The phasing out of the car scrappage scheme in the beginning of 2010 has considerably slowed car purchases. Investment rebounded significantly in the first half of 2010 but weakened following the termination of the tax incentives for investment in June. Government consumption was flat. Labor productivity increased following a sharp decline during the crisis, with the highest gains recorded in manufacturing and services sectors. The current account deficit worsened despite robust export growth, owing to rising energy prices and high import growth.

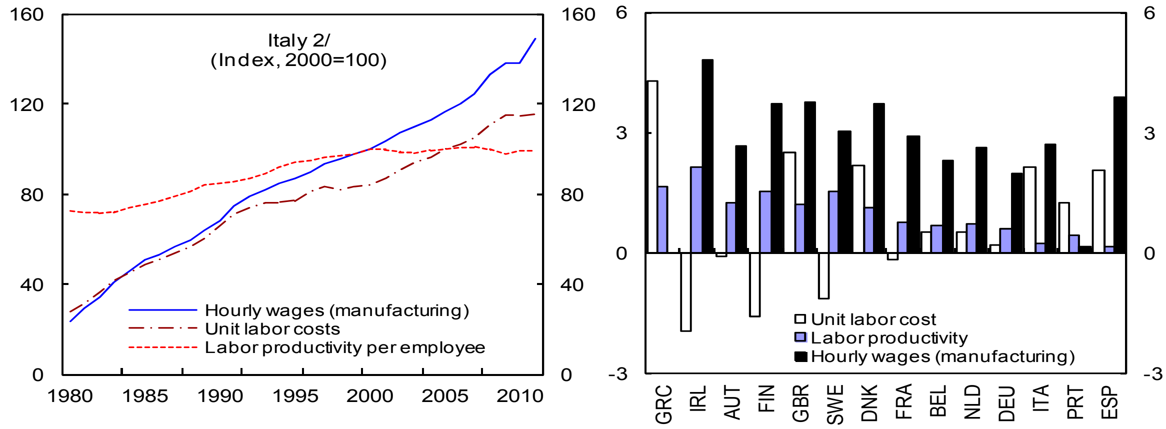


Sources: Haver; and IMF staff calculations.

5. **The labor market remains weak.** Average employment declined by 0.6 percent year-on-year in 2010 as companies continued to shed hoarded labor. Employment contracted most sharply in the South (-1.4 percent), and in manufacturing (-4.0 percent). Firms used more flexible arrangements such as part-time and temporary contracts. In fact, the employment contraction was limited to full-time permanent employees, while the numbers of self-employed, part-time, and fixed-term employees rose. Unemployment rose to 8.6 percent in Q4 2010 from 8.3 percent in the same period in 2009. However, the unemployment rate remains below the EA average, thanks in part to the state-funded wage supplementation program (*Cassa Integrazione Guadagni*, or CIG).[1] The number of hours of wage supplementation fund benefits increased by 32 percent in 2010, declining in Q4 2010. The youth unemployment rate remains at 28 percent. Long-term unemployment, defined as those unemployed for a period of 12 months or more, constitutes almost half of total unemployment.

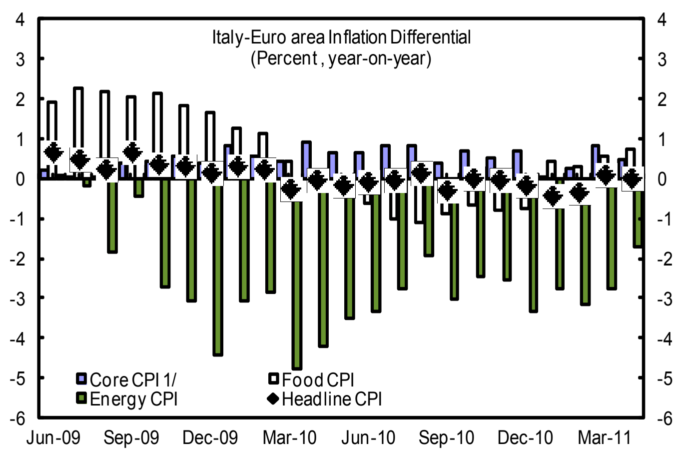
[1] The program makes up the pay of permanent employees affected by temporary lay-offs (who are not considered unemployed), or under a forced reduction of working hours, for a maximum of two years. Italy does not have a general unemployment benefit scheme.

Earnings, Productivity and Competitiveness 1/



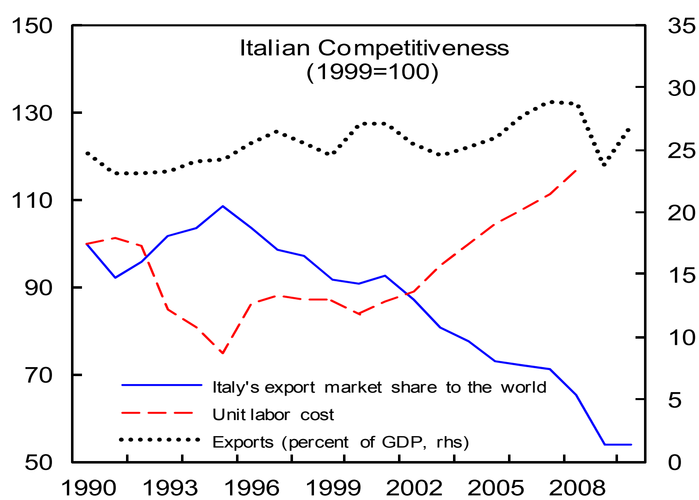
Sources: Istituto Nazionale di Statistica; and European Central Bank.
1/ Cross-country data are average annual growth rates during 1998-2010. Unit labor cost average for France and Portugal is 1998-2008 and for Denmark, Ireland, and Spain 1998-2009. Hourly wages average for Austria is 1998-2007 and for the UK 1998-2009.
2/ Latest observation is as of 2011q1.

6. **Inflation increased moderately due to rising energy and commodity prices.** Consumer price inflation rose to 1.6 percent in 2010 from 0.8 percent in 2009. The Italy-euro area positive inflation gap closed, mainly on the back of non-core components, while the inflation differential on core prices remained relatively stable. Unit labor costs in manufacturing fell by 2.8 percent in 2010 in light of moderating hourly compensation.



Source: Eurostat.
1/ Total CPI excluding energy, food, alcohol, and tobacco.

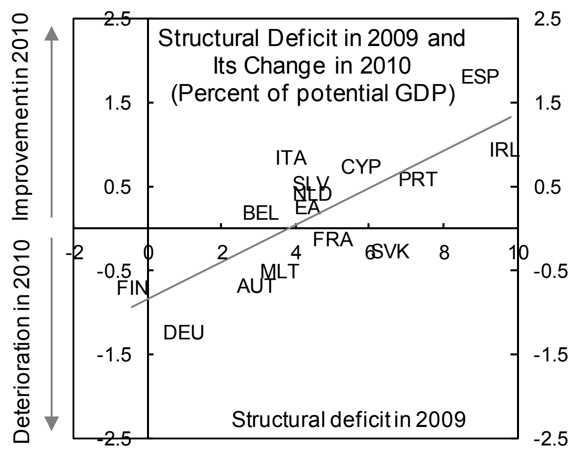
7. **The competitiveness gap remains significant.** Wages have increased more than productivity, resulting in a loss of competitiveness. All price competitiveness measures show significant deterioration. Italian export volume shares in world markets have been consistently declining. Applications of the CGER methodologies indicate a competitiveness gap of 7 to 10 percent.



Sources: WEO; and IMF staff estimates.

Fiscal targets achieved so far

8. **The authorities comfortably achieved the 2010 fiscal target.** The overall fiscal balance declined from 5.3 percent of GDP in 2009 to 4.5 percent of GDP in 2010 (Figure 4), well below the target of 5.0 percent of GDP. The improvement reflected both good revenue performance and contained budget outlays. The increase in indirect taxes partly offset the decline in capital revenues. More stringent VAT refund rules introduced in 2010 reduced refunds by over €5.5billion (0.4 percent of GDP). The phasing out of the 2009 anti-crisis measures and cuts in capital spending and the wage bill contained outlays. Real primary current expenditure grew at the lowest rate since mid-1990s. However, payment delays increased. The positive budgetary trends continued in the first months of 2011.

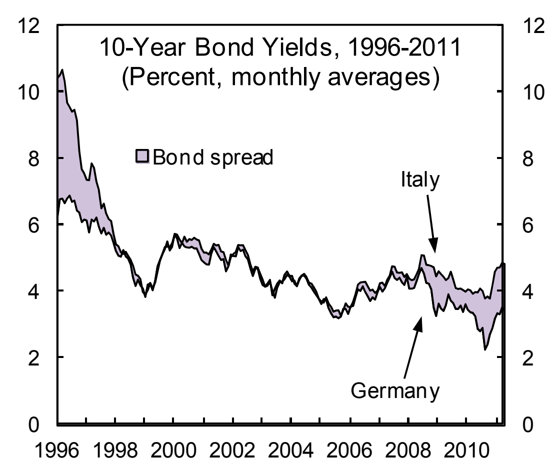


Sources: WEO, and IMF staff estimates.

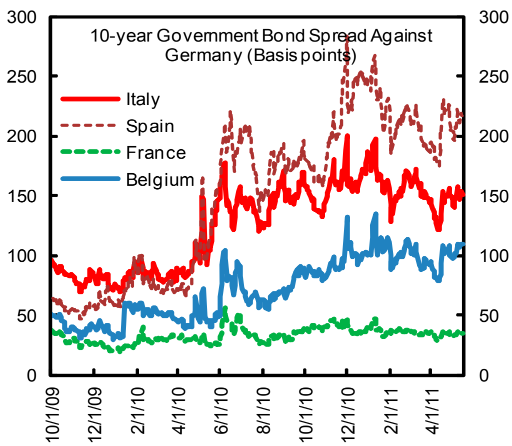
9. **The structural balance improved by about 1 percentage point of GDP in 2010, among the largest improvements in the EA.** The fiscal consolidation is closer to the EA average if the one-off measures, which reduced the deficit in 2009, are included.

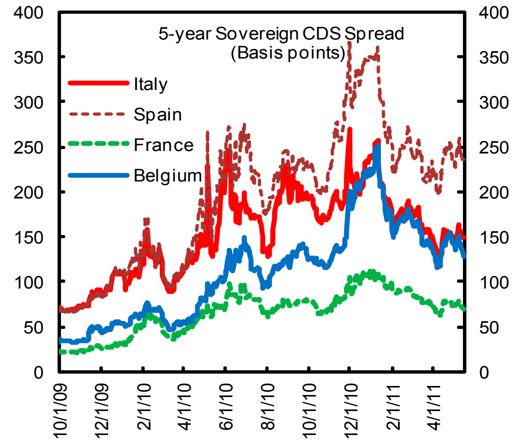
No immunity from spillovers from the European sovereign debt crisis

10. **Italy's sovereign spreads widened considerably after the Greek and especially the Irish crisis, reaching pre-euro levels.** In Spring 2010, as the Greek crisis was unfolding, Italian sovereign spreads increased abruptly mostly because German yields declined. In contrast, the Irish crisis led to a significant increase in both Italy's government bond spreads and yields. Overall, 10-year sovereign bond yields rose from around 370 basis points (bps) in mid-October 2010 to 460 bps in mid-May 2011. After peaking at almost 200 bps in late November 2010 and early January this year, government bonds spreads in mid-May were at 150 bps, still well above pre-Greek crisis levels.



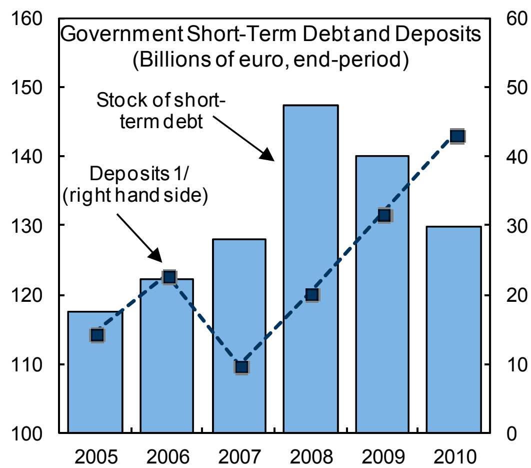
Source: Bloomberg.





Source: Bloomberg.

11. **Italy remains vulnerable to market turbulence.** The high public debt-to-GDP ratio, large gross financing requirements, and dismal growth performance are Italy's main vulnerabilities. However, sound household balance sheets, the absence of housing bubbles, traditionally high private savings, low current account deficits and relatively favorable net foreign asset position are Italy's main points of strength.



Source: Bank of Italy.
1/ Government deposits at the Bank of Italy.

12. **Despite intensified regional market turbulence, the budget was financed without major difficulty**, thanks to prudent debt management, high market liquidity, and a relatively favorable risk-return profile of the Italian bonds. Lengthening debt maturity and strengthening the budget's cash buffers reduced further rollover/financing risk.

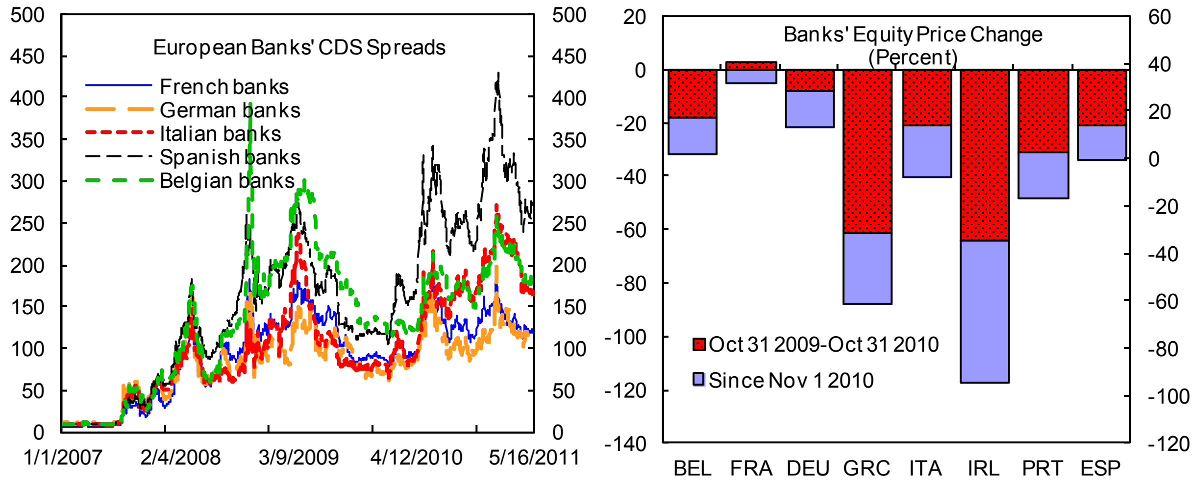
13. **The European sovereign debt crisis affected Italian banks, even though direct exposure to euro area crisis countries is limited.** The five largest banks' equity prices have dropped by over 35 percent on average since end-October 2009, and their CDS spreads have shot up by about 170 bps over the same period. In fact, the five largest Italian banks' CDS spreads have been increasing more than the average CDS spreads of the largest EA banks since the announcement of the Greek program in April 2010, driven by Italian sovereign risks (forthcoming Selected Issues). The direct exposure of Italian

Consolidated Exposure of Italian Banks to Selected Countries
(Billions of euros, as of end September 2010)

	Public sector	Banks	Non-bank private	Other 1/	Total
Greece	1.9	0.2	1.4	1.2	4.6
Ireland	0.6	2.4	7.8	6.7	17.4
Portugal	0.6	1.6	1.1	2.3	5.6
Total	**3.1**	**4.2**	**10.2**	**10.2**	**27.7**

Source: Bank for International Settlements.
1/ Unallocated sector, plus positive market value of derivatives contracts, guarantees extended, and credit commitments.

banks to Greece, Ireland, and Portugal is limited, totaling about €27.7 billion, or 0.7 percent of assets, with the largest five banks exposed for less than €3 billion.

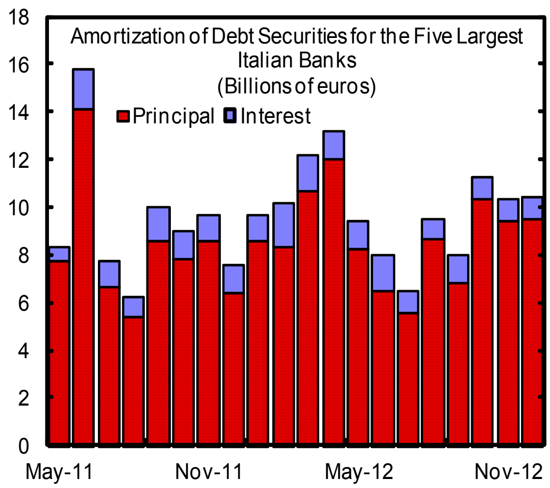


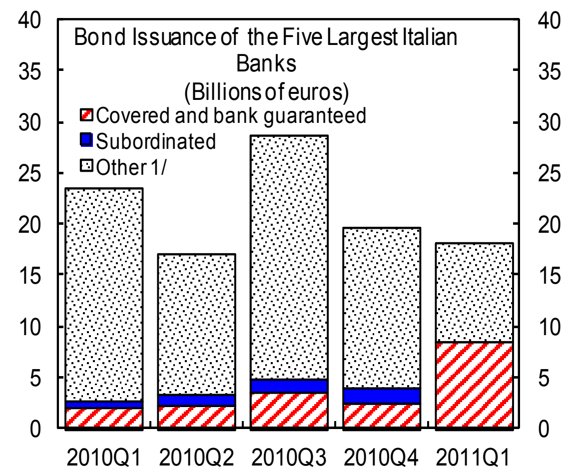
Source: Bloomberg.

Resilient banking sector, but with relatively low capitalization levels

14. **Bank credit is recovering but lending rates are inching up.** After a sharp fall in 2009, credit growth to the private sector started to rebound in February 2010 (Figure 5). The 12-month growth in lending to non-financial firms turned positive in September 2010, and reached 4.6 percent last March. The 12-month growth in lending rate for households remained solid at about 5 percent in March. According to the latest bank lending survey as well as recent firm surveys, credit supply conditions for firms tightened slightly in Q1 2011, and are expected to remain stable over the next three months. Credit conditions will be adversely affected by the ongoing increase in lending rates for both firms and mortgages, following the rise in the ECB policy rate, the euribor, and bank funding costs.

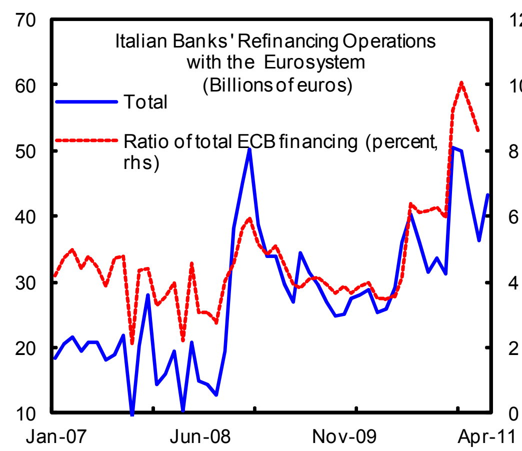
15. **Bank financing needs are large, and funding costs are increasing.** Stable retail funding (deposits and retail securities) account for over 75 percent of the total funding for the largest five banks. However, banks currently face large refinancing requirements, with over €65 billion and €104 billion of bonds coming to maturity for the largest five banks during the rest of 2011 and in 2012, respectively. Nonetheless, in the first three months of the year the largest banks refinanced about 75 percent of wholesale bonds due to mature in 2011. Funding costs have been increasing since the second half of 2010. Deposits rates have risen by 20–80 bps since end-May 2010, and yields on banks' securities have climbed by about 80 bps over the same period, driven by sovereign risk and the higher euribor (Figure 5). Recently, banks have been issuing more covered bonds than before to hold down funding costs.





Sources: Bloomberg; and IMF staff calculations.
1/ Includes senior unsecured, notes, and certificates of deposit.

16. **Italian banks' use of Eurosystem lending facilities has grown.** Refinancing operations have been on average relatively low throughout the global financial crisis, but they increased in the summer 2010 and remain volatile. They were slightly above €40 billion in April 2011. As of mid-April 2011, for the 32 largest banks the eligible collateral for Eurosystem refinancing operations was on average about 7 percent of their assets, while their average monthly cash outflow (assuming no rollover of maturing obligations) was around 3 percent of their assets.

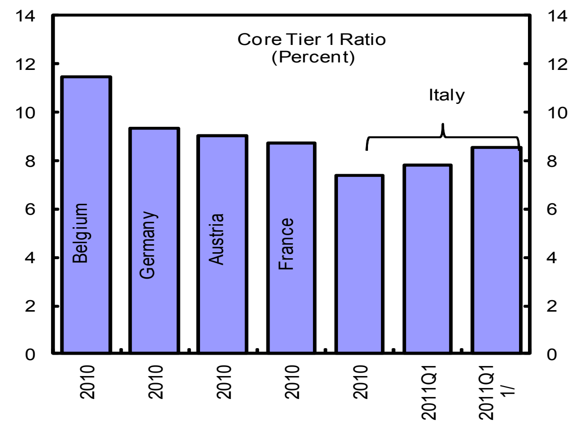


Sources: Bank of Italy, European Central Bank.

17. **Italian bank asset quality and profitability remain low.** While non-performing loans have increased steadily since 2008, the most recent data on the inflows of new bad debt point to some stabilization in bad debt growth. Due to higher provisions for loan losses and lower net interest income, profits dropped significantly in 2008–10, and large banks' returns are currently underperforming compared to other European peers (Figure 6).

18. **Bank capital levels are relatively low, but rising.** Thanks to capital increases, retention of profits, asset sales, and the issuance of securities subscribed by the Ministry for the Economy and Finance (MEF), capital buffers rose in the past two years, with the average core tier 1 ratio of the five largest banks up from 6.0 percent in 2008 to 7.4 percent in 2010. Nevertheless, large Italian banks' capital ratios continued to be low by international comparison at the end of last year. Since January, five of the six largest banks have completed or announced recapitalization plans for a total of €11.7 billion. The financial

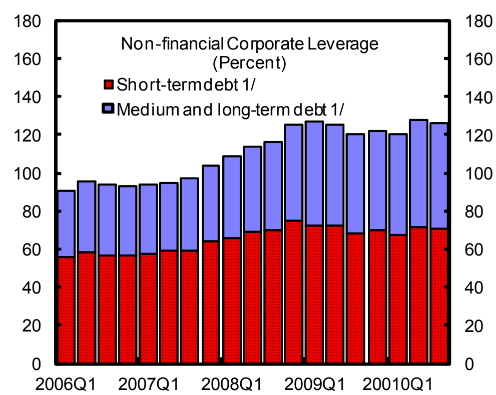
leverage of the largest Italian groups, measured by the ratio of total balance sheet assets to tier 1 capital, is lower than in other European peers (Figure 6).



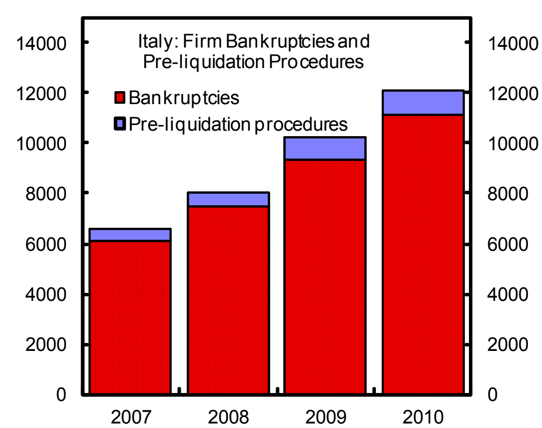
Sources: Banks' financial statements; and IMF staff calculations.
1/ Including announced recapitalizations, net of governemnt recapitalization bonds reimbursements.
2/ Simple average by country of the largest banks' core tier 1. For Italy, average of the largest five banks. For the other euro area countries the banks considered are Erste, Raiffesein, Dexia, KBC, BNP Paribas, Credit Agricole, Societe Generale, Deutsche Bank, Commerzbank.

19. **Italian banks have a large volume of operations in Central and Eastern Europe and little exposure to Northern African countries.** As of December 2010, Italian banking groups' exposure toward Central and Eastern European (CEE) countries amounted to €160 billion (around 4 per cent of the banking system's total assets). Most of CEE exposure is towards countries for which the market's risk assessment (as gauged by CDS spreads on sovereign debt) is relatively less severe. As of December 2010, Italian banking groups' exposure toward the Northern African countries amounted to around €5 billion (mostly toward Egypt, with Libya accounting only for €8 million).

20. **Non-financial corporate balance sheets are rather fragile.** Financial conditions of Italian firms are undermined by low capitalization levels, relatively high leverage, a large share of short-term debt, and the prevalence of variable rate loans, which increases the risks stemming from rising interest rates. Bankruptcies have grown steadily since 2007. The MEF is promoting a number of initiatives to support lending to small and medium enterprises (SMEs), as well as their recapitalization, in collaboration with the private sector and the Cassa Depositi e Prestiti—a joint stock company under public control. These include, among others, the creation of a bank specialized in credit to firms in Southern Italy and a private equity fund. Household debt remains low by international comparison, but variable rate mortgages have grown sharply in past few years, and now account for almost 70 percent of the total stock, creating some potential risks in the context of increasing interest rates.



Source: Bank of Italy.
1/ Ratio to equity.



Political context

21. **Some political commentators suggest that the center-right government has weakened, with some high-ranking public officials indicted and tensions within the coalition intensifying**. The coalition relies on a thin parliamentary majority. However, an important fiscal reform is under study and may be implemented before the end of the legislature.

II. OUTLOOK: STRUCTURAL WEAKNESSES LIMIT GROWTH

22. **Italy's growth is expected to continue at a modest pace.** Staff projects Italy's output to grow by 1 percent in 2011 and 1.3 percent in 2012, in line with most other forecasters. By end-2012, the Italian economy would have recouped only half of the output loss suffered during the crisis. Growth is expected to continue to be driven by exports and the resumption of investment from low crisis levels. However, it will likely be held back by subdued domestic demand and further fiscal consolidation. Such a modest pace of activity will not allow a significant recovery in employment. Persistent labor market weakness, sluggish income growth, a decrease in government transfers, and a rising cost of credit will curb household spending. A persistent competitiveness gap hindering export growth, and slow progress in structural reforms, will also limit growth.

Italy: Comparative Growth Forecasts

	Forecast Date	2011	2012
IMF/WEO	May-11	1.0	1.3
Ministry of Finance	Apr-11	1.1	1.3
OECD	May-11	1.1	1.6
EC	May-11	1.0	1.3
Consensus	May-11	1.0	1.1

Sources: MEF; OECD; EC; Consensus; and IMF staff estimates.

23. **Italy's permanent medium-term output losses associated with the crisis are estimated to be around 10 percent of pre-crisis trend.** Potential growth is projected to remain below one percent, with the output gap currently estimated around 3 percent and is projected to be closed by 2016.

24. **Inflation is expected to increase due to rising energy and commodity prices.** Consumer price inflation is forecast to increase to 2.5 percent in 2011 and 2.2 percent in 2012. Capacity utilization is rising but remains well below normal levels; and the private consumption recovery is likely to remain anemic given the lack of a turnaround in the labor market. As a result, domestic inflationary pressures will be modest, and core inflation will broadly stabilize. Rising energy and commodity prices will exert some upward pressure on headline inflation.

25. **The authorities agreed with staff on the pace of the recovery but are more optimistic on the medium term.** The authorities substantially revised downwards growth projections in the April update of the Stability Programme. However, they are more optimistic than staff on the contractionary effects of fiscal consolidation after 2012.

Risks

26. **The main downside risk comes from market turmoil in the euro area periphery.** Renewed tensions in EA periphery countries may turn capital markets against highly indebted countries like Italy, leading to higher spreads. Declining public bond prices would worsen the banks' and insurance companies' balance sheets, with a possible vicious cycle. Even absent this, continued tight credit and uncertainty could hinder private investment, while rising unemployment may weigh heavily on consumption. Fiscal tightening could further depress aggregate demand.

27. **Another decade of stagnation poses also a major risk.** The decline in potential output and policy inaction may prolong economic stagnation; rising financing costs could produce a vicious circle. Another decade of disappointing growth would make public debt difficult to sustain.[2]

28. **Other uncertainties on outlook persist.** The recent turmoil in Libya is expected to have only limited impact on growth, mostly through higher energy prices. On the upside, the global recovery and the inventory cycle could gain stronger momentum, and the vigorous pursuit of fiscal consolidation objectives could increase confidence and investment.

III. THE POLICY AGENDA: MAINTAINING FINANCIAL STABILITY AND FISCAL SUSTAINABILITY WHILE RAISING GROWTH THROUGH REFORMS

29. **The government's overarching goal is to increase potential growth while maintaining fiscal consolidation.** The government has started a few reforms to address some long-term structural bottlenecks, including low quality of education, regional disparities, and public sector inefficiencies. Fiscal federalism, and the reforms of the universities and the public sector will take time to implement, and their effects on growth will take even longer to bear fruit. Staff pointed out that other reforms, especially in the product and labor market areas, should also be implemented. While Italy's potential growth slowly builds on the back of reforms, the near-term policy agenda must focus on preserving fiscal sustainability, strengthening financial stability, and implementing labor and product market reforms.

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[2] On May 21st, Standard & Poor's revised its rating outlook for Italy from stable to negative, citing the country's poor growth prospects and political gridlock.

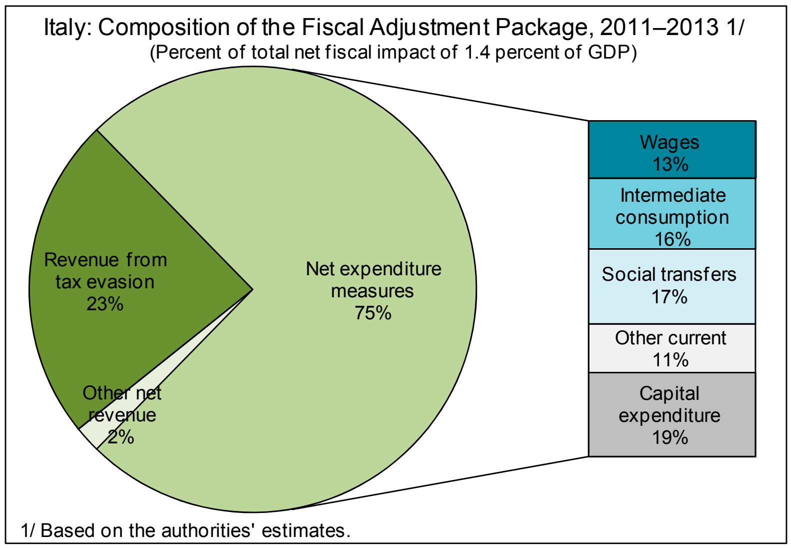
30. **International pressure is helping Italy implement needed reforms.** The implementation of the "European Semester" is strengthening fiscal planning. The Basel III agreement is putting pressure to increase banks' capital adequacy.

A. Fiscal Policy: Consolidation and Better Expenditure Quality Required

Fiscal outlook

31. **The Authorities target a deficit below 3 percent of GDP by 2012 and a near-balanced budget by 2014.** Measures for 2011–2012 have been identified but measures for 2013–2014 need to be announced.

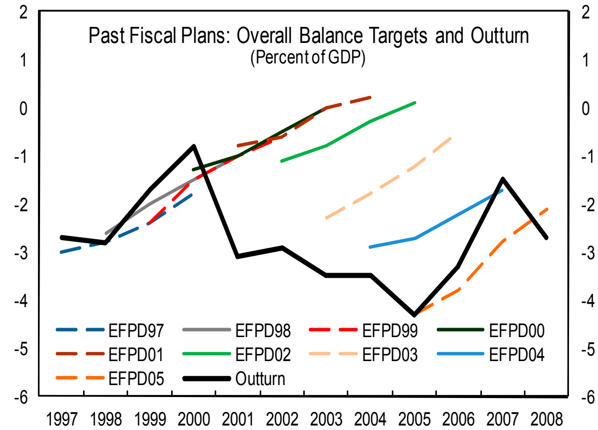
- **Identified adjustment in 2011–2013:** The July 2010 fiscal package identified measures for €12 billion for 2011 (¾ percent of GDP) and €13 billion for 2012. Expenditure-saving measures, accounting for about ¾ of the adjustment, include a reduction in transfers to sub-national governments, a public wage freeze, and cuts in public investment and social transfers. The rest is expected to come from fighting tax evasion. The 2011 budget weakened somewhat the quality of the adjustment. A one-off receipt from a tender of broadband licenses (€2.4 billion) and some additional revenue administration measures will offset some increases in recurrent expenditure and tax relief. Furthermore, waivers from the 2011 Domestic Stability Pact for local governments have been introduced.



- **Additional adjustment needed in 2013–2014:** In the April 2011 Stability Programme Update, the authorities have committed to additional 2.3 percent of GDP consolidation in 2013–14—about €20 billion each year. The plan envisages an expenditure-based consolidation but does not outline any specific measures.

32. **The authorities' consolidation plan is appropriate but its implementation could be problematic.** The plan rightly focuses on expenditure measures, including a further strengthening of the pension system, and acknowledges the importance of combating tax evasion. However, more than half of the expenditure reduction in 2011–2012 is to be delivered by sub-national governments, which is politically difficult, while revenue increases rely on administrative measures.

33. **While welcoming the authorities' commitment to sustain consolidation after 2012, staff expressed concerns about the plan to achieve the targeted adjustment.** In particular, the plan lacks specific measures, and it uses optimistic assumptions on the growth effect of the envisaged fiscal consolidation. Also, while most recent evidence of strengthened fiscal rigor is encouraging, the track record of past fiscal plans offers little optimism. Overall, the success of the consolidation depends on ongoing fiscal structural reforms, including fiscal federalism reforms and the reform of public administration.



Source: Balassone, Momigliano, and Rizza, *Medium-term fiscal Planning under (mostly) Short-term Governments: Italy 1988-2008* (forthcoming).
Note: EFPD = Economic and Financial Planning Document.

34. **With less optimistic revenue assumptions, the fiscal deficit would likely exceed the target 3 percent of GDP in 2012 (Figure 7).** The overall balance will reach 3 percent of GDP only in 2015, assuming that real primary current expenditure growth averages zero in 2011–2016 (compared to over 2 over 1999–2008), and less optimistic revenues from administrative measure. Public debt, after stabilizing at close to 120 percent of GDP in 2011–2013, will decline to about 118 percent of GDP by 2016. Public debt dynamics are most sensitive to a shock to real GDP and the assumed fiscal adjustment effort but are less sensitive to an interest rate shock (Figure 8; Box 1).

Box 1. Characteristics of Italy's Public Debt

Despite its size, Italy's public debt is relatively resilient to interest rate shocks. Of the total gross general government debt: (i) over 75 percent is long-term debt; (ii) close to 85 percent has an initial maturity of over 1 year; and (iii) less than 12 percent is at variable rates. The authorities extended the average maturity of debt from 5.7 years in 2000 to 7.2 years as of end-March 2011. Simulations suggest that a 100 basis point increase in interest rates will increase the deficit by about 0.2 percentage points of GDP in the same year.

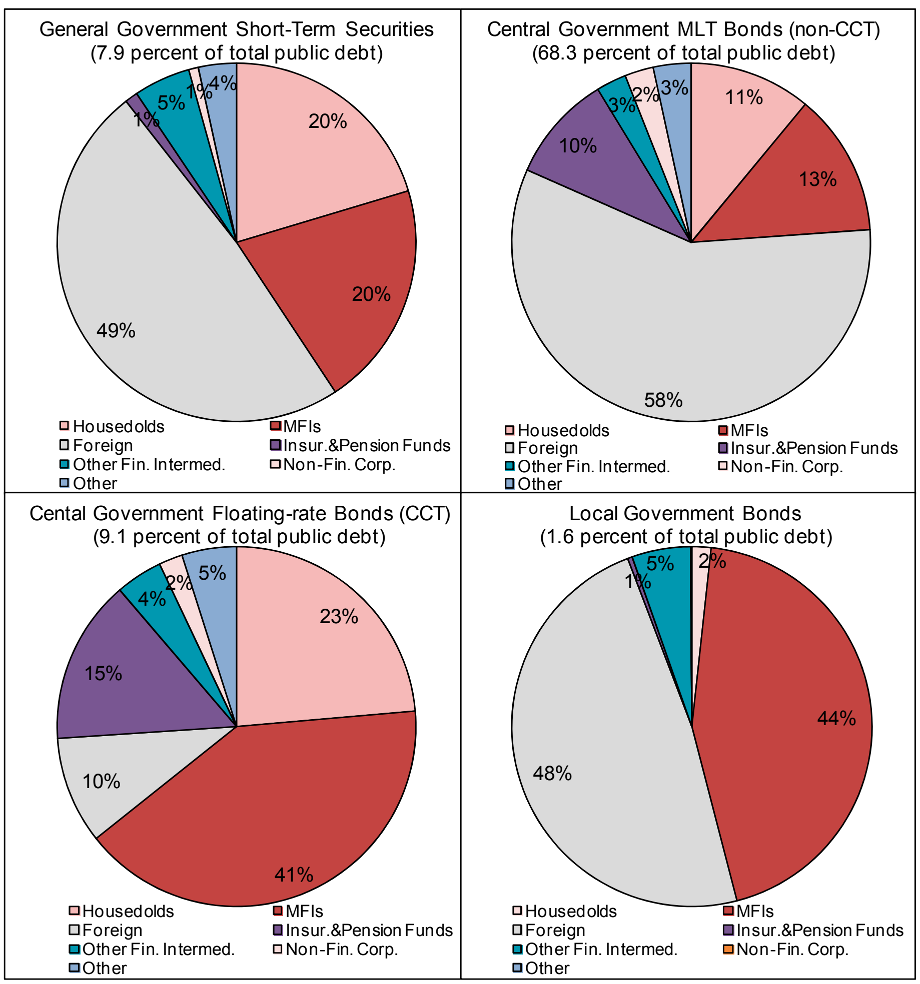
Budgetary Sensitivity to Interest Rate 1/
(Percentage points of GDP)

	T	T+1	T+2
Interest expenditure 2/	0.20	0.39	0.50

1/ Impact of 100 basis points interest rate increase (shift of the w hole yield curve) in T=2011.
Source: Ministry of Economy and Finance; Stability Programme Update (April 2011).

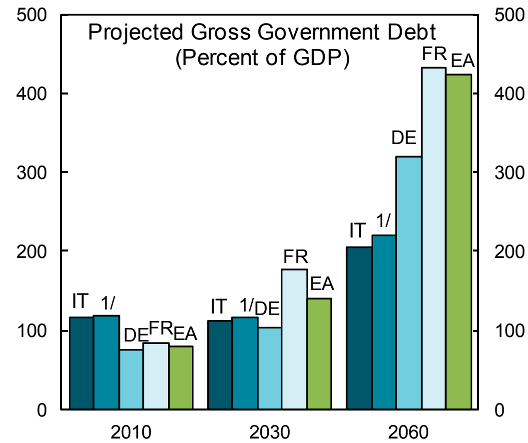
Non-residents held about half of the total public debt at end-2009. The share of non-resident holding is close to that of Germany and lower than in France (around 65) or Portugal (over 75), but higher than in Spain (about 40) or the UK (30). During the crisis, the share of non-resident holdings of short-term debt more than doubled, but remained broadly unchanged for medium- and long-term debt.

Italy: Composition of Government Securities by Holders
(Percent of respective total aggregates; end-2009)



Source: Bank of Italy.

35. **The authorities pointed out that Italy's longer-term fiscal outlook compares favorably to that of euro area peers.** The European Commission (EC) projects Italy's public debt to be the lowest in the euro area by 2060, on unchanged policy relative to 2009 (EC Sustainability Report, 2009). Staff's baseline estimates, which assume an average annual growth rate of about 0.9 percent in 2017–2060 and no reform, project the debt-to-GDP ratio close to 220 percent by 2060, well below the EA average. In addition to the assumed medium-term fiscal effort, the relatively contained debt dynamics reflects the impact of the enacted pension reform.

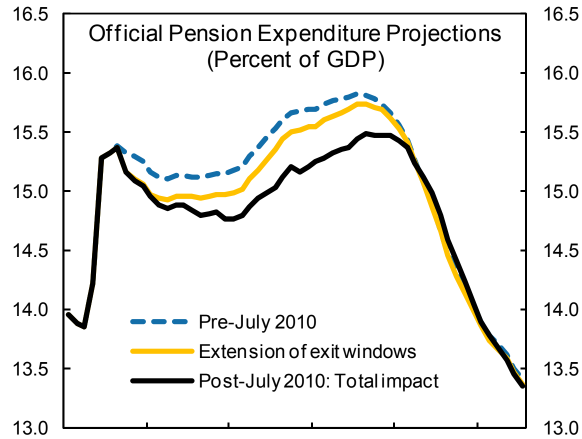


Sources: EC 2009 Sustainability Report; and IMF staff estimates.
1/ Updated estimates for Italy based on IMF staff long-term sustainability analysis, which reflects staff's basline fiscal projections for 2010–2016 and assumes average real GDP growth of 0.85% in 2017–2060. All other projections are from EC(2009).

36. **Achieving the SGP debt target of 60 percent of GDP poses a big challenge for Italy (Figure 9).** Given the projected large negative growth-interest rate differential, primary surplus has to be close to its historical maximum for the debt-to-GDP ratio to reach 60 percent by 2030. This would be similar to the authorities' policy scenario presented in the 2011 Stability Programme Update.

37. **The authorities and staff concurred that public expenditure remains very inefficient, and the tax burden is large.** Italy scores poorly in terms of the quality and efficiency of public expenditure, while standing out among countries with highest tax burden and lowest tax compliance (Figure 10). Overall, progress on improving public expenditure as identified in previous reviews (such as, *Libro verde sulla spesa pubblica*) has been limited, with few exceptions. Some steps on improving the budget classification, institutionalizing spending reviews, and reorganizing public administration have been taken. The public administration modernization reform ("Brunetta reform") is still in an experimental phase, and is constrained by the fiscal cuts. Fiscal consolidation is also difficult given the size of transfers to sub-national governments, large entitlement programs, and the sizeable interest expenditure (Figure 11). Recognizing that the tax system is unduly cumbersome and prone to abuse, the government recently initiated a technical review of tax expenditure. A broader tax reform has been one of the authorities' goals but still remains under study. Staff urged the authorities to a more forceful action to improve the efficiency of public expenditure instead of resorting to horizontal cuts.

38. **The pension system has been strengthened further in 2010 but remains generous and generationally inequitable.**[3] The July 2010 fiscal consolidation package increased the retirement age for female public sector employees, extended the so-called "exit-windows," effectively postponing retirement, and linked the retirement age to life expectancy from 2015, with an estimated saving of up to 0.5 percentage points of GDP by 2030. Still, at 13.5 percent of GDP by 2060, Italy's pension expenditure will remain among the highest in Europe, along with relatively high replacement rates. As a result of a slow transition to the notional defined contribution scheme, a large burden of the reform is yet to be borne by future generations.



Source: Ministry of Economy and Finance.

Fiscal consolidation should continue

39. **The authorities and staff concurred that fiscal consolidation should be sustained beyond the medium term.** Without continued fiscal retrenchment after 2012, the slow reduction in debt-to-GDP ratio will not be long-lasting, and debt would stay at over 100 percent of GDP level in the long term (Figure 12). The authorities rightly aim at continued fiscal retrenchment in 2013–2014, well above the euro area average. Fiscal consolidation at a pace of at least ¾ percentage points of GDP per year during 2013–2015 (similar to the authorities' planned €20 billion annual adjustment) would help reach a balanced budget by 2015, bringing up the structural primary surplus back to its end-1990s levels, while the debt would steadily decline to reach 60 percent of GDP by 2035.

Change in Structural Primary Balance
(Percent of potential GDP, unless otherwise indicated)

	2010	2011–12	2013–14
Italy: WEO baseline	0.7	1.9	0.0
Italy: SP-P 1/	0.6	1.8	2.0
Euro area	0.3	1.8	1.0
France	0.1	2.4	1.3
Germany	-1.3	0.7	1.1
Spain	1.9	3.8	0.9
UK	1.0	3.7	3.0

Sources: WEO, and IMF staff estimates.
1/ Stability Programme Update (April 2011) policy scenario; percent of GDP.

[3] See IMF Country Report No. 10/157, May 2010.

The challenges of durable fiscal consolidation

40. **The authorities and staff discussed ways to achieve durable fiscal consolidation.** Public expenditure should be rationalized through periodic expenditure reviews. Pension reform should be further accelerated. Tax expenditure should be reduced substantially. Budgetary procedures should be strengthened further. Fiscal federalism should enhance the fiscal discipline at all levels of government.

41. **Staff stressed the need for structural changes to underpin sustained fiscal consolidation.** To avoid indiscriminate spending cuts, structural changes should be designed well in advance (Box 2). The budget framework reform, started with the implementation of the 2009 Accounting and Public Finance Law, should continue and be strengthened further through the adoption of new EU-wide fiscal governance rules (Box 3). Tax evasion should be tackled including through the use of anti-money laundering measures, and the tax system should be simplified, particularly by streamlining tax expenditure.

Italy: An Illustrative Package of Fiscal Consolidation Measures in 2013–2014
(Percent of GDP)

Possible Measures	Fiscal Impact
Increase in public expenditure efficiency, including:	1.0
Health sector 1/	0.2
Functional overlaps 2/	0.2
Provinces 3/	0.2
Savings in social transfers	0.5
Additional pension measures 4/	0.4
Non-pension social transfers 5/	0.1
Rationalization of tax expenditure 6/	0.5
Personal income tax	0.4
Corporate income tax	0.1
Increase in indirect taxes	0.5
VAT efficiency 7/	0.5
Total resources	**2.5**

Source: IMF staff estimates.
Underlying assumptions: 1/ Potential savings in regions with health-sector deficits; 2/ Streamlining overlapping functions (e.g., public order and security forces); 3/ Reducing current expenditure of provinces by one-third; 4/ Including bringing forward the increase in early retirement age and increase in private sector women retirement age; 5/ Lower nominal growth of non-pension transfers in 2013-2014; 6/ Reducing direct tax expenditure by 10 percent; 7/ Increasing VAT C-efficiency by 5 percentage points (reducing exemptions and reduced-rate taxation, and increasing tax compliance).

Box 2: Lessons from the Literature on Fiscal Consolidations[1]

Fiscal consolidations are contractionary. Fiscal consolidations are likely to be particularly contractionary when policy rates are near zero, and when many countries consolidate simultaneously—two conditions relevant to Italy's current environment. However, some features of fiscal consolidation may lessen the contractionary effects and enhance potential output.

Fiscal consolidations are less contractionary when they are expenditure-based. The contractionary effects of fiscal adjustments may be mitigated or even inverted in specific cases. Evidence shows that expenditure-based consolidations are more likely to be expansionary. At the same time, increasing revenue may help before governments can selectively cut current spending.

Targeted spending cuts are preferable. Successful adjustments rely mostly on cuts in primary current expenditures, especially government wages, transfers and subsidies. Civil service reform (and the related question of the right balance between salaries and number of employees) seems critical to achieving wage bill retrenchment. The evidence that successful consolidations preserve investment is less clear-cut, probably because of a sequencing problem: in many successful cases, countries start their consolidation by retrenching capital spending but reverse the cuts in due course thereafter.

Fiscal consolidation may stimulate growth through both demand and supply channels. Fiscal stabilizations are expansionary if agents believe that the fiscal tightening eliminates the need for a larger adjustment in the future. This effect is stronger when the initial debt-to-GDP ratio is high and when the fiscal contraction is large. Moreover, reducing public spending, in particular wages and unemployment benefits may lower unit labor costs. Finally, fiscal consolidation may also eliminate rents, helping reduce corruption and improve private sector incentives.

Intense consolidation efforts are difficult to maintain overtime. Evidence shows that longer consolidation periods increase the probability of ending the adjustment ("consolidation fatigue").

The involvement of sub-central tiers of government is crucial to achieving cuts in expenditure, particularly when it comes to the wage bill. Central governments appear to exert a strong influence on the expenditures of sub-central tiers through their grant allocations; control of these allocations is therefore essential to "force the hand" of local governments to adjust spending.

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[1] WEO (2010); Giavazzi, F., and M. Pagano (1990); Alesina, A., and R. Perotti (1996); Von Hagen, J., Hallett, A. H., and R. Strauch (2002); Darby J., Muscatelli, V., and G. Roy (2005); Tsibouris, G., Horton, M., Flanagan, M., and W. Maliszewski (2006); Alesina, A., and S. Ardagna (2009).

42. **Staff recommended that fiscal federalism should proceed cautiously.** Reducing further the local governments' transfer dependency should improve the overall fiscal performance, as supported also by robust cross-country evidence (see forthcoming Selected Issues). The share of sub-national own spending financed with transfers declined from 70 percent in 1992 to 40 percent in 2007 (Figure 13)—one of the largest reductions among the OECD countries. However, transfers and borrowing as a share of sub-national own expenditure remain above the OECD average. The ongoing fiscal federalism reform aims at closing the gap further. The government has already approved most of the decrees to implement the reform. But its impact remains uncertain, given: the long and still unclear transitional arrangements; many yet-to-be-quantified features; the large and persistent regional differences; and the track record of bailouts. Local authorities should be allowed to tax all real estate properties. Clear safeguards need to be established to guarantee deficit neutrality (at the minimum) and avoid increases in the tax burden. The reform should also be integrated with the envisaged fiscal consolidation.

Box 3. European Semester and Italy

The new EU fiscal policy framework introduces more stringent fiscal targets. It retains the medium-term objective (MTO) of a close-to-balance fiscal structural position and introduces the principle that annual expenditure growth should not exceed (prudent) medium-term GDP growth ("*prudent fiscal policy making*").

The EU fiscal governance reforms could have important implications for Italy. At a projected 2.8 percent of GDP deficit by 2016, Italy's structural position would still be far from the MTO and worse than the EA average structural deficit of about 1.6 percent. Italy would comply with the prudent fiscal policy making rule under the staff's baseline projections of real primary expenditure and GDP growth for 2011–16 (for example)—on average, -0.3 percent and 1.3 percent, respectively. The new framework proposes to adopt a numerical benchmark for the debt-to-GDP ratio declining over the previous three years at a rate of the order of $1/20^{th}$ per year of its distance from 60 percent of GDP threshold. This rule would call for a debt reduction of 3 percent of GDP per year in Italy. However, the rule indicates that the level of the private sector debt should be taken into consideration.

Domestic budget procedure has been modified to incorporate the new EU fiscal framework. This is expected to strengthen the budget reform law (*Legge di contabilità e finanza pubblica*) enacted in 2010 by explicitly banning the use of windfall current revenue to finance current expenditure and extending the application of medium-term spending limits to all the state budget expenditure. However, some of the previously identified shortcomings persist, including the lack of a formal scrutiny of macroeconomic forecasts and policies by an independent national institution.

43. **Staff recommended that pension reforms should be accelerated further.** The retirement age for women working in the private sector should be raised from 60 to 65 years as for men. The planned increase in the early retirement age could be brought forward from 2013 to 2012. The automatic retirement age adjustment to changes in life expectancy will increase the retirement age by up to 3.5 years by 2050, but its effectiveness depends on policies to encourage longer participation of older workers. Private pensions should be encouraged.

Standard Pension Eligibility Age and Labor Market Exit Age

	Average exit age from labor force in 2001	Average exit age from labor force in 2008	Statutory retirement age for M/W in 2009	Statutory retirement age for M/W in 2020	Further increases in statutory retirement age for M/W after 2020	Life expectancy at 65 in 2008
Germany	60.6	61.7	65/65	65y9m/65y9m	67/67	18.5
Spain	60.3	62.6	65/65	65/65	…	19.0
France	58.1	59.3	60-65	60/60	…	19.9
Italy	59.8	60.8	65/60	66y7m/61y7m*	**	19.5
Sweden	62.1	63.8	61-67	61-67	…	18.9
UK	62.0	63.1	65/60	65/65	68/68	18.2

Source: European Commission (Occasional Papers 71, Nov 2010).
* = Age requirement is half a year higher for self-employed; for civil servants, the statutory retirement age of women equalizes that of men, starting from 2012; further increases in the retirement age after 2020 accounts for about 4 months every three years.
** = Retirement age evolves in line with life expectancy gains over time, introducing flexibility in the retirement provision.

B. Financial Sector: Continuing to Boost Capital Buffers

44. **Bank profitability is expected to improve gradually, but vulnerabilities will remain.** Net interest income is expected to increase moderately, due to the rebound in loan growth and the rise in lending rates. The pace of deterioration in credit quality is likely to slow in 2011 and especially in 2012 thanks to the recovery. However, given the accumulated high level of non-performing loans and fragile corporate balance sheets, banks will continue to face high loan-loss provision costs. A large and stable retail funding base and ample collateral to access Eurosystem refinancing will help Italian banks face liquidity and funding risks, which have intensified with the EA sovereign crisis. However, Italian banks' funding costs remain sensitive to market sentiment about the Italian sovereign and may undermine profitability.

45. **The implementation of the Basel III regulations will require a substantial increase in bank capital**. In the stress tests conducted by the Committee of European Supervisors last summer, the five largest Italian banks were found to be sufficiently capitalized, but one of them nearly failed to meet the 6 percent tier 1 threshold. The authorities have urged banks to shore up capital buffers. According to the Quantitative Impact Study (QIS) carried out by the authorities, the capital shortfall if Basel III capital definitions and requirements were applied immediately would be around €40 billion for the entire banking system. The new capital definition will be the main driver of the changes vis-à-vis current rules with the largest impact deriving from the new treatment of participations

in insurance companies and deferred tax assets. Parliament has approved an amendment to the treatment of tax assets, which could allow deferred tax assets to be considered part of capital even under Basel III regulation and reduce significantly this capital shortfall. The authorities are currently seeking the endorsement of the Basel Committee and the EU commission on this matter. According to the QIS, the forthcoming changes on the computation of risk-weighted assets and the introduction of leverage and liquidity ratio requirements will have a limited impact on Italian banks.

46. **Staff recommended that banks should recapitalize further and that recapitalization should be front-loaded.** The recently announced recapitalizations go a long way towards the goal of strengthening banks' position. But the implementation of Basel III regulations requires a substantial capital increase, and financial markets demand capital reinforcements well in advance of the phase-in period. Italian banks' capital ratios are also low compared to peers. Therefore, the announced recapitalization plans should be swiftly implemented. Banks that remain with a relatively low capital base should strengthen it through earnings retention, disposal of non-strategic assets, by taking advantage of the outstanding convertible instruments, and by raising capital from the market. Further bank mergers could also be part of the recapitalization strategy. The objective should be to build core tier 1 capital beyond the minimum ratios required under Basel III, in line with evolving international best practice.

47. **Staff suggested that consideration should be given to introducing governance reforms in the banking system.** Charitable foundations (*Fondazioni*)—which remain significant shareholders in a number of major banks— have proven to be stable and committed investors. However, better governance and more transparency would be desirable (Box 4). Improving the governance of *Banche Popolari* would also strengthen shareholders' protection. Reforms could include raising limits on proxy voting, encouraging institutional investor representation at the board, and measures to ensure access to adequate, accurate, and timely ownership information.

48. **Further recapitalization or restructuring of enterprises may be necessary.** The actions taken by the authorities in the past two years in support of SMEs are still in place, and the bank loan moratorium agreement has been extended. While supporting SMEs was appropriate, these measures could result in additional loan losses in the future if they are not accompanied by recapitalization or corporate restructuring when needed. In this context, the private equity fund for SMEs recently set up jointly by the government and the private sector could strengthen the capital base of viable firms. Some improvements to the existing bankruptcy regime could also help rehabilitate distressed, but creditworthy, firms and the speedy liquidation of non-viable enterprises. The reorganization and debt restructuring frameworks could be ameliorated, for instance, by clarifying the scope of the judicial review of the restructuring plans. The current eligibility criteria for bankruptcy trustees could also be reexamined to better promote the appointment of trustees with firm management and restructuring skills.

Box 4: The Role of Foundations as Shareholders in the Italian Banks

Non-profit foundations (*Fondazioni*) are significant shareholders in a number of major banks. Foundations were created during the process of banks' privatization in the early 1990s, when state-owned banks transferred their banking operations to newly-formed joint-stock companies, and turned themselves into non-profit foundations. In the late 1990s, foundations were recognized as private legal entities, with full statutory and operational autonomy, and in most cases were obliged to sell their controlling interests in banks. Nevertheless, the foundations continue to be important shareholders in several banks. As a whole, foundations hold stakes of more than five percent in over fifty banks, including the largest three, and own more than 20 percent of two of the largest three banks.

The foundations have proven to be long-term stable investors, but their role and the way they operate also raise some issues. During the global crisis, and also more recently, the foundations have provided stability to the banking system, by remaining committed shareholders, and by subscribing for repeated capital increases. However, local politicians who control foundations may exert undue political interference in banks' governance. Furthermore, their strong influential power in several banks' boards may deter other potential investors.

Enhancing the regime of foundations would be desirable to improve their autonomy, transparency, and accountability. To strengthen their autonomy, current eligibility requirements regarding members of their governing bodies could be refined and expanded. To boost accountability vis-à-vis their social mandate, foundations could develop and disclose on a regular basis detailed criteria on their investment strategies and exercise of ownership rights. The existing supervisory arrangement, whereby foundations are supervised by the Minister of Economy and Finance, should be reconsidered, given the risks of blurred lines between supervised entities and the supervisor.

Foundations are already mandated by law to diversify and obtain adequate returns on their investments. Given increasing international integration and harmonization among banking systems and their institutional structures, part of their stakes in banks should eventually be taken up by other, more market driven investors. In fact, it would be in the foundations' best interest to dismiss some of their bank stake holdings, as that would allow greater investment diversification and higher returns.

49. **The authorities agreed that the recently announced recapitalization will strengthen banks.** They agree that some further efforts to shore up capital buffers may be needed. They also share with staff the view that more restructuring and recapitalization may be necessary in the non-financial corporate sector. The authorities are well aware of the corporate governance issues concerning *Fondazioni* and *Banche Popolari*, and, on the latter, they are pushing for reforms.

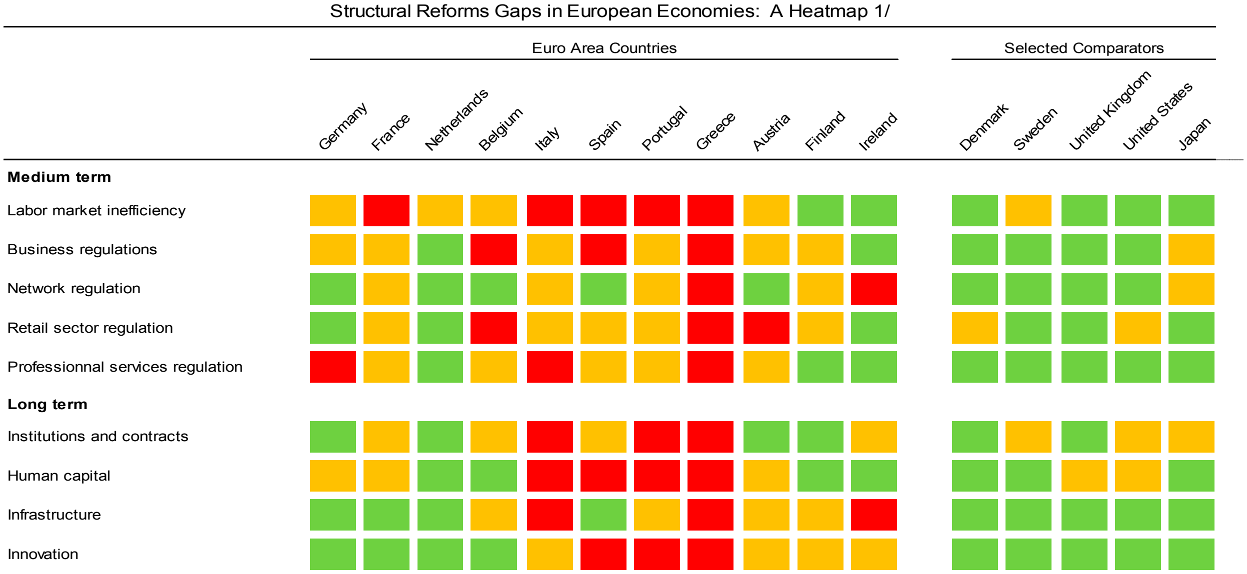
C. Structural Reforms: Comprehensive Reforms to Address Long-Term Weaknesses

50. **The gap in GDP per capita relative to the EU average is increasing.** Italian income per capita was 97 percent of the income of the major Western European countries in 1995 and it is currently at a level similar to the 1970s. The decline started before the euro adoption and continued during and after the global financial crisis. The decline persisted regardless of the various policies pursued by the governments.

51. **The authorities concurred with staff that increasing growth potential is the key policy priority.** They stressed that large regional differences within Italy require very different approaches. In the Center-North, excessive bureaucracy should be cut. SMEs should be encouraged to grow bigger and to internationalize. The government should have only a catalytic role to favor these processes. In the South, basic infrastructure, better education, security, and rule of law should be ensured.

52. **Staff pointed out that there has been little progress on structural reforms, even some slippage.** Stronger momentum is needed. The government recently introduced: measures to reduce the bureaucratic burden for starting businesses; performance-related pay in public administration; the possibility to file class action lawsuits against public sector inefficiencies; and competitive tendering for local public services contracts. However, parliament is undoing some previous product market liberalization, for instance reintroducing minimum tariffs for lawyers' services.

Structural Reforms Gaps in European Economies: A Heatmap 1/

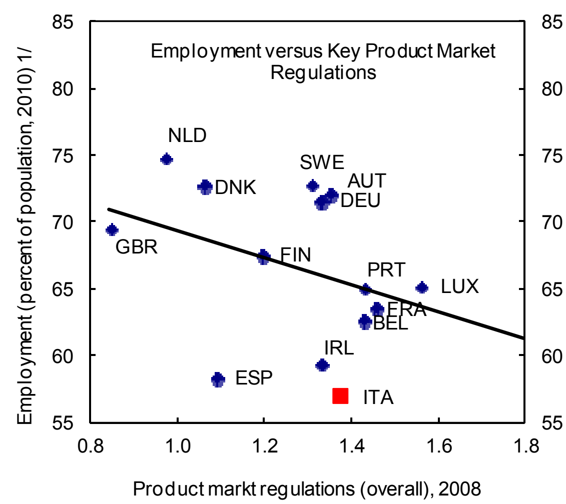


Sources: OECD; World Economic Forum; Fraser Institute; and IMF staff calculations.
1/ The heatmap is constructed based on a variety of structural indicators from alternative sources in order to flag areas where a country has the greatest need to implement structural reforms. For a discussion of the methodology and detailed components, see IMF, 2010d, "Cross-Cutting Themes in Employment Experiences During the Crisis," IMF Report SM/10/274, http://www.imf.org/external/pp/longres.aspx?id=4499 (Washington: International Monetary Fund).

53. **The EU Services Directive was implemented with some delay.** In adherence with the EU Service Directive, the government has completed a review of existing regulations on

service activities at the central, regional, and local level to ensure consistency of existing regulation on service activities at all government levels with the EU legislation. The EC is now in the process of assessing to what extent all the required changes in specific legislation have been implemented. "*Points of single contact*" for business start-ups are not available online yet.

54. **The National Reform Program identifies some key priorities, but more needs to be done to unleash sustained growth.** In addition to the reforms already in the implementation stage, the plan envisages some new measures mostly in the energy sector and education. Some decree laws were recently introduced to spur economic development, including simplifying administrative and fiscal procedures, increasing corporate tax credit for R&D and for hiring in the South, and establishing "zero bureaucracy areas" in the South. But further labor and product market reforms are necessary to address long-lasting structural problems. The authorities were open to staff's suggestion about a "growth commission."



Sources: OECD; and Eurostat.
1/ data as of 2010Q4.

55. **Further product market reforms are necessary to remove impediments to competition.** Regulation should be more effective, promoting a higher degree of competition by opening up further services and network industries, and reducing public ownership, especially at the local level. The conflict of interest deriving from local authorities' dual role as regulators and shareholders should be resolved.

56. **Policies should address labor market duality and the low participation rate.** Indeed, the partial liberalization in the labor market may have undermined investment in human capital and innovation, especially in the context of incomplete product market liberalization. Harmonizing labor contracts and legislation between protected and unprotected workers can boost employment. The authorities agreed that the high level of youth unemployment is a problem. They pointed out that a recently approved legislation on apprenticeship will facilitate entry into the labor force.

57. **Staff stressed that wage setting needs to promote job creation.** Nationally-bargained wages are less binding in the North, but too high for the South. In the private sector, more decentralized bargaining would better align wages with productivity and boost competitiveness. Recently, the Fiat car company has managed to negotiate with Italian trade unions more flexible contracts outside the framework of nationally-negotiated and binding collective contracts, which could shepherd in a more decentralized wage bargaining system. In the public sector, regional differentiation of wages should be introduced to reflect

the cost of living. This could also lead to private sector wage moderation in regions with high public employment concentration.

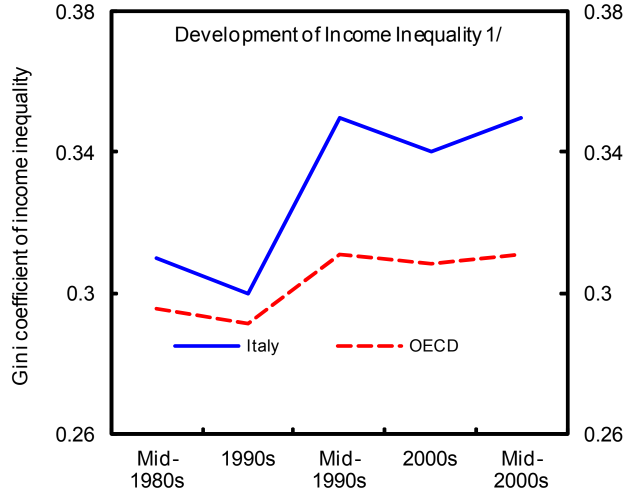
58. **Italy's dismal economic performance has deep-rooted causes.**[4] Educational attainment and the quality of education (as measured by PISA) are among the lowest across OECD countries. Exports, which are specialized in low value-added products, have been losing market share to competition from emerging markets in the last decade. The tax burden is heavy, but the quality of public services is low. Regional income disparities are very large. Several regions are plagued by organized criminality.[5] A dual labor market, where highly protected older workers co-exist with younger temporary workers, exacerbates inequality and contribute to the low employment outcomes. Youth and long-term unemployment rates are among the highest in OECD countries. Employment rates, especially among women, youth, and older workers remain significantly below the EA average, with large regional disparities. Labor market duality is also exacerbating income and wealth inequalities (See Box 5). High-level of business and service regulation hinders competition, especially for professional services. Delays of civil justice procedures are among the longest across OECD countries.

[4] See forthcoming Selected Issues.

[5] Italy ranks 67th on the Transparency International Corruption Perception Index 2010, among the lowest in the EU. The Council of Europe's Group of States against Corruption in its last evaluation of Italy (2008) noted that "...corruption in public administration is widely diffused" and recognized the "connections (that) exist between corruption and organized crime."

Box 5: Italy's Income Inequality in the Wake of the Crisis

Income inequality and poverty in Italy grew rapidly since the 1990s. Italy has one of the largest gaps between rich and poor among OECD countries. The average income of the poorest 10 percent of Italians is around $ 5,000 in purchasing power parities – below the OECD average of $ 7,000, while the average income of the richest 10 percent is $ 55,000 — above OECD average. Wealth is distributed more unequally than income: the top 10 percent hold some 42 percent of total net worth, while the richest 10 percent have 28 percent of total disposable income. Furthermore, social mobility is low. The government has partly offset the growing gap between rich and poor by increasing household taxation and spending more on social benefits for the poor.



Sources: OECD; and IMF staff calculations.
1/ After taxes and transfers.

Labor markets play a crucial role in explaining income disparities. Unemployment, especially long-term unemployment, has a regressive impact on income equality. A higher employment rate, especially for women and youth, is associated with lower economic disparities. Currently, the shares of employed youth and women are especially low in Italy relative to the OECD average, underscoring the potential equity gains from increased utilization of these groups. Dual labor markets worsen inequality. A low level of education attainment is associated with an uneven income distribution.

Inequality was exacerbated during the crisis, mainly through the increase in unemployment. The rise in unemployment during crisis is estimated to have increased inequality by 2.6 percentage points in Italy. The recession also increased the number of discouraged workers who dropped out of the labor force, a factor that is likely to have further exacerbated income disparities. On the other hand, social safety nets are likely to have cushioned the impact of unemployment on inequality. A jobless recovery or engrained long-term unemployment could further worsen economic disparities.

IV. Staff Appraisal

59. **Despite some elements of strength, key fragilities persist.** Low private indebtedness, the resilience of the financial sector, and the ongoing fiscal consolidation are mitigating the spillover from international financial turbulence. However, the large public debt, disappointing growth performance, and lagging structural reforms are persistent weaknesses. The ongoing regional market distress is affecting domestic financial markets. The recovery is disappointing, and growth prospects are weak. The structural reform agenda stalled. Further delay in implementing comprehensive reforms may increase financial instability.

60. **The overarching priority should be to boost the economy's potential growth, while maintaining fiscal discipline and financial stability.** Fiscal consolidation is not sustainable if it is not accompanied by solid growth. But growth potential can be increased only with a (still missing) comprehensive program of structural reforms. The government is committed to gradual fiscal consolidation but has not yet taken decisive steps to foster reforms.

61. **Given the high level of public debt and the current market turbulence, fiscal discipline is a prerequisite for growth.** The ongoing fiscal consolidation is a fundamental factor of stability and should continue.

62. **The authorities' welcome commitment to reduce the fiscal deficit to close to zero by 2014 needs to be accompanied by action.** However, the authorities' plan appears optimistic on the growth effect of the envisaged fiscal consolidation. Also, the authorities have so far resorted to across-the-board cuts and have not specified measures to achieve consolidation beyond 2012. The large size of the envisaged fiscal retrenchment requires structural changes which must be designed well in advance. This calls for a strong political consensus and careful planning.

63. **The fiscal adjustment should rely on expenditure rationalization and help boost potential growth.** There is considerable scope for growth-enhancing savings in the public sector. Containing public sector wages could generate positive spillovers for the private sector. An increase in the retirement age for women in the private sector will boost employment participation and generate savings. The province system could be streamlined, removing an extra layer of bureaucracy.

64. **The tax system should be simplified to support growth and to reduce tax evasion.** Recognizing that the tax system is unduly complex and subject to abuse, the government initiated a review of the preferential tax regimes. Staff welcomes this initiative and sees it as an important component of the fiscal consolidation plan.

65. **The fiscal federalism reform should be integrated with the fiscal consolidation.** Clear safeguards need to be established to guarantee deficit neutrality and avoid an increase in the tax burden. Local authorities should be allowed to tax all real estate properties.

Federalism at variable speeds should be considered, reflecting the regional differences in administrative capacity.

66. **The authorities' strong call for capital increases and the banks' prompt response are welcome and the announced recapitalization plans should be swiftly implemented.** Financial markets demand capital reinforcements well in advance of the Basel III phase-in period. Banks should be encouraged to keep ample capital buffer. Banks that remain with a relatively low capital base should strengthen it through earnings retention, disposal of non-strategic assets, by taking advantage of the outstanding convertible instruments, and by raising capital from the market. Further bank mergers could also be part of the recapitalization strategy.

67. **Further recapitalization or restructuring of enterprises may be necessary.** The anti-crisis measures to sustain SMEs have been appropriate, but these actions should not prevent needed restructuring or recapitalization. The private equity fund for SMEs recently set up will be useful to strengthen enterprise capital. In addition, improving further the bankruptcy regime would help rehabilitate distressed, but creditworthy, firms and liquidate non-viable ones.

68. **The National Reform Program is a step in the right direction, but Italy's pervasive structural problems require further efforts.** Italy's chronically weak growth performance has deep-rooted causes, including deep regional disparities, a heavy and distortive tax burden, public service inefficiencies, high business and service regulations, labor market duality, low education attainment, and export specialization in low value-added products. The reform plan envisages some new measures mostly in the energy sector and education but substantive reforms in other areas are missing.

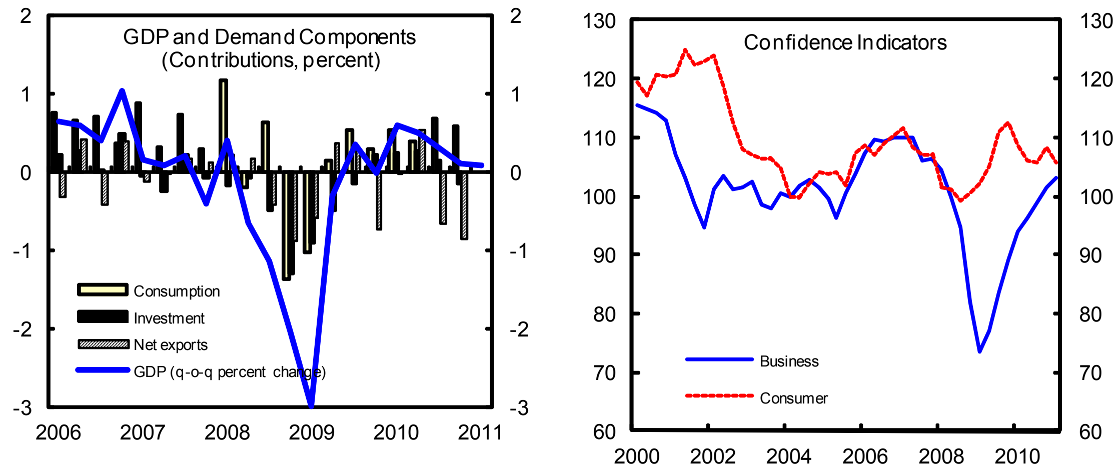
69. **Only a comprehensive reform package can deliver growth.** Complementary labor and service sector reforms are essential to boost job creation, investment, and growth. Promoting decentralized wage bargaining would allow wages to be better aligned with productivity, providing firms with stronger incentives to invest. Harmonizing labor contracts and employment legislation between permanent and temporary employment would reduce labor market dualism and raise employment. Whenever fiscally possible, the authorities should reduce the tax wedge, which is among the largest in EU. Competition in product market and services need to be strengthened by giving more power to the antitrust authority. Combating organized crime, corruption, and related money laundering, should remain a priority.

70. **A national commission for growth should be considered.** A comprehensive structural reform package could raise productivity and enhance growth potential. Establishing an independent review and advisory body for reforms ("*growth commission*") could foster consensus and focus policies on priority areas, while ensuring the continuity of the reform agenda. Ownership of reforms at all level of government is a crucial prerequisite.

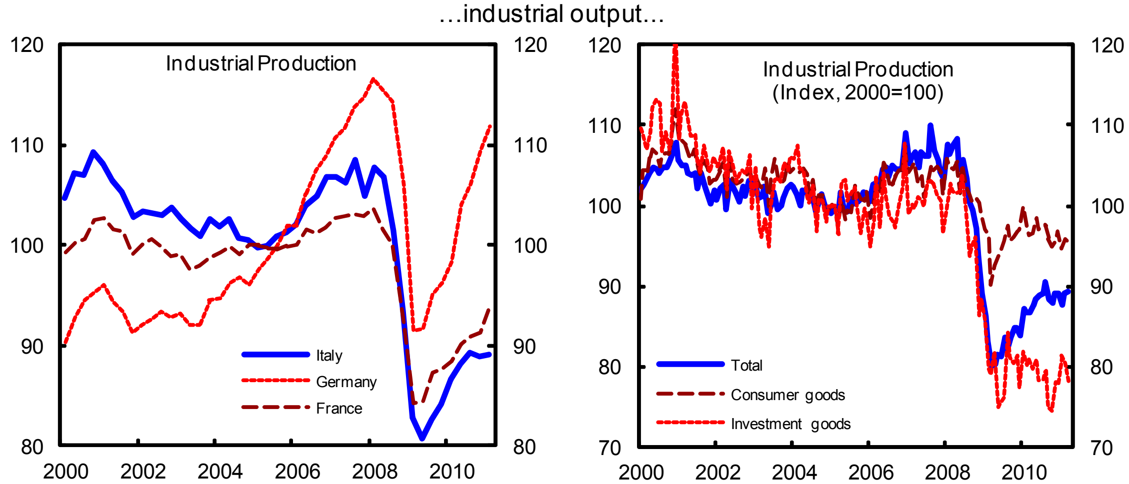
71. It is proposed that the next Article IV Consultation be held on the regular 12-month cycle**.**

Figure 1. Italy: Cyclical Indicators

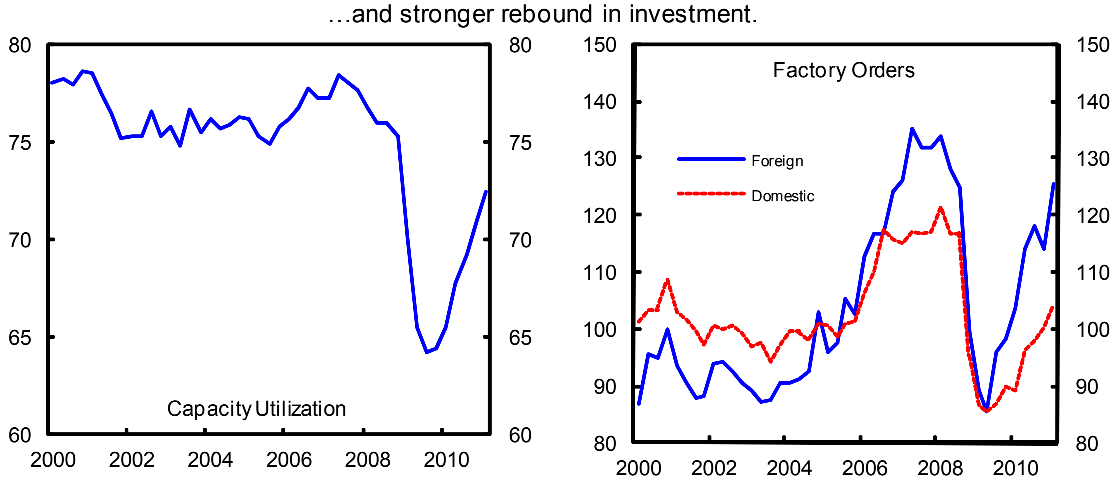
Indicators point to a modest recovery in consumption ...



...industrial output...

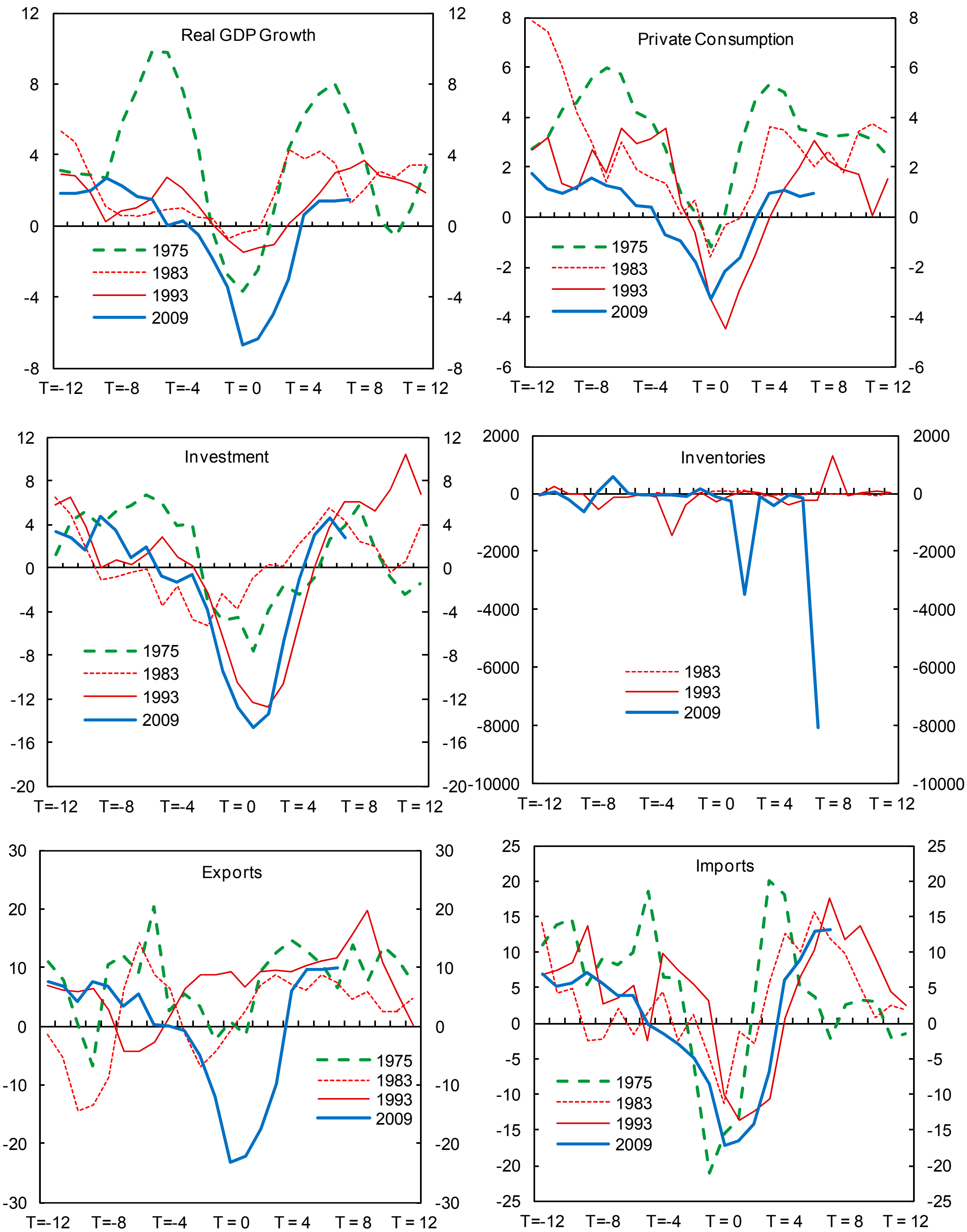


...and stronger rebound in investment.



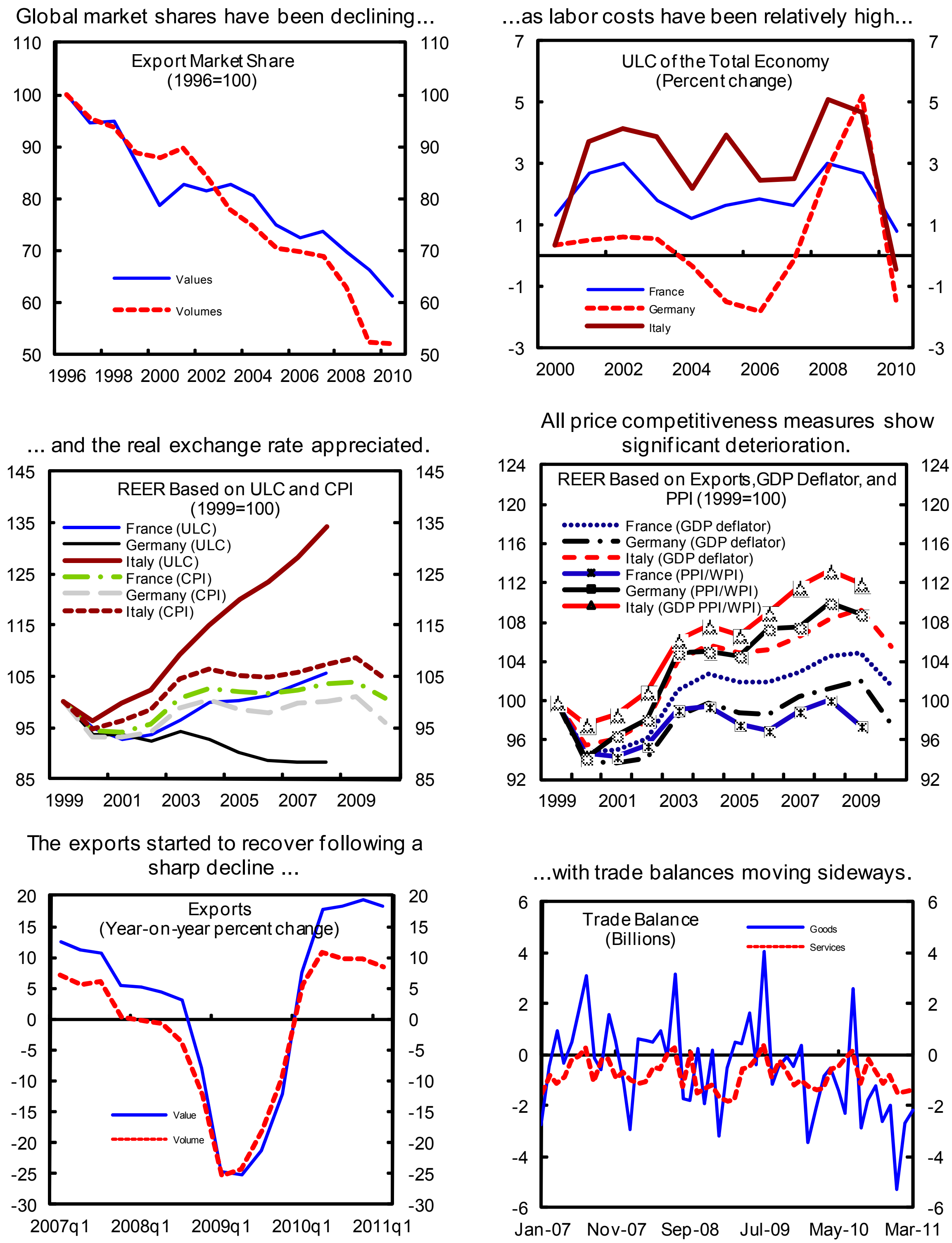
Sources: Istituto Nazionale di Statistica; and IMF staff calculations.

Figure 2. The Recovery in Historical Perspective
(Year-on-year change, Index, Trough=0) 1/



Sources: Eurostat; and Istituto Nazionale di Statistica.
1/ The troughs correspond to 1975(q2), 1983(q1), 1993(q1), and 2009(q1).

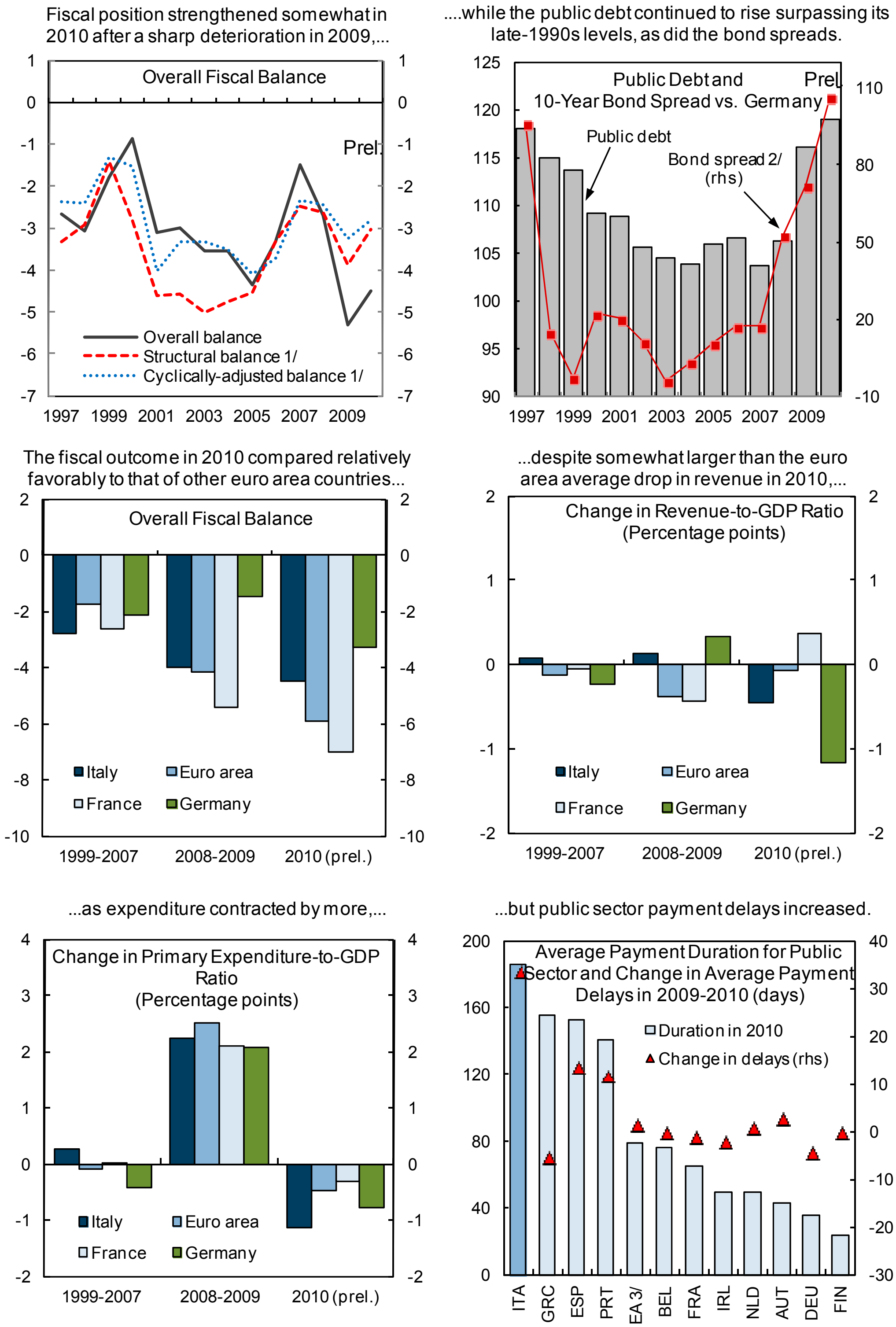
Figure 3. Standard Competitiveness Indicators Point to a Gap



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

Figure 4. Italy: Fiscal Overview, 1997–2010

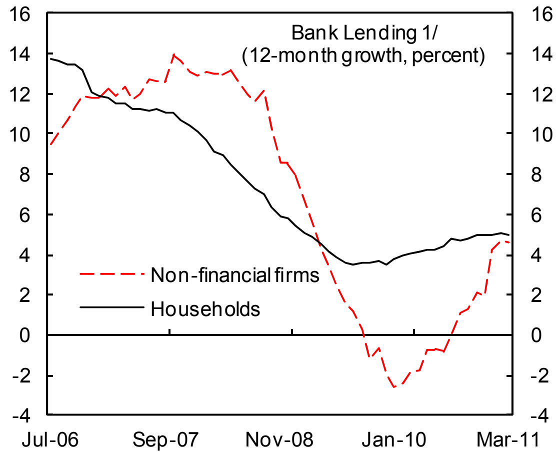
(Percent of GDP, unless otherwise indicated)

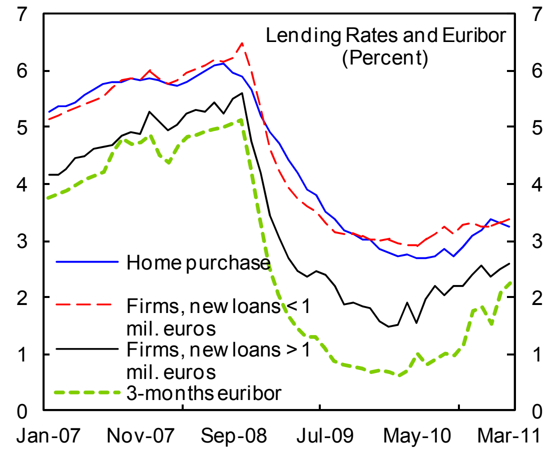


Sources: ISTAT; WEO; European Payment Index; and IMF staff estimates.
1/ Percent of potential GDP.
2/ Basis points.
3/ EA = Euro area-11, excluding Italy.

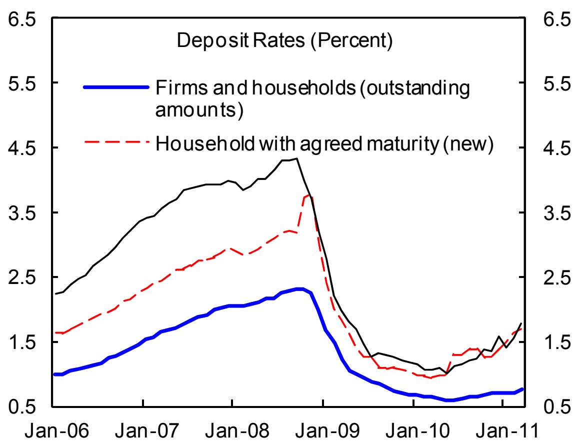
Figure 5. Italy: Bank Credit, Interest Rates, and Non-performing Loans

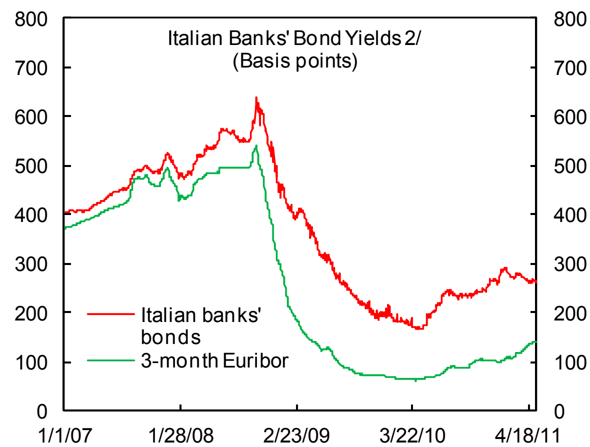
Bank credit is recovering, but lending rates are inching up.



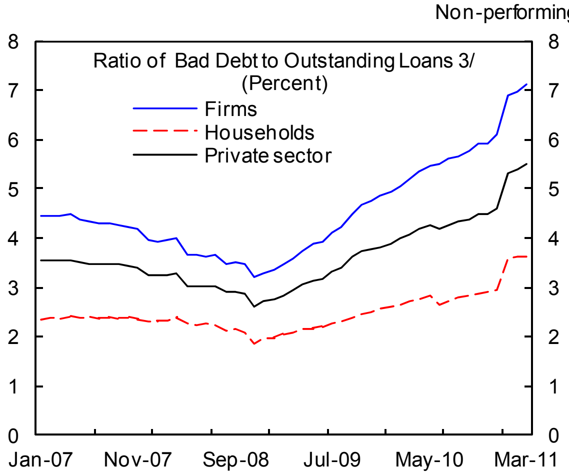


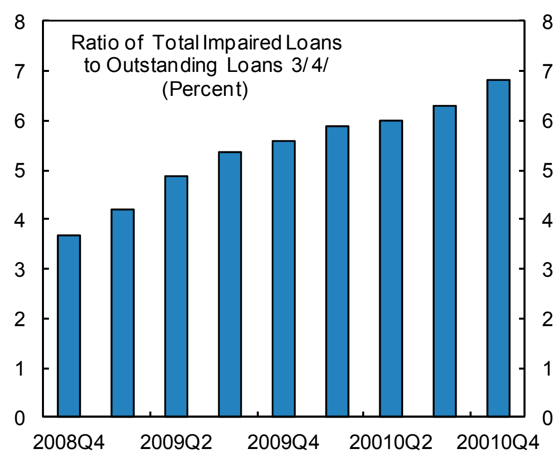
Funding costs are increasing.





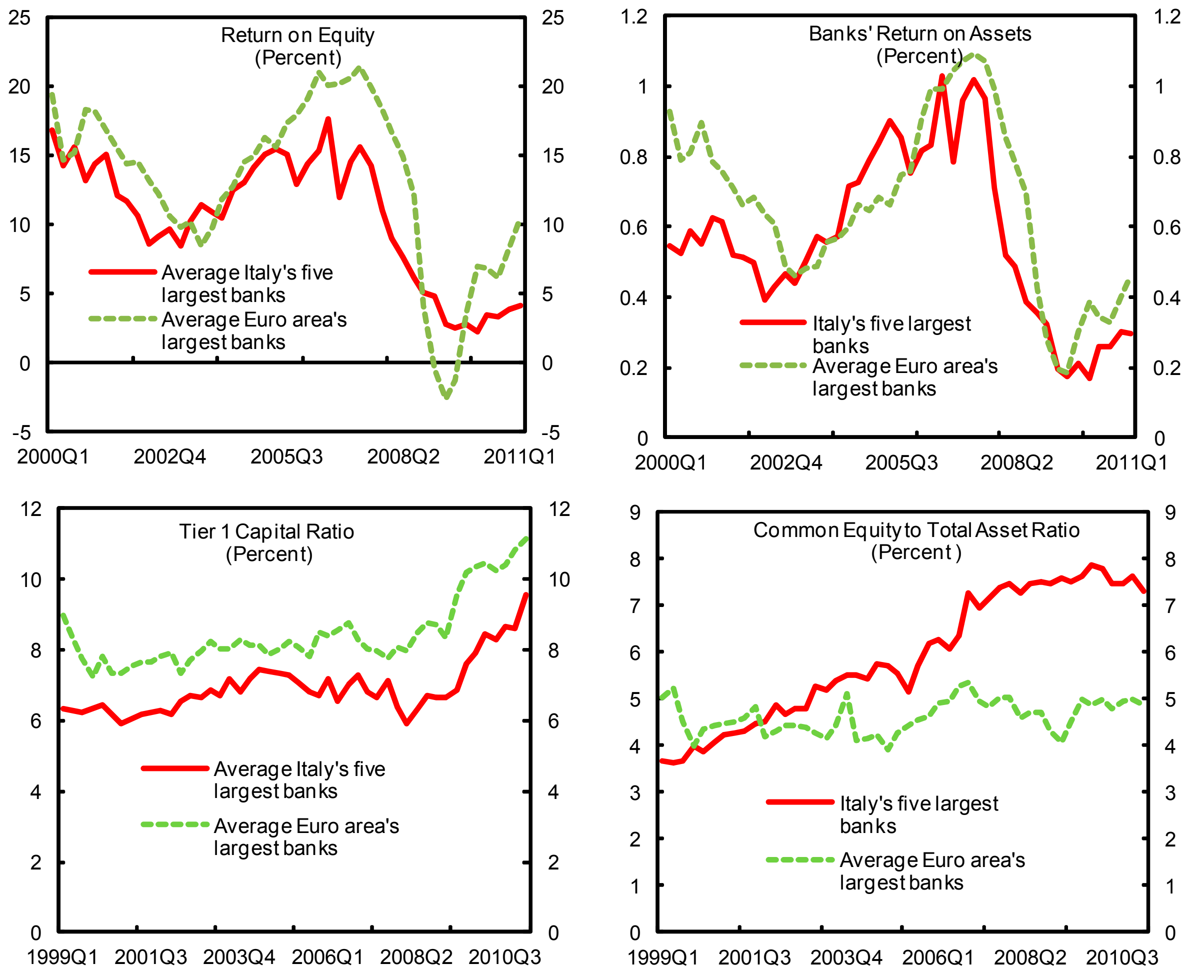
Non-performing loans remain elevated.





Sources: Bank of Italy; Bloomberg, Datastream; and IMF staff calculations.
1/ Corrected for securatization.
2/ Average yields of bonds issued by the five largest Italian banks.
3/ The sharp increase in bad debt in January 2011 is partly due to a statistical discontinuity in the data.
4/ Bad debt, substandard, restructured and overdue/overdrawn loans.

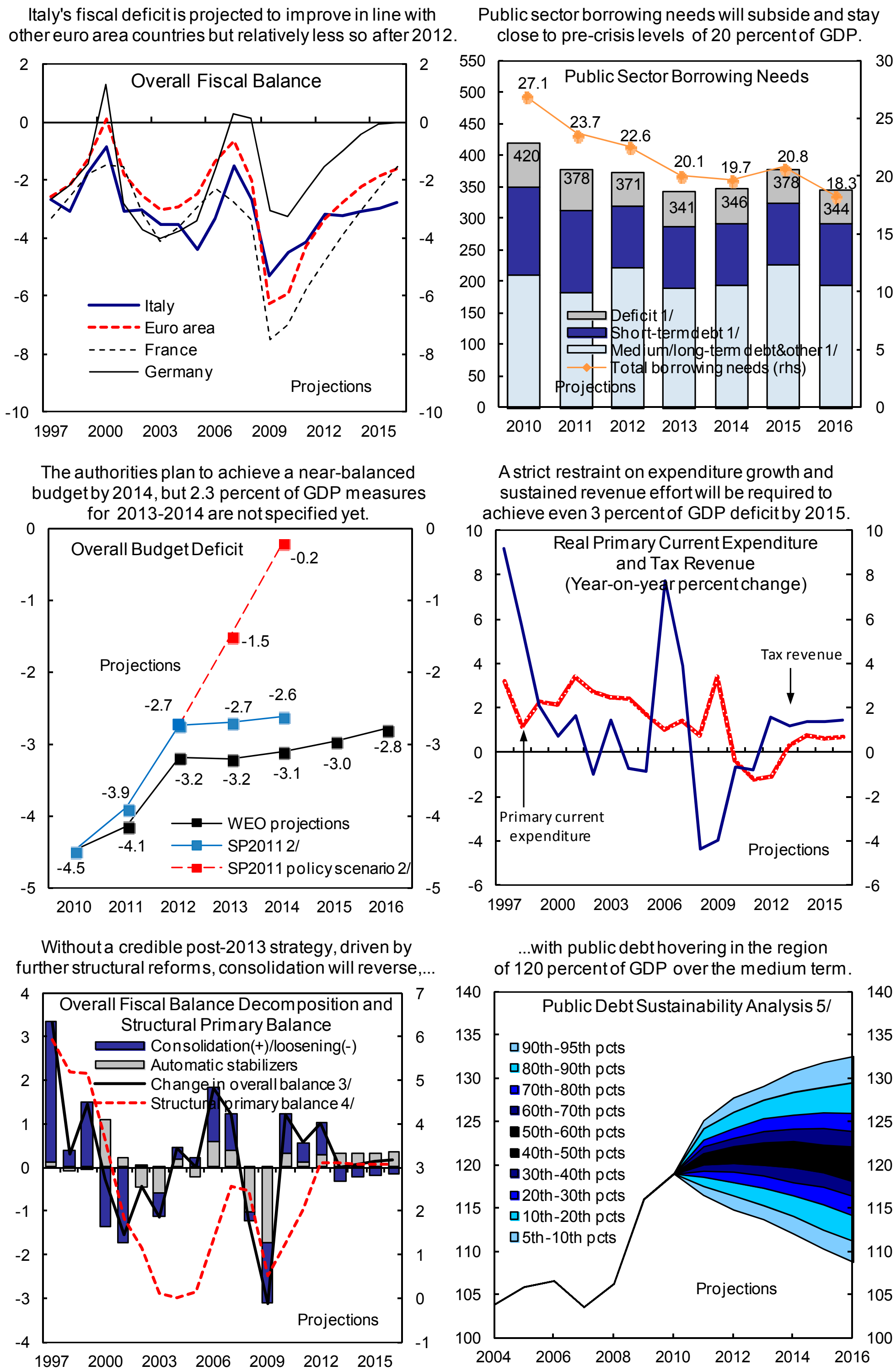
Figure 6. Italy: Indicators on the Five Largest Banks



Sources: Bloomberg; and IMF staff calculations.

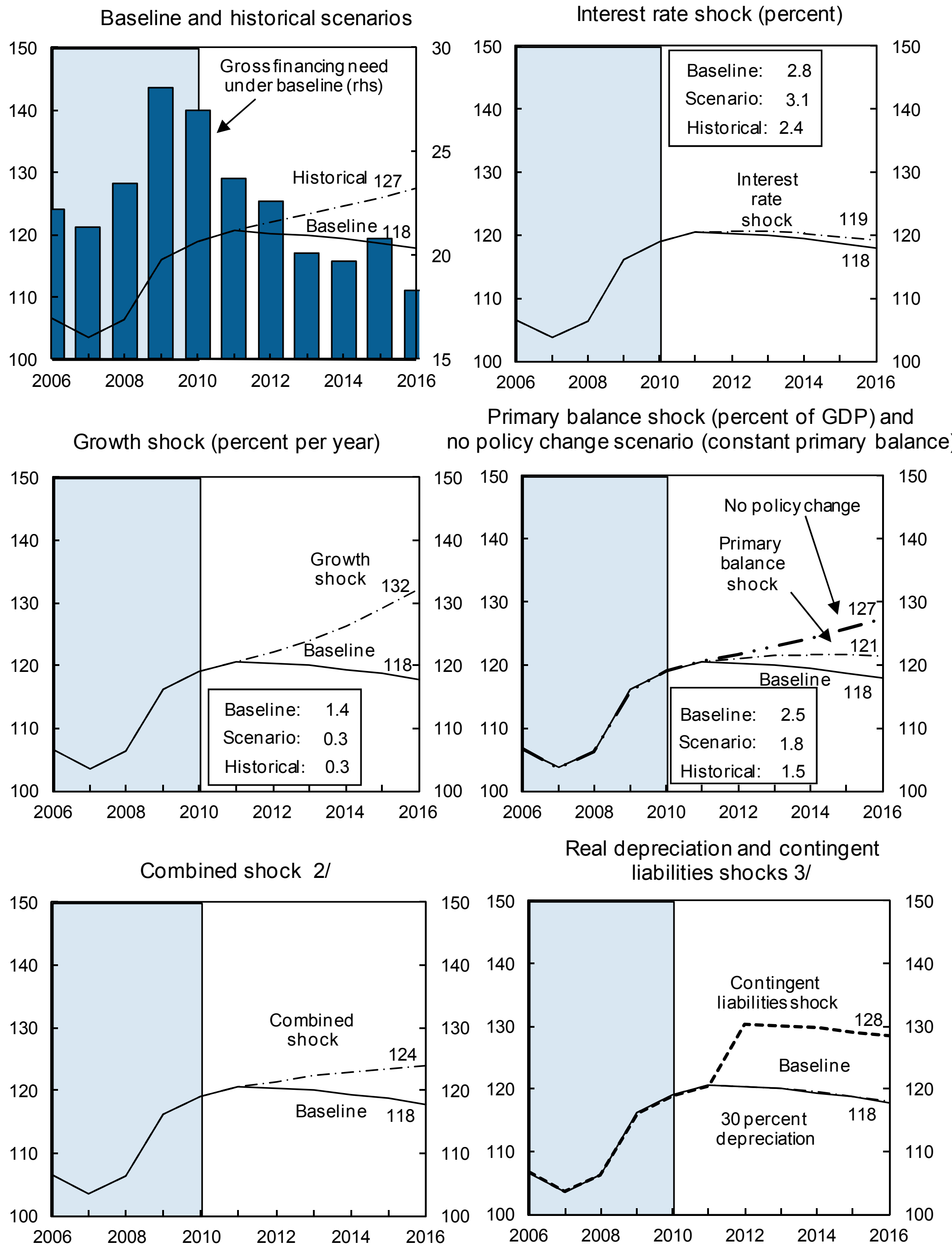
Figure 7. Italy: Medium-Term Fiscal Outlook, 1997–2016

(Percent of GDP, unless otherwise indicated)



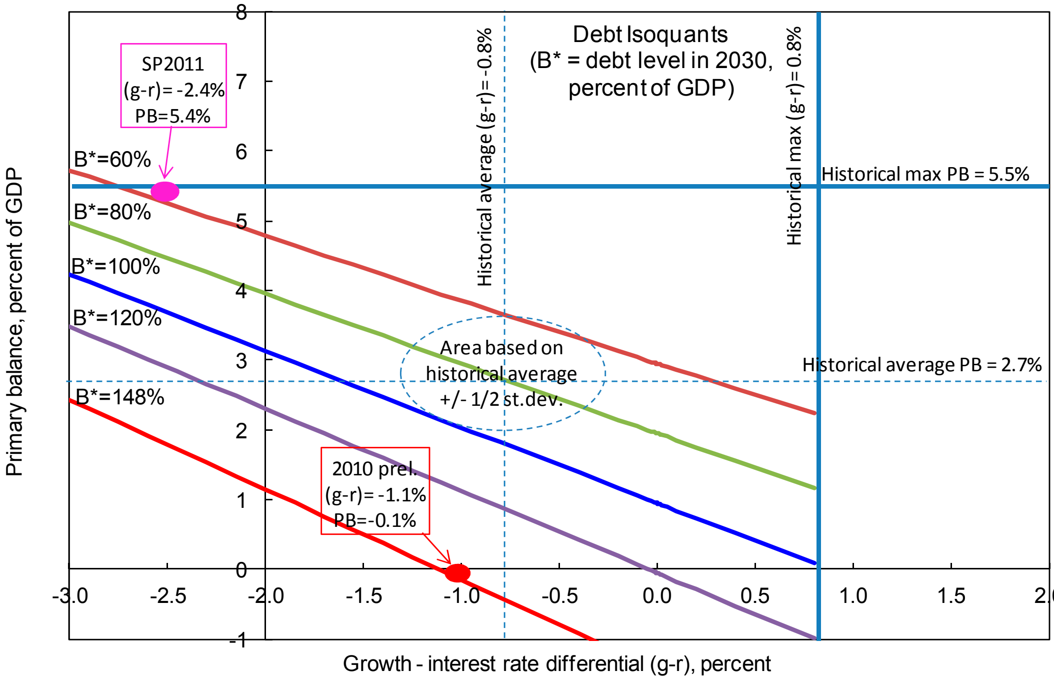
Sources: Bank of Italy; ISTAT; WEO; Ministry of Economy and Finance; and IMF staff estimates.
1/ Billions of euros.
2/ SP2011 = Stabililty Programme (April 2011).
3/ Excluding one-off measures.
4/ Excluding one-off measures (percent of potential GDP, right hand side).
5/ Based on staff projections for the primary fiscal balance. For discussion of methodology, see IMF SPN/09/18.

Figure 8. Italy: Public Debt Sustainability: Bound Tests 1/
(General government gross debt; percent of GDP, unless otherwhise indicated)



Sources: WEO; and IMF 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 1/4 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 2012, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Figure 9. Italy: An Illustrative Range of Possible Levels of Public Debt in 2030

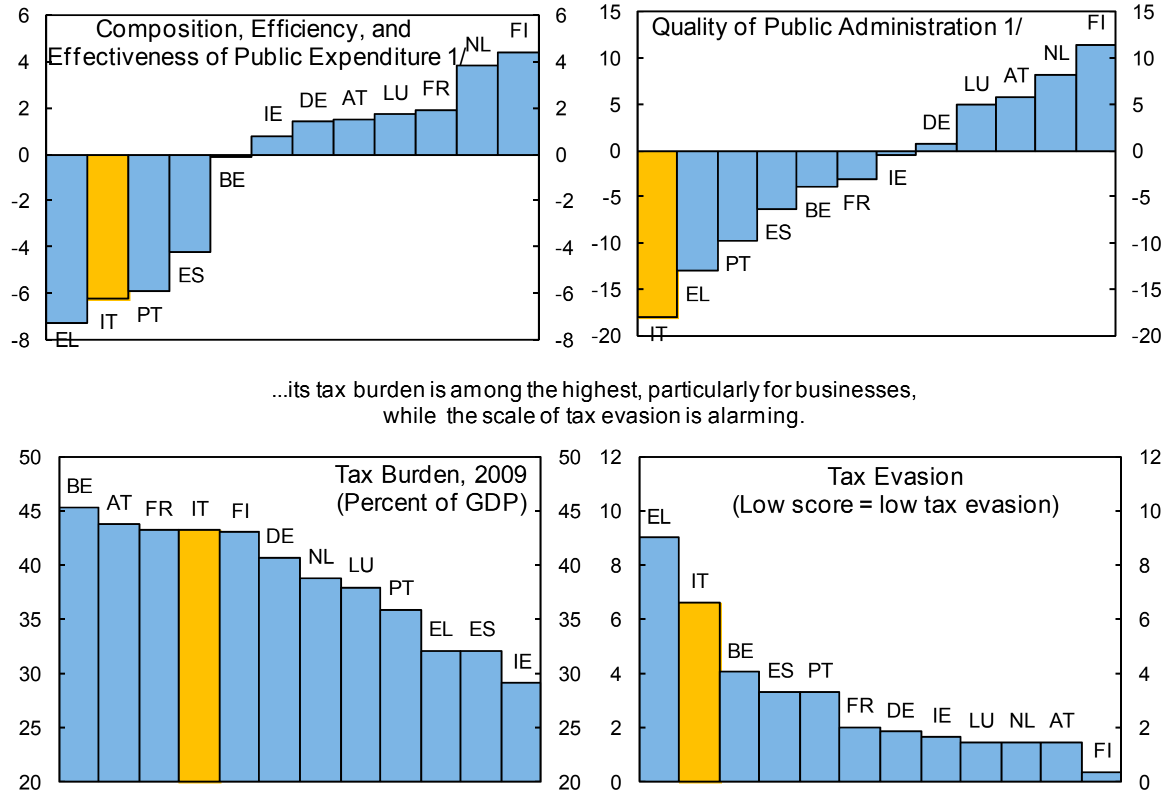


Source: IMF staff estimates.

Note: The figure shows combinations of primary balance (PB) and growth-interest rate differential (g-r) that would result in the same levels of debt in 2030. In paritcular, by 2030: (i) with PB and (g-r) kept at historical average levels, the debt would reach about 80 percent of GDP; (ii) with PB and (g-r) kept at their 2010 levels, the debt would reach about 150 percent of GDP; and (iii) with PB and (g-r) kept at their expected 2014levels as projected in the authorities' April 2011 Stability Programme Update (SP2011), the debt would reach close to 60 percent of GDP. Historical averages and maximums refer to the perod of 1999-2007.

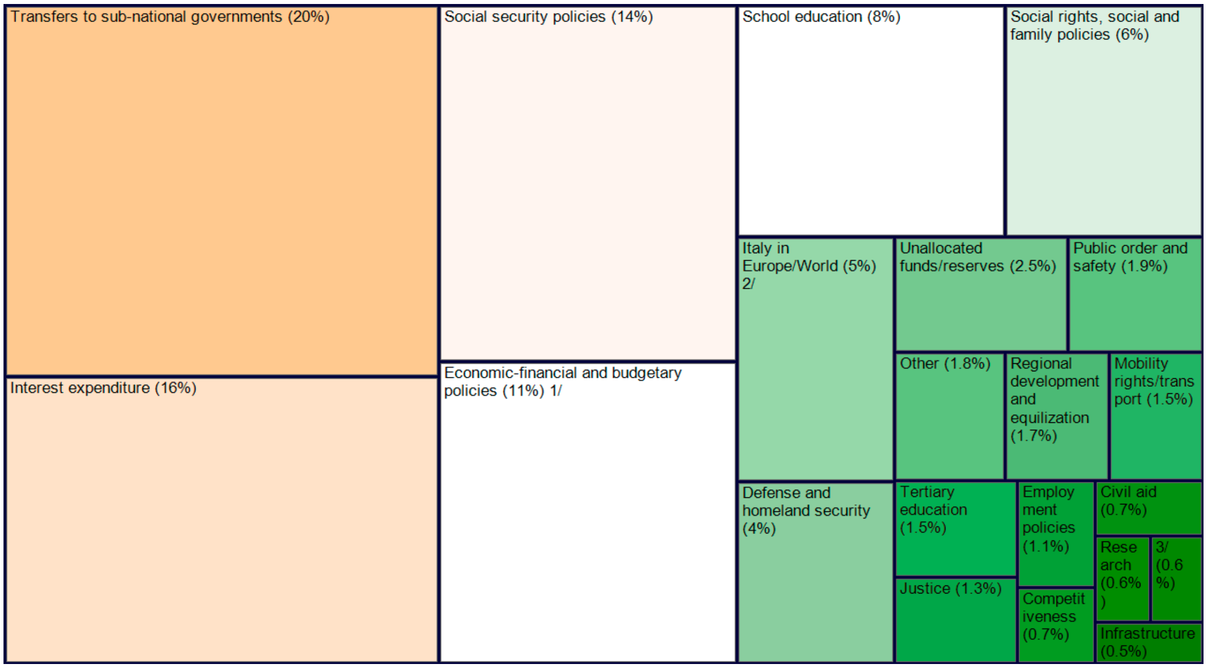
Figure 10. Italy: Selected Fiscal Structural Indicators

While Italy's public expenditure ranks among the worse in the euro area in terms of quality and efficiency, especially for public administration...



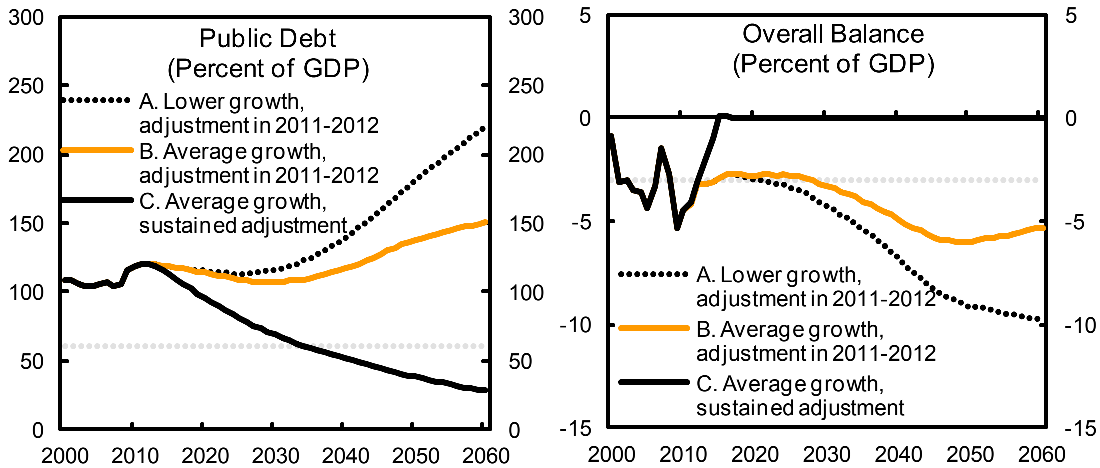
Sources: European Commission (Economic Papers 382, July 2009); ISTAT; and Sustainable Governance Indicators 2009.
1/ Scores range from -30 to +30 with an EU-15 average of 0: (-30 ,-10) = very poor; (-10,-4) = poor; (-4,+4) = average, (+4,+10) = good ; (+10 ,+30) = very good.

Figure 11. Central Government Expenditure by Main Missions in 2011
(Percent of total €533 billion accrual-based initial allocations as per 2011 Budget Law, excluding debt amortization of €210 billion)



Sources: Ministry of Economy and Finance, and IMF staff calculations.
1/ Includes mainly accounting adjustments and tax refunds.
2/ Includes mainly participation in EU budgetary policies.
3/ Constitutional bodies and Presidency of the Council of Ministers.

Figure 12. Italy: Long-Term Fiscal Sustainability, 2000–2060—Illustrative Scenarios 1/



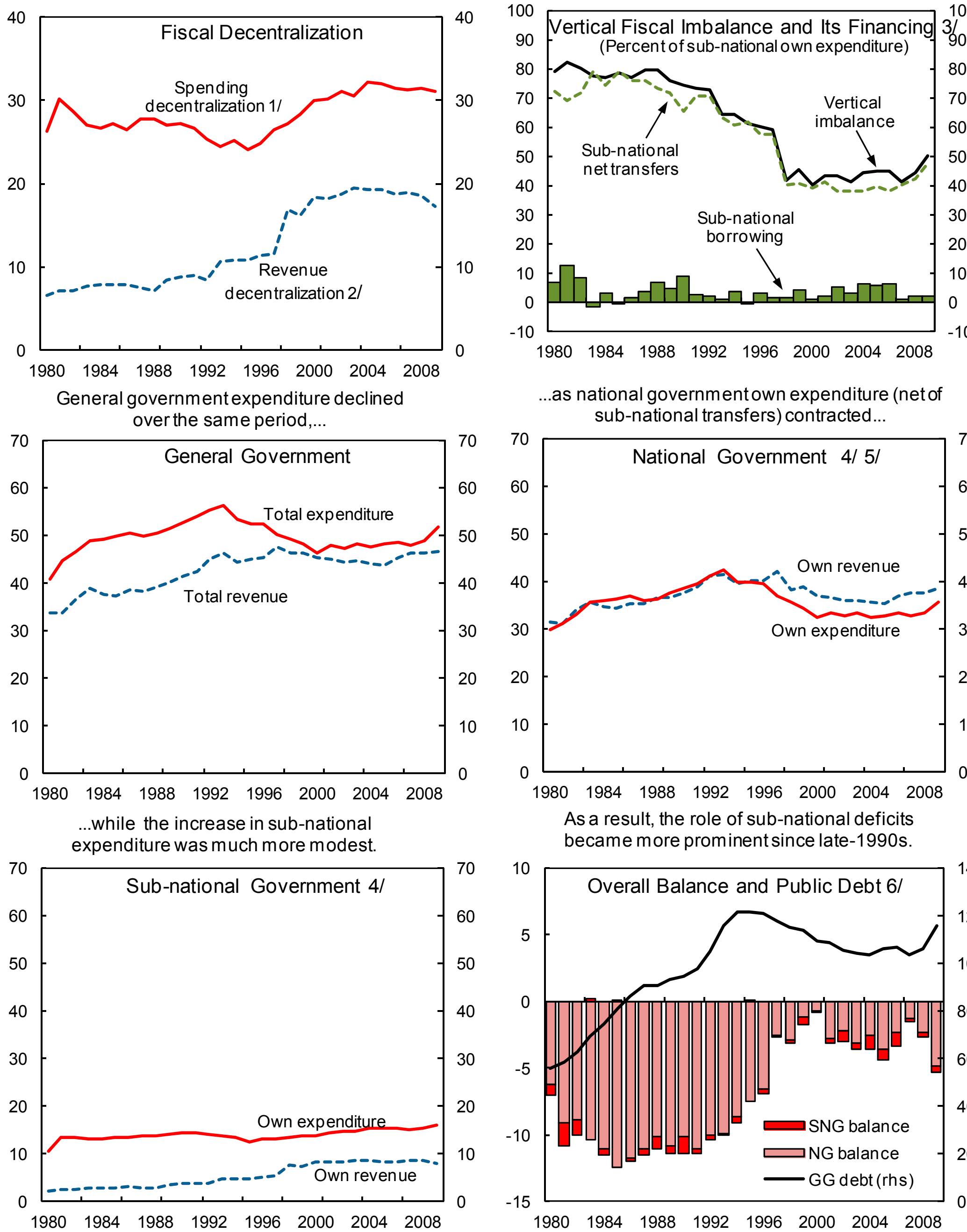
Sources: Ministry of Economy and Finance; and IMF staff estimates.

1/ Assumptions underlying the illustrative scenarios (growth rates are average rates for 2017–2060):
A: Fiscal projections as in the staff's baseline for 2010–2016 (adjustment of 1.2% of GDP in 2011–2012 and loosening of about 1.0% of GDP in 2013–2016); long-term real GDP growth of 0.85%.
B: Fiscal projections as Scenario A; long-term real GDP growth of 1.1%.
C: Sustained fiscal adjustment, including 1.3% of GDP in 2011–2012 and 0.75% of GDP in each 2013–2015; long-term real GDP growth of 1.1%. Structural balance is kept unchanged at zero once the headline overall balance reaches zero in 2015. The overall size of the adjustment in 2011–2014 is similar to that envisaged in the authorities' April 2011 Stability Programme Update.

Figure 13. Italy: Fiscal Decentralization, Vertical Imbalance, and Fiscal Performance by Level of Government, 1980–2009

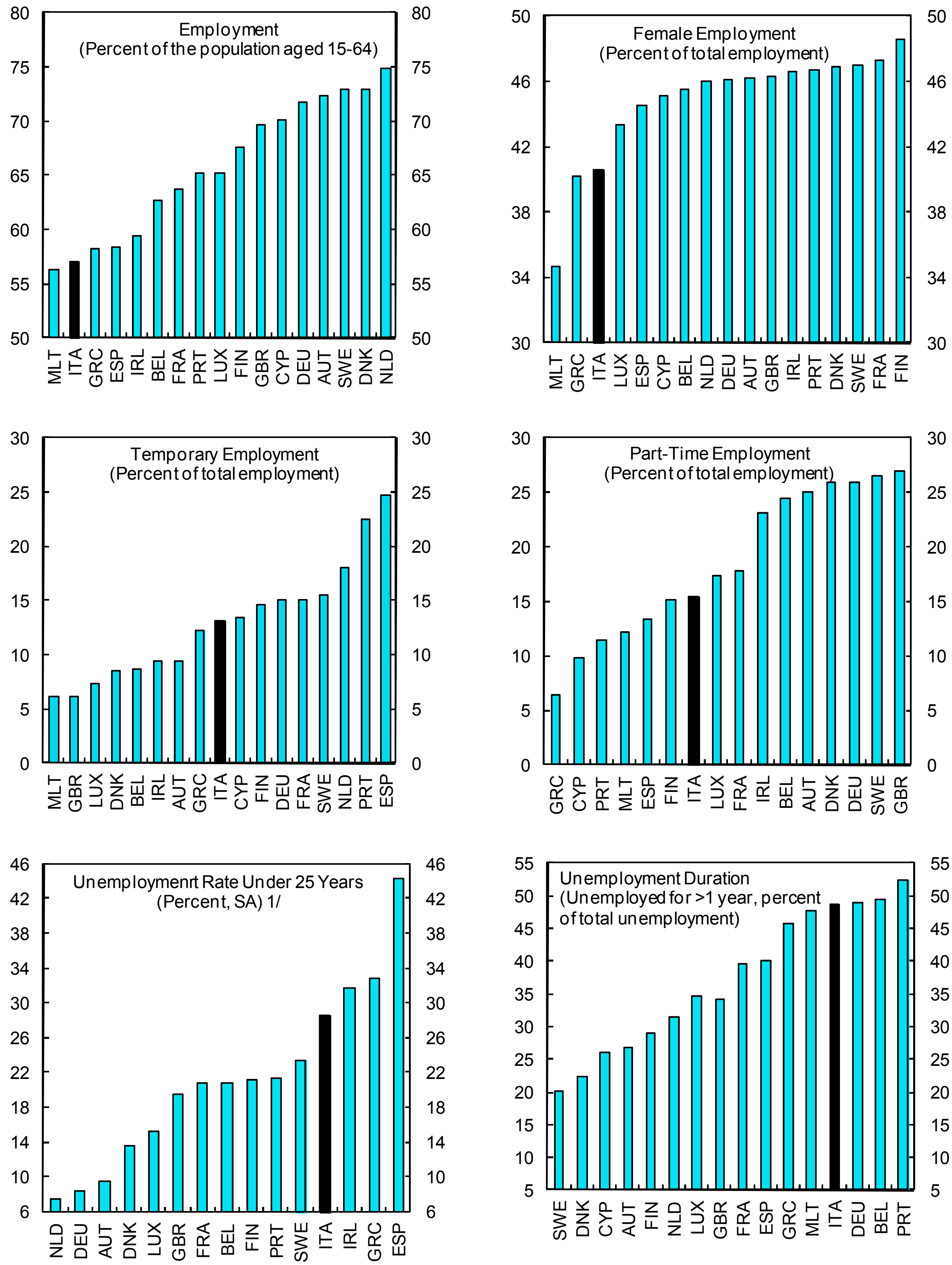
(Percent of GDP, unless otherwise indicated)

Expenditure and revenue shares assigned to sub-national governments increased since early 1990s, with the share of sub-national spending financed with transfers declining until most recently.



Sources: OECD; ISTAT; WEO; and IMF staff calculations.
1/ Share of sub-national expenditure (excluding transfers paid) in general government expenditure.
2/ Share of sub-national own revenue (excluding transfers received) in general government revenue.
3/ Vertical fiscal imbalance is defined as the share of sub-national own expenditure financed with sources other than own revenue (i.e., transfers and borrowing).
4/ Own revenue/expenditure is defined as revenue/expenditure net of transfers received/paid.
5/ National government is consolidated central government and social security.
6/ SNG = sub-national government; NG = National government; GG debt = general government gross debt.

Figure 14. Italy's Labor Market Outcomes in Cross-Country Comparison, 2010



Source: Eurostat.
1/Data for Greece and the UK is as of 2010. All other data are as of 2011q1.

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

	2007	2008	2009	2010	2011 1/	2012 1/	2013 1/	2014 1/	2015 1/	2016 1/
Real GDP	1.5	-1.3	-5.2	1.3	1.0	1.3	1.4	1.4	1.4	1.4
Public consumption	0.9	0.5	1.0	-0.6	-0.3	0.2	-0.8	0.3	0.2	0.3
Private consumption	1.1	-0.8	-1.8	1.0	1.4	1.4	1.4	1.3	1.2	1.2
Gross fixed capital formation	1.7	-3.8	-11.9	2.5	2.6	2.6	2.6	2.2	2.1	2.0
Final domestic demand	1.2	-1.2	-3.4	0.9	1.3	1.4	1.2	1.3	1.2	1.2
Stock building 2/	0.1	-0.2	-0.6	0.7	0.1	0.0	0.0	0.0	0.0	0.0
Net exports 2/	0.2	0.1	-1.3	-0.5	-0.2	0.4	0.1	0.1	0.2	0.2
Exports of goods and services	4.6	-4.3	-18.4	9.1	4.6	4.6	4.5	4.5	4.5	4.5
Imports of goods and services	3.8	-4.4	-13.7	10.5	5.0	3.0	4.0	3.9	3.7	3.7
Money and credit (end of period, percent change)										
Private sector credit 3/	9.8	4.9	1.7	8.4	…	…	…	…	…	…
National contribution to euro area M3 4/	7.6	6.9	5.5	2.4	…	…	…	…	…	…
Interest rates (percent, end of period)										
6-month interbank rate	4.9	3.7	1.0	2.3	…	…	…	…	…	…
Government bond rate, 10-year	4.7	4.5	4.1	4.8	…	…	…	…	…	…
Resource utilization										
Potential GDP	0.8	0.7	-1.9	0.6	0.7	0.7	0.7	0.7	0.7	0.7
Output Gap (percent of potential)	1.5	-0.5	-3.9	-3.3	-3.1	-2.5	-2.0	-1.3	-0.7	0.0
Natural rate of unemployment	6.2	6.7	7.5	8.2	8.4	8.1	7.8	7.5	7.4	7.4
Employment	1.0	0.8	-1.6	-0.5	0.2	0.7	0.9	0.9	0.8	0.6
Unemployment rate (percent)	6.1	6.8	7.8	8.4	8.6	8.3	7.9	7.6	7.4	7.4
Prices										
GDP deflator	2.6	2.8	2.3	0.6	1.8	1.9	1.9	2.0	2.0	2.0
Consumer prices	2.0	3.5	0.8	1.6	2.5	2.2	2.0	2.0	2.0	2.0
Hourly compensation	3.8	6.0	6.6	-0.8	-0.1	2.0	2.0	2.3	2.4	2.4
Productivity	0.4	-1.0	-2.4	2.0	0.6	0.6	0.6	0.7	0.8	0.8
Unit labor costs	3.4	7.0	9.0	-2.8	-0.7	1.4	1.4	1.6	1.6	1.6
Fiscal indicators										
General government net lending/borrowing 5/	-1.5	-2.7	-5.3	-4.5	-4.1	-3.2	-3.2	-3.1	-3.0	-2.8
Structural overall balance (percent of potential GDP)	-2.5	-2.6	-3.9	-3.0	-2.6	-1.9	-2.2	-2.4	-2.6	-2.8
Public debt 5/	103.6	106.3	116.1	119.0	120.6	120.3	120.0	119.4	118.7	117.8
Exchange rate regime				Member of EMU						
Exchange rate (national currency per U.S. dollar)	1.4	1.5	1.4	1.3	1.4	1.4	1.4	1.4	1.4	1.4
Nominal effective rate: CPI based (2000=100)	101.7	103.7	104.6	101.3	…	…	…	…	…	…
Real effective exchange rate based on										
CPI (2000=100)	113.3	115.0	115.8	110.7	…	…	…	…	…	…
normalized ULC (2000=100)	135.1	142.3	142.4	137.2	…	…	…	…	…	…
External sector 5/										
Current account balance	-2.4	-2.9	-2.1	-3.3	-3.8	-3.4	-3.3	-3.3	-3.1	-2.7
Trade balance	0.2	-0.1	0.1	-1.2	-0.9	-0.7	-0.7	-0.8	-0.6	-0.3
Saving investment balance 5/										
Gross national saving	19.4	18.3	16.8	16.9	16.3	16.7	17.4	17.9	18.3	18.7
Public	2.2	0.8	-2.1	-1.6	-1.5	-0.9	-0.9	-0.9	-0.8	-0.6
Private	17.2	17.5	18.9	18.5	17.7	17.6	18.4	18.8	19.1	19.4
Gross domestic investment	21.9	21.2	18.9	20.2	20.0	20.1	20.7	21.3	21.4	21.4
Gross fixed domestic investment	21.2	20.8	19.1	19.5	20.2	20.6	20.9	21.2	21.4	21.6
Public	2.3	2.2	2.5	2.1	1.8	1.5	1.6	1.5	1.5	1.5
Private	18.9	18.5	16.6	17.4	18.4	19.1	19.4	19.7	19.9	20.1
Net lending	-2.4	-2.9	-2.1	-3.3	-3.8	-3.4	-3.3	-3.3	-3.1	-2.7

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.
4/ Excludes currency in circulation held by nonbank private sector.
5/ Percent of GDP.

Table 2. Italy: General Government Accounts (National Presentation), 2008–2016

(Percent of GDP, unless otherwise indicated)

	2008	2009	2010	2011		2012		2013			2014			2015	2016
			Prel.	Proj.	DEF/SP	Proj.	DEF/SP	Proj.	DEF/SP	SP-P	Proj.	DEF/SP	SP-P	Proj.	Proj.
Total Revenues	46.7	47.1	46.6	46.2	46.4	46.3	46.8	46.1	46.6	…	46.1	46.4	…	46.1	46.1
Current revenues	46.4	46.1	46.2	45.9	46.1	45.9	46.4	45.8	46.2	…	45.8	46.1	…	45.8	45.8
Tax revenues	29.1	29.0	28.8	28.5	28.7	28.6	29.0	28.6	29.0	…	28.6	28.9	…	28.6	28.6
Direct taxes	15.3	14.7	14.6	14.4	14.4	14.5	14.8	14.5	14.8	…	14.5	14.7	…	14.5	14.5
Indirect taxes	13.8	13.6	14.0	14.1	14.2	14.1	14.2	14.0	14.2	…	14.0	14.2	…	14.0	14.0
Social security contributions	13.8	14.1	13.8	13.8	13.8	13.7	13.7	13.6	13.6	…	13.6	13.5	…	13.6	13.6
Other current revenues	3.6	3.8	3.8	3.7	3.7	3.6	3.7	3.6	3.7	…	3.6	3.6	…	3.6	3.6
Capital revenues	0.3	1.0	0.5	0.3	0.3	0.3	0.4	0.3	0.4	…	0.3	0.4	…	0.3	0.3
Total expenditures	49.4	52.5	51.2	50.4	50.3	49.5	49.5	49.3	49.3	…	49.2	49.0	…	49.1	48.9
Current expenditures	45.6	48.1	47.8	47.4	47.3	46.8	46.7	46.7	46.6	…	46.7	46.4	…	46.6	46.4
Wages and salaries	10.8	11.3	11.1	10.7	10.7	10.4	10.4	10.1	10.1	…	10.0	9.8	…	10.0	9.9
Goods and services	8.2	9.0	8.8	8.6	8.6	8.4	8.5	8.4	8.4	…	8.3	8.4	…	8.1	8.0
Social transfers	17.7	19.2	19.3	19.2	19.2	19.1	19.1	19.1	19.1	…	19.2	19.2	…	19.2	19.2
Other	3.8	4.1	4.0	4.0	3.9	3.8	3.7	3.8	3.6	…	3.7	3.5	…	3.6	3.4
Interest payments	5.2	4.6	4.5	4.8	4.8	5.1	5.1	5.4	5.4	5.4	5.6	5.6	5.6	5.7	5.9
Capital expenditures	3.8	4.4	3.5	3.0	3.1	2.6	2.8	2.6	2.7	…	2.5	2.6	…	2.5	2.5
Of which: asset sales	-0.1	-0.1	-0.1	-0.2	…	-0.1	…	-0.1	…	…	-0.1	…	…	-0.1	-0.1
Overall balance	-2.7	-5.4	-4.6	-4.1	-3.9	-3.2	-2.7	-3.2	-2.7	-1.5	-3.1	-2.6	-0.2	-3.0	-2.8
Memorandum items:															
Primary balance	2.5	-0.7	-0.1	0.6	0.9	1.9	2.4	2.2	2.7	3.9	2.5	2.9	5.4	2.8	3.1
One-off measures (negative=balance-improving)	-0.2	-0.7	-0.2	-0.1	0.0	-0.1	-0.1	0.0	0.0	0.0	-0.1	0.0	0.0	-0.1	-0.1
Cyclically-adjusted overall balance	-2.4	-3.4	-2.9	-2.6	-2.9	-1.9	-2.2	-2.2	…	-1.3	-2.4	…	-0.5	-2.6	-2.8
Cyclically-adj. overall balance excl. asset sales 1/	-2.5	-3.3	-2.9	-2.7	…	-1.9	…	-2.2	…	…	-2.4	…	…	-2.6	-2.8
Cyclically-adj. primary balance excl. asset sales 1	2.6	1.1	1.5	1.9	…	3.1	…	3.1	…	…	3.1	…	…	3.1	3.1
Structural overall balance	-2.7	-4.0	-3.1	-2.7	-3.0	-1.9	-2.2	-2.2	…	-1.4	-2.5	…	-0.5	-2.7	-2.8
Change in structural overal balance	-0.2	-1.4	0.9	0.4	0.5	0.7	0.8	-0.3	…	0.8	-0.2	…	0.8	-0.2	-0.2
Structural overall balance 1/	-2.6	-3.9	-3.0	-2.6	…	-1.9	…	-2.2	…	…	-2.4	…	…	-2.6	-2.8
Change in structural overal balance 1/	-0.2	-1.2	0.9	0.4		0.7		-0.3	…	…	-0.2	…	…	-0.2	-0.2
Structural primary balance 1/	2.5	0.6	1.4	1.0	…	3.1	…	3.1	…	…	3.1	…	…	3.1	3.1
Primary current expenditure real growth rate 2/	0.8	3.4	-0.3	-1.2	-1.0	-1.1	-1.0	0.3	0.3	…	0.8	0.7	…	0.7	0.7
Nominal GDP growth rate 2/	1.4	-3.1	1.9	2.8	2.9	3.2	3.1	3.3	3.3	…	3.4	3.4	…	3.4	3.5
Real GDP growth rate 2/	-1.3	-5.2	1.3	1.0	1.1	1.3	1.3	1.4	1.5	1.5	1.4	1.6	1.6	1.4	1.4
Output gap 1/	-0.5	-3.9	-3.3	-3.1	-1.9	-2.5	-1.1	-2.0	-0.3	-0.3	-1.3	0.5	0.5	-0.7	0.0
Public debt	106.3	116.1	119.0	120.6	120.0	120.3	119.4	120.0	…	116.9	119.4	…	112.8	118.7	117.8

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

1/ Percent of potential GDP.

2/ Percent.

DEF/SP = Documento di Economia e Finanza 2011/Stability Programme Update (April 2011); unchanged legislation scenario.

SP-P = Documento di Economia e Finanza 2011/Stability Programme Update (April 2011); policy scenario.

Table 2.1. Italy: Statement of Operations – General Government (GFSM 2001 format), 2008–2016

	2008	2009	2010	2011	2012	2013	2014	2015	2016
			Prel.	Projections					
		(Billions of euros)							
Revenue	723.4	707.0	713.0	727.9	753.8	775.5	802.0	829.3	858.2
Taxes	455.9	441.1	445.4	453.2	470.6	485.7	502.3	519.5	537.4
Social contributions	215.9	213.5	214.5	219.7	225.2	230.5	238.4	246.5	255.1
Grants	2.9	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Other revenue	48.8	49.3	50.1	52.0	55.0	56.3	58.3	60.3	62.7
Expenditure	765.5	787.6	782.5	793.9	806.1	829.8	856.5	883.1	910.3
Expense	759.5	779.4	781.8	795.5	810.1	832.7	859.3	885.7	912.7
Compensation of employees	169.7	171.0	171.9	171.1	170.7	170.8	175.7	180.8	186.4
Use of goods and services	85.6	91.7	91.6	90.8	91.1	92.9	93.9	94.6	95.2
Consumption of fixed capital	29.0	29.9	31.2	30.1	28.9	29.6	29.6	29.7	29.8
Interest	80.7	69.2	68.4	76.2	84.2	91.7	97.9	104.4	110.7
Social benefits	320.0	335.9	343.6	352.8	361.4	374.4	387.8	401.0	414.9
Other expense	74.6	81.6	75.1	74.5	73.8	73.2	74.4	75.2	75.7
Net acquisition of nonfinancial assets	6.0	8.2	0.7	-1.6	-4.0	-2.8	-2.7	-2.6	-2.4
Gross / Net Operating Balance 1/	-36.1	-72.4	-68.7	-67.6	-56.3	-57.1	-57.3	-56.4	-54.6
Net lending/borrowing	-42.1	-80.6	-69.4	-66.0	-52.3	-54.3	-54.6	-53.8	-52.1
Net acquisition of financial assets	17.0	23.6	…	…	…	…	…	…	…
Net incurrence of liabilities	57.4	100.6	…	…	…	…	…	…	…
		(Percent of GDP, unless otherwise indicated)							
Revenue	46.1	46.5	46.0	45.7	45.9	45.7	45.7	45.7	45.7
Taxes	29.1	29.0	28.8	28.5	28.6	28.6	28.6	28.6	28.6
Social contributions	13.8	14.1	13.8	13.8	13.7	13.6	13.6	13.6	13.6
Grants	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Other revenue	3.1	3.2	3.2	3.3	3.3	3.3	3.3	3.3	3.3
Expenditure	48.8	51.8	50.5	49.9	49.0	48.9	48.8	48.6	48.5
Expense	48.4	51.3	50.5	50.0	49.3	49.0	48.9	48.8	48.6
Compensation of employees	10.8	11.3	11.1	10.7	10.4	10.1	10.0	10.0	9.9
Use of goods and services	5.5	6.0	5.9	5.7	5.5	5.5	5.3	5.2	5.1
Consumption of fixed capital	1.8	2.0	2.0	1.9	1.8	1.7	1.7	1.6	1.6
Interest	5.1	4.6	4.4	4.8	5.1	5.4	5.6	5.7	5.9
Social benefits	20.4	22.1	22.2	22.2	22.0	22.1	22.1	22.1	22.1
Other expense	4.8	5.4	4.8	4.7	4.5	4.3	4.2	4.1	4.0
Net acquisition of nonfinancial assets	0.4	0.5	0.0	-0.1	-0.2	-0.2	-0.2	-0.1	-0.1
Gross / Net Operating Balance 1/	-2.3	-4.8	-4.4	-4.2	-3.4	-3.4	-3.3	-3.1	-2.9
Net lending/borrowing	-2.7	-5.3	-4.5	-4.1	-3.2	-3.2	-3.1	-3.0	-2.8
Net acquisition of financial assets	1.1	1.6	…	…	…	…	…	…	…
Net incurrence of liabilities	3.7	6.6	…	…	…	…	…	…	…
Memorandum items:									
Primary balance 2/	2.5	-0.7	-0.1	0.6	1.9	2.2	2.5	2.8	3.1
Structural balance 3/	-2.6	-3.9	-3.0	-2.6	-1.9	-2.2	-2.4	-2.6	-2.8
Change in structural balance 3/	-0.2	-1.2	0.9	0.4	0.7	-0.3	-0.2	-0.2	-0.2
Structural primary balance 3/	2.5	0.6	1.4	2.0	3.1	3.1	3.1	3.1	3.1
General government gross debt	106.3	116.1	119.0	120.6	120.3	120.0	119.4	118.7	117.8

Sources: ISTAT; IMF GFS; and IMF staff estimates.
1/ Revenue minus expense.
2/ Revenue minus primary expenditure.
3/ Percent of potential GDP.

Table 2.2. Italy: General Government Balance Sheet, 2005–2010

	2005	2006	2007	2008	2009	2010 Prel.
(Billions of euros)						
Net worth	…	…	…	…	…	…
Nonfinancial assets	…	…	…	…	…	…
Net financial worth	-1341	-1348	-1347	-1409	-1525	-1534
Financial assets	375	397	397	398	418	428
Currency and deposits	58	69	58	68	80	93
Securities other than shares	9	11	14	15	17	20
Loans	59	49	51	54	55	58
Shares and other equity	137	146	145	129	131	124
Insurance technical reserves	2	2	2	2	2	2
Financial derivatives	0	0	0	0	0	0
Other accounts receivable	109	119	127	130	134	132
Financial liabilities	1716	1745	1744	1807	1943	1962
Currency and deposits	220	223	212	211	221	221
Securities other than shares	1327	1328	1333	1403	1527	1541
Loans	118	141	141	135	138	139
Shares and other equity	0	0	0	0	0	0
Insurance technical reserves	0	0	0	0	0	0
Financial derivatives	1	1	1	1	1	1
Other accounts receivable	50	53	57	56	58	61
(Percent of GDP)						
Net worth	…	…	…	…	…	…
Nonfinancial assets	…	…	…	…	…	…
Net financial worth	-93.8	-90.8	-87.1	-89.9	-100.4	-99.0
Financial assets	26.2	26.7	25.7	25.4	27.5	27.6
Currency and deposits	4.1	4.7	3.8	4.3	5.3	6.0
Securities other than shares	0.7	0.7	0.9	1.0	1.1	1.3
Loans	4.1	3.3	3.3	3.4	3.6	3.7
Shares and other equity	9.6	9.9	9.4	8.2	8.6	8.0
Insurance technical reserves	0.1	0.1	0.1	0.1	0.1	0.1
Financial derivatives	0.0	0.0	0.0	0.0	0.0	0.0
Other accounts receivable	7.7	8.0	8.2	8.3	8.8	8.5
Financial liabilities	120.0	117.5	112.8	115.3	127.9	126.7
Currency and deposits	15.4	15.0	13.7	13.5	14.5	14.3
Securities other than shares	92.9	89.4	86.2	89.5	100.5	99.5
Loans	8.3	9.5	9.1	8.6	9.1	9.0
Shares and other equity	0.0	0.0	0.0	0.0	0.0	0.0
Insurance technical reserves	0.0	0.0	0.0	0.0	0.0	0.0
Financial derivatives	0.0	0.0	0.0	0.0	0.0	0.0
Other accounts receivable	3.5	3.5	3.7	3.6	3.8	3.9

Sources: IMF GFS; and Eurostat.

Table 3. Italy: Financial Soundness Indicators (FSIs)
(Percent, unless otherwise noted)

	2005	2006	2007	2008	2009	2010Q2
Core FSIs for Deposit-taking Institutions						
Regulatory capital to risk-weighted assets	10.0	10.1	10.1	10.4	11.7	12.0
Regulatory tier I capital to risk-weighted assets	7.2	7.1	7.1	6.9	8.3	8.6
Nonperforming loans net of provisions to capital	36.9	30.7	23.5	37.1	54.8	59.5
Nonperforming loans to total gross loans	7.0	6.6	5.8	6.3	9.4	9.9
Sectoral distribution of loans to total loans						
Residents	88.1	88.2		72.3	72.3	72.8
Deposit-takers	4.1	4.2		5.5	3.0	2.7
Central bank	0.8	0.9		1.0	1.3	0.7
Other financial corporations	9.9	9.8		3.4	5.1	4.4
General government	4.3	3.9		2.0	3.1	3.0
Nonfinancial corporations	42.8	43.5		37.0	37.5	36.6
Other domestic sectors	26.2	25.8		23.4	22.4	25.5
Nonresidents	11.9	11.8		27.7	27.7	27.2
Return on assets	0.6	0.8	0.8	0.3	0.3	0.3
Return on equity	11.7	14.8	13.9	4.9	4.0	4.0
Interest margin to gross income	50.6	51.9	55.2	65.9	60.8	56.8
Non-interest expenses to gross income	61.5	59.4	61.1	65.7	61.5	64.1
Liquid assets to total assets	0.5	0.6		0.8	1.1	0.6
Liquid assets to short-term liabilities		0.5		0.7	0.6	0.3
Net open position in foreign exchange to capital				2.2	1.6	1.8
Encouraged FSIs for Deposit-taking Institutions						
Capital to assets	4.6	4.6	4.6	4.1	4.8	4.9
Large exposures to capital	26.9	25.5	21.9	21.1	11.9	14.6
Geographical distribution of loans to total loans						
Gross asset position in financial derivatives to capital				108.3	76.5	99.7
Gross liability position in financial derivatives to capital				110.4	77.8	101.4
Trading income to total income	3.6	6.6	2.6	-7.1	3.2	-0.1
Personnel expenses to noninterest expenses	58.1	58.3	57.4	57.4	57.5	56.5
Spread between reference lending and deposit rates (basis points)	378.1	385.0	401.9	413.1	336.2	301.9
Spread between highest and lowest interbank rate (basis points)	23.2	24.1	46.1	56.2	41.4	31.3
Customer deposits to total (noninterbank) loans	63.1	68.1	70.1	59.0	64.0	63.4
Foreign currency-denominated loans to total loans	6.3	6.8		10.7	9.9	10.2
Foreign currency-denominated liabilities to total liabilities	12.4	15.3		22.5	45.7	42.3
Net open position in equities to capital						

Source: IMF, Financial Soundness Indicators.

INTERNATIONAL MONETARY FUND

ITALY

Staff Report for the 2011 Article IV Consultation—Informational Annex

Prepared by Staff Representatives for the 2011 Consultation with Italy

Approved by Juha Kähkönen and Tamim Bayoumi

June 20, 2011

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ANNEX I. ITALY: FUND RELATIONS
(As of April 30, 2011)

Mission: Rome, April 26–May 11, 2011. The concluding statement of the mission is available at: http://www.imf.org/external/np/ms/2011/051111.htm.

Staff team: A. Spilimbergo (Head), L. Lusinyan, H. Morsy, E. Zoli (all EUR), L. Eyraud (FAD). Mr. Borges, the European Department Director, and 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 Labor and Social Policies, the Ministry for Public Administration and Innovation, Department of Institutional Reforms; Parliamentary Budget services; Technical commission on fiscal federalism implementation (COPAFF); Conference of Regions and Public Administration; association of municipalities (IFEL); major Italian banks; rating agencies; the Securities and Exchange Commission (CONSOB); the Antitrust Authority; Pension funds regulatory authority (Covip); Insurance regulatory authority (Isvap); Association on insurance companies (Ania); the National Statistics Institute (Istat); the Confederation of Italian Industry (Confindustria); the Italian Banking Association (ABI); Eni; and research centers.

Fund relations: The previous consultation discussions took place during March 18–30, 2010. The associated Executive Board's assessment is available at: http://www.imf.org/external/np/sec/pn/2010/pn1066.htm and the staff report and other mission documents at: http://www.imf.org/external/pubs/cat/longres.aspx?sk=23920.0 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	7,882.30	100.00
Fund holdings of currency	5,668.53	71.91
Reserve position in Fund	2,213.78	28.09

III. **SDR Department**:

	SDR Million	Percent Allocation
Net cumulative allocation	6,576.11	100.00
Holdings	5,979.60	90.93

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				
	2011	2012	2013	2014	2015
Principal					
Charges/Interest	2.14	3.31	3.31	3.31	3.31
Total	2.14	3.31	3.31	3.31	3.31

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 March 18-30, 2010, and the staff report (Country Report No. 10/157, 06/01/10) was discussed on May 26, 2010.

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
Fiscal ROSC update	November 2003	No. 03/353
Fiscal ROSC update	February 2006	No. 06/64
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. Despite some improvements in the national accounts, changes in inventories are derived as a residual and lumped together with the statistical discrepancy thus hampering the economic analysis.

The *Report on the Observance of Standards and Codes— Fiscal Transparency Module—Update* (Country Report No. 06/64, February 2006) found that some progress has been made vis-à-vis the 2003 ROSC update, especially toward strengthening the integrity of data. However, according to the report a few issues remain outstanding. First, the transparency and timeliness of budget documents should be improved; for example, key details underlying budgetary plans have typically been available only well after the draft budget itself, hampering a proper the assessment of fiscal plans. Second, more information on financial transactions between the government and public enterprises should be made available—this would also help address the discrepancies in fiscal balances discussed above. Third, the general lack of data on the operations of larger nonstate entities where the state is a shareholder, such as the road company, should be addressed. Finally, as public private partnerships gain ground from the current low base, these operations and associated contingent liabilities should be transparently recorded, including in budget documentation; and project evaluation should be strengthened across all levels of government. Also on fiscal data, in recent years progress has been made in reconciling the discrepancy between the cash-based net borrowing requirement and the accrual budget deficit, and, as a result, the statistical discrepancy has decreased in recent years. Furthermore, on-line access to main fiscal documents has improved recently, and consolidated cash accounts of central government economic entities (such as the road company, Anas) are reported in the quarterly cash reports (*relazione trimestrale di cassa*) of the Ministry of Economy and Finance.

Table 1. Common Indicators Required for Surveillance

(As of April 30, 2011)

	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]	Memo Items: Data Quality – Accuracy and reliability[9]
Exchange Rates	April 2011	April 2011	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	Feb. 2011	April 2011	M	M	M		
Reserve/Base Money	Feb. 2011	April 2011	M	M	M	O,O,LO,LO	O,O,O,O,LO
Broad Money	Feb. 2011	April 2011	M	M	M		
Central Bank Balance Sheet	Feb. 2011	April 2011	M	M	M		
Consolidated Balance Sheet of the Banking System	Feb. 2011	April 2011	M	M	M		
Interest Rates[2]	April 2011	April 2011	D	D	D		
Consumer Price Index	Feb. 2011	March 2011	M	M	M	O,O,O,O	LO,O,LO,O,O
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	Q4 2010	April 2011	Q	Q	Q	LO,O,LO,O	LO,O,O,O,LO
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	Feb. 2011	April 2011	M	M	M		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Feb. 2011	April 2011	M	M	M		
External Current Account Balance	Jan. 2011	Feb. 2011	M	M	M	O,LO,LO,O	LO,O,LO,O
Exports and Imports of Goods and Services	Jan. 2011	Feb. 2011	Q	Q	Q		
GDP/GNP	Q4 2010	March 2011	Q	Q	Q	O,O,O,O	LO,LO,O,O,O
Gross External Debt	Q1 2011	April 2011	Q	Q	Q		
International Investment position[6]	Q3 2010	April 2011	Q	Q	Q		

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5] Including currency and maturity composition.
[6] Includes external gross financial asset and liability positions vis 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 revisions.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 11/89
FOR IMMEDIATE RELEASE
July 12, 2011

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

IMF Executive Board Concludes 2011 Article IV Consultation with Italy

On July 11, 2011, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Italy.[1]

Background

Italy is experiencing a weak recovery mainly driven by exports. The economy grew by 1.3 percent year-on-year in 2010, less than the euro area average of 1.7 percent. The trend continued in the first quarter of 2011, with growth at 0.1 quarter-on-quarter. Domestic demand was weak. Household spending remained cautious on the back of rising unemployment and declining real disposable income. Investment rebounded significantly in the first half of 2010 but weakened following the termination in June of the tax incentives for investment. Government consumption was flat. The current account deficit worsened despite robust export growth, owing to rising energy prices and high import growth. Inflation increased moderately to 1.6 in 2010 from 0.8 percent in 2009 due to rising energy and commodity prices. Inflation rates are now comparable to those in the euro area, mainly because of non-core components, while the inflation differential on core prices remained relatively stable.

The authorities comfortably achieved the 2010 fiscal target. The overall fiscal balance declined from 5.3 percent of GDP in 2009 to 4.5 percent of GDP in 2010, well below the

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[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm

target of 5.0 percent of GDP. The improvement reflected both good revenue performance and contained budget expenditure. The increase in indirect taxes partly offset the decline in capital revenues. The introduction in 2010 of more stringent VAT refund rules reduced reimbursements by about 0.4 percent of GDP. The phasing out of the 2009 anti-crisis measures and cuts in capital spending and the wage bill contained expenses. Real primary current expenditure grew at the lowest rate since mid-1990s. The structural balance improved by about 1 percentage point of GDP in 2010, among the largest improvements in the euro area. However, payment delays increased. The positive budgetary trends continued in the first months of 2011. The government has recently enacted a fiscal adjustment package identifying the measures to reach a near-balanced budget target by 2014.

Italian banks have been adversely affected by the recession, with their asset quality worsening over the last two years due to the economic slowdown. Earnings were hampered by low net interest income and high loan-loss provisions but banks remained profitable. While the deterioration in credit quality is likely to slow, loan-loss provision costs will remain elevated, given the high level of accumulated non-performing loans. Profitability will also be undermined by rising funding costs. A large and stable retail funding base and ample collateral to access Eurosystem refinancing help Italian banks to face liquidity and funding risks, which have intensified with the euro area sovereign crisis. The ongoing recapitalizations in the amount of about €12 billion are strengthening them.

Executive Board Assessment

Executive Directors noted that Italy is experiencing a modest recovery, mainly driven by exports. While the economy has strengths, the public debt is high and growth is expected to remain constrained because of long-standing structural bottlenecks. The main policy goals should be to continue pursuing fiscal consolidation to reduce the large public debt, maintain financial sector stability, and boost growth potential through structural reforms.

Directors welcomed the authorities’ commitment to reduce the fiscal deficit to below 3 percent of GDP by 2012 and close to zero by 2014. They saw the medium-term fiscal package recently enacted by the government as an important step towards making these goals achievable. Directors stressed that decisive implementation of the package is key, and a number of them felt that more frontloaded spending measures would have a positive effect on market sentiments. They noted that the adjustment appears to rely also on measures at the sub-national level, and that the tax reform envisioned in the package is still to be defined.

Directors emphasized that sustainable fiscal consolidation should rely first and foremost on expenditure rationalization based on clear priorities. In this regard, they were encouraged by the government’s intention to undertake comprehensive public expenditure reviews. They emphasized that such reviews should result in major public expenditure contraction and improve public sector's efficiency. Containing the public sector wage bill within a broader public administration reform would generate positive spillovers for the private sector. While important pension reforms have already been implemented, Directors saw scope for further measures to boost employment and generate savings. More generally, Directors stressed that the large fiscal retrenchment requires structural changes in public expenditure.

Turning to the revenue side, Directors noted that the tax system should be simplified to support growth and enhance tax compliance. They welcomed the government's ongoing review of preferential tax regimes. Directors noted that careful execution of fiscal federalism should not undermine fiscal discipline.

Directors commended the authorities' preemptive call for bank capital increases and the banks' prompt response. They looked forward to swift completion of the recapitalization plan. Directors noted that bank funding costs and equity prices remain sensitive to market sentiment about the Italian sovereign, underscoring the need for fiscal consolidation. They also saw scope for improving governance and transparency in some local banks.

Directors stressed the need for decisive progress on structural reforms. While the National Reform Program identifies several key priorities, a comprehensive package of reforms is necessary to further raise productivity and enhance growth potential. In the product market, measures should aim at establishing a more efficient regulatory environment, opening up further services and network industries, and reducing public ownership. In the labor market, policies should address duality and the low participation rate. Reducing the labor tax burden, in a fiscally prudent way, could also boost employment. More decentralized bargaining would better align wages with productivity and boost competitiveness and, in this regard, Directors welcomed the flexibility introduced by the recent labor market agreement. Directors concurred that establishing an independent review and advisory body for reforms could foster consensus and focus policies on priority areas, while ensuring the continuity of the reform agenda.

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 2011 Article IV Consultation with Italy is also available.

Summary of Economic Indicators

(Annual percentage change, unless noted otherwise)

	2005	2006	2007	2008	2009	2010	2011 1/
Real GDP	0.7	2.0	1.5	-1.3	-5.2	1.3	1.0
Public consumption	1.9	0.5	0.9	0.5	1.0	-0.6	-0.3
Private consumption	1.1	1.2	1.1	-0.8	-1.8	1.0	1.4
Gross fixed capital formation	0.8	2.9	1.7	-3.8	-11.9	2.5	2.6
Final domestic demand	1.2	1.4	1.2	-1.2	-3.4	0.9	1.3
Stock building 2/	-0.3	0.5	0.1	-0.2	-0.6	0.7	0.1
Net exports 2/	-0.3	0.0	0.2	0.1	-1.3	-0.5	-0.2
Exports of goods and services	1.1	6.2	4.6	-4.3	-18.4	9.1	4.6
Imports of goods and services	2.1	5.9	3.8	-4.4	-13.7	10.5	5.0
Money and credit (end of period, percent change)							
Private sector credit 3/	7.7	11.0	9.8	4.9	1.7	8.4	...
National contribution to euro area M3 4/	6.3	7.7	7.6	6.9	5.5	2.4	...
Interest rates (percent, end of period)							
6-month interbank rate	2.6	3.8	4.9	3.7	1.0	2.3	…
Government bond rate, 10-year	3.5	4.2	4.7	4.5	4.1	4.8	…
Resource utilization							
Potential GDP	1.1	0.9	0.8	0.7	-1.9	0.6	0.7
Output Gap (percent of potential)	-0.4	0.8	1.5	-0.5	-3.9	-3.3	-3.1
Natural rate of unemployment	7.7	6.8	6.2	6.7	7.5	8.2	8.4
Employment	0.7	1.8	1.0	0.8	-1.6	-0.5	0.2
Unemployment rate (percent)	7.7	6.8	6.1	6.8	7.8	8.4	8.6
Prices							
GDP deflator	2.1	1.8	2.6	2.8	2.3	0.6	1.8
Consumer prices	2.2	2.2	2.0	3.5	0.8	1.6	2.5
Hourly compensation	3.0	1.5	3.8	6.0	6.6	-0.8	-0.1
Productivity	0.6	0.6	0.4	-1.0	-2.4	2.0	0.6
Unit labor costs	2.4	0.9	3.4	7.0	9.0	-2.8	-0.7
Fiscal indicators							
General government net lending/borrowing 5/	-4.4	-3.3	-1.5	-2.7	-5.3	-4.5	-4.1
Structural overall balance (percent of potential GDP)	-4.5	-3.3	-2.5	-2.6	-3.9	-3.0	-2.6
Public debt 5/	105.9	106.6	103.6	106.3	116.1	119.0	120.6
Exchange rate regime				Member of EMU			
Exchange rate (national currency per U.S. dollar)	1.2	1.3	1.4	1.5	1.4	1.3	1.4
Nominal effective rate: CPI based (2000=100)	100.0	100.0	101.7	103.7	104.6	101.3	…
Real effective exchange rate based on							
CPI (2000=100)	112.3	111.9	113.3	115.0	115.8	110.7	…
normalized ULC (2000=100)	127.4	129.3	135.1	142.3	142.4	137.2	…
External sector 5/							
Current account balance	-1.7	-2.6	-2.4	-2.9	-2.1	-3.3	-3.8
Trade balance	0.0	-0.7	0.2	-0.1	0.1	-1.2	-0.9
Saving investment balance 5/							
Gross national saving	19.0	19.0	19.4	18.3	16.8	16.9	16.3
Public	-0.6	1.4	2.2	0.8	-2.1	-1.6	-1.5
Private	19.7	17.6	17.2	17.5	18.9	18.5	17.7
Gross domestic investment	20.7	21.6	21.9	21.2	18.9	20.2	20.0
Gross fixed domestic investment	20.7	21.1	21.2	20.8	19.1	19.5	20.2
Public	2.4	2.3	2.3	2.2	2.5	2.1	1.8
Private	18.4	18.8	18.9	18.5	16.6	17.4	18.4
Net lending	-1.7	-2.6	-2.4	-2.9	-2.1	-3.3	-3.8

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.
4/ Excludes currency in circulation held by nonbank private sector.
5/ Percent of GDP.

Statement by the Staff Representative on Italy
July 11, 2011

1. This statement provides additional information on economic developments and policy action in Italy since the Article IV mission complementing the staff report (SM/11/127). The additional information does not change the thrust of the staff appraisal.

2. **The recovery remains weak.** In the first quarter, net exports and government consumption made a positive contribution, while private consumption and gross fixed investment were subdued and destocking of inventories was a drag. Business surveys point to weak industrial and services activity also in the second quarter. HICP inflation rose to 3.0 percent year-on-year in May, owing to rising commodity and energy prices. The unemployment rate declined to 8.1 percent in May. The general government deficit was 1.8 percent of annual GDP in the first quarter of 2011, less than in the same period in 2010. Recent cash-based developments show that improvements continued in the second quarter.

3. **The employers' confederation and the three major trade unions signed an important labor agreement in June.** The agreement modifies the rules on the representation and contract enforceability and fosters wage bargaining decentralization.

4. **Sovereign and bank spreads have widened considerably over the past month as the financial turmoil in Europe increased.** After peaking at over 200 basis points (bps) in late June, government bond spreads are now at 197 bps, about 50 bps up since mid-May. Sovereign CDS spreads have also climbed to above 200 bps. In May, S&P's cut Italy's outlook, and in June, Moody's placed Italy's Aa2 rating on review for a possible downgrade, citing structural macroeconomic weaknesses, uncertain growth prospects, risks over fiscal consolidation, and higher premiums for countries with large public debt. Banks' CDS spreads and equity prices have also worsened significantly, underperforming relatively to other European peers. The outlook of several banks was also cut. The recapitalization plans announced in April–May are being implemented.

5. **The government approved a fiscal package of about €50 billion (2¾ percent of GDP) to reach a near-balanced budget by 2014.** The parliament will vote on the package in July. The package includes an extension of the public wage freeze and hiring restrictions to 2014, a rationalization of public expenditure based on spending review, and bringing forward the retirement age adjustment to life expectancy. Revenue measures include higher taxes for luxury cars and an increase in financial transaction taxes. The package contains also measures to revive growth, including tax incentives for young entrepreneurs and proposals for liberalization in product markets. The government has also proposed a comprehensive deficit-neutral tax reform, with the goal of lowering the personal income tax and rationalizing tax expenditure further.

Statement by Arrigo Sadun, Executive Director for Italy
July 11, 2011

Recent Developments

Although the Italian economy has not yet fully regained the output losses incurred during the 2008–09 recession, a moderate recovery has been underway since mid-2009. GDP grew by 1.3 percent in 2010 and it is expected to increase by 1.1 percent this year. The recovery is mostly driven by exports, as the large manufacturing sector has benefited from strong demand from both its traditional trading partners and dynamic emerging market countries. Domestic demand, however, remains subdued due to stagnant disposable income and weak consumer sentiments.

The prudent fiscal stance maintained during the economic downturn has allowed the country to reduce the government budget deficit from 5.3 percent of GDP in 2009 to 4.5 percent last year, well below the original target. The government is fully on track to achieving its goal of reducing the deficit to below 3 percent by next year. Recently, the government enacted a comprehensive package of specific measures, amounting to almost 3 percent of GDP, aiming to reinforce their commitment to bring the budget close to being balanced by 2014, as indicated in the Stability Programme (SP) and the National Reform Programme (NRP), already approved by the European institutions.

The worsening of the debt crisis in some EU sovereigns has put pressure on the Italian sovereign bonds; however, the increases in the spreads with German bonds have been relatively contained thanks to the high level of domestic savings and the low indebtedness of the private sector, as well as to the country's limited exposure to peripheral euro area countries. Despite these elements of strength, some rating agencies have put Italian sovereign debt on negative outlook out of concern that the low rate of growth could hamper the financing of the large public debt.

Fiscal Policy

The fiscal strategy adopted during the crisis minimized the burden for public finances while supporting employment and income through the automatic stabilizers. This policy was successful in limiting its impact on public finances as recognized by the EU Council, which in its June 20 statement recognized that: "*Given the very high government debt ratio, Italy kept an appropriately prudent fiscal stance during the crisis, refraining from undertaking a large fiscal stimulus, and thus keeping the government deficit below the euro area average in 2009-2010.*"

On July 6, the cabinet enacted a medium-term fiscal plan detailing the measures necessary to balance the budget by 2014. The plan is largely based on the recommendations by IMF staff as well as those by the commissions of independent experts established by the Minister of Finance. The plan includes a rationalization of public expenditures (based on a comprehensive spending review), a reduction of tax evasion, a simplification of tax expenditures, an enhancement of the previous pension reforms, renewed efforts on fiscal federalism, and the reform of the inefficient tax system. Furthermore, reducing the tax wedge (through a reduction of the two lowest income tax rates and a contemporaneous increase of the VAT rate) is an integral part of the proposed tax reform. This fiscal package will fully close the gap between targets and projections underscored in the staff report.

The Growth Strategy

The low potential growth of the Italian economy has long been recognized as one of its fundamental weaknesses. Thus, the staff analysis on structural reforms and growth is quite welcome by the authorities, who share much of the staff conclusions and recommendations. In the face of growing expectations by the public opinion for quick and decisive fixes, it is important to underscore that there is no silver bullet to deliver faster growth. Instead, a successful growth strategy should be based on a wide range of specific measures, each one producing only incremental benefits but collectively aligning the growth potential of the Italian economy with those of other European countries.

The Italian authorities agree that further efforts should be made to eliminate the key bottlenecks limiting the growth potential of the Italian economy, including low R&D expenditures and innovations, the sharp regional divide, labor market segmentation, and excessive product market regulation; other priorities are raising the efficiency of the public administration, including the judicial system, and improving education levels. Accordingly, the authorities are committed to prioritizing the reforms needed to remove the structural bottlenecks that hamper growth. Such commitment has already been spelled out in the NRP, which identified 85 structural measures, half of which were recently implemented and the remaining ones are already in the legislative pipeline.

Increasing competition in the service market is considered crucial for improving productivity and hence competitiveness. Accordingly, several measures have already been implemented to increase the effectiveness of Public Administration, to increase competition for professional services, and to streamline bureaucratic procedures in order to facilitate start-ups and investments, including from abroad. Moreover, the recent introduction of the mandatory mediation in civil and commercial disputes, aimed at reducing the length of contract enforcement procedures, is considered a first step in reforming civil justice. In addition, the modernization of bankruptcy law will also improve the business environment. The implementation of these reforms is expected to result in a permanent increase of GDP amounting to 0.4 percentage points per year from 2014.

1. Labor Market and Wage-Bargaining Reforms

Low labor participation, particularly among women, the youth, and older workers, is a key factor accounting for the lower growth rates of the Italian economy. Accordingly, the Italian authorities have already identified a number of measures, mostly in line with IMF recommendations, to address these issues, including a recently approved legislation on apprenticeship to facilitate the entry of young workers into the labor force.

Given the sharp disparities in productivity levels at both the regional and firm levels, it is necessary to improve the flexibility of the labor market. The government is trying to achieve this objective not through the automatic definition of regionally-differentiated wages as suggested by staff, but rather through greater decentralization of the wage-bargaining process. In this respect, on June 28th, the three main trade unions (*CGIL, CISL, and UIL*) and the employer's federation (*Confindustria*) signed a potentially far-reaching agreement on wage negotiations that could substantially enhance the flexibility of the labor market. Under certain circumstances, the agreement allows negotiations at the firm level to modify national contracts, limit the use of sectarian strikes.

2. Further Enhancements to the Pension System

Building on previous reforms, the government has introduced additional measures that should further strengthen the long-term sustainability of the pension system. The postponement of the effective retirement by 12 months for salaried workers and by 18 months for self-employed will reduce pension expenditures over the period 2011-2060. Preliminary estimates suggest that these measures will decrease the long-term debt dynamics by 0.5 percentage point of GDP.

Starting from 2015, the statutory retirement age will increase according to changes in life expectancy at 65 years old (measured over the preceding five-year period). From a technical point of view, the first implementation of such a mechanism in 2015 will determine an increase in the statutory retirement age. More substantial increases are foreseen in the next decades along with the progress of population ageing.

3. Fiscal Federalism Well Underway

The institutional process aimed at gradually implementing fiscal federalism in Italy is well on track, with primary legislation already approved and secondary legislation (implementing decrees) on schedule. Recently-approved measures provide further tools for the strengthening of local governments' financial autonomy, and for enhancing the role of these entities in fighting tax evasion (for example by envisaging the participation of municipalities in tax auditing activities, as well as by allowing these entities retain one third of the amount of taxes and penalties levied).

In order to enhance the financial autonomy of local entities and to improve management of public goods and services at the local level, several measures have already been taken, including the transfer of some state properties to regional and local municipalities. These are expected to increase the efficiency of their spending with a particular emphasis on reducing personnel costs.

The Financial Sector

Sound business models and prudent risk management practices, supported by effective supervision, account for the broad resilience of the Italian financial system during the crisis. This notwithstanding, the 2008-09 recession has taken its toll on asset quality and profitability of Italian banks.

Non-performing loans of Italian banking groups, after rising substantially during the economic downturn (to 9.1 percent of total loans), have increased only moderately in 2010 to 9.9 percent.

At the same time, Italian banks have supported the corporate sector: in the twelve months leading up to April 2011, loans grew by 4.4 percent, the highest value among the main countries of the euro area.

In the face of rising interest rates in the money market, Italian banks increased their use of the Eurosystem's refinancing, from euro 29 billion in 2009 to euro 52 billion in 2010. Despite the increase in absolute terms, Italian banks' use of the Eurosystem refinancing is lower than that of other euro area banking systems, and well below the Italian banks' share of the euro area banking system as a whole. In the first half of 2011, total borrowing from the Eurosystem decreased to an average of close to euro 40 billion.

Since 2010, the Bank of Italy has asked banks to strengthen their capital levels. The average core tier 1 ratio of the five largest banks increased from 6.0 percent at end-2008 to 7.4 percent at end-2010. Since January 2011, five among the largest banks have completed or announced recapitalization plans for a total of euro 11.7 billion (as opposed to euro 4 billion for 2010 as a whole). Bank capitalization is also benefiting from retained earnings.