INTERNATIONAL MONETARY FUND

IMF Country Report No. 16/222

ITALY

July 2016

2016 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR ITALY

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2016 Article IV consultation with Italy, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its July 6, 2016 consideration of the staff report that concluded the Article IV consultation with Italy.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on July 6, 2016, following discussions that ended on May 23, 2016, with the officials of Italy on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on June 20, 2016.
- An **Informational Annex** prepared by the IMF staff.
- A **Staff Supplement** updating information on recent developments.
- A **Statement by the Executive Director** for Italy.

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

Selected Issues

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Price: $18.00 per printed copy

International Monetary Fund
Washington, D.C.

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Press Release No. 16/329
FOR IMMEDIATE RELEASE
July 11, 2016

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

IMF Executive Board Concludes 2016 Article IV Consultation with Italy

On July 6, 2016, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with Italy.

The Italian economy is recovering gradually from a deep and protracted recession. Buoyed by exceptionally accommodative monetary policy, favorable commodity prices, supportive fiscal policy, and improved confidence on the back of the authorities' wide-ranging reform efforts, the economy grew by 0.8 percent in 2015 and continued to expand in the first quarter of 2016. Labor market conditions have been improving gradually, and nonperforming loans (NPLs) appear to be stabilizing at around 18 percent of total loans. Nonetheless, the structural challenges remain significant. Productivity and investment growth are low; the unemployment rate remains above 11 percent, with considerably higher levels in some regions and among the youth; bank balance sheets are strained by very high NPLs and lengthy judicial processes; and public debt has edged up to close to 133 percent of GDP, a level that limits the fiscal space to respond to shocks.

Against this backdrop, the recovery is likely to be prolonged and subject to risks. Growth is projected to remain just under 1 percent this year and about 1 percent in 2017. Risks are tilted to the downside, including from financial market volatility, the refugee surge, and headwinds from the slowdown in global trade. This growth path would imply a return to pre-crisis (2007) output levels only by the mid-2020s and a widening of Italy's income gap with the faster growing euro area average. It also implies a protracted period of balance sheet repair, and thus of vulnerability.

Cognizant of Italy's complex challenges, the authorities have embarked on a range of very important reforms, including institutional, public administration, fiscal, labor market, and banking sector reforms. It is imperative that these efforts are fully carried out and deepened. Taking advantage of the start of economic recovery and the current favorable tailwinds of monetary easing, low commodity prices and fiscal support, the timely implementation of

[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.

complementary and mutually reinforcing efforts in the financial and fiscal sectors and structural measures would help boost growth, lower the upfront cost of reforms, and accelerate the building of buffers.

Executive Board Assessment[2]

Executive Directors noted that Italy is recovering from a protracted recession supported by accommodative monetary and fiscal policy, favorable commodity prices, and improved confidence on the back of the authorities' wide-ranging reform efforts. Nonetheless, Directors noted that the recovery is likely to be modest against the backdrop of an unsettled external environment, structural rigidities, strained bank balance sheets, and high public debt. They, therefore, urged the authorities to fully implement and deepen the reforms to strengthen near-term growth, further build up buffers, enhance resilience, and bolster economic performance over the medium term.

Directors welcomed the implementation of the Jobs Act and the approval of a framework law on public administration reform. They noted the high youth unemployment and low female labor participation, and supported implementation of active labor market policies. They called for pressing ahead with ambitious product and service market reforms, including a strengthened Annual Competition Law; modernizing the wage bargaining system to align wages with productivity at the firm level; and implementing public administration reforms decisively, including to lower the cost of doing business and improve the investment climate.

Directors underscored that financial sector reforms are critical to entrench financial stability and support the recovery. They commended the recent insolvency reforms, the framework for bank consolidation, and steps to address nonperforming loans (NPLs). To substantially reduce the stock of NPLs over the medium term, lower the cost of risk, and improve operating efficiency, Directors supported further measures, including more intensive use of out-of-court debt restructuring mechanisms; strengthened supervision; and a systematic assessment of asset quality for banks not already subject to the ECB comprehensive assessment, with follow-up actions in line with regulatory requirements. Directors considered that effective use of the framework for the prompt resolution of banks is important. Recognizing the adoption of the Bank Recovery and Resolution Directive (BRRD) framework, they noted that concerns related to the bail-in of retail investors should be dealt with appropriately.

Highlighting the need to balance efforts to reduce debt with support for growth, Directors noted that the debt dynamics are expected to decline only gradually in the coming years and remain vulnerable to shocks. Building on the progress achieved recently, they urged the authorities to move forward decisively on pro-growth reforms, giving greater priority to lower and more

[2] 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.

efficient spending and less distortive taxation, including broadening the tax base and introducing a modern real estate tax. Many Directors saw the need to place debt on a firmer downward path as a priority to enhance resilience to shocks, and accordingly recommended an evenly-phased adjustment over 2017–19, net of any remaining upfront costs from structural reforms, to achieve a small structural surplus. A number of other Directors, however, saw merit in backloading adjustment to cushion the impact on growth, while considering a balanced budget as an appropriate medium-term objective, but called for special attention to managing risks, including through ambitious privatization efforts.

Italy: Selected Economic Indicators 1/

	2013	2014	2015	2016	2017
Real Economy (change in percent)					
Real GDP	-1.7	-0.3	0.8	1.1	1.3
Final domestic demand	-2.7	-0.4	0.6	1.3	1.3
Exports of goods and services	0.6	3.1	4.3	1.3	3.8
Imports of goods and services	-2.3	3.2	6.0	2.4	4.4
Consumer prices	1.2	0.2	0.1	0.0	0.7
Unemployment rate (percent)	12.1	12.6	11.9	11.4	10.9
Public Finances					
General government net lending/borrowing 4/	-2.9	-3.0	-2.6	-2.4	-1.9
Structural overall balance (percent of potential GDP)	-0.6	-1.1	-0.7	-1.2	-1.1
General government gross debt 4/	128.9	132.5	132.7	132.9	132.1
Balance of Payments (percent of GDP)					
Current account balance	0.9	1.9	2.2	2.1	1.7
Trade balance	2.2	3.0	3.2	3.2	2.9
Exchange Rate					
Exchange rate regime		Member of the EMU			
Exchange rate (national currency per U.S. dollar)	0.8	0.8	0.8	...	...
Nominal effective rate: CPI based (2000=100)	100.0	100.7	96.9	...	...

Sources: National Authorities; and IMF staff calculations.

1/ Staff estimates and projections as of June 20, 2016 (pre-Brexit referendum), unless otherwise noted, based on fiscal plans included in the government's April 2016 Documento di Economia e Finanza and subsequent approved measures.

2/ Percent of GDP.

INTERNATIONAL MONETARY FUND

ITALY

STAFF REPORT FOR THE 2016 ARTICLE IV CONSULTATION

June 20, 2016

KEY ISSUES

Context. The economy has started to recover from a prolonged recession. The recovery, however, is modest and fragile, against the backdrop of long-standing structural rigidities, strained bank balance sheets, and high public debt that leave very little room to cope with shocks. On current projections, the economy is not expected to return to its pre-crisis (2007) output peak until the mid-2020s, implying nearly two lost decades, a growing income gap with euro zone partners, and a protracted period of balance sheet vulnerability. The challenge is to turn around productivity performance, facilitate faster bank balance sheet cleanup, and lower public debt.

Policies. Recognizing Italy's complex challenges and incomplete efforts to address them in the past, the government is pursuing a multi-pronged strategy to boost potential output, support the recovery, and restore balance sheet health. This includes institutional, public administration, fiscal, labor market and banking sector reforms, which once fully implemented should yield benefits gradually over time. To support the recovery, it has eased fiscal policy quite markedly this year, and while efforts are made to start bringing public debt down, structural adjustment has been backloaded to 2019.

Recommendations. While the authorities are seeking to strike a balance between supporting the recovery and building buffers to improve resilience, some of the initiatives may not go far enough in bringing about a timely reduction of vulnerabilities. To enhance the impact of their efforts, consideration could be given to the following:

- *Deepen structural reforms:* more ambitious product and service market reforms to enhance competition could support near-term growth and facilitate bolder financial and fiscal efforts. They should be supplemented by a wage bargaining framework to align wages with productivity and full implementation of public sector reforms.

- *Accelerate financial sector repair:* decisive steps are needed, including through stricter supervisory oversight, to reduce faster the high nonperforming loans in the coming years and support the emergence of sound banking groups, and address concerns about the resolution framework including by tackling mis-selling to retail investors.

- *Strengthen fiscal buffers:* an evenly-phased adjustment over 2017–19, net of any remaining upfront costs of structural reforms, could support the recovery while increasing the credibility of adjustment. A small structural surplus over the medium term would help build buffers faster. Rationalizing spending, rebalancing taxes, and creating room for notable tax cuts on productive factors would be growth friendly.

Approved By
Thanos Arvanitis and Hugh Bredenkamp

The mission visited Rome and Milan during May 9–23, 2016, and comprised Rishi Goyal (head), Julia Bersch, Mehdi Raissi, and Anke Weber (all EUR), José Garrido (LEG), and Dermot Monaghan (MCM). Thanos Arvanitis (EUR) attended the concluding meetings. Carlo Cottarelli and Cristina Quaglierini (OED) attended the policy meetings. The mission met Finance Minister Padoan, Bank of Italy Governor Visco, Justice Minister Orlando, other senior government officials, SSM officials, and financial sector, private sector, academic, parliamentary, and trade union representatives. Barbra Licudine and David Velazquez-Romero assisted in the preparation of this report.

CONTENTS

CONTEXT: THE LONG VIEW 4

NEAR-TERM DEVELOPMENTS 7

OUTLOOK AND RISKS 12

POLICY DISCUSSIONS 14

A. Structural Reforms 15

B. Financial Sector Policies 22

C. Fiscal Policy 29

STAFF APPRAISAL 32

BOXES

1. The Impact of Product Market Reforms on Firm Productivity in Italy 17
2. Civil Justice Reforms 19
3. Boosting Female Labor Force Participation and Responding to the Refugee Surge 21
4. Banks' Profitability Challenge 23
5. Italian Banks' Liability Structure and the Bail-in Requirement 25

FIGURES

1. A Modest and Fragile Recovery, 2007–16 5
2. Lagging Productivity and Manufacturing, 1996–2016 6
3. Real Sector Selected Economic Indicators, 2005–16 35
4. Real Sector High Frequency Indicators, 2005–16 36
5. The Financial Sector Remains Under Pressure 37
6. Fiscal Developments 38
7. External Developments 39

TABLES

1. Summary of Economic Indicators, 2008–21 40
2. Statement of Operations—General Government (GFSM 2001 Format), 2008–21 41
3. Summary of Balance of Payments, 2015–21 42
4. Financial Soundness Indicators, 2011–15 43

ANNEXES

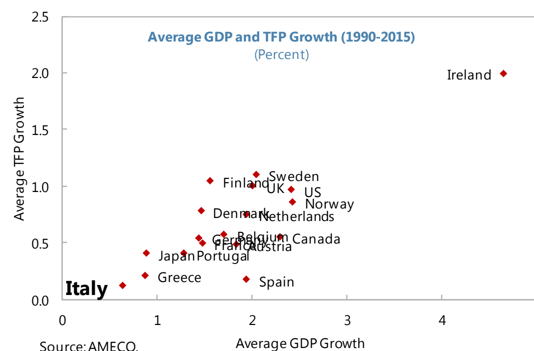
I. External Sector Assessment 44
II. Debt Sustainability Analysis 46

APPENDIX

Progress Against IMF Recommendations 55

CONTEXT: THE LONG VIEW

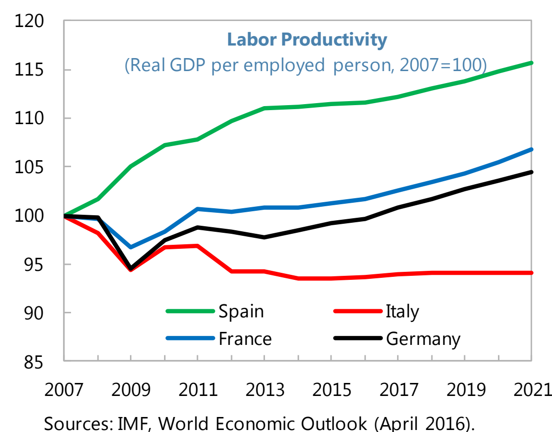
1. Italy has wrestled with addressing long-standing structural rigidities for several years. Structural rigidities—not least product and service market inefficiences, wage growth in excess of productivity, high taxation, an inefficient public sector, and lengthy judicial processes—have contributed to Italy experiencing one of the lowest productivity growth rates among advanced economies over the last three decades. Reforms lagged or were piecemeal, and generally failed to address rigidities. This left Italy in a weak position to adapt to the enormous global trade and technological changes that occurred during this period.



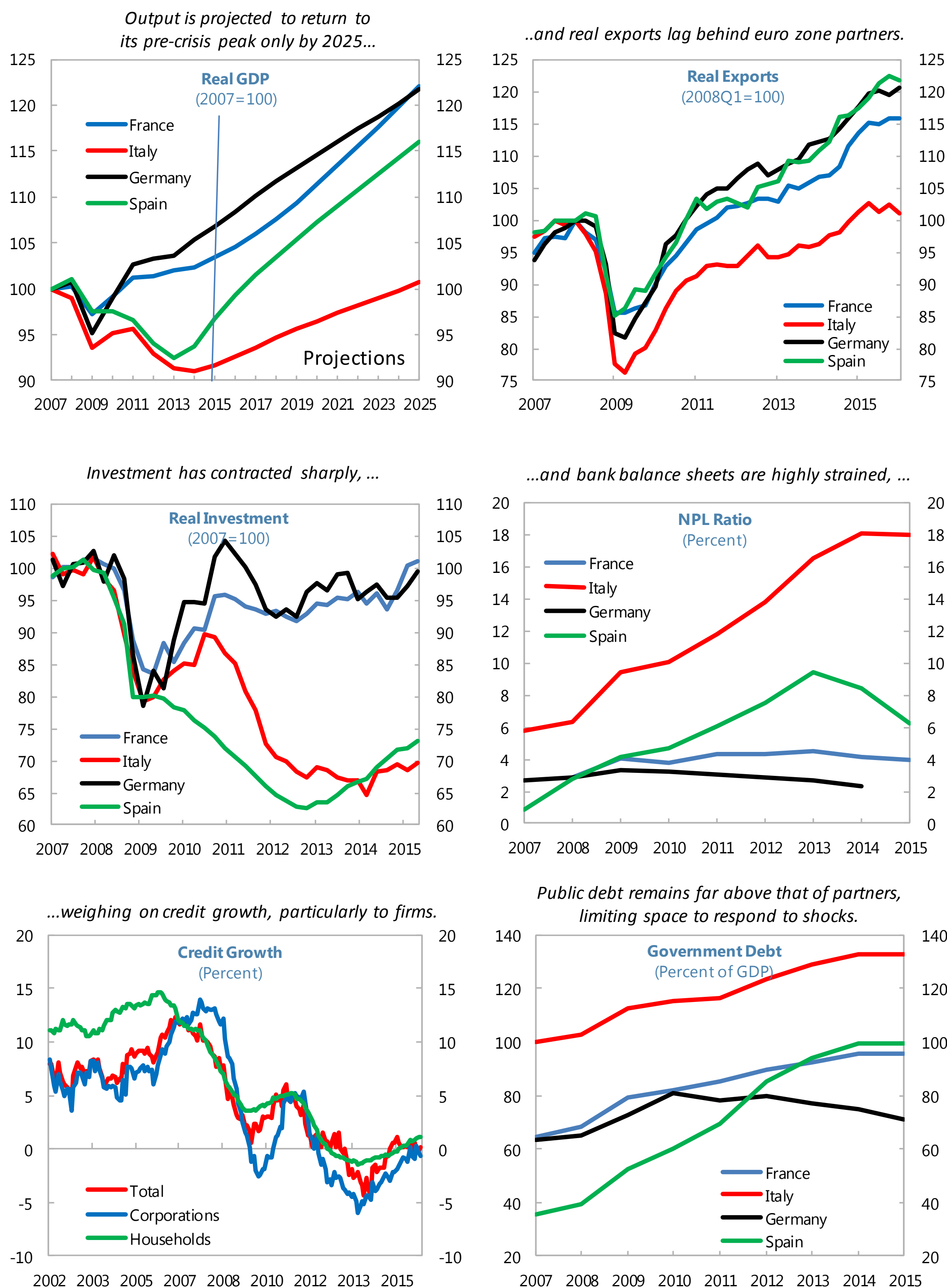
Source: AMECO.

2. At the same time, high public debt left Italy exposed at the eve of the global financial crisis and limited fiscal space to respond to shocks. Public debt was around 100 percent of GDP both at the time of euro accession and at the eve of the global financial crisis, and has since climbed to almost 133 percent of GDP, the second highest in the euro zone. High debt and structural rigidities exacerbated the impact of the global financial crisis and restricted Italy's ability to cope with its fallout. Output contracted sharply by 9 percent during 2007–14, and the recession lasted longer than Italy's European peers (Figure 1). The decline was especially severe in manufacturing, where the crisis appears to have exacerbated a trend decline in a number of subsectors that started well before 2007 (Figure 2). Although services have assumed a larger share of the economy, productivity is generally low and has greatly lagged that of manufacturing. The decline in total output had attendant implications for bank balance sheets and led nonperforming loans to rise to 18 percent of loans, an overhang that is weighing on the recovery and potential growth.

3. Notwithstanding efforts to kick-start growth, Italy's income gap is set to grow further. Under current staff projections, the economy is not expected to return to its pre-crisis (2007) real output peak until the mid-2020s. Italy is, thus, likely to experience nearly two lost decades, while its euro zone partners are projected to grow cumulatively by 20–25 percent. The prospect of relatively low growth within the euro zone has important implications. For one, growth may be too weak to firmly unwind financial fragilities, and balance sheets could remain a source of vulnerability for a protracted period. Also, with slow growth, unemployment would remain high, well above pre-crisis levels. Absent further productivity-enhancing measures, real wage growth in Italy would lag its partners or competitiveness would lag—both of which would weigh on the economy and could have implications for emigration from Italy.



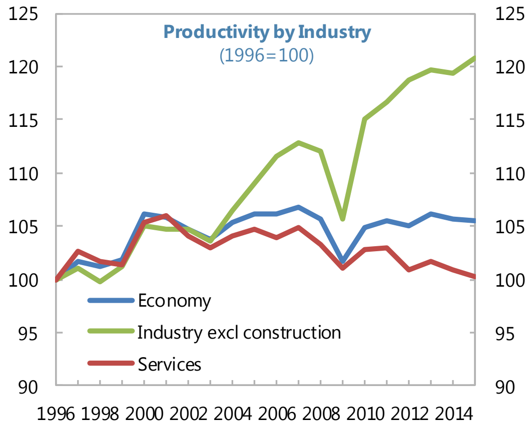
Sources: IMF, World Economic Outlook (April 2016).



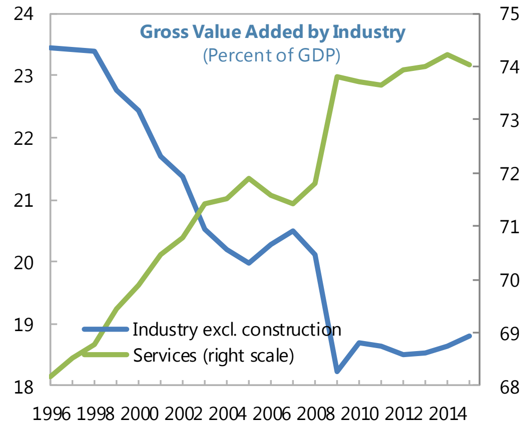
Sources: IMF, WEO; Eurostat; IMF, FSI; and IMF staff estimates.

Figure 2. Italy: Lagging Productivity and Manufacturing, 1996–2016

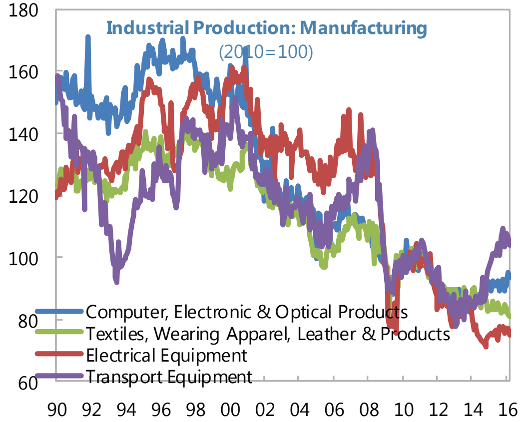
Productivity in manufacturing has increased, while that of services has been declining steadily for several years...



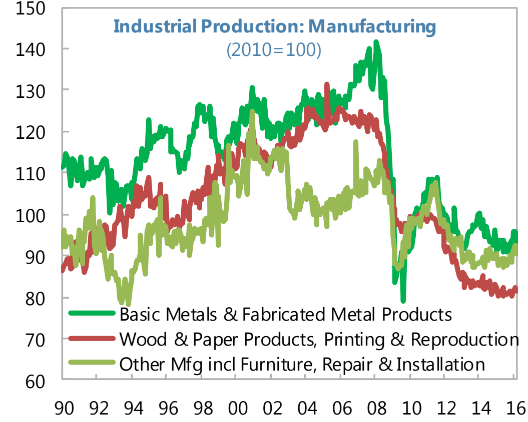
...even as the economy has become more service oriented.



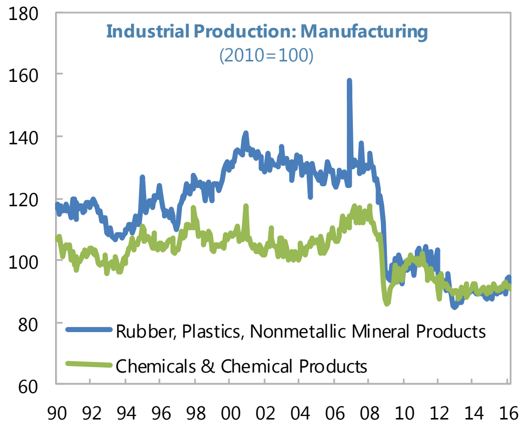
Several manufacturing subsectors, including high-tech, have been on a long-term decline.



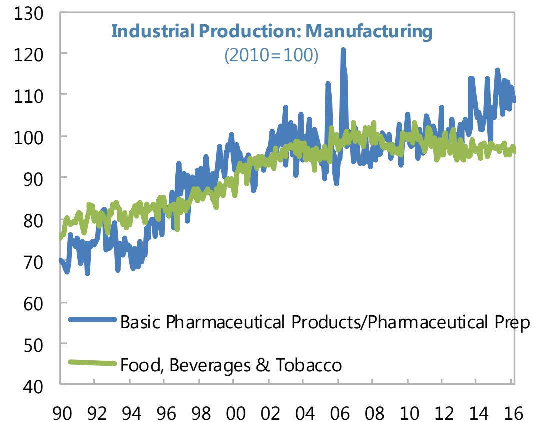
Some, including medium-tech, have been severely affected by the global financial crisis...



...while others were broadly stagnant even before the crisis.



Food and pharmaceuticals, however, have been growing.



Source: ISTAT.

4. Cognizant of Italy's complex challenges, the government has been pursuing a range of important reforms. The list of reform initiatives has been impressive, and includes institutional, public administration, fiscal, labor market, and banking sector reforms. In particular, the government's signature labor market legislation, the Jobs Act, is being implemented. Legislation has been passed on the reform of cooperative and mutual banks. The insolvency system is being revised. A framework law on public administration has been approved and some implementing decrees have been issued. A reform of the state budget is underway. A reform of the education system has been approved by parliament and is being implemented. Legislation has also been passed and a constitutional referendum is planned for October on institutional reforms aiming to facilitate decision making and the transfer of competencies from regions to the center.

5. There is an urgent need to accelerate and deepen reforms, especially before new headwinds emerge. Within an incomplete economic and monetary union, there is urgency for Italy to reduce decisively its exposure to risks. This includes, among other things, ambitious product and service market reforms to enhance competition and investment; a new wage bargaining framework to align wages with productivity; insolvency reforms to deal with current nonperforming loans; and making room for notable cuts in the labor tax wedge while achieving medium-term fiscal targets. Half-way through Prime Minister Renzi's term, however, the environment has become more complicated. A constitutional referendum is planned for October, while general elections must be held no later than May 2018. The global economy remains unsettled, and euro zone policymakers grapple with a host of complex challenges, not least the surge in refugees, including those coming through Italy, the risks of Brexit and Grexit, and criticisms of the euro zone's fiscal and financial sector policy frameworks.

NEAR-TERM DEVELOPMENTS

6. In 2015, the economy started to recover after three years of recession. It expanded by 0.8 percent, buoyed by exceptionally accommodative monetary policy, declining commodity prices, and improved confidence on the back of the authorities' reform efforts. Private consumption and inventory re-stocking were key contributors, while external demand weighed on growth (Figure 3).

7. However, the recovery is not yet robust. Quarterly growth slowed over the course of 2015 to end the year at a seasonally-adjusted 0.2 percent q-o-q (Figure 4) and picked up slightly to 0.3 percent q-o-q in 2016 Q1.

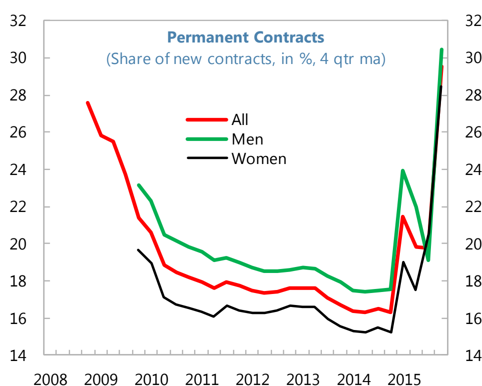
- While the economy continues to expand—industrial production, for instance, rose in April—other recent high frequency indicators suggest some loss of momentum. Business and the purchasing managers' indices declined significantly in May.

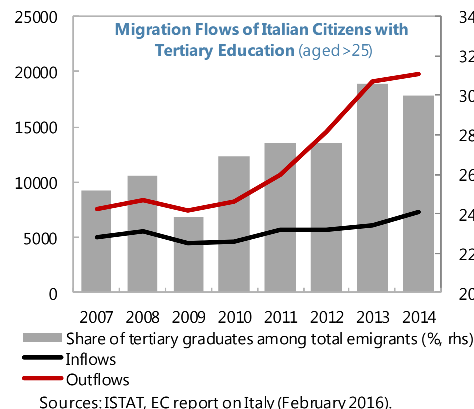
- The recovery in investment is very slow. Although transportation-related investment rebounded strongly in recent months and there are tentative signs of stabilization in the construction sector, the investment ratio remains far below that of key euro zone partners, following the sharp decline in 2010–14.

- After several years that net exports contributed positively to growth, net exports are now a drag on growth as slowing global demand weighs on exports while imports recover. Real exports are back to their pre-crisis (2008 Q1) peak, but this is a relatively modest performance compared to large euro area partners that are 15–25 percent above pre-crisis peaks. The current account and trade balances remain in surplus, including from favorable commodity prices and more generally import compression in recent years.

- Inflation is very low. Headline is back in negative territory since February owing in part to the decline in oil prices but also subdued demand (as seen in low core inflation). Long-term inflation expectations are still significantly below the ECB's objective, despite recent actions.

- Labor market indicators have been broadly improving, but labor market conditions are still challenging. Unemployment declined to 11.7 percent at end 2015 (from a peak of 13.1 percent in November 2014). However, long-term unemployment remains high at close to 60 percent of unemployed persons; youth unemployment is above 35 percent; and female labor force participation remains relatively low. Regional differences are sizable. In a positive development, job creation picked up recently among those in the 50–64 year age group and the share of workers in new permanent contracts is up notably.[1] Nonetheless, skilled young Italians are increasingly emigrating abroad, which also weighs on potential growth.





Sources: ISTAT, EC report on Italy (February 2016).

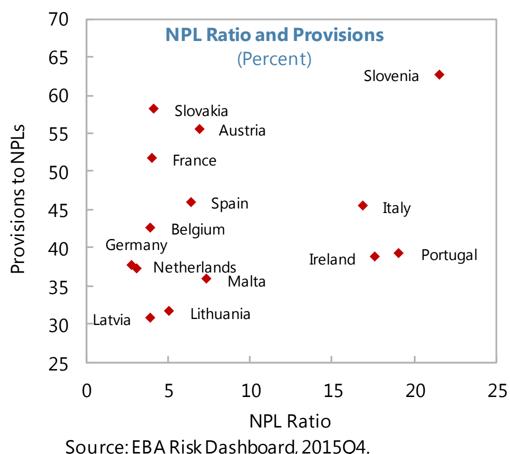
- Reflecting the deep recession, the incidence of absolute poverty has increased—to 5.7 percent (1.4 percentage point higher than 2011) with significant regional differences. Income inequality has also increased and is well above the OECD average.

8. Banks have made progress in strengthening their capital position but face significant challenges from weak asset quality and low profitability (Figure 5).

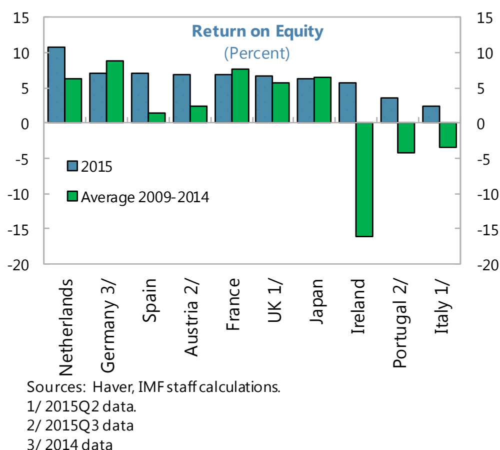
- With the economy turning around, nonperforming loans (NPLs) appear to be stabilizing at about 18 percent of loans, one of the highest in the euro zone. Provisions amount to

[1] Although data are still limited, empirical work by the Bank of Italy suggests this is due largely to the economic recovery and tax incentives, with the Jobs Act contributing at the margin.

45 percent (excluding collateral and guarantees, a variable markets often focus on as court times to access them are very long). High NPLs are adversely affecting profitability—profit margins are among the lowest in Europe—and weighing on banks' ability to extend credit.

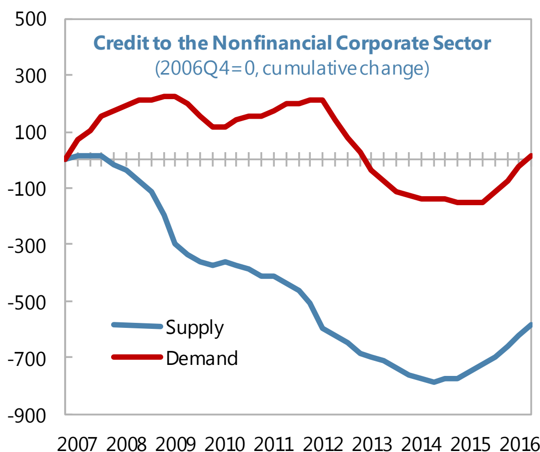


Source: EBA Risk Dashboard, 2015Q4.

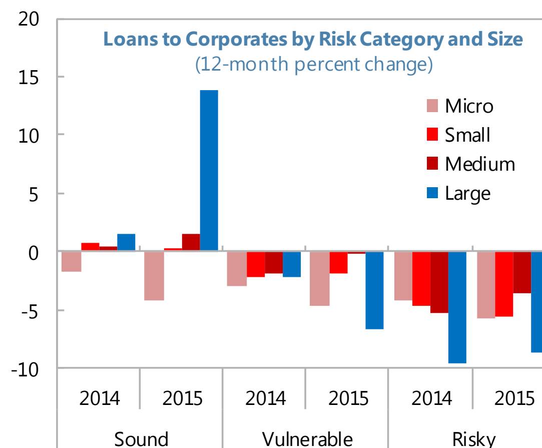


Sources: Haver, IMF staff calculations.
1/ 2015Q2 data.
2/ 2015Q3 data
3/ 2014 data

- Overall lending conditions are subdued. Credit to households has been growing modestly, but credit to the corporate sector has continued to decline and is about 11 percent lower than five years ago, despite the decline in real lending rates to SMEs. Recent bank surveys suggest an incipient improvement in both the supply of and demand for credit, although more granular data show that this is the case for larger and healthier firms.



Sources: Bank of Italy; and IMF staff estimates.
Notes: Based on Bank Lending Survey, Questions 1 and 6 Overall (Changes in Bank Lending Standards, Changes in Demand for Loans).



Sources: Bank of Italy; Cerved.
Note: Loans granted by banks and financial companies. Data for 2014 refer to a sample of about 423,000 companies; those for 2015 refer to about 373,000 companies whose 2014 balance sheets are available. The classification by risk category is according to the scores assigned by Cerved.

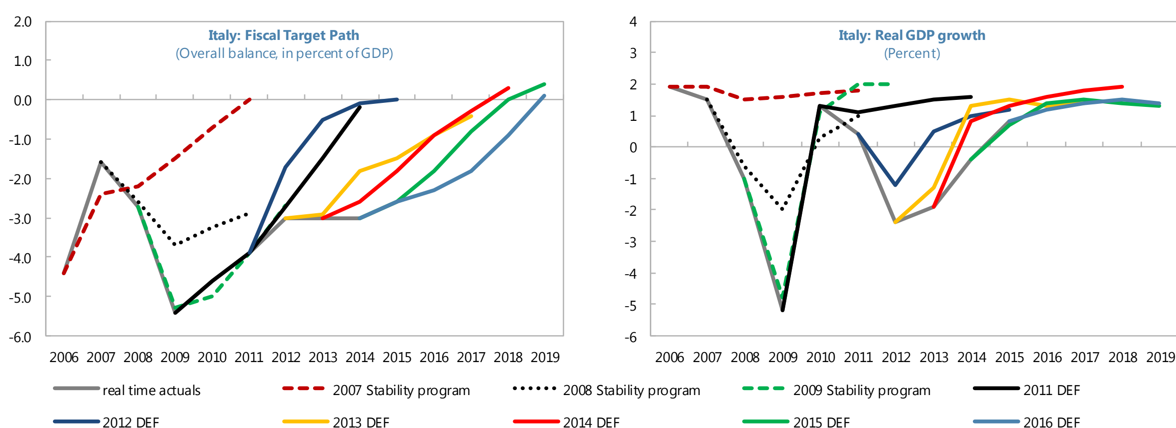
- Following the 2014 asset quality review and stress tests of the largest banking groups that comprise about 60 percent of assets in Italy, banks raised about €4 billion in capital in the first half of 2015. Common equity tier 1 ratios improved to 11.5 percent on average for the significant banks at end 2015, which was about 2 percentage points below the average and the lowest in a sample of large European banks compiled by the European Banking Authority (EBA

Risk Dashboard). In the context of the Supervisory Review and Evaluation Process, provisioning and further capital requirements were imposed on a few specific banks. Nevertheless, reflecting concerns about the speed of dealing with the NPL overhang and weak profitability in a period of very low interest rates, Italian banks have come under intense market pressure, losing over 40 percent of their market value this year.

- Four small troubled banks, accounting for about 1 percent of system-wide deposits, were resolved in late November 2015, before the stricter bail-in requirement under the Bank Recovery and Resolution Directive (BRRD) came into effect at the start of 2016.[2] The authorities implemented a limited bail-in of equity and subordinated debt and spared senior bondholders. However, in the face of significant social pressures as nearly half of the €0.8 billion of subordinated debt that was bailed in was held by retail investors, a fund has been set up by other banks to compensate a large number of retail investors.

9. Fiscal policy continues to be expansionary to support growth (Figure 6).

- The government tightened the fiscal stance considerably during the crisis to register a peak structural primary surplus of 4.1 percent of GDP in 2013, among the highest in the euro zone. Since then, fiscal policy has been eased, and is set to ease further in 2016, with the structural primary surplus projected to decline to 2.6 percent of GDP. Meanwhile, the overall deficit is projected to decline to 2.4 percent of GDP in 2016 (from 2.9 percent of GDP in 2012–13) with the sizable interest savings of more than 1 percent of GDP largely offset by the fiscal relaxation (Fund advice had been to use the interest windfall to reduce debt). Debt continued to increase to 132.7 percent of GDP at end-2015.



- In terms of composition, real primary spending has been contained in recent years, mainly through cuts in capital spending and the wage bill (through attrition of the workforce and a wage freeze). Social benefits including pensions continued to rise and remain an outlier in the euro area (although full implementation of past pension reforms would ensure its long-term

[2] The banks were split into four bridge banks and one bad bank, with the resolution cost of €3.6 billion borne by the national resolution fund, which in turn drew upon liquidity from three major banks.

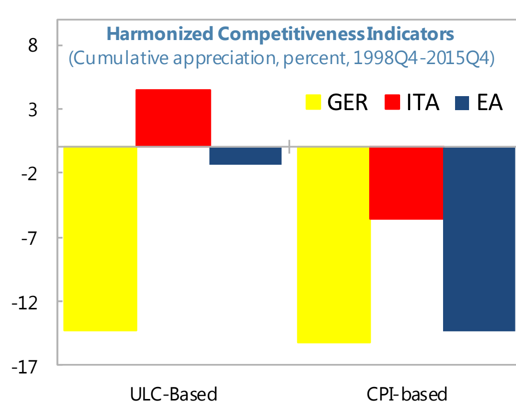
sustainability). Meanwhile, the government has been easing the tax burden, e.g., through a monthly bonus of €80 for workers with incomes below €24,000 (phased out for incomes up to €26,000); cuts in social contributions for new hires; and the elimination of an effective but unpopular real estate tax on primary residences (home ownership rates are high). Additional revenues were sought through, e.g., a voluntary disclosure scheme and gaming revenues.

Italy: Fiscal Expenditures

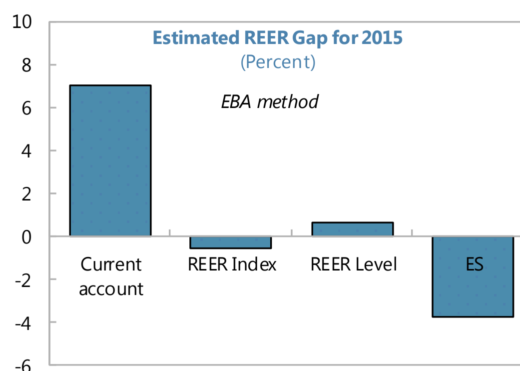
	Nominal levels (€ billions)			Real levels (2010 € billions)		
	2008	2012	2015	2008	2012	2015
Total spending	780.7	819.2	826.4	798.5	796.4	781.4
Primary spending	700.2	735.7	758.0	716.2	715.1	716.7
Social benefits	320.6	354.8	377.6	328.0	344.9	357.0
Wage bill	170.3	166.1	161.7	174.2	161.5	152.9
Gross capital formation	48.5	41.4	37.4	49.6	40.2	35.4
Other primary spending	160.8	173.4	181.2	164.5	168.5	171.4
Interest bill	80.5	83.6	68.4	82.3	81.2	64.7

Source: Eurostat, Istat.

10. Italy's competitiveness has suffered from stagnant productivity and rising labor costs. As detailed in Annex I, Italy's external position as of 2015 was broadly consistent but likely still weaker than suggested by medium-term fundamentals and desirable policy settings. From an average deficit of 1¼ percent of GDP in the 2000s, the current account moved into balance in 2013 and, by 2015, registered a surplus of 2.2 percent of GDP, driven by a growing trade surplus, helped by lower commodity prices (Figure 7). Nonetheless, the 2015 cyclically-adjusted current account surplus was about 0–2 percent of GDP weaker than justified by fundamentals and appropriate policies. From a savings-investment perspective, the steady rise of the current account since 2010 is related mainly to the decline in investment as both the corporate and the public sector deleveraged. Competitiveness has suffered from stagnant productivity and rising labor costs, leading to a gradual appreciation of the real effective exchange rate (REER) since Italy's joining the euro zone both in absolute terms and relative to the euro zone average. In 2015, the fall in the value of the euro contributed to a sizable depreciation of the REER, bringing its value close to 1999 levels. Taking into account a broad range of indicators and model-based estimates of the REER gap for 2015, staff considers that a real effective depreciation of 0–10 percent—supported by structural reforms—would be appropriate to restore competitiveness.



Sources: ECB, IMF staff estimates.



Source: IMF staff estimates.

OUTLOOK AND RISKS

11. Growth is expected to be modest in 2016–17 and over the longer term.

- Real GDP growth is projected at 1.1 percent in 2016 and about 1¼ percent in 2017–18, supported by expansionary monetary and fiscal policies and continued low oil prices. The measures contained in the 2016 budget are estimated to boost growth by about 0.3 percent in 2016 and 2017. Investment is expected to pick up gradually, financed largely by firms' retained earnings and modest credit provision by the banking sector. However, bank financing could become a binding constraint to a further pickup in investment, unless strong progress is made in restoring corporate and bank balance sheet health. Weak external demand is also expected to weigh on net exports.

- Backloaded fiscal consolidation according to the authorities' plans would result in a decline in real GDP growth in 2019–21 to around 0.8 percent. Beyond that, growth of around 0.8 percent is projected in the steady state, including a dividend on structural reforms of about 0.3 percent per year over the medium to long term, in line with the authorities' estimate. Absent reforms, staff estimates potential growth of around ½ percent, which reflects crisis legacies such as the collapse in investment as well as unfavorable demographics and slow productivity growth that predates the crisis.

- As the output gap closes, inflation will rise gradually, yet slower than that of Italy's euro zone partners owing to a projected productivity differential. Relatively low nominal growth is expected to slow the pace at which Italy is able to grow out of its crisis legacies and structural vulnerabilities, leaving it exposed to adverse shocks.

12. Risks are tilted to the downside. Risks are manifold and interconnected (see Risk Assessment Matrix).

- Upside risks relate to better-than-anticipated effects of monetary and fiscal easing, strong implementation of structural reforms, larger-than-expected lagged impact of euro depreciation, and a sustained period of low global energy prices.

- Downside risks, on the other hand, arise from delays in addressing bank asset quality; intensified global financial market volatility, including from Brexit; the global trade slowdown weighing on exports; and the refugee influx and security threats that could further complicate policy making. Setbacks in the reform process could weigh on investment and undermine sentiment, which could result in stagnation.

- If downside risks were to materialize, regional and global spillovers could be significant given Italy's systemic weight. In this regard, efforts by the Italian authorities to address decisively the low productivity, high public debt, and bank balance sheet vulnerabilities are of paramount importance. At the same time, efforts at the European level should continue to strengthen the euro zone's architecture (see staff report for the Article IV consultation on euro area policies).

Italy: Risk Assessment Matrix

Italy: Risk Assessment Matrix and Transmission Channels

Potential Deviations from Baseline

Sources of Risk: Trigger Event (color = relative likelihood)	Sources of Risk: Vulnerabilities	Impact if realized (color = severity)	Policy Response
Sovereign stress re-emerges due to tighter or more volatile global financial conditions, including from sharp asset price decline and decompression of credit spreads. (orange)	**Fiscal:** High public debt and gross financing needs	Higher yields could undermine confidence in sovereign and push Italy into a bad equilibrium. (red)	- Observe structural fiscal targets to boost credibility - Activate OMT if needed
	Bailout cost / Asset quality		
British voters elect to leave the EU. A period of elevated financial volatility and heightened uncertainty could ensue, with potential contagion. (red) Further turmoil in Italian banking system resulting from a failure to address weak profitability and NPLs (red)	**Banks:** High NPLs and sovereign exposure Low profitability	Further deterioration in corporate financing conditions; weakening of bank balance sheets and solvency positions. Recovery cannot be supported by financial sector. (red)	- Greater push to clean up bank balance sheets - Remove unviable firms from market - Faster progress on banking union--clarify backstops - Put in place comprehensive strategy involving legal, economic and supervisory measures
	Asset quality / Credit crunch		
Weak demand and persistently low inflation from a failure to fully address crisis legacies and undertake structural reforms (red) Rising populism which weighs on reform implementation and strengthening of the EU architecture (orange) Fragmentation/security dislocation in parts of the Middle East, Africa, and Europe, leading to a sharp rise in migrant flows. (red) A significant slowdown in China and other large EMs/frontier economies (orange)	**Real:** - Large corporate debt overhang - Dismal productivity (especially for nontradeables) - Cumbersome business environment	Stagnation, low inflation, and high unemployment will complicate efforts to reduce public debt. (red) Delay in reform agenda could undermine domestic confidence, and lead to stagnation. (orange) Falling external demand hurts exports. (orange)	- Accelerate structural reforms to improve productivity - Let automatic stabilizers work plus budget rebalancing to support growth
QE, fiscal easing, structural reforms and lower oil prices could have larger positive impact than currently expected. (green)		Higher growth will help efforts to reduce public debt. (green)	- Run higher fiscal surpluses to reduce public debt - Stick to planned structural reforms to consolidate gains from QE/oil prices

[1] The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood of risks listed is the staff's subjective assessment of the risks surrounding the baseline ("low" (green) is meant to indicate a probability below 10 percent, "medium" (orange) a probability between 10 and 30 percent, and "high" (red) a probability between 30 and 50 percent). For the severity if realized, green denotes a positive impact, yellow a negative impact, and red a severe negative impact. The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly.

13. There is broad agreement with the authorities on the near-term outlook and the long-term challenges facing the Italian economy. Real growth projections in 2016–17 are largely aligned (text table), although the authorities expect the GDP deflator and thus nominal growth to be somewhat higher. They consider the resilience of the economy to have improved as a result of the ongoing reforms. They agreed that a further pickup in investment is critical to a sustained recovery and, in that regard, viewed the slowdown in external demand and its potential impact on investment as a key downside risk. Other downside risks include deflation and adverse euro zone political developments such as those associated with Brexit. The authorities noted that, in view of the substantial output decline during the crisis, the output gap remains large, and considered the common EU methodology to result in too small of a gap. As discussed in detail in subsequent sections, views differed on the policies to address some of the underlying challenges.

Italy: Real Growth Projections

	2016	2017
IMF	1.1	1.3
MEF (2016 Stability Program, Apr 2016)	1.2	1.4
BoI (Macro Projections, June 2016)	1.1	1.2

14. There is also broad agreement on the external sector assessment. The authorities emphasized the importance of structural reforms in lifting potential output and improving Italy's competitiveness. They consider the price-elasticity of exports to have declined over the past twenty years—hence, the impact on exports of euro depreciation has been lower than expected—while sluggish external demand has also weighed on export performance in the near term. They cautioned against relying on labor-based indicators of competitiveness, which show a wider competitiveness gap than other price-based measures, as they consider these may underestimate Italian firms' capacity to compete. Italy has the second largest manufacturing sector in Europe and the seventh globally, although staff notes that manufacturing has suffered significantly (Figure 2).

POLICY DISCUSSIONS

15. The discussions focused on policies to deliver stronger and more inclusive growth while strengthening buffers. Even with the benefit of exceptionally accommodative monetary policy, notably easier fiscal policy, relatively low global commodity prices, and the launch of important reforms, growth is expected to remain relatively modest, public debt very high, and financial sector vulnerabilities elevated in the near to medium-term.

16. Substantial progress must therefore be made in addressing these challenges. The authorities are keen to stay the course, prioritizing growth, including through fiscal accommodation, and avoiding exacerbating financial deleveraging, not least because a step up in growth could facilitate bank balance sheet cleanup and lower the debt burden. Yet, unless growth increases notably, such a strategy could well leave a greater risk of a future procyclical tightening in the event of adverse shocks. Staff suggested that consideration be given to deeper structural reforms and a pro-growth fiscal policy mix that can create space for earlier fiscal adjustment and stronger financial sector policies. This will help build buffers faster, and any impact on near-term growth would be compensated by stronger resilience to shocks and a higher growth payoff in the medium term.

A. Structural Reforms

17. Sustained implementation of reforms and broadening of the effort in three priority areas are key to raising growth. Reform efforts in the past few years have built on a host of earlier initiatives. In the last two decades, for instance, there have been about five important labor market reforms, three public administration reforms, three education system reforms, and numerous justice reforms. However, reforms were generally piecemeal and implementation lagged, with the overall economic results being less than desired. Thus, sustained and full implementation of the current reform efforts is critical. In addition, further efforts are needed in three mutually reinforcing areas: product and service markets, which have the potential to yield near- and longer-term growth dividends (*World Economic Outlook*, April 2016); public administration to improve the quality of services, enhance efficiency, and lower costs to business and investment; and a wage bargaining system to align wages with productivity, improve competitiveness, and complement the Jobs Act.

Product and Service Market Reforms

18. Regulatory rigidities and barriers to competition remain significant in certain sectors. Key problems are concentrated in network industries (e.g., energy and transport), professional services (e.g., legal, notaries, and pharmaceutical), and the provision of local public services. Together these services account for about one-third of the total value added in the economy and about 30 percent of household's final consumption, and contribute about 40 percent of input to other sectors' output. The Monti government introduced several reforms in 2011–12, aimed at reducing entry barriers in several non-tradable sectors, removing unnecessary regulation of economic activities, and improving the business environment through administrative simplification. Although de jure measures of competition improved, business perceptions of de facto barriers to competition remain considerable. Analysis by staff suggests potentially sizable gains from product and service market reforms, especially when coupled with public sector reforms (Box 1).

19. Parliament has been debating the Annual Competition Law for over a year. Although the government is required to present to parliament a draft law on enhancing competition on an annual basis since 2009, such a law has not yet been approved. The current draft includes some recommendations of the competition authority and proposes measures aimed at addressing regulatory barriers to entry and competition in the insurance, postal, communications, pharmaceutical, electricity, gas and fuel distribution sectors and further liberalization of professional services (notaries, lawyers, architects and engineers). However, on the back of pressure from vested interests, many provisions of the draft law have been weakened during the parliamentary discussions—in particular, related to the insurance sector and professional services, such as notaries, lawyers, and pharmacies.

20. Bold steps to open up professions and services to competition can have immediate payoff. Strengthening the draft law in line with the recommendations of the competition authority and ensuring an annual process of adopting pro-competition laws would be critical to their

effectiveness. Going forward, consideration should be given to enhancing competition in other areas, including:

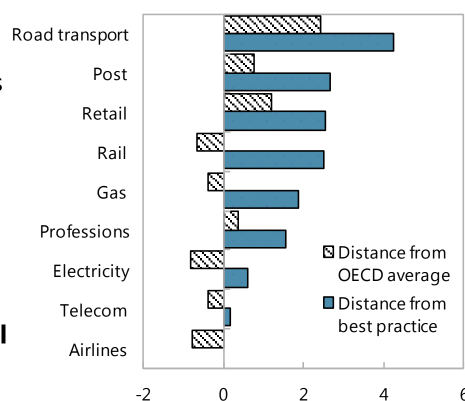
- *Provision of local public services*. Given the impact of public sector inefficiency on firm productivity (Box 1), enhancing competition in local public service provision would be critical to tackling rent seeking and could yield sizable economic benefits. The competition authority has provided specific proposals, such as liberalizing local transport and waste collection, while past spending reviews outlined a proposal to significantly rationalize local public companies over three years, with the goal of improving efficiency and the quality of services offered.

- *Retail, transport, and permits*. Italy's retail sector remains one of the most regulated in Europe according to the OECD product market regulation indicators, and even measures legislated to liberalize certain aspects of this sector have been poorly implemented by regional authorities. Large-surface retail outlets remain subject to special rules, especially concerning new openings; incumbents are excessively protected from new entrants; and restrictions on promotions, discounts, and below-cost sales are very severe. There is also substantial scope for further liberalization in electricity generation (hydroelectric power plants), radio spectrum frequencies, local public transport and taxis, ports and airports. Competition in a number of sectors is hindered by permit schemes, and service providers are given the right to use public infrastructure for long periods with no competitive procedures. As these are essential inputs to production, enhancing competition should raise growth.

21. The authorities agreed with the critical importance of enhancing competition in product and service markets. They expect the current draft Annual Competition Law to be adopted by mid-2016, and concurred that there is scope to strengthen the current draft law in a number of areas, including in legal and professional services. In that regard, the government submitted the National Plan for Professional Reform in February 2016, with a view to implementing the European Directive on the recognition of professional qualifications. Other areas such as communications, healthcare, transport and other public services are expected to be tackled in future annual competition laws, and be linked to the reform of the public administration.

Box 1. The Impact of Product Market Reforms on Firm Productivity in Italy

While Italy has made some progress in liberalizing its product markets in recent years, business perception of barriers to competition remains unfavorable. According to the OECD Product Market Regulation indicators, Italy was the sixth least regulated economy as of 2013 among the 31 OECD economies for which this indicator is available. In some areas such as telecommunications and airlines, Italy is at or close to OECD best practice, but in other areas such as road transportation and retail, it remains heavily regulated. However, the World Bank's Doing Business indicator paints a very different picture, largely reflecting its emphasis on de facto rather than de jure measures. Italy has moved up only one spot in its ranking—from thirtieth place out of 31 OECD economies in 2012 to twenty-ninth place in 2015.



Sources: OECD; and World Economic Forum.

A recent IMF working paper examines empirically the potential role of removing obstacles to competition in Italian product markets in boosting growth and productivity.[1] Using annual firm-level data from Italy over 2003–13 from the Orbis database by Bureau van Dijk, OECD product market measures of regulation (PMR), and Italy's input-output matrix, it tries to address three questions: (1) did the performance of previously regulated sectors improve as barriers to competition were removed? (2) what was the impact on downstream industries, which use the output of regulated network industries as inputs in their production function? And (3) how is the response to liberalization shaped by government efficiency?

Reforms that raise competition in product market can affect the economy in two ways. First, deregulation is expected to affect firms in the regulated sectors themselves, through the usual effects of competition on growth. Greater competitive pressures could lead to reallocation of output across heterogeneous firms, as inefficient firms exit, and/or induce firms to innovate and adopt new technologies, thereby raising sectoral productivity. This effect by itself could be important as regulated industries account for close to 30 percent of Italy's GDP. Second, higher competition, which may lead to lower mark-ups, greater availability of services and higher quality products and services, could benefit firms that use the output of regulated industries as inputs. These are the so-called downstream effects. This is another quantitatively important channel as regulated sectors account for about 30 percent of total inputs in the Italian economy, according to Italy's input-output matrix.

There is evidence of a positive association between deregulation in network sectors and value added and productivity of firms in these sectors. For instance, a one-standard deviation improvement in the PMR is associated with 3 percent relatively higher growth in sales, 10 percent relatively larger firms (in terms of output), and 4.7 percent relatively higher value added per worker. Firms using outputs from network sectors as production inputs also benefit. Upon deregulation of network sectors, those firms that use regulated inputs more intensely increase their size and productivity relatively more.

There is also evidence of complementarity between better quality of public services and product market deregulation. In provinces with more efficiently provided public services, the positive association between deregulation and firm performance in previously regulated sectors is significantly stronger. For instance, a one-standard-deviation improvement in the PMR is associated with a 0.3 percent increase in output for a firm in a province in the upper quartile of government efficiency, but only 0.1 percent for a firm in a province in the lower quartile of government efficiency.

[1] Lanau, Sergi, and Petia Topalova, 2016, "The Impact of Product Market Reforms on Firm Productivity in Italy," IMF Working Paper WP/16/119 (Washington: International Monetary Fund).

Public Administration Reforms

22. Public sector inefficiencies weigh on investment and productivity. According to the World Bank's Doing Business indicators for 2016, for instance, it takes 1,120 days to enforce a contract, 227 days to obtain a construction permit, and 124 days to get an electricity connection, substantially longer than the OECD average. Weak public sector performance can be attributed to several factors, notably, excessively long and burdensome bureaucratic procedures, overlapping competences and intra-institutional conflicts, and the lack of administrative capacity, including an aging workforce and skill-job mismatches (e.g., the agency for collective bargaining for the public administration found skills mismatches in one-third of positions studied). The average length of a tendering procedure is 210 days, compared to an EU average of 77.4 days, while the number of single-bid contracts that are awarded is close to one third. This adds to a perception of corruption as a widespread phenomenon. The number of local public enterprises has proliferated to more than 8,000, against the backdrop of a complex framework and direct awarding of service contracts with no open tender. In many areas, local service provision is dominated by monopolies assigned to companies owned by or related to local governments. There are also notable regional differences.

23. An enabling law was approved in August 2015. It foresees reforms to simplify procedures, streamline and accelerate decision making, rationalize local public enterprises, and improve the recruitment and management of staff, among others. A set of legislative decrees was proposed for discussion by the government in January 2016, and is in the process of being implemented. Others are planned for later this year. A reform of procurement is underway, including through centralizing purchasing power to about 35 bodies, down from tens of thousands. A new framework aims to systematically regulate state-owned enterprises in line with the principles of efficient management, protection of competition and reduced public expenditure, and with an enhanced oversight role for the Court of Auditors. New provisions clarify that state-owned enterprises are subject to the bankruptcy legislation. However, state-owned giants such as Eni, Enel, Finmeccanica, Poste Italiane, Cassa Depositi e Prestiti, Ferrovie, and Rai are left outside the perimeter of rationalization. The government plans to implement stricter rules for disciplinary firing of public sector workers.

24. Timely implementation and follow-up are key, and several challenges would need to be tackled as part of successfully modernizing the public administration. These include improving the skill-mix in the public sector, matching positions with skills, and aligning wages with productivity; accelerating court processes to ensure timely enforcement, including by the public administration of laws (Box 2); tackling privileges and employment in public enterprises, including through privatization; ensuring most products at all levels of government are covered under rationalized procurement procedures; and further strengthening anti-corruption efforts, particularly by implementing AML/CFT measures on domestic politically exposed persons.

25. The authorities intend to complete the legislative process by end-2016. While agreeing that completing the transformation of the public administration will take time and will require full and timely implementation of the reforms as well as constant monitoring, the authorities expressed optimism about the efficiency-enhancing impact of the reforms. They noted that, in the context of the 2016 stability law, a broader range of public administrations and local governments is required

to purchase through centralized procurement bodies and use benchmark pricing. They broadly agreed with the assessment and identification of priorities on justice and insolvency reforms.

Box 2. Civil Justice Reforms

Reform of the court system is essential to ensure enforcement in a timely manner, including implementation of laws. An over-burdened court system is a hindrance to efficient resource allocation. This includes ensuring the public administration implements legislative decrees. Despite incremental reforms, Italy has one of the slowest court systems in the adjudication of civil and commercial disputes in the EU. According to the European Justice Scoreboard 2016, only Malta, Portugal and Cyprus have less efficient systems for the resolution of civil and commercial cases. Civil or commercial cases are resolved in first instance on average in more than 500 days from the start of the process. Appeals can multiply that by more than three times to around six years.

The government is adopting actions to increase the quality of the judicial system and reduce the backlog of cases. These include promoting alternative dispute resolution techniques, reinforcing the auxiliary staff of the courts with personnel from other parts of the public sector, and introducing better information technology. The development of court performance indicators and best practices (Project Strasbourg 2.0) aims to reduce the gap between the best managed courts and those that are underperforming, which however represent a majority in certain geographical areas.

The reform of the appeal system needs to be a priority. Consideration should be given to rationalizing the type of cases that reach the Supreme Court (Corte di Cassazione). The enterprise courts should be further strengthened. The specialization afforded by the enterprise courts should translate into a more efficient commercial justice in a variety of cases, including corporate litigation and insolvency cases.

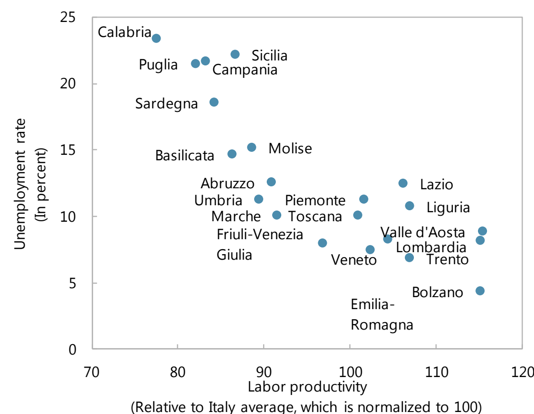
Recent reforms to reduce the time for enforcement of secured claims are important steps.[1] These reforms—including the enforcement of commercial secured credit and the introduction of new forms of security interests over movable assets—should reduce the inflow of NPLs by improving the position of creditors and the realization of collateral. Effective introduction of the electronic civil procedure (*processo civile telematico*) should reduce the time for enforcement of unsecured credit. Reforms of the law of secured transactions should improve the legal environment of credit, increasing the possibility of creating security interests over movable assets. However, many important technical details remain to be solved, including the creation of an efficient, notice-based registry, and the transposition into law of the measures announced in early May also requires special attention to a number of technical issues in the implementation of the new contracts and security interests.

[1] See Garrido, José, "Insolvency and Enforcement Reform in Italy," forthcoming IMF Working Paper.

Labor Market Reforms

26. The labor market is characterized by high (youth) unemployment, low (female) labor force participation, inefficient wage setting, and job-skill mismatch. The gradual liberalization of employment contracts since the mid-1990s contributed to high labor market duality. Meanwhile, wage setting has generally outpaced productivity gains and is not differentiated regionally.

Regions with Higher Productivity Have Lower Unemployment

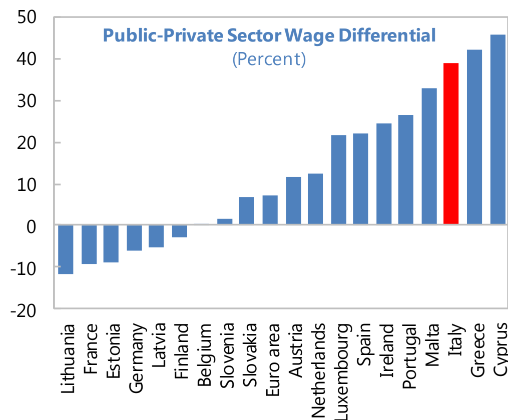


Sources: Eurostat; and IMF staff estimates.

27. The authorities have passed the necessary legislation to implement the Jobs Act. The Act is a comprehensive overhaul that attempts to make the labor market more flexible and inclusive, improve the reallocation of labor across firms and sectors, expand the safety net to protect workers from higher labor market flexibility, and enhance job matching. It introduces a new standard employment contract in which protection rises with tenure. As it affects new workers (current workers are grandfathered), the Act is expected to have its full impact only over the long term.

28. Going forward, the authorities are keen to implement active labor market policies (ALMPs). Effective implementation, including through a new National Employment Agency, will require significant national-regional cooperation on provision of services, sharing of information over an under-developed infrastructure, enhancing placement capacity, and instituting regular and coordinated monitoring of service delivery. At the same time, boosting (female) labor force participation and ensuring that refugees are integrated into the workforce are topical issues that would improve labor market and economic outcomes (Box 3).

29. To complement these reforms and boost employment, a new wage bargaining system is needed. Italy's two-tier collective wage bargaining system leaves little scope for many firms, especially small enterprises and many in the South, to engage in firm-level negotiations. Rules on collective bargaining are set by social partners rather than by law. However, social partners are no closer to a comprehensive new system. Decentralized bargaining can strengthen the responsiveness of wages to productivity and labor market conditions, and alleviate regional disparities in labor outcomes and economic performance. In addition, public sector wage setting in line with productivity developments can better reflect the value of public services as well as address over time the current wedge between public and private sector wages.

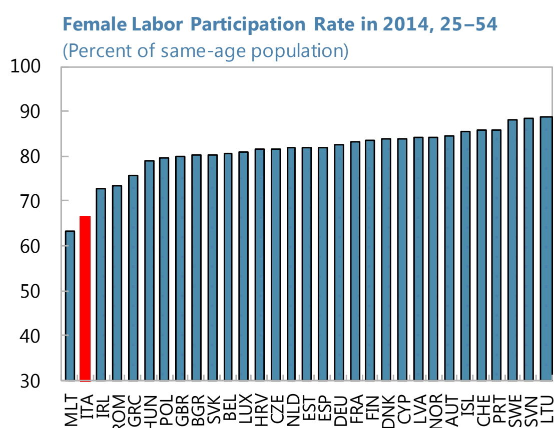


Source: Eurostat, Annual National Accounts.
Note: Differential is the percent change between hourly public wage and hourly private wage. Hourly wages are calculated by using wages & salaries and employees' hours worked from annual national accounts data by A*10 industry breakdowns.

Box 3. Boosting Female Labor Force Participation and Responding to the Refugee Surge

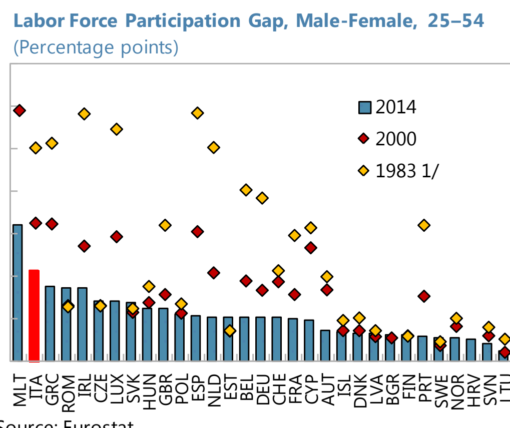
Female labor force participation. A Selected Issues Paper[1] examines the scope for increasing the role of women in the formal economy and the potential benefits of closing gender gaps in the Italian labor market. Existing studies and evidence from Italian provinces suggest a substantial role for policies, such as removing fiscal disincentives (lowering the tax wedge) and enhancing the supply of child- and elderly-care services, to support women's decisions to enter the labor market. Having more women in the labor force would increase potential output and paves the way for increased diversity in senior corporate positions, which could bring added economic benefits. New evidence reported in the SIP from 300,000 firms in Italy suggests that the higher presence of women in senior corporate position is tied to stronger corporate profitability, particularly in sectors with larger shares of women in the labor force and with higher demand for creativity and innovative capacity.

Female Labor Participation Rate in 2014, 25–54
(Percent of same-age population)



Source: Eurostat.

Labor Force Participation Gap, Male-Female, 25–54
(Percentage points)



Source: Eurostat.
1/ Or earliest data point available.

Refugee surge. The authorities estimate that about 270,000 refugees are expected to reach Italy in 2016, much higher than last year, and have been considering urgent action, e.g., to establish new asylum centers. As identified in a recent Staff Discussion Note,[2] policies can help open up the refugees' path to the labor market, reduce the net fiscal cost, and counter some of the adverse fiscal effects of population aging, e.g., minimizing restrictions on taking up work during the asylum application phase; to the extent feasible, strengthening targeting of ALMPs to refugees, e.g., wage subsidies to private employers; easing avenues to self employment (including access to credit); facilitating skill recognition; lowering barriers to entrepreneurship; reducing restrictions on geographical mobility (including those linked to housing); and improving education policies. Most of these policies have broad application to Italy's labor market.

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[1] Topalova, Petia, 2016, "Female Labor Force Participation in Italy: Drivers and Benefits," Selected Issues Paper.

[2] Aiyar, Shekhar, et. al., 2016, "The Refugee Surge in Europe: Economic Challenges," IMF Staff Discussion Note, SDN/16/02.

30. **The authorities are confident that the Jobs Act will bring about important changes to the labor market, and concurred on the need for more decentralized bargaining.** They pointed to the positive effect of the Jobs Act that are already reflected in the labor statistics. They remain committed to strengthening ALMPs to decrease the duration of unemployment, and expect the National Employment Agency to reach its potential once the forthcoming constitutional reform shifts responsibility for the management and specific design of ALMPs from regions to the center. They noted that the 2016 Stability Law incentivizes firm-level bargaining through tax relief on productivity wage components and non-monetary compensations. While the expiration of several central contracts is an opportunity for such improvements, they were concerned, however, about the potential locking in of current low inflation expectations into wage bargaining contracts.

B. Financial Sector Policies

31. Effectively addressing the enormous financial sector challenges is of paramount importance, given the ramifications for the financial system and economic activity.

- Non-financial corporates account for almost two-thirds of bank NPLs, a large fraction of which are subject to enforcement. Closing unviable enterprises and rehabilitating viable enterprises that need a fresh start would unlock capital for lending to healthier firms and sectors. However, neither is likely to proceed apace, unless long court processes are substantially shortened and weak bank profitability is addressed. There is also a notable pricing gap between the market value of NPLs and those on the banks' books.

- Weak profitability, related to high NPLs, compressed interest margins, and elevated operating costs, hinders a timely repair of balance sheets through retained earnings. Although ECB actions are helping improve funding conditions, calculations based on publicly available data for the 15 largest banks suggest that, at current lending rates and funding costs, a number of smaller banks are likely to face profitability challenges (Box 4) and thus may continue to deleverage. Measures to lower NPLs and curtail operating expenses, including through bank consolidation, are critical.

- At the same time, as a matter of principle, alongside efforts to strengthen individual banks, the effective use of the framework for the prompt resolution of failing banks is needed. Delayed or reactive resolution can exacerbate uncertainty and destroy value for individual banks and the system as a whole. Indeed, unless asset quality and profitability problems are addressed in a timely manner, lingering problems of weaker banks can eventually weigh on the rest of the system.

32. The authorities are implementing a multi-pronged approach, including legal and insolvency reforms, a framework for bank consolidation, and other measures.

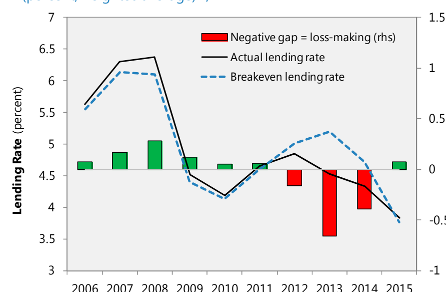
- *Legal measures.* Recent measures include insolvency reforms to shorten the duration of procedures and increase both the survival rates of distressed enterprises and creditors' recovery values, civil procedure measures to strengthen debt enforcement, an out-of-court mechanism for the enforcement of secured credit over immovable assets in commercial loans, and flexible forms of security interests over enterprise assets. These positive changes will require proper implementation, including adequate judicial infrastructure and registration systems.

- *Consolidation and governance reform.* To spur much needed consolidation in Italy's highly fragmented banking system that comprises about 640 banks, the authorities passed legislation to transform the governance structure of the larger cooperative (*popolare)* banks (March 2015) and of the smaller cooperative (mutual) banks (February 2016). The largest *popolare* banks must be transformed into joint stock companies by end 2016. So far, one potential merger—between Banco Popolare and Banca Popolare di Milano—has been announced that, once completed, would create the third largest banking group in Italy. Mutual banks must consolidate under joint-stock (holding) companies with at least €1 billion in equity in 18 months.

Box 4. Banks' Profitability Challenge[1]

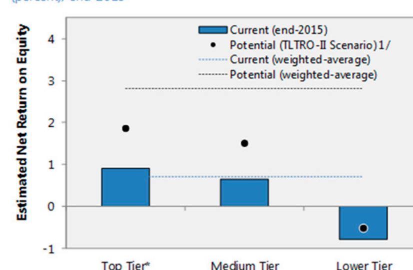
A bottom-up analysis of the 15 largest Italian banks suggests that—absent strong reforms—a number of smaller banks are likely to face profitability challenges, owing to low interest earnings (including from high NPLs) and high operating costs. Staff calculated the net return on equity (RoE) based on current net interest margins (NIMs) and commissions/fee income at end-2015—after accounting for firm-specific capitalization and default risk of the loan portfolio, which were obtained from the 2015 Transparency Exercise of the European Banking Authority. Assuming that loan provisions are forward looking, reflecting expected losses, current lending by about half the number of all banks in the sample generates profits; larger banks are profitable but a number of smaller banks are likely to struggle. Applying this analysis to historical data suggests that, since 2009, lending rates for most banks were below what would have been required to fund sufficient loan loss reserves ex post. Put differently, credit risk turned out to be underpriced; if credit conditions reflected subsequent loan performance, the rise of NPLs (and resultant provisioning needs) would have implied a higher lending rate for banks to maintain their profitability.

Italy: Difference between *Actual* and Breakeven Lending Rates—Sample Banks (Expected Loss Provisioning)
(percent, weighted average) 1/



Sources: Haver, SNL and IMF staff calculations. Note: 1/ weighed by total loans (as of end-2015).

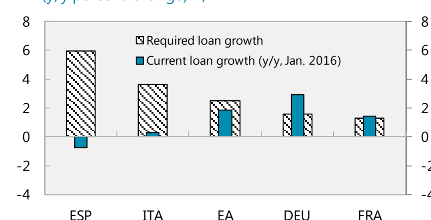
Italy: Estimated Net Return on Equity of Current Lending under Expected Loss Provisioning (with and without funding benefit due to TLTRO II)
(percent), end-2015



Sources: SNL and IMF staff calculations. Note: */ The sample was split into three tiers (of 5 banks each), ordered by RoE and weighted by total loans; 1/ Funding rate at MRO (0 %) via TLTRO II (and full rollover of existing TLTRO); any new deposits at 0 %; lending rates adjust according to marginal policy rate (since end-2015: -20 bps) and expected pass-through from term spread compression at historical elasticity of NIMs banks maintain their capital ratio as of end-2015.

Credit easing would improve overall bank profitability without materially altering the negative earnings outlook for a number of smaller banks. In a sensitivity analysis, all Italian banks are assumed to participate in the ECB's TLTRO II as of June 2016 and—in an extreme assumption—cease to remunerate deposits, reducing their average funding cost of currently about 1.5 percent to the ECB's marginal refinancing rate of zero. At the same time, their lending rates are considered fully variable and adjust in response to the recent decline of the marginal policy rate (i.e., the ECB's deposit rate) and the historical pass-through of term premia to NIMs. Under these very favorable funding terms, overall system profitability would improve, assuming sufficient loan demand. Even so, one-third of banks in the sample could still face profitability challenges, which may not be solved through higher loan growth.

Annual Loan Growth Required to Maintain Net Interest Margin, end-2015
(y/y percent change) 1/



Sources: Bloomberg L.P., EBA Transparency Exercise (2015), ECB, SNL, and IMF staff calculations. Note: 1/ based on the historical pass-through of policy rates and the elasticity of net interest margins to changes in term premia between Jan. 2010 and Feb. 2016; total mortgage and corporate loans at end-2015 to EA residents.; scenario is based on the estimated impact of the increase of monthly asset purchases (until Sept. 2017) by the ECB and a reduction of the deposit rate by 10 bps (as per ECB decision on March 10).

For the larger banks, robust credit growth could improve bank profitability. Staff estimates that the current easing measures by the ECB lower the NIMs of Italian banks by 11 basis points on average. This suggests that lending growth in Italy would need to increase to at least 3.6 percent annually (or about 3 percentage points above current credit growth) for banks to maintain current profitability over the amortization period of their loan book to offset the negative impact of lower NIMs. In this regard, it would be important to ensure that banks have adequate capital to support strong credit growth.

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[1] See Jobst, Andreas, and Anke Weber, 2016, "Profitability and Balance Sheet Repair of Italian Banks," Selected Issues Paper.

- *Other initiatives*. In early 2016, the authorities set aside previous plans for a system-wide bad bank following an inability to agree with the EC on addressing state-aid concerns, and instead launched or supported initiatives to backstop capital issuances of banks and facilitate NPL securitization. Further, the Bank of Italy is helping create an NPL information center to encourage private non-bank participation in the market for NPLs.

    - *GACS*. This mechanism seeks to provide government guarantees for the securitization of NPLs. Under GACS, banks can move their bad loans at market values into special purpose vehicles for their eventual sale to markets. They can buy public guarantees for the senior tranches of securities issued against these bad loans, as long as these tranches are rated as investment grade. No state aid is expected, since the fees paid by the banks for the public guarantees should cover expected costs. Staff agrees with the authorities that it will have at best a marginal impact on the large gap between the price of NPLs on banks' books and their market price. Banks expressed cautious optimism, with some indicating they intend to create vehicles involving GACS, although none has yet been finalized.

    - *Atlante*. In April 2016, to prevent the failure of capital increases by smaller banks, Italy's largest banks together with nonbank financial institutions and banking foundations created a fund that, so far, has raised €4.25 billion. The aim was to backstop capital increases of banks and possibly purchase non-investment grade tranches of NPL securitizations (so as to reduce the pricing gap between what banks are willing to sell at and those sought by investors). In the event, capital raising by Banco Popolare di Vicenza failed to attract private investors' interest in May 2016, and Atlante invested €1.5 billion, taking over 99 percent stake in the bank. The announced capital increase by Banca Veneto is an important test of the ability to attract sufficient private sector support in bank recapitalization and avoid the need for Atlante to invest in these banks.

- *Resolution framework*. With the bail-in provisions of the BRRD taking effect from the start of 2016, retail investors are likely to be impacted if any future resolutions were to occur (Box 5). Retail holdings in Italy are relatively large compared to other countries, comprising about one-third of about €600 billion worth of bank bonds and half of about €60 billion worth of subordinated bonds. The authorities are very concerned about social and potential confidence effects of resolutions, however, particularly given the social backlash that followed the limited burden sharing in the four small banks resolved in November 2015. Thus, except in the case of very small banks, it is not clear to staff whether and how the current resolution framework will be implemented. That said, delaying resolution in cases of unviable banks can be costly.[3]

[3] Bridge banks were created for the four small banks that were resolved in November 2015, owing to the shortage of time and concerns related to European state aid rules. However, the creation of bridge banks is nonstandard for non-systemic institutions and invariably more expensive than the standard purchase and assumption operation.

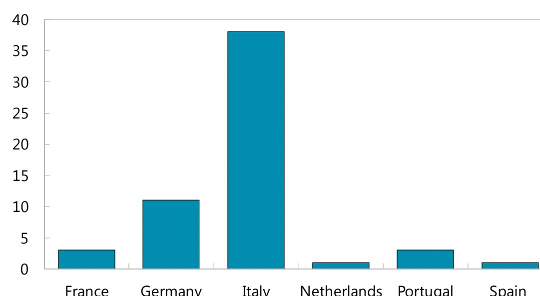
Box 5. Italian Banks' Liability Structure and the Bail-in Requirement

The bail-in tool of the BRRD has been operational in Italy since January 1, 2016. This requires bail-in of at least 8 percent of total liabilities as a pre-condition for availing resolution funds. The liabilities subject to bail in are capital instruments, then subordinated debt, and subsequently uncovered bank bonds and other senior liabilities. Deposits can be bailed in only for the part exceeding €100,000. Italian law goes beyond BRRD by establishing full depositor preference over unsecured senior debt from January 1, 2019. Between January 1, 2016 and December 31, 2018, uninsured deposits rank pari-passu with senior debt, unless the resolution authorities decide otherwise.

Italian households hold significant amounts of senior bank bonds and subordinated debt in their portfolios. While these holdings have been declining over time as a result of changes in their tax treatment and the low yield environment, they are still high. Households hold about one-third of senior bank debt and almost half of total subordinated bank debt. According to the Bank of Italy, about 50 percent of senior retail bonds will mature in 2017 and only a small amount will be left by 2020, assuming that banks find alternative sources of financing.

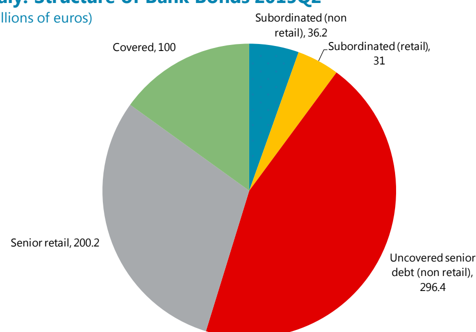
As an illustration, if a resolution is needed under current rules, it would likely entail bail-in of junior and senior creditors. Staff calculations based on publicly available data from SnL show that, for the majority of the 15 largest Italian banks, the 8 percent minimum requirement would currently imply bail-in of retail investors of subordinated debt. For about two-thirds of the number of banks in the sample, losses would also be imposed on some senior debt holders. These calculations are just an example of the current liability structure of the largest banks and are not an assessment of viability. In a resolution case, presumably the banks' own funds (capital) would have shrunk further, which would mean that bail in of 8 percent of liabilities would push deeper into senior debt. This example points to the importance of proactive measures to ensure banks' viability.

Share of Domestic Investor Held Banks' Debt Securities Held by Domestic Households, 2015Q3



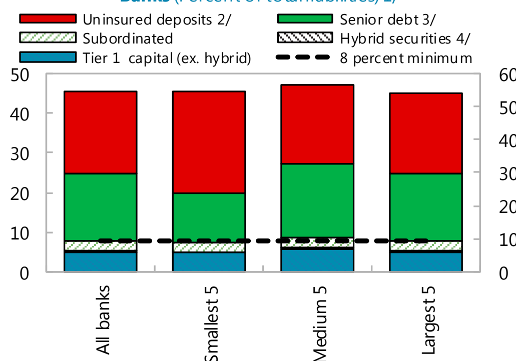
Source: Moody's

Italy: Structure of Bank Bonds 2015Q2
(Billions of euros)



Sources: Bank of Italy; Consob; Dealogic; and IMF staff estimates.

Italy: Bail-inable Liabilities of the 15 Largest Banks (Percent of total liabilities) 1/



Sources: SnL; Dealogic; and IMF staff estimates. The chart shows weighted averages by assets for the 15 SSM banks.
1/ Most recent year available. This is generally 2014.
2/ Assuming 50 percent of deposits are uninsured.
3/ Uses Dealogic data on maturing debt to approximate percentage of covered/total bonds. Assume covered debt amounts to 20 percent.
4/ Uses information on hybrids as reported under liabilities in SnL and those under tier 1 capital.

33. A more ambitious and proactive approach can enhance the authorities' strategy in effectively repairing the banking system. The financial sector remains subject to risks, as a number of banks may continue to find it difficult to generate sufficient profits to bolster capital, write-off bad debts, and finance new credit. Buffers to cope with shocks are very limited. In this regard, it is not evident that the banking system is durably ahead of its problems. Thus, the emphasis needs to be on a comprehensive framework that facilitates and supports strategies for NPL workouts, procedures for timely bank restructuring and insolvency, and a coordinated approach to banking system consolidation.

- *Advancing insolvency reforms*. Recent reforms to accelerate debt enforcement actions represent a welcome development, although their impact is only likely to be realized over time as they gradually improve the legal environment for credit.
    - Distressed enterprises need a streamlined and flexible system of out-of-court and in-court restructuring options, with fast-track solutions for the existing stock of NPLs. In this regard, debt restructuring principles for multilateral workouts and adoption of a triage approach for indebted firms would be important additions to the restructuring toolkit.
    - Enterprise courts with insolvency competences, qualified insolvency administrators, and adoption of best practices by courts across Italy would notably enhance implementation.
    - The systematization underway (the Rordorf Commission) also offers an opportunity to address outstanding issues, including integrating recent reforms into a coherent insolvency and creditor rights framework, incorporating special insolvency procedures for large companies, introducing effective incentives for early treatment of distressed firms, and rationalizing creditor priorities.
- *Accelerating NPL resolution*. The Bank of Italy is implementing a new NPL reporting framework by end 2016.
    - Banks should be required to present comprehensive NPL strategies with ambitious targets to significantly reduce NPLs over the medium term (including through more effective internal workout procedures, outsourcing to external servicers, joint ventures, and sales). Best practice elements of such strategies include separating NPLs from usual credit management, developing a comprehensive suite of loan restructuring tools, and requiring enhanced management and board of directors' focus on the NPL strategy.
    - As NPL management is highly specialized, a dedicated expert team in the Bank of Italy could critically review banks' NPL strategies, provide comprehensive feedback on their implementation, and require urgent mitigation in areas where shortfalls are identified. Guidance should also be provided on banks' approaches to provisioning and loan restructuring practices.

  - Consideration could also be given to time-bound tax incentives to encourage accelerated workouts and remove bad debt and real estate assets from balance sheets. Moreover, private asset management companies could be encouraged to pool NPLs from the smaller banks that lack the resources or capacity to manage them.

- *Supervisory encouragement and oversight of consolidation.* Given the large number of operating banks, consolidation can be an important route toward a more efficient banking system, particularly for weaker banks. The emerging banking groups need to be assessed ex ante as sound from capital, assets, management, earnings and liquidity perspectives. This would result in a healthier and more vibrant banking system. In that regard, subjecting banks that are not under the supervision of the SSM to a process of capital assessment following an asset quality review would clarify uncertainty, with follow-up actions in line with regulatory requirements. The supervisor should set clearer expectations of the bank consolidation process including in terms of viability and time-bound operational cost reductions, while banks' business models need to become more efficient through streamlining branch networks and exploiting other synergies realized through consolidation.

- *Atlante.* Atlante's recent intervention helped preserve financial stability. It is not a game changer, particularly given its limited resources, but has bought time for measures to place weaker banks on a sounder footing. It is important, therefore, that timely and effective progress is made, as otherwise it would impose a burden on the profitability of participating banks. In this regard, although Atlante is privately run, supervisors should ensure that banks' future investments are based solely on commercial considerations, and the use of funds is tied with strict governance improvements in the banks they invest in. This is especially so if Atlante is to be scaled up or if similar initiatives are launched for future capital backstops or investing in NPLs (the resources currently available are unlikely to notably impact NPL pricing). Foreign investor participation could be encouraged. There should also be a clear requirement to dispose assets (bank equity or junior tranches of NPL securities) in a timely manner.

- *Prompt resolution of unviable banks.* The political concern of bailing in retail investors is a barrier to the application of the resolution framework. To address concerns about bailing in retail investors, consideration could be given to (i) identifying and dealing firmly with cases of mis-selling to retail investors—through application of the relevant penalties on the seller and remediation measures for the buyer (e.g., structured buy-back or debt exchange programs); (ii) preventing irregular selling practices to retail customers, such as by strengthening legal and regulatory safeguards, increasing the quality of information, and improving the effectiveness of controls; and (iii) safeguarding poor households through a means-tested social safety net that is a more efficient and better targeted instrument.[4] Moreover, central bank liquidity backstops for viable banks remain the quintessential stabilizer and backstop against contagion.

[4] Italian households are wealthy, with strong balance sheets (stronger than the public sector). Net financial wealth is twice GDP and net total household wealth is 5½ times GDP, one of the highest among advanced countries.

34. The authorities were fully aware of the scope of the banking system problems but stressed that their efforts were the most they could do under the current circumstances and constraints and will bear fruit over time.

- They considered NPLs to be at a turning point, with the flow of new bad debts projected to decline as the economy recovers.

- They stressed that the recent insolvency reforms, together with Atlante and GACS, would reduce the current high stock of NPLs over time. Moreover, any success by Atlante in reducing the markups on NPL sales would reduce pricing gaps on bank balance sheets. They thus emphasized the critical importance of implementing the current measures and supporting (nominal) growth and strongly cautioned against aggressive NPL reduction that would be procyclical and undercut growth.

- There was agreement on the need for swift market-driven bank consolidation, including addressing governance and profitability issues with the smaller mutual banks. However, the authorities were cautious about forcing consolidation, in view of the fragile state of confidence. They considered that onsite supervision and banks' own due diligence are adequate safeguards to ensure the emergence of strong banking groups through bank consolidation.

- The authorities strongly felt that the bail-in rules of the BRRD exacerbate systemic risk and that a longer transition period would have been welcome. They stressed the risks of bail-in as too high, even from being applied to small institutions, and pointed to the social pressures that were brought to bear following the burden sharing in the four small institutions of November 2015 (which was the first time that bail-in occurred in Italy in several decades). In that regard, they noted that banks themselves had internalized the possible systemic risk associated with the failure of capital raising by banks, and thus had supported the creation of Atlante. The authorities also emphasized that European state-aid rules are being applied too restrictively and inhibiting a less costly restoration of banking sector health that, as it is financed by private resources, would not be borne by the taxpayers.

C. Fiscal Policy

35. To support the still weak economy, the authorities are notably easing fiscal policy this year and backloading adjustment.

- *Adjustment path*. For 2016, the authorities are pursuing a very small deficit reduction, implying a sizable relaxation of about 0.7 percent of GDP in structural terms.[5] No adjustment is planned in the structural primary balance for 2017, a 0.2 percent adjustment is proposed for 2018, and a backloaded adjustment of ½ percent for 2019. This path postpones the achievement of structural balance to 2019–20 (against a previously agreed target of 2018). Debt will remain high but on a downward trend, relying on the achievement of ambitious privatization proceeds, which the authorities project at ½ percent of GDP per year over the next three years.

- *Policy mix*. The authorities plan to continue lowering taxes, including on corporate income in 2017 and on personal income in 2018, and cancel planned hikes in VAT and excise rates (i.e., the safeguard clause in place to achieve the originally-planned fiscal targets). The latter are planned to be replaced in part by spending review measures, including a review of tax expenditures, and measures to improve tax compliance. The authorities noted that, following considerable cumulative savings in recent years (which they estimate around €25 billion), the spending reviews will now seek qualitative improvements through more efficient budget processes and procurement reform. They plan a small increase in capital spending. Proposals are under consideration for easing the path to early retirement, e.g., through actuarially fair cuts in pension benefits or bank loans to retirees that capitalize part of their future benefit stream.

Structural Balance Adjustment Path (in percent of potential GDP)

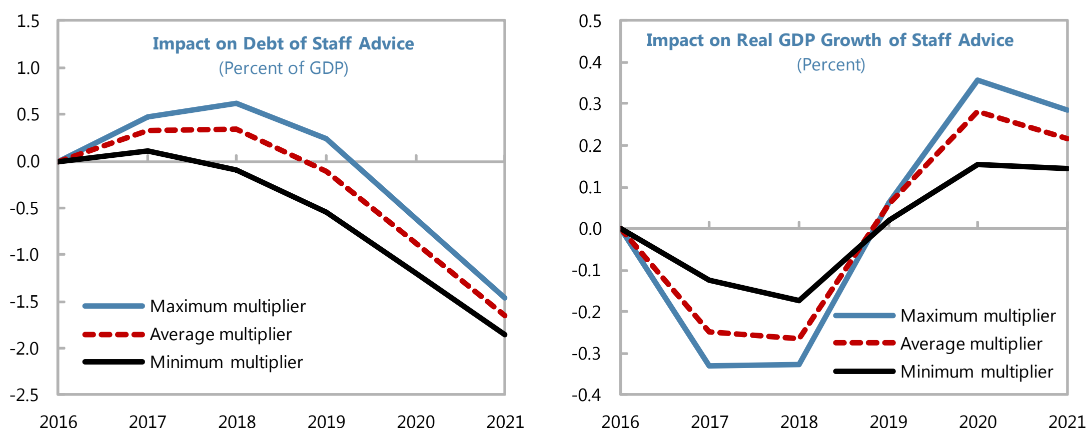
	2015	2016	2017	2018	2019	2020
Required adjustment path following SGP 1/						
Change in structural balance		-0.35	0.5	> 0.5 3/	...	...
Authorities' plans (2016 DEF)						
Structural balance	-0.6	-1.2	-1.1	-0.8	-0.2	...
Change in structural balance		-0.7	0.1	0.3	0.6	...
Interest expenses	4.0	3.9	3.7	3.6	3.5	...
Primary structural balance 2/	3.4	2.7	2.6	2.8	3.3	...
Change in primary structural balance 2/		-0.7	0.0	0.2	0.5	...
IMF recommendation						
Structural balance		-1.2	-0.7	-0.1	0.5	0.5
Change in structural balance			0.5	0.6	0.6	0.0
Interest expenses		3.9	3.8	3.7	3.7	3.6
Primary structural balance 2/		2.7	3.1	3.6	4.1	4.1
Change in primary structural balance 2/			0.4	0.5	0.6	0.0

1/ Taking into account the flexibility approved for 2016 (including on a preliminary basis). The calculation of the required adjustment in 2017 and 2018 is based on IMF staff forecast of growth and output gap.
2/ Excluding the projected interest expenses.
3/ Conventionally understood to be at least 0.6 percent of GDP, see Vade Mecum 2016 edition.

[5] For 2016, the EC approved requests for flexibility under the structural reform (0.5 percent of GDP) and investment clauses (0.25 percent) and, on a preliminary basis, for additional spending related to the refugee emergency (0.04 percent) and exceptional security measures (0.06 percent). On that basis, the EC has pointed to a risk of some deviation from Italy's obligations under the SGP.

36. To strengthen the credibility of the adjustment and bring debt down more decisively while supporting the economy, staff recommends a more evenly phased consolidation path, with space for the upfront cost of reforms. The high debt level makes Italy vulnerable to shifts in market sentiment and changes in interest rates and leaves very little space to adjust to adverse shocks. Indeed, although debt is expected to decline very gradually under the baseline, the debt dynamics are fragile and debt could get back on a rising path under moderate scenarios (Annex II). With growth stabilizing at around 1–1½ percent in the coming years, and declining thereafter, greater priority should be given to building buffers by reducing the debt burden, which would have a stronger impact on confidence and, hence, on growth. In the meantime, should adverse shocks materialize, automatic stabilizers should be allowed to operate.

- *Structural surplus and phasing.*
  - For 2017–19, an adjustment of about ½ percent of GDP per year (in the structural primary balance) would allow rebuilding buffers while not overly taxing growth. Although the size of multipliers is highly uncertain, for a reasonable range of multipliers encompassing those used by the authorities,[6] the proposed adjustment path would lead to a faster decline in debt beyond the next two years.



Note: These simulations measure the change in the debt ratio and in growth rates (staff fiscal policy advice relative to a baseline determined by 2016 DEF).
Note: Cumulative multipliers: Maximum is 0.8 in the first year, 1 in the second year. Average is 0.6 in the first year, 0.8 in the second year. Minimum is 0.3 in the first year, 0.5 in the second year.

  - In case of clearly defined and bolder reforms, this path could be adjusted to accommodate their temporary upfront costs. However, it should be noted that not all structural reforms entail direct and measurable budgetary costs. Thus, general reforms should not be used as a reason to postpone the needed adjustment.

[6] According to the 2016 DEF, revenue multipliers are 0.2 in the first year, 0.6 in the second year and 0.8 beyond, while spending multipliers are 1 in the first two years, before declining to 0.3 in year 5. The Bank of Italy estimated fiscal multipliers to be 0.3 in the first year and 0.5 in the second year (Economic Bulletin, January 2013).

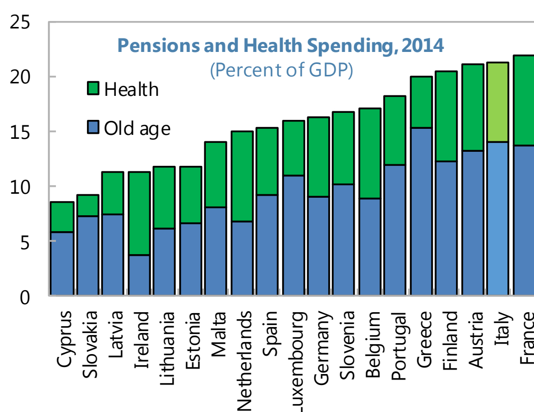
- This path would result in a small structural overall surplus of about ½ percent of GDP by about 2019. This has been long standing Fund advice and remains appropriate to ensure debt is on a firmly declining trajectory, while providing valuable insurance against shocks.

- The sizable relaxation in 2016 provides an opportunity to push ahead with decisive reform implementation this year, including in the fiscal area. However, unless the authorities are successful in carrying out these reforms to substantially boost potential growth, the relaxation entails the risk of a future procyclical tightening.

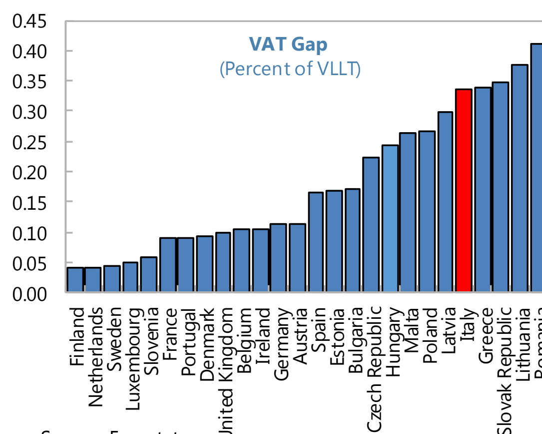
- *Pro-growth mix.* This fiscal path needs to be supported by a growth-friendly policy mix, giving greater priority to more efficient and reduced levels of spending, broadening the tax base, and lowering statutory tax rates on labor and capital.

  - With primary spending having been contained in real terms in recent years, largely through wage restraint and cuts in capital spending, the "low hanging fruit" have been exhausted. Achieving the fiscal targets and creating space to notably lower the still high labor tax wedge requires reducing further primary current spending. This will entail difficult political choices, including possibly on the high levels of social spending. In that regard, it is important that any discussion of early retirement options does not reverse the gains from the 2012 pension reforms or undercut pension sustainability.

  - Broadening the tax base—including by rationalizing the relatively large tax expenditures and reducing the VAT gap (which is among the highest in the euro zone)—would be steps in the right direction. A modern real estate tax also should be introduced, as it is a relatively efficient tax instrument.



Source: Eurostat.



Source: Eurostat.

37. The authorities agreed that fiscal policy walks a tightrope between supporting growth and bringing debt on a clear downward path. Given the weak economic environment and balance of risks, they considered a more restrictive fiscal policy as potentially counterproductive. In this regard, they favored postponing the consolidation to a time when the economy would be in a stronger cyclical position to minimize unduly impacting the recovery. In the meantime, they expected ambitious privatization proceeds to result in a small decline in the debt ratio in 2016 and a

balanced budget over the medium term adequate to bring debt down. More generally, they questioned the focus on structural fiscal adjustment, given the challenges in measuring the output gap.

38. The authorities noted that they plan to continue reducing the tax burden on households and firms. Having kept spending under control for several years, they intend to continue doing so. The main goal is to increase spending efficiency and the quality of public services, with the procurement, public administration, and state budget reforms important in that regard. They are also seeking to broaden the tax base, including through emphasis on voluntary compliance and reviewing of tax expenditures. Given its unpopularity, they do not intend to introduce a real estate tax on primary residences.

STAFF APPRAISAL

39. The economy continues to emerge from a protracted recession. Buoyed by exceptionally accommodative monetary policy, supportive fiscal policy, low commodity prices, and improved confidence on the back of reforms, the economy is projected to grow by 1.1 percent this year. This outcome is welcome, although insufficient to make a notable dent in accumulated crisis legacies. Unemployment has started to come down, but remains very high. NPLs appear to be stabilizing, but are around 18 percent of loans. Public debt has edged up marginally to close to 133 percent of GDP.

40. The recovery is likely to be fragile and prolonged. Risks are to the downside. With financial sector and fiscal buffers being very limited, the recovery is vulnerable to shocks and expected to be modest. Even after adding a growth dividend from the timely implementation of reforms in line with the authorities' expectations, growth is projected to rise to 1¼ percent in 2017–18 and about 0.8 percent per year over the medium term. This growth outlook, alongside prolonged low inflation, implies a potentially protracted period of balance sheet repair. It also implies that Italy is expected to return to its pre-crisis output peak only in about a decade; over the same period, Italy's euro zone partners are expected to rise by 20–25 percent above their pre-crisis peaks. Within an incomplete economic and monetary union, Italy would fall further behind, with potential implications for its competitiveness within the euro zone.

41. The authorities thus face a monumental challenge. The recovery needs to be strengthened to reduce the high unemployment faster and buffers need to be built, including by repairing strained bank balance sheets and decisively lowering the very high public debt. This requires deep reforms to transform the economy and enable Italy to catch up to two decades of productivity underperformance, alongside prudent fiscal policy and financial sector reforms. This is a multi-year effort, and broad and sustained political support for comprehensive reforms—through multiple electoral cycles—will be critical for success. In this regard, political pressures to dilute or delay implementation of reforms should be resisted firmly.

42. Cognizant of Italy's complex challenges and risks, the authorities have embarked on a range of very important reforms. Their efforts span institutional, public administration, fiscal, labor

market, and banking sector reforms. In particular, the government's signature labor market legislation, the Jobs Act, is being implemented; legislation has been passed on the reform of cooperative and mutual banks; the insolvency system is being revised; a framework law on public administration has been approved and some implementing decrees have been issued; a reform of the state budget is underway; and legislation has been passed and a constitutional referendum is planned to streamline decision making and transfer competencies from regions to the center.

43. These efforts are welcome and now need to be implemented fully and deepened to have a decisive impact. Steadfast and full implementation of existing efforts is necessary to break from past experiences where legislation was approved but implementation lagged. However, current reform efforts are often the result of numerous constraints and balancing considerations that diminish their effectiveness. They would reduce vulnerabilities only gradually over the medium term, implying limited buffers to cope with shocks for a protracted period. It is thus a matter of urgency to broaden and deepen reforms. This urgency is accentuated by the limited progress in completing the economic and monetary union. The start of economic recovery and the current favorable tailwinds of monetary easing, low commodity prices and fiscal support provide scope to front-load financial, fiscal, and structural measures. These complementary efforts can be mutually-reinforcing: boosting growth could lower the upfront cost of reforms and create room for more ambitious measures to build buffers and accelerate growth.

44. Deeper structural reforms could bear near- to medium-term growth dividends. In particular, enhancing competition in the product and services markets—by adopting bold reforms in the context of the annual competition law—has the potential to boost growth and investment in the near as well as medium terms. The focus in the labor markets should now turn to modernizing the wage bargaining system—by broadening the scope for firms, specifically smaller enterprises as well as many in the South, to engage in effective firm-level negotiations that aligns wages with productivity. This would improve competitiveness, complement the Jobs Act, and help alleviate regional disparities in labor outcomes and economic performance. Bold implementation of public administration reform can lower the cost of doing business and improve the investment climate. Further reforms should seek, among others, to improve the skill-mix in the public sector, simplify functions and procedures, and tackle privileges and employment in public enterprises, including through privatization.

45. Building on recent measures to bolster the stability of the financial sector, further steps would help advance banks' balance sheet repair. These should aim to materially reduce the very high stock of NPLs over the medium term, lower the cost of risk, and improve operating efficiency, including through: more intensive use of out-of-court debt restructuring mechanisms; strengthened supervision to facilitate decisive progress in reducing NPLs; and a systematic assessment of asset quality for those banks not already subject to the ECB comprehensive assessment, with follow-up actions in line with regulatory requirements. An effective framework for the timely and orderly resolution of failing banks would prevent the costs of the weaker banks being borne by the rest of the system and eventually raising stability concerns. Mechanisms such as Atlante can buy time to move forward with needed reforms, which should be implemented speedily

and thus contain the costs for the participating banks and the system. Moreover, concerns related to bail-in of retail investors should be dealt with expeditiously.

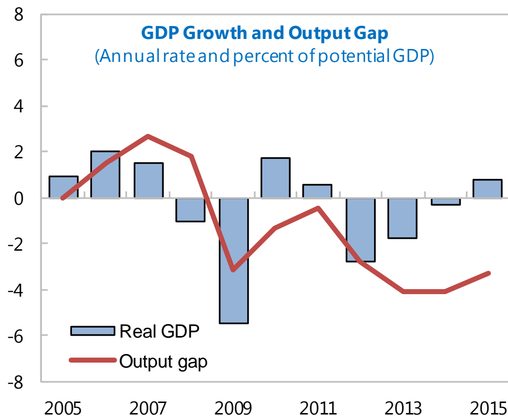
46. Fiscal policy should place greater priority on reducing high public debt, with an evenly-phased adjustment path. Fiscal policy has been eased gradually since 2013, and most notably in 2016, while adjustment has been backloaded to 2019. This relaxation increases the risk of a future procyclical tightening, unless the authorities are successful in significantly boosting potential growth, which increases the urgency of ambitious pro-growth reforms. Absent significant privatization proceeds, the debt-to-GDP ratio is likely to continue rising this year. While the debt dynamics are expected to start improving in the coming years, the decline in the debt-to-GDP ratio is expected to be gradual and vulnerable to shocks. An evenly-phased structural adjustment over 2017–19, net of any remaining upfront costs from structural reforms, that achieves a small structural surplus would send a stronger signal of the authorities' determination to place public debt on a firmer downward path and increase Italy's resilience to shocks.

47. This recommended adjustment path should be supported by pro-growth policies that give greater priority to more efficient and lower spending and less distortive taxation. In that regard, while the reduction in the wage bill and capital spending over the last few years has ensured control over primary spending, stronger efforts in reducing other current primary spending, including high social spending, would create room for notably lowering high statutory tax rates on productive factors. Broadening the tax base and introducing a modern real estate tax are strongly advisable.

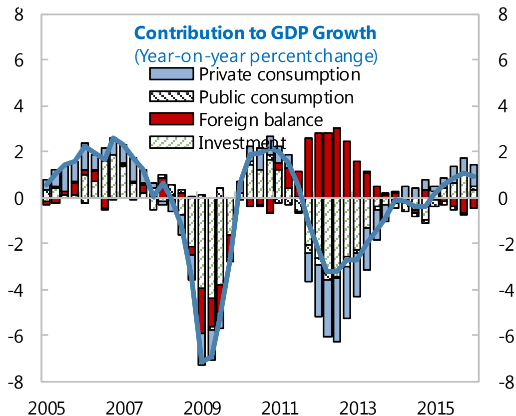
48. It is recommended that the next Article IV consultation be held in the usual 12-month cycle.

Figure 3. Italy: Real Sector Selected Economic Indicators, 2005–16

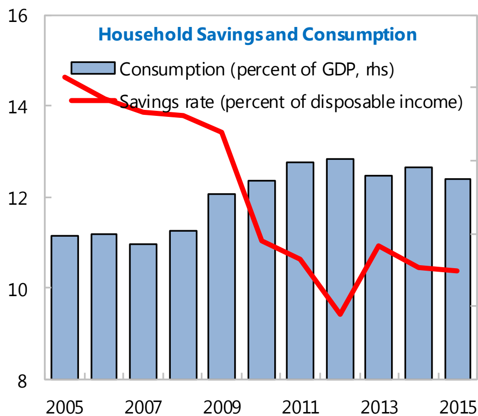
The economy has started to recover very modestly...



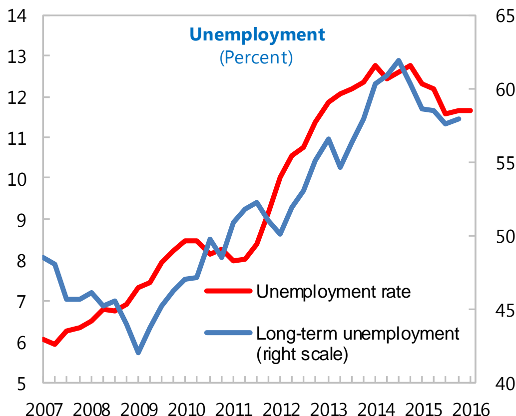
..driven by private consumption and inventory restocking.



The household savings rate remains low...

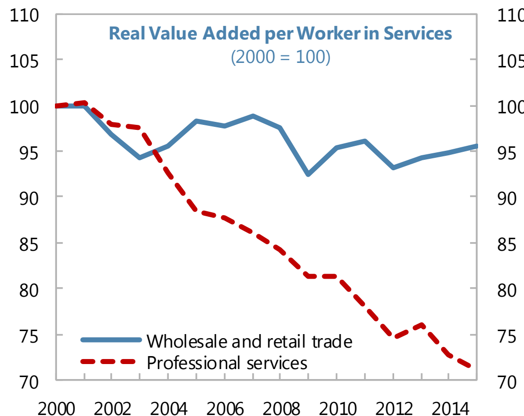


..while unemployment has started to decline.



Wages continue to outpace productivity growth..

...which has been very weak in the service sector.



Sources: Haver; ISTAT; and IMF staff estimates.

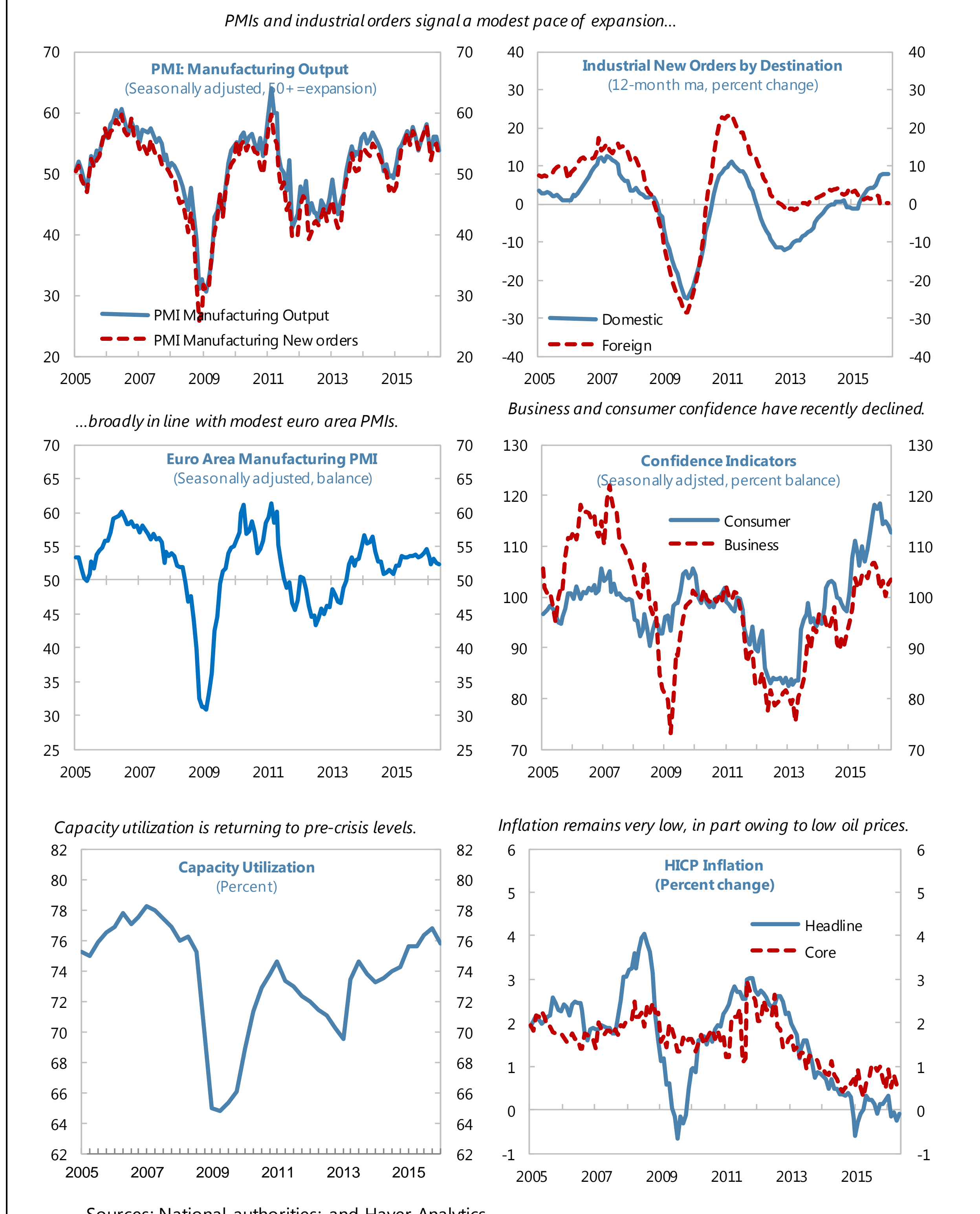
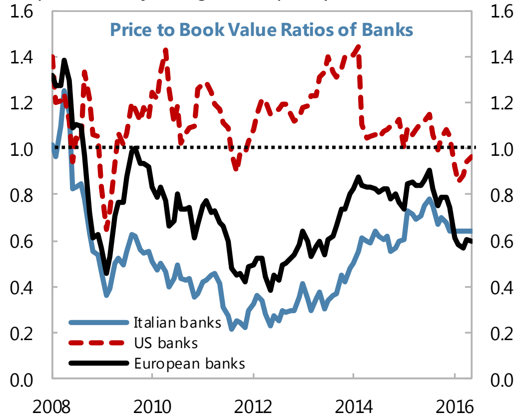


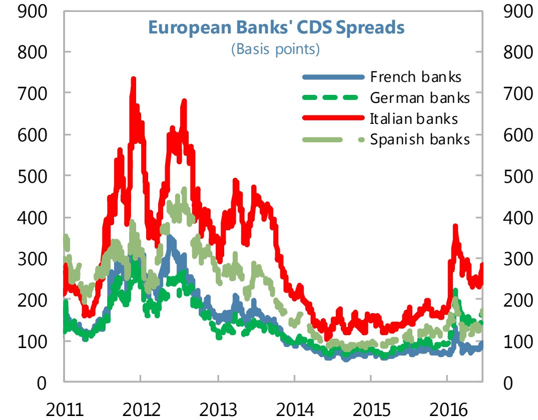
Figure 4. Italy: Real Sector High Frequency Indicators, 2005–16
PMIs and industrial orders signal a modest pace of expansion…
PMI: Manufacturing Output
(Seasonally adjusted, 50+ =expansion)
PMI Manufacturing Output
PMI Manufacturing New orders
Industrial New Orders by Destination
(12-month ma, percent change)
Domestic
Foreign
…broadly in line with modest euro area PMIs.
Euro Area Manufacturing PMI
(Seasonally adjusted, balance)
Business and consumer confidence have recently declined.
Confidence Indicators
(Seasonally adjsted, percent balance)
Consumer
Business
Capacity utilization is returning to pre-crisis levels.
Capacity Utilization
(Percent)
Inflation remains very low, in part owing to low oil prices.
HICP Inflation
(Percent change)
Headline
Core
Sources: National authorities; and Haver Analytics.

Figure 5. Italy: The Financial Sector Remains Under Pressure

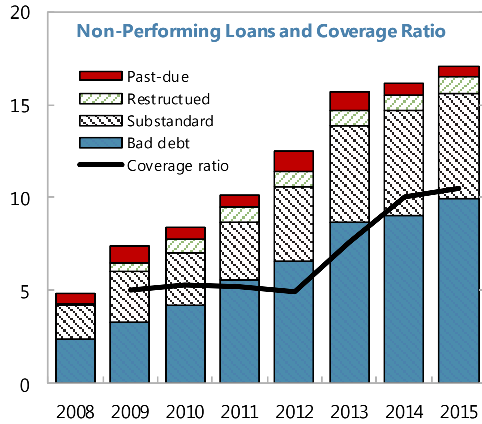
Bank equity prices have been under substantial pressure, reflecting asset quality concerns…



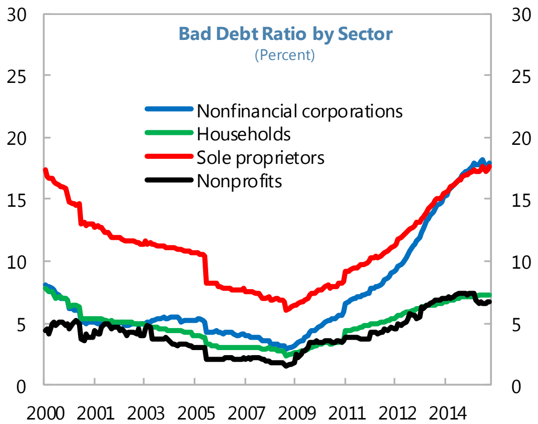
…though CDS spreads that signal default risks have remained relatively contained.



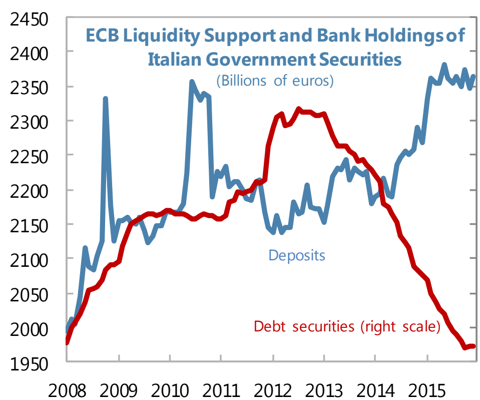
NPLs have risen through 2015.



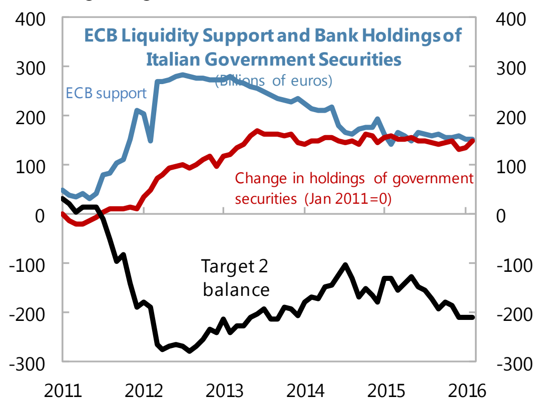
NPLs in the corporate sector are very high.



Deposits are increasing, as holders shift out of bank bonds…



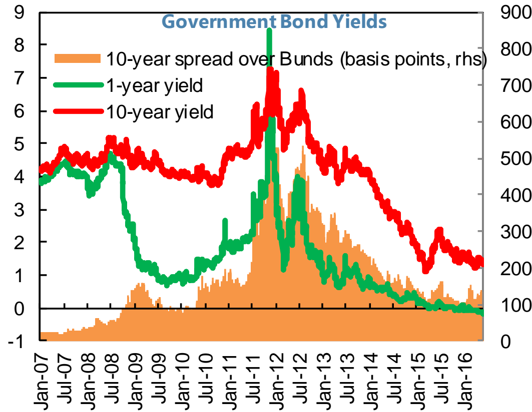
…facilitating a decline in ECB liquidity support, although Target 2 balance has risen.



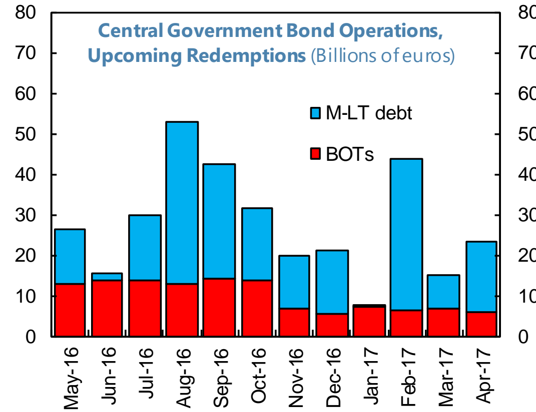
Sources: Bloomberg; Bank of Italy; SNL; ECB; and IMF staff estimates.

Figure 6. Italy: Fiscal Developments

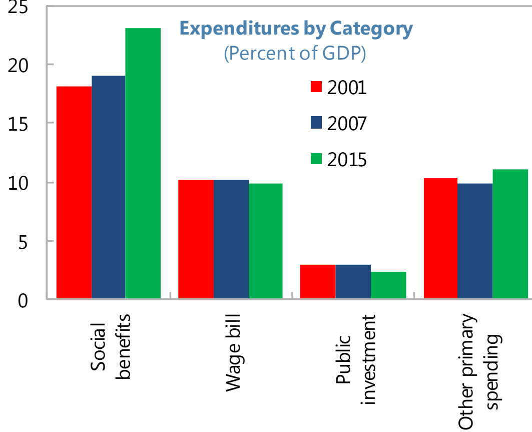
Government bond yield have declined significantly, thanks to the ECB's policy.



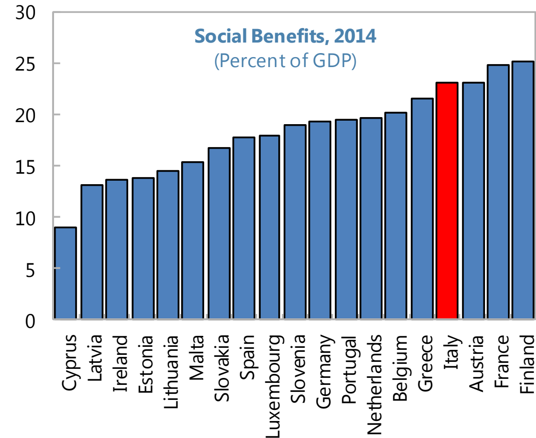
Sizeable bond redemptions are coming due over the next 12 months.



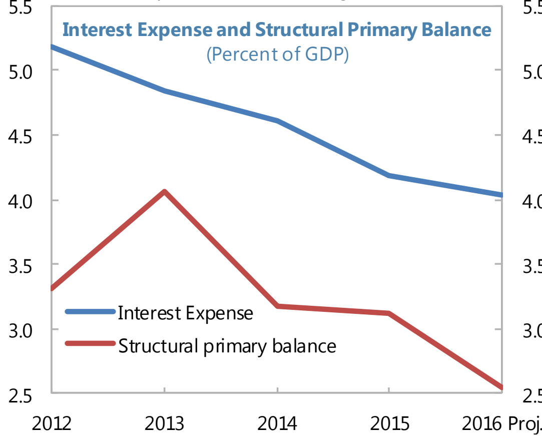
Social spending continues to increase as a share of GDP...



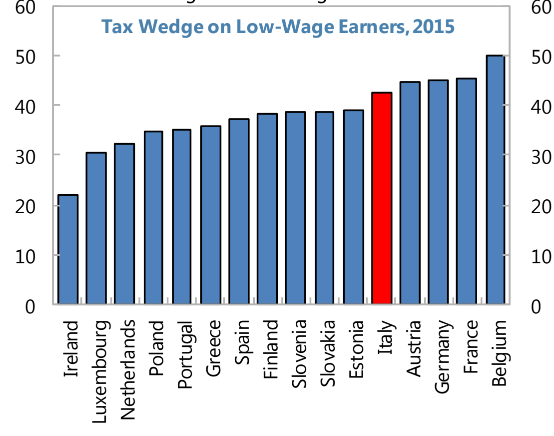
... and remain among the highest in the EU.



The structural primary surplus is deteriorating, while interest expenses are declining.



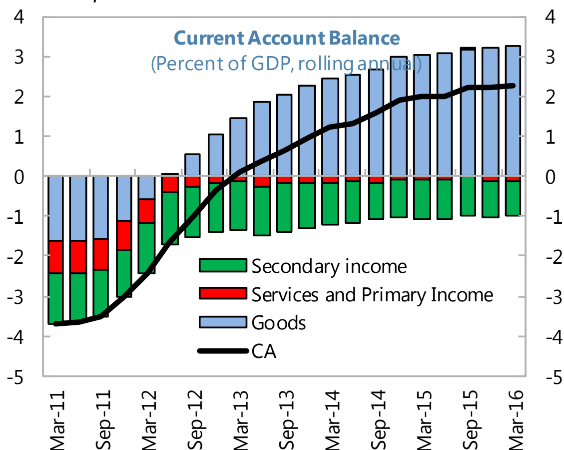
Even though labor taxes were reduced, the labor tax wedge remains high.



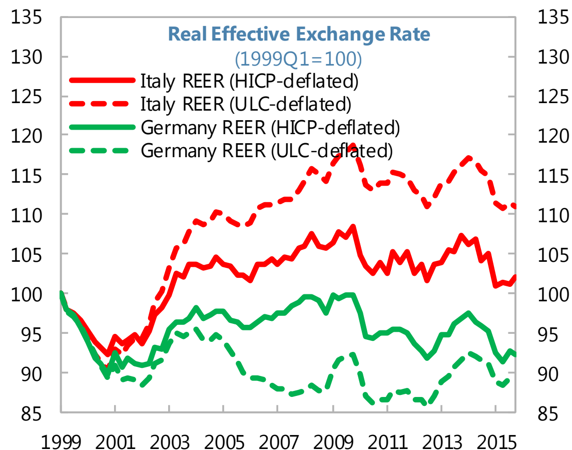
Sources: Eurostat; Haver; Bloomberg; and Bank of Italy.

Figure 7. Italy: External Developments

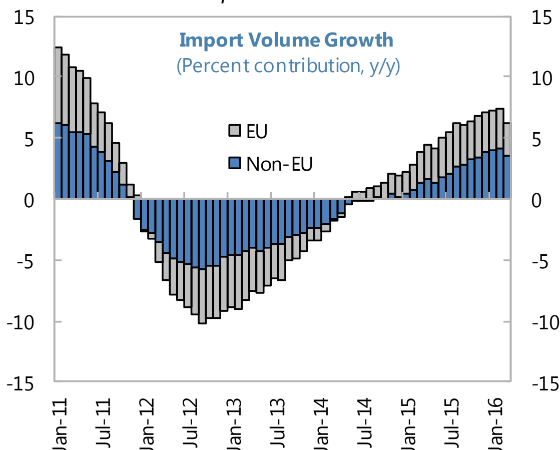
The growing trade surplus has driven the improvement in the current account…



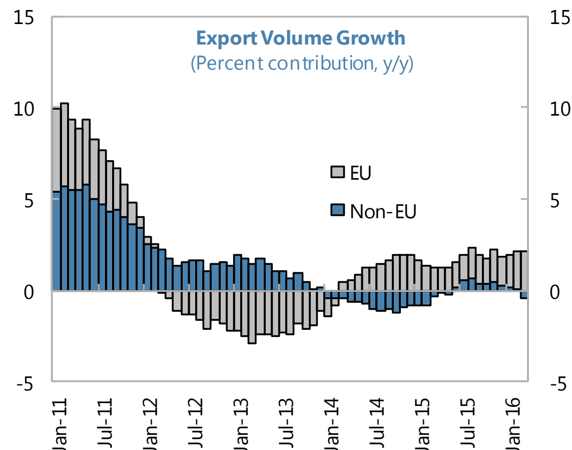
…but stagnant productivity and rising labor costs have led to REER appreciation over 1 ½ decades.



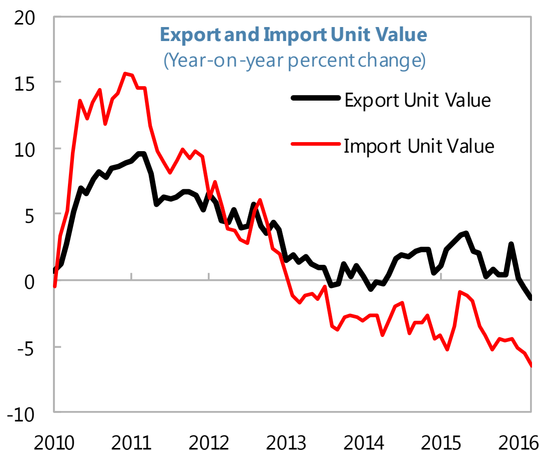
The trade balance is in surplus, even with a fairly sizable rebound in import volumes…



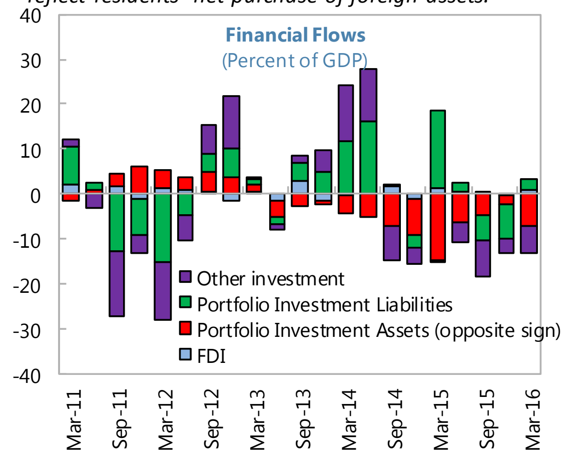
…given a modest increase in export volumes to the EU…



…and improving terms of trade.



Net outflows from financial account since 2014Q3 largely reflect residents' net purchase of foreign assets.



Sources: Haver; Eurostat; and IMF staff estimates.

Table 1. Italy: Summary of Economic Indicators, 2008–21

(Annual percentage change, unless noted otherwise)

									Projections					
	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Real GDP	-1.1	-5.5	1.7	0.6	-2.8	-1.7	-0.3	0.8	1.1	1.3	1.2	0.8	0.8	0.8
Real domestic demand	-1.2	-4.1	2.0	-0.6	-5.6	-2.6	-0.4	1.1	1.4	1.3	1.2	0.7	0.7	0.8
Public consumption	1.0	0.4	0.6	-1.8	-1.4	-0.3	-1.0	-0.7	0.8	0.4	0.2	-0.6	-0.3	0.0
Private consumption	-1.1	-1.5	1.2	0.0	-4.0	-2.4	0.6	0.9	1.4	1.2	1.1	0.8	0.8	0.8
Gross fixed capital formation	-3.1	-9.9	-0.5	-1.9	-9.3	-6.6	-3.4	0.8	1.9	2.8	2.3	2.1	1.9	1.8
Final domestic demand	-1.2	-2.9	0.7	-0.8	-4.5	-2.7	-0.4	0.6	1.3	1.3	1.2	0.7	0.8	0.8
Stock building 2/	-0.1	-1.2	1.3	0.2	-1.1	0.2	0.0	0.5	0.0	0.0	0.0	0.0	0.0	0.0
Net exports 2/	0.2	-1.3	-0.3	1.2	2.8	0.8	0.1	-0.3	-0.3	-0.1	0.0	0.1	0.1	0.1
Exports of goods and services	-3.1	-18.1	11.8	5.2	2.3	0.6	3.1	4.3	1.3	3.8	4.3	3.9	3.5	3.5
Imports of goods and services	-3.7	-12.9	12.4	0.5	-8.1	-2.3	3.2	6.0	2.4	4.4	4.6	3.8	3.4	3.4
Savings 4/	18.9	17.5	17.1	17.5	17.5	17.9	18.2	19.0	18.9	18.9	18.9	18.9	18.9	19.0
Investment 4/	21.8	19.4	20.5	20.5	17.9	17.0	16.3	16.8	16.9	17.2	17.6	17.8	17.9	18.3
Resource utilization														
Potential GDP	-0.2	-0.7	-0.2	-0.3	-0.5	-0.4	-0.3	-0.1	0.1	0.2	0.3	0.5	0.7	0.8
Output gap (percent of potential)	1.8	-3.2	-1.3	-0.5	-2.8	-4.1	-4.1	-3.3	-2.4	-1.4	-0.5	-0.2	-0.1	0.0
Employment	0.9	-1.7	-0.8	0.3	-0.1	-1.7	0.4	0.8	0.8	0.9	0.9	0.9	0.9	0.9
Unemployment rate (percent)	6.7	7.7	8.3	8.4	10.7	12.1	12.6	11.9	11.4	10.9	10.5	10.1	9.7	9.3
Prices														
GDP deflator	2.5	2.0	0.3	1.5	1.4	1.2	0.8	0.8	0.5	0.6	0.9	1.1	1.2	1.3
Consumer prices	3.5	0.8	1.6	2.9	3.3	1.2	0.2	0.1	0.0	0.7	0.9	1.1	1.2	1.3
Hourly compensation 3/	4.2	2.4	3.4	3.0	1.9	2.6	1.4	2.2	1.6	1.5	1.6	1.7	1.8	2.0
Productivity 3/	-1.5	-7.7	7.0	0.9	0.7	1.7	0.2	0.5	0.5	0.6	0.6	0.7	0.7	0.7
Unit labor costs 3/	5.7	10.1	-3.7	2.2	1.2	0.9	1.2	1.7	1.1	0.9	1.0	1.1	1.1	1.3
Fiscal indicators														
General government net lending/borrowing 4/	-2.7	-5.3	-4.2	-3.5	-2.9	-2.9	-3.0	-2.6	-2.4	-1.9	-1.2	-0.4	0.0	0.0
General government primary balance 4/ 5/	2.0	-1.0	-0.1	1.0	2.1	1.7	1.4	1.4	1.5	1.8	2.4	3.1	3.4	3.5
Structural overall balance (percent of potential GDP)	-3.8	-4.4	-3.8	-3.9	-1.6	-0.6	-1.1	-0.8	-1.2	-1.1	-0.8	-0.2	0.0	0.0
Structural primary balance (percent of potential GDP) 5/	1.0	-0.1	0.3	0.6	3.3	4.1	3.2	3.1	2.6	2.5	2.7	3.2	3.5	3.5
General government gross debt 4/	102.4	112.5	115.4	116.5	123.3	129.0	132.5	132.7	132.9	132.1	130.4	128.2	125.6	123.0
Exchange rate regime						Member of the EMU								
Exchange rate (national currency per U.S. dollar)	-4.2	-3.2	-2.2	-1.2	-0.2	0.8	0.8	0.8	...	...	...	...	...	...
External sector 4/														
Current account balance	-2.9	-1.9	-3.4	-3.0	-0.4	0.9	1.9	2.2	2.1	1.7	1.3	1.2	1.0	0.7
Trade balance	-0.2	0.0	-1.4	-1.1	1.0	2.2	3.0	3.2	3.2	2.9	2.7	2.5	2.4	2.1

Sources: National Authorities; and IMF staff estimates.

1/ Staff estimates and projections, unless otherwise noted, based on measures outlined in the government's 2016 medium-term fiscal plan.

2/ Contribution to growth.

3/ In industry (including construction).

4/ Percent of GDP.

5/ Excludes interest expenditure.

Table 2. Italy: Statement of Operations—General Government (GFSM 2001 Format), 2008–21

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
									Projections					
	(Billions of euros)													
Revenue	736.7	721.8	732.4	747.8	771.7	772.0	776.6	784.0	786.2	779.6	792.5	811.5	827.0	844.9
Taxes	461.8	446.1	453.9	464.9	487.4	483.7	487.7	492.8	492.1	489.6	492.9	502.5	512.7	523.8
Social contributions	212.9	212.1	213.7	216.3	215.8	215.3	214.3	218.5	218.4	220.3	226.7	234.7	238.4	243.6
Grants	2.7	2.7	1.7	3.4	4.2	4.6	5.4	4.7	4.7	4.7	4.7	4.7	4.7	4.7
Other revenue	59.3	60.8	63.1	63.2	64.3	68.4	69.2	68.0	71.0	65.0	68.2	69.6	71.1	72.7
Expenditure	780.7	804.7	800.5	804.7	819.2	819.0	825.5	826.4	825.5	822.0	824.6	828.3	845.5	864.6
Expense	781.0	804.5	800.3	808.4	819.0	818.5	825.0	826.1	825.5	822.0	824.6	828.3	845.5	864.6
Compensation of employees	170.3	171.7	172.5	169.6	166.1	164.8	163.6	161.7	163.1	160.7	160.4	158.2	161.4	164.9
Use of goods and services	82.6	85.6	87.4	87.2	87.0	89.6	88.6	88.4	85.1	84.0	81.8	83.5	85.2	87.0
Consumption of fixed capital	40.7	42.2	42.8	42.7	43.4	44.4	44.1	43.8	44.5	45.3	46.3	47.2	48.2	49.2
Interest	80.5	69.5	68.8	76.4	83.6	77.6	74.3	68.4	67.1	65.5	64.1	64.6	65.3	67.6
Social benefits	320.6	337.2	345.0	349.1	354.8	363.2	370.6	377.6	383.0	387.1	392.7	399.3	407.4	416.2
Other expense	86.4	98.4	83.7	83.4	84.1	78.9	83.7	86.0	82.6	79.3	79.3	75.6	78.0	79.7
Net acquisition of nonfinancial assets	-0.4	0.2	0.2	-3.6	0.2	0.5	0.5	0.4	0.0	0.0	0.0	0.0	0.0	0.0
Safeguards clause/unidentified measures	...	...	...	...	...	...	...	...	0.0	10.3	11.9	9.7	17.9	19.6
Gross / Net Operating Balance 1/	-44.3	-82.7	-67.9	-60.6	-47.3	-46.5	-48.4	-42.0	-39.3	-32.1	-20.2	-7.1	-0.6	-0.1
Net lending/borrowing	-43.9	-82.9	-68.1	-57.0	-47.5	-47.0	-48.9	-42.4	-39.3	-32.1	-20.2	-7.1	-0.6	-0.1
	(Percent of GDP, unless otherwise indicated)													
Revenue	45.1	45.9	45.6	45.7	47.8	48.1	48.2	47.9	47.3	46.0	45.8	46.0	46.0	46.0
Taxes	28.3	28.4	28.3	28.4	30.2	30.1	30.3	30.1	29.6	28.9	28.5	28.5	28.5	28.5
Social contributions	13.0	13.5	13.3	13.2	13.4	13.4	13.3	13.4	13.1	13.0	13.1	13.3	13.3	13.3
Grants	0.2	0.2	0.1	0.2	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Other revenue	3.6	3.9	3.9	3.9	4.0	4.3	4.3	4.2	4.3	3.8	3.9	3.9	4.0	4.0
Expenditure	47.8	51.2	49.9	49.1	50.8	51.0	51.2	50.5	49.7	48.6	47.7	47.0	47.0	47.1
Expense	47.9	51.1	49.9	49.4	50.8	51.0	51.2	50.5	49.7	48.6	47.7	47.0	47.0	47.1
Compensation of employees	10.4	10.9	10.8	10.4	10.3	10.3	10.2	9.9	9.8	9.5	9.3	9.0	9.0	9.0
Use of goods and services	5.1	5.4	5.4	5.3	5.4	5.6	5.5	5.4	5.1	5.0	4.7	4.7	4.7	4.7
Consumption of fixed capital	2.5	2.7	2.7	2.6	2.7	2.8	2.7	2.7	2.7	2.7	2.7	2.7	2.7	2.7
Interest	4.9	4.4	4.3	4.7	5.2	4.8	4.6	4.2	4.0	3.9	3.7	3.7	3.6	3.7
Social benefits	19.6	21.4	21.5	21.3	22.0	22.6	23.0	23.1	23.0	22.9	22.7	22.7	22.7	22.7
Other expense	5.3	6.3	5.2	5.1	5.2	4.9	5.2	5.3	5.0	4.7	4.6	4.3	4.3	4.3
Net acquisition of nonfinancial assets	0.0	0.0	0.0	-0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Safeguards clause/unidentified measures	...	...	...	...	...	...	...	...	0.0	0.6	0.7	0.6	1.0	1.1
Gross / Net Operating Balance 1/	-2.7	-5.3	-4.2	-3.7	-2.9	-2.9	-3.0	-2.6	-2.4	-1.9	-1.2	-0.4	0.0	0.0
Net lending/borrowing	-2.7	-5.3	-4.2	-3.5	-2.9	-2.9	-3.0	-2.6	-2.4	-1.9	-1.2	-0.4	0.0	0.0
Memorandum items:														
Primary balance 2/	2.0	-1.0	-0.1	1.0	2.1	1.7	1.4	1.4	1.5	1.8	2.4	3.1	3.4	3.5
Structural balance 3/	-3.8	-4.2	-3.7	-3.9	-1.6	-0.6	-1.1	-0.8	-1.2	-1.1	-0.8	-0.2	0.0	0.0
Change in structural balance 3/	-0.7	-0.4	0.5	-0.1	2.3	1.0	-0.5	0.3	-0.5	0.1	0.3	0.6	0.2	0.0
Structural primary balance 3/	1.0	-0.1	0.3	0.6	3.3	4.1	3.2	3.1	2.6	2.5	2.7	3.2	3.5	3.5
General government gross debt	102.4	112.5	115.4	116.5	123.3	129.0	132.5	132.7	132.9	132.1	130.4	128.2	125.6	123.0

Sources: National Authorities; and IMF staff estimates.

1/ Revenue minus expense.

2/ Primary revenue minus primary expenditure.

3/ Percent of potential GDP.

Table 3. Italy: Summary of Balance of Payments, 2015–21

	2015	2016	2017	2018	2019	2020	2021
		Projections					
	(Billions of euros)						
Current account balance	36.0	34.3	29.0	23.1	20.6	17.9	12.9
Balance of goods and services	51.5	51.6	46.2	40.6	37.8	35.1	29.0
Goods balance	52.7	53.5	49.8	45.9	44.4	42.8	38.7
Exports	405.9	413.8	431.9	453.6	476.0	498.1	521.2
Imports	353.3	360.3	382.1	407.7	431.6	455.2	482.5
Services balance	-1.2	-1.9	-3.6	-5.3	-6.6	-7.8	-9.7
Credit	88.6	89.6	93.5	98.2	103.1	107.8	112.8
Debit	89.8	91.5	97.1	103.6	109.6	115.6	122.6
Primary income balance	-0.9	-0.7	-0.3	-0.2	0.5	0.8	2.3
Credit	58.6	59.7	61.3	62.7	64.6	66.2	69.1
Debit	59.5	60.4	61.6	62.9	64.1	65.4	66.8
Secondary income balance	-14.6	-16.6	-16.9	-17.3	-17.6	-18.0	-18.4
Capital account balance	2.6	1.7	1.7	1.7	1.8	1.8	1.8
Financial account	33.1	35.9	30.7	24.9	22.4	19.7	14.7
Direct investment	6.6	6.8	7.1	7.1	7.2	7.3	7.3
Portfolio investment	89.6	26.2	12.4	9.7	7.2	6.3	3.7
of which: government debt	21.1	31.3	24.3	16.3	10.1	5.4	5.4
Other investment	-67.0	2.9	11.2	8.1	8.0	6.1	3.7
Derivatives (net)	3.4	0.0	0.0	0.0	0.0	0.0	0.0
Reserve assets	0.5	0.0	0.0	0.0	0.0	0.0	0.0
Net errors and omissions	-5.5	0.0	0.0	0.0	0.0	0.0	0.0
	(Percent of GDP)						
Current account balance	2.2	2.1	1.7	1.3	1.2	1.0	0.7
Balance on goods and services	3.1	3.1	2.7	2.3	2.1	1.9	1.6
Goods balance	3.2	3.2	2.9	2.7	2.5	2.4	2.1
Services balance	-0.1	-0.1	-0.2	-0.3	-0.4	-0.4	-0.5
Primary income balance	-0.1	0.0	0.0	0.0	0.0	0.0	0.1
Secondary income balance	-0.9	-1.0	-1.0	-1.0	-1.0	-1.0	-1.0
Capital account balance	0.2	0.1	0.1	0.1	0.1	0.1	0.1
Financial account	2.0	2.2	1.8	1.4	1.3	1.1	0.8
Direct investment	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Portfolio investment	5.5	1.6	0.7	0.6	0.4	0.4	0.2
of which: government	1.3	1.9	1.4	0.9	0.6	0.3	0.3
Other investment	-4.1	0.2	0.7	0.5	0.5	0.3	0.2
Derivatives (net)	0.2	0.0	0.0	0.0	0.0	0.0	0.0
Reserve assets	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net errors and omissions	-0.3	0.0	0.0	0.0	0.0	0.0	0.0
Gross external debt	127.3	126.7	125.3	123.3	121.1	118.5	116.9
Public sector	67.0	65.8	64.1	62.0	59.4	56.5	54.8
Private sector	60.3	60.9	61.2	61.4	61.7	61.9	62.1

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

Table 4. Italy: Financial Soundness Indicators, 2011–15[1/]

(Percent, unless otherwise noted)

	2011	2012	2013	2014	2015
	Core FSIs for Deposit-taking institutions				
Regulatory capital to risk-weighted assets	12.7	13.4	13.7	14.3	14.5
Regulatory tier 1 capital to risk-weighted assets	9.5	10.5	10.6	11.9	12.0
Nonperforming loans net of provisions to capital	64.6	79.7	89.9	93.4	87.8
Nonperforming loans to total gross loans	11.7	13.7	16.5	18.0	18.0
Sectoral distribution of loans to total loans:					
Loans to Residents	75.5	75.5	75.7	75.3	74.8
Loans to Deposit takers	2.6	2.6	2.7	2.5	2.8
Loans to Central Bank	1.0	1.1	0.8	0.6	0.7
Loans to Other financial corporations	3.7	6.0	6.1	6.6	6.4
Loans to General government	2.5	2.6	2.5	2.4	2.3
Loans to Nonfinancial corporations	39.0	37.2	36.8	36.8	36.3
Loans to Other domestic sectors	26.7	25.9	26.9	26.5	26.2
Loans to Nonresidents	24.5	24.5	24.3	24.7	25.2
Return on assets	-0.9	-0.1	-0.8	-0.2	0.2
Return on equity	-13.0	-0.9	-11.5	-2.8	2.5
Interest margin to gross income	57.1	53.8	49.1	50.4	45.7
Liquid Assets to Total Assets (Liquid Asset Ratio)	12.3	14.6	16.6	16.4	16.8
Liquid Assets to Short Term Liabilities	91.3	89.7	105.5	122.6	94.0
Net open position in foreign exchange to capital	1.7	1.2	2.0	0.0	0.4
	Encouraged FSIs for Deposit-taking institutions				
Capital to assets	5.4	5.4	5.4	5.9	6.1
Large exposures to capital	89.2	91.8	81.9	210.3	190.2
Gross asset position in financial derivatives to capital	112.3	76.7	70.2	70.8	78.6
Gross liability position in financial derivatives to capital	117.9	83.2	75.5	71.6	80.4
Personnel expenses to noninterest expenses	56.5	55.7	57.7	55.0	54.5
Customer deposits to total (noninterbank) loans	58.2	67.9	70.5	70.6	72.8
Foreign-currency-denominated loans to total loans	8.9	8.3	8.8	9.5	9.8
Foreign-currency-denominated liabilities to total liabilities	30.7	27.8	28.7	32.0	36.6

Source: IMF, Financial Soundness Indicators.
1/ Data from the IMF Financial Soundness Indicators database have been updated, when possible, with Bank of Italy's or ECB's data. 2015Q2 data is latest available.

Annex I. External Sector Assessment

	Italy	Overall Assessment
Foreign asset and liability position and trajectory	**Background**. Italy's net international investment position (NIIP) has deteriorated significantly since joining the Euro area, with net liabilities of 24 percent of GDP (December 2015) as compared with 7 percent at end 2000, reflecting mainly current account deficits and valuation adjustments. Gross assets and liabilities grew steadily during this period, reaching 144 and 169 percent of GDP respectively, 47 and 64 percentage points higher than in 2000. External debt represents about ¾ of gross external liabilities. While the level of external debt is in line with the Euro area as a whole, its composition—half is owed by the public sector—underscores the vulnerabilities related to the high level of government debt. Looking forward, modest current account surpluses forecast over the medium term should gradually shrink Italy's net liability position as a share of GDP. **Assessment**. In light of the current account's shift into a surplus, overall external sustainability is not a major concern. Nonetheless, further strengthening of balance sheets is desirable, as Italy is vulnerable to financial contagion given its large stock of government debt.	**Overall Assessment**: *The external position in 2015 was broadly consistent but likely still weaker than suggested by medium-term fundamentals and desirable policy settings.* While there was an improvement in 2015 on price-based competitiveness indicators, the overall assessment reflects Italy's continued weak productivity growth and need for balance sheet repair. Stronger growth, consistent with reducing high unemployment and public debt, while strengthening the external balance sheet, would require a modest weakening of the real effective exchange rate from average 2015 levels. The recent small appreciation of the REER, does not alter the overall assessment for 2015. **Potential policy responses**: Continued implementation of structural reforms as well as efforts to strengthen bank balance sheets will be critical to improving competitiveness and boosting potential growth. Further progress in medium-term fiscal consolidation will also help improve competitiveness and maintain investor confidence. Combined, these measures will support growth and employment over the medium term.
Current account	**Background**. Italy's current account (CA) averaged a deficit of 1¼ percent of GDP in the decade following the adoption of the euro. Starting in 2013, it moved into balance and by 2015, it registered a surplus of 2.2 percent of GDP (as compared to 1.9 percent of GDP in 2014). The improvement in the current account is mainly driven by Italy's growing trade surplus, which reached 3.2 percent of GDP in 2015. In terms of saving and investment, declining investment accounted for ⅔ of the improvement in the CA since 2010, while higher public saving contributed most of the rest. **Assessment**. Despite the recent improvement in the current account, the EBA model suggests that the cyclically-adjusted level, which stood at 1.1 percent of GDP in 2015, was about 1.8 percent of GDP below the norm implied by medium-term fundamentals and desirable policy settings. Given these estimates and the need for stronger growth to reduce public debt and unemployment over the medium term, while improving the external balance sheet, staff assesses a gap of -2 to 0 percent of GDP for 2015.	
Real exchange rate	**Background**. Stagnant productivity and rising labor costs had led to a gradual appreciation of the real effective exchange rate (REER) since Italy's joining the Euro area both in absolute terms and relative to the Euro area average (by about 0 to 10 percent using price-based REER indices). In 2015, the fall in the value of the euro contributed to a sizable depreciation of the REER , bringing its value close to 1999 levels.1/ As of May 2016, the REER has appreciated 1¼ percent over its 2015 average. **Assessment**. The EBA methodologies provide a relatively wide range of REER gap estimates in 2015. The REER regression methods suggest an overvaluation of 0.6 percent (EBA Level REER model) and –0.6 percent (EBA Index REER model) in 2015. The CA regression method yields an overvaluation of about 7 percent. On balance, and consistent with the staff assessment of the CA in 2015, staff assesses that a modest real effective depreciation of 0–10 percent would support further adjustment and address economic imbalances over the medium term.	
Capital and financial accounts: flows and policy measures	**Background**. Portfolio and other-investment inflows typically have financed the current account deficits of the past, despite a modest net FDI outflow, without much difficulty. Italy's financial account posted net outflows of about 3 percent of GDP in 2015, largely reflecting residents' net purchases of foreign assets, even as foreign investment in Italian portfolio securities continued. TARGET2 liabilities, accumulated by banks over 2011-12, widened in 2015, reflecting the creation of liquidity by the Bank of Italy within the framework of the Eurosystem's asset purchase program. **Assessment**. While supported by QE, Italy remains vulnerable to market volatility, owing to the large refinancing needs of the sovereign and banking sectors, and the potentially tight credit conditions from the high stock of NPLs in the banking sector.	

	Italy	Overall Assessment
FX intervention and reserves level	**Background**. The euro has the status of a global reserve currency. **Assessment**. Reserves held by the euro area are typically low relative to standard metrics, but the currency is free floating.	
Technical Background Note	1/ Depending on the measure used, Italy's REER depreciated by 3-10 percent between 2014 and 2015 (year average on year average).	

Annex II. Debt Sustainability Analysis

Italy's public debt is very high at about 133 percent of GDP and yet to peak. It should start to decline gradually, once the government delivers the necessary adjustment towards achieving its target of structural balance and if growth and inflation materialize as currently assumed and accommodative monetary policy ensures continuing low interest rates. If, however, growth disappoints or contingent liabilities materialize, debt will keep rising. Debt sustainability is thus subject to significant risks. Achieving and maintaining for several years a structural surplus of about ½ percent of GDP should ensure that debt declines steadily.

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

- Debt increased from about 100 percent of GDP in 2007 to 132.7 percent of GDP in 2015, far above the SGP target of 60 percent.[1] It is yet to peak. In nominal terms, it is the highest in the euro zone. In percent of GDP, it is the second highest, after Greece. In 2011–12, its high debt and financing needs were the proximate cause for its spiking spreads and economic troubles.

- Gross financing needs are sizable, related to still large rollover needs (14–17 percent of GDP). The structure of public debt partially mitigates refinancing risks. Average maturity is around 6½ years and about 70 percent of debt is at fixed interest rates, which moderates the pass-through to the budget of falling or rising interest rates. For instance, a 100 basis point increase in the yield curve is estimated to raise the interest bill by 0.13 percent of GDP in the first year, about 0.3 percent in the second, 0.4 percent in the third year, and 0.5 percent in the fourth year. About two-thirds of debt is held by domestic investors.

- The ECB's exceptionally accommodative stance is helping to keep yields down, and its sovereign bond purchasing program mitigates refinancing risk. During 2015, the ECB's net purchases of Italian public debt were about €80 billion, compared with gross financing needs of €450 billion. The purchases are expected to rise in 2016, given further ECB easing.

2. In the baseline where the government is assumed to approach structural balance by 2019 and nominal growth exceeds 2 percent annually, public debt is projected to decline.

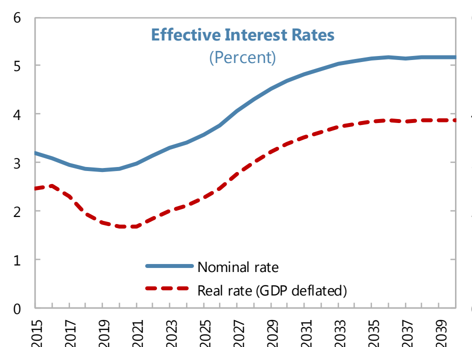
- Real GDP growth is projected at 1.1 percent in 2016, increasing somewhat to 1¼ percent in 2017–18 and declining thereafter to a steady state of 0.8 percent. The long-run growth rate includes a dividend, in line with the authorities' estimate, of about 0.3 percent annually that is assumed to accrue from comprehensive and timely implementation of reforms.

[1] The definition of public debt comprises Excessive Deficit Procedure (EDP) debt of the General Government, which includes the Central Government, Regional Governments, Local Government, and Social Security Funds. EDP debt is a subset of General Government consolidated debt, excluding items such as certain trade credits and other accounts payable. Stocks are recorded at their face value and thus usually exclude unpaid accrued interest.

- The GDP deflator is projected to rise above 1 percent in the next few years. Over the medium term, inflation and the deflator are assumed to remain below the euro area average, reflecting Italy's slower (productivity) growth rate relative to the rest of the euro zone. Within the monetary union, competitiveness is projected to be maintained in slower growing Italy through relatively lower inflation. This, however, also implies a slower pace of growing out of the debt overhang and, thus, a longer period of vulnerability.

- The government is assumed to take the measures necessary to achieve structural balance, which was delayed to 2019.

- Spreads are assumed to be around 150 bps. Yields are expected to rise moderately as monetary policy normalizes very gradually, with the effective nominal interest rate remaining at around 3 percent through 2021. Beyond 2021, effective interest rates are projected to increase to around 5 percent. This has implications for the debt-stabilizing primary balance. For instance, an effective interest rate of 5 percent, with nominal GDP growth of 2 percent, implies a debt stabilizing primary balance of 3¾ percent of GDP (see below).



- In 2016, privatization proceeds of about 0.1 percent of GDP are projected. Going forward, no projection is made, given uncertainties in timing of sales and amounts.

- Under the above assumptions, debt is projected to peak at 133 percent of GDP in 2016 and declining starting in 2017 to 123 percent in 2021.

3. Important risks are embedded in the baseline assumptions.

- Sizable primary surpluses of 3½–4½ percent of GDP will be needed in the baseline to maintain structural balance for many years. Italy has a history of running primary surpluses. Primary surpluses averaged 1¼ percent of GDP during 2001–15, while structural primary surpluses have averaged about 3.4 percent during 2012–15, reflecting the sizable output gap. But running primary surpluses around 4 percent of GDP for many years through several political cycles, against the backdrop of low output growth, will test political willingness. Already over 2013–16, the structural primary surplus is projected to decline from 4.1 percent of GDP in 2013 to 2.6 percent of GDP in 2016. Lower primary surpluses than assumed will have a significant impact on the path of debt. As the historical scenario illustrates, with a primary balance at around 1 percent of GDP, debt would be 20 percentage points higher by 2021 than in the baseline (see Figure A2.4).

- Stagnation risks are considerable, against the backdrop of a relatively weak global economy, the overhang of public debt domestically, and long-standing structural rigidities. As such, real

growth and inflation could fall short of what is assumed in the baseline, complicating efforts to reduce debt.

- On the upside, the impact of the authorities' policies and of ECB monetary easing, euro depreciation and low oil prices for longer could have a larger positive impact than currently expected. Rapid progress on the domestic reform agenda would also boost confidence, thus spurring a stronger recovery and lowering debt somewhat faster.

4. **Materialization of moderate shocks could put at risk the goal of stabilizing and reducing debt.** For instance:

- **Standard growth shock.** Real output growth rates are assumed to be lower by one standard deviation for two years starting in 2017, resulting in an average growth of –1.1 percent in 2017–18. Furthermore, for every 1 percentage point decline in growth, inflation is assumed to decline by 25 bps. The primary balance improves more slowly than the baseline, reaching only 1 percent of GDP by 2021. Debt increases rapidly to about 144 percent of GDP and fails to come down over the projection period.

- **Interest rate shock.** Spreads could increase, from earlier and more rapid exit from unconventional monetary policies in the United States and euro area or from a re-emergence of concerns about medium-term debt sustainability. An increase in spreads of 200 bps is assumed, which is moderate compared to the late 2011–12 episode when spreads increased above 500 bps. Higher borrowing costs are passed on to the real economy, depressing growth by 0.4 p.p. The government's interest bill climbs reaching an implicit average interest rate of 3.6 percent by 2021. Debt declines but only very modestly to around 128 percent by 2021.

- **Contingent liability shock.** Negative surprises, such as from the financial system, could lead to a standardized one-time increase in non-interest expenditure of about 10 percent of banking sector assets. This is assumed to depress domestic demand, lower growth for two consecutive years by –1.2 percentage points, and lower inflation by 0.3 percent. The primary balance is assumed to worsen by 12 percent of GDP in 2017. Debt rises to 149 percent of GDP, after which it starts declining very modestly. Gross financing needs would be significantly higher.

5. **The discussion can be reframed in terms of tolerance for risk.** Achieving and maintaining structural balance will lead to a decline in debt only if nominal GDP growth materializes as assumed and interest rates remain low. Debt will not decline if growth disappoints, interest rates rise, or other contingent liabilities come onto the public sector balance sheet. Thus, in setting the fiscal target, how much is the tolerance for risk in regards to ensuring debt is on a firmly declining path? Using the fan chart analysis below (Figure A2.1), the probability of debt not declining below the current level (about 133 percent of GDP) by 2021 is relatively low, at about 13 percent, if shocks are distributed symmetrically. However, with modest asymmetric shocks to growth and to the primary balance, the probability of debt not falling increases to about 50 percent. Higher primary balances are needed to stabilize and bring debt down, including when interest rates normalize (text table below).

Debt Stabilizing Primary Balance

(in percent of GDP, under different interest rate-growth constellations)

		Debt/GDP at 133 percent			
		Nominal growth rate (in percent)			
		0	1	2	3
Nominal interest rate (in percent)	2	**2.7**	1.3	0.0	-1.3
	3	4.0	**2.6**	1.3	0.0
	4	5.3	4.0	**2.6**	1.3
	5	6.7	5.3	3.9	**2.6**

Note: the structural primary surplus is currently 2.6 percent of GDP

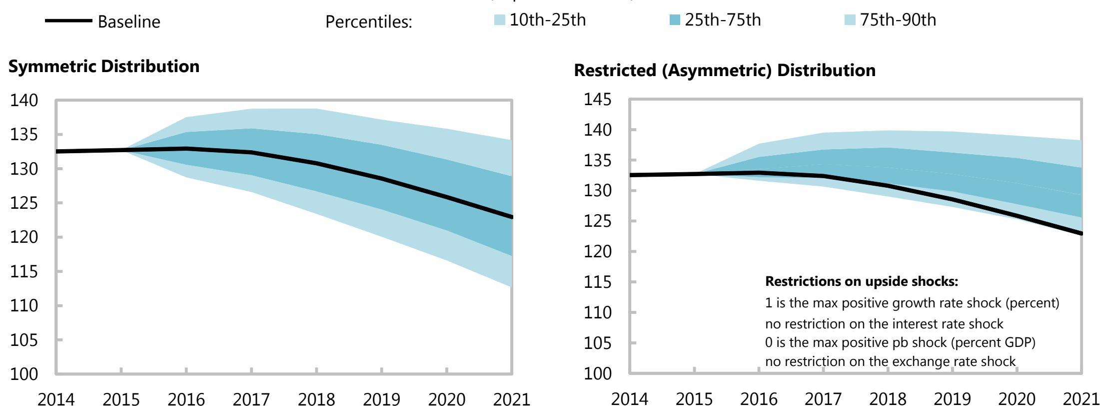
Figure A2.1. Italy: Public DSA Risk Assessment

Heat Map

Debt level 1/	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability shock
Gross financing needs 2/	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability Shock
Debt profile 3/	Market Perception	External Financing Requirements	Change in the Share of Short-Term Debt	Public Debt Held by Non-Residents	Foreign Currency Debt

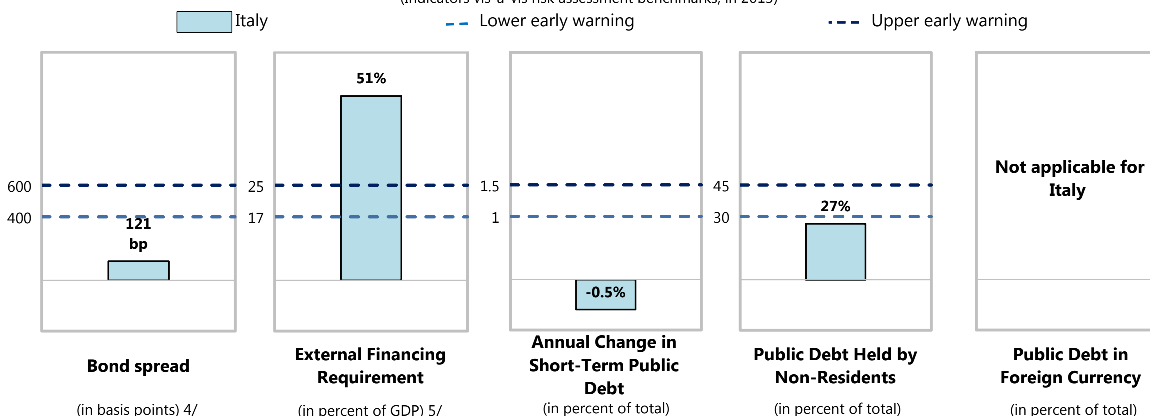
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2015)



Source: IMF staff.

1/ The cell is highlighted in green if debt burden benchmark of 85% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

2/ The cell is highlighted in green if gross financing needs benchmark of 20% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

3/ The cell is highlighted in green if country value is less than the lower risk-assessment benchmark, red if country value exceeds the upper risk-assessment benchmark, yellow if country value is between the lower and upper risk-assessment benchmarks. If data are unavailable or indicator is not relevant, cell is white.
Lower and upper risk-assessment benchmarks are:

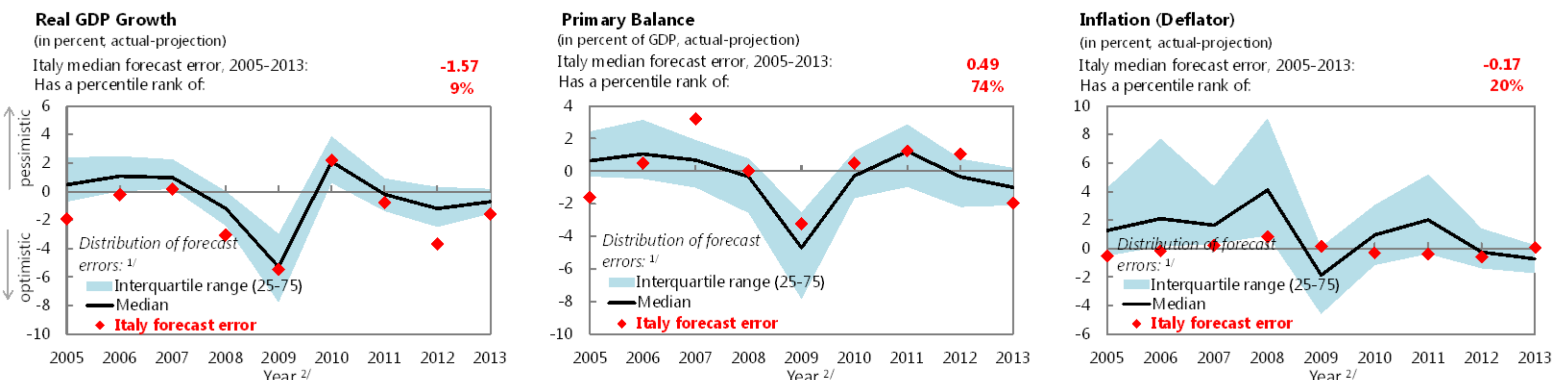
400 and 600 basis points for bond spreads; 17 and 25 percent of GDP for external financing requirement; 1 and 1.5 percent for change in the share of short-term debt; 30 and 45 percent for the public debt held by non-residents.

4/ Long-term bond spread over German bonds, an average over the last 3 months, 03-Mar-16 through 01-Jun-16.

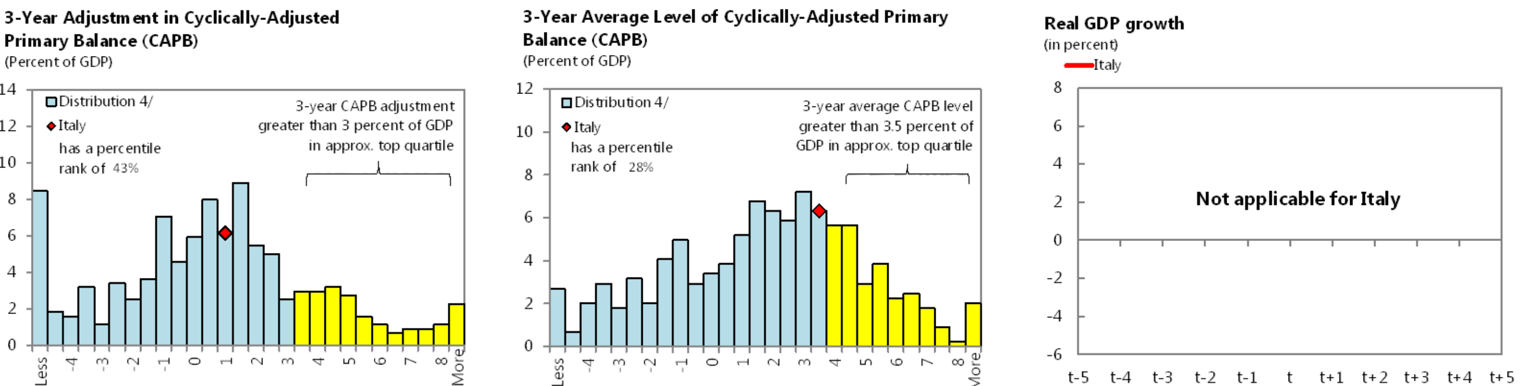
5/ External financing requirement is defined as the sum of current account deficit, amortization of medium and long-term total external debt, and short-term total external debt at the end of previous period.

Figure A2.2. Italy: Public DSA—Realism of Baseline Assumptions

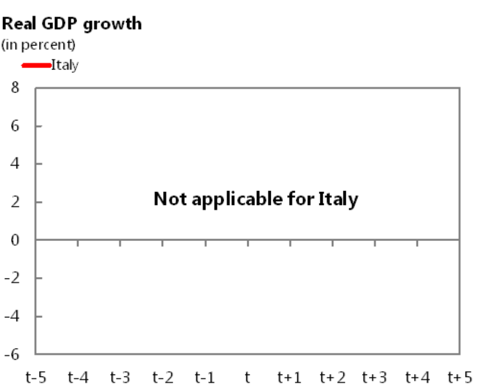
Forecast Track Record, versus surveillance countries



Assessing the Realism of Projected Fiscal Adjustment



Boom-Bust Analysis 3/



Source : IMF Staff.

1/ Plotted distribution includes surveillance countries, percentile rank refers to all countries.

2/ Projections made in the spring WEO vintage of the preceding year.

3/ Not applicable for Italy, as it meets neither the positive output gap criterion nor the private credit growth criterion.

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

Figure A2.3. Italy: Public Sector Debt Sustainability Analysis (DSA)—Baseline Scenario

(in percent of GDP unless otherwise indicated)

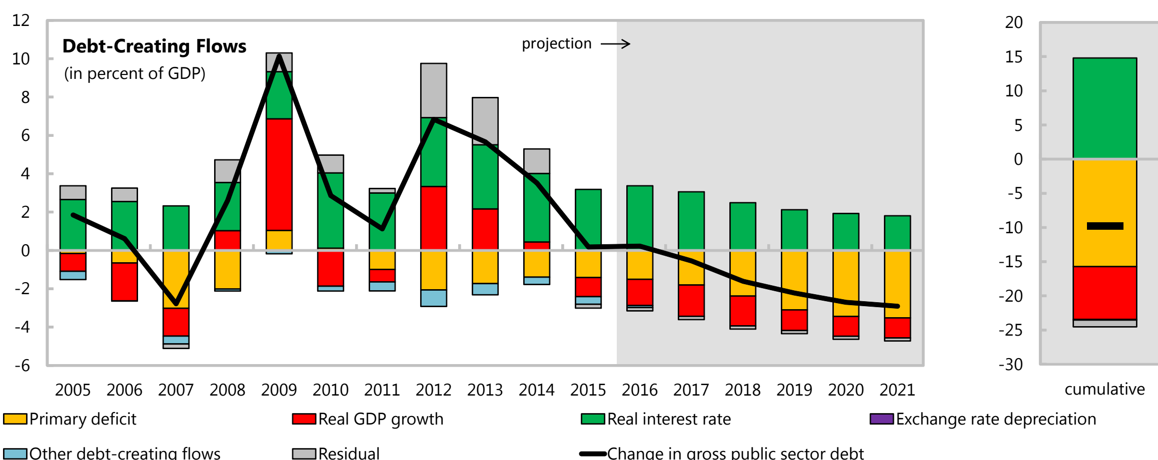
Debt, Economic and Market Indicators [1]

	Actual			Projections					
	2005-2013 [2]	2014	2015	2016	2017	2018	2019	2020	2021
Nominal gross public debt	111.5	132.5	132.7	132.9	132.4	130.8	128.6	125.9	123.0
Public gross financing needs	22.9	32.2	26.5	20.4	16.9	16.4	16.1	14.0	14.9
Real GDP growth (in percent)	-0.5	-0.3	0.8	1.1	1.3	1.2	0.8	0.8	0.8
Inflation (GDP deflator, in percent)	1.7	0.8	0.8	0.5	0.6	0.9	1.1	1.2	1.3
Nominal GDP growth (in percent)	1.2	0.5	1.5	1.6	1.9	2.1	1.9	2.0	2.2
Effective interest rate (in percent) [4]	4.4	3.6	3.2	3.1	3.0	2.8	2.8	2.7	2.8

As of June 01, 2016		
Sovereign Spreads		
EMBIG (bp) 3/		125
5Y CDS (bp)		129
Ratings	Foreign	Local
Moody's	Baa2	Baa2
S&Ps	BBB-	BBB-
Fitch	BBB+	BBB+

Contribution to Changes in Public Debt

	Actual			Projections							
	2005-2013	2014	2015	2016	2017	2018	2019	2020	2021	cumulative	debt-stabilizing primary balance [9]
Change in gross public sector debt	3.2	3.5	0.2	0.2	-0.5	-1.6	-2.2	-2.7	-2.9	-9.8	
Identified debt-creating flows	2.1	2.2	0.4	0.4	-0.4	-1.4	-2.1	-2.5	-2.8	-8.8	
Primary deficit	-1.0	-1.4	-1.4	-1.5	-1.8	-2.4	-3.1	-3.4	-3.5	-15.7	0.8
Primary (noninterest) revenue and grants	45.4	48.0	47.7	47.1	45.9	45.7	45.9	45.8	45.8	276.2	
Primary (noninterest) expenditure	44.4	46.6	46.3	45.6	44.1	43.3	42.8	42.4	42.3	260.5	
Automatic debt dynamics [5]	3.5	4.0	2.2	2.0	1.4	0.9	1.0	0.9	0.8	7.1	
Interest rate/growth differential [6]	3.5	4.0	2.2	2.0	1.4	0.9	1.0	0.9	0.8	7.1	
Of which: real interest rate	2.9	3.6	3.2	3.4	3.1	2.5	2.1	1.9	1.8	14.8	
Of which: real GDP growth	0.6	0.4	-1.0	-1.4	-1.6	-1.6	-1.1	-1.0	-1.0	-7.7	
Exchange rate depreciation [7]	0.0	0.0	0.0	…	…	…	…	…	…	…	
Other identified debt-creating flows	-0.4	-0.4	-0.4	-0.1	0.0	0.0	0.0	0.0	0.0	-0.1	
Privatization Receipts (negative)	-0.1	-0.2	-0.4	-0.1	0.0	0.0	0.0	0.0	0.0	-0.1	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Other debt flows (incl. ESM and Euroare	-0.2	-0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes [8]	1.1	1.3	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-1.0	



Source: IMF staff.

1/ Public sector is defined as general government.

2/ Based on available data.

3/ Long-term bond spread over German bonds.

4/ Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.

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

6/ The real interest rate contribution is derived from the numerator in footnote 5 as r - π (1+g) and the real growth contribution as -g.

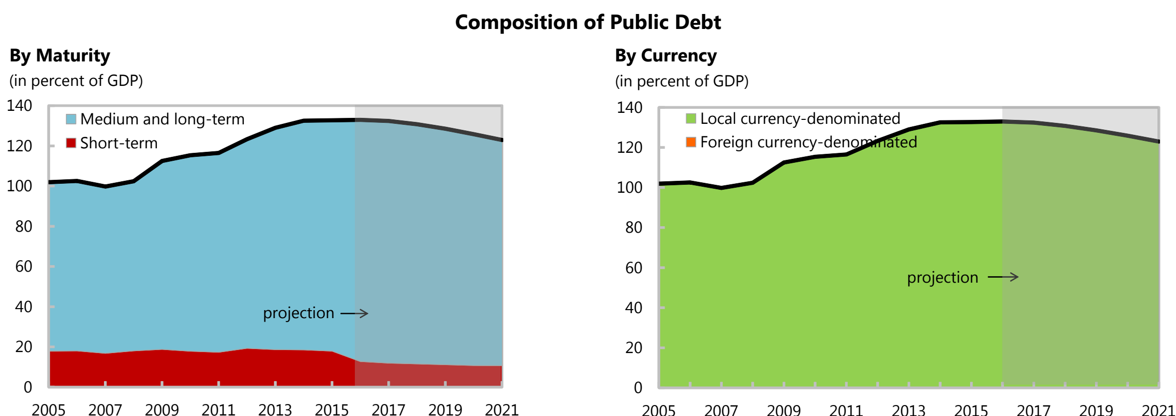
7/ The exchange rate contribution is derived from the numerator in footnote 5 as ae(1+r).

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

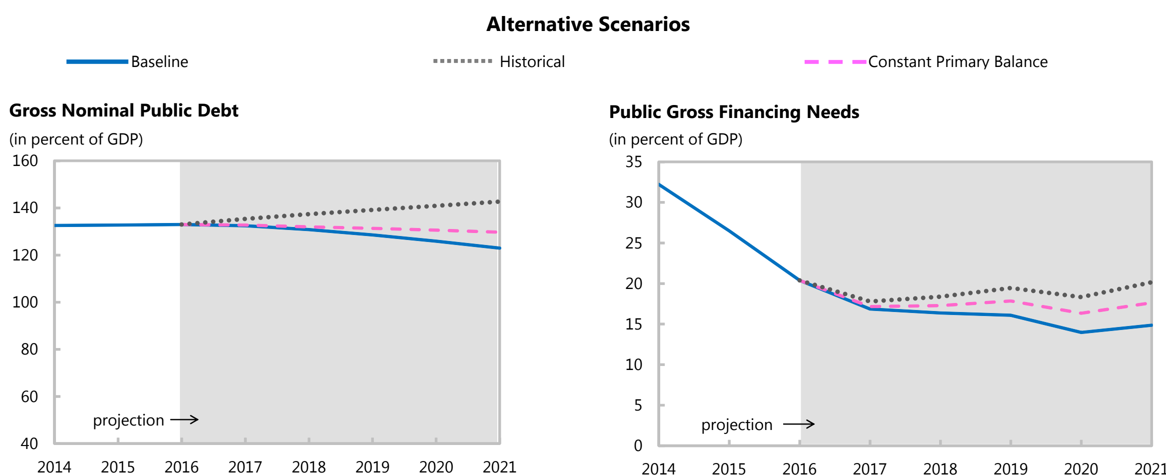
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Figure A2.4. Italy: Public DSA—Composition of Public Debt and Alternative Scenarios

Composition of Public Debt



Alternative Scenarios



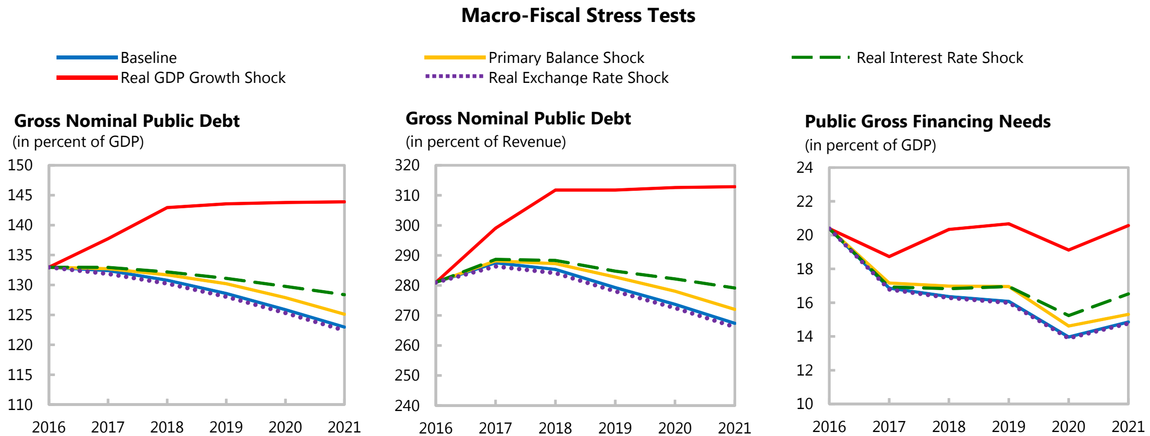
Underlying Assumptions
(in percent)

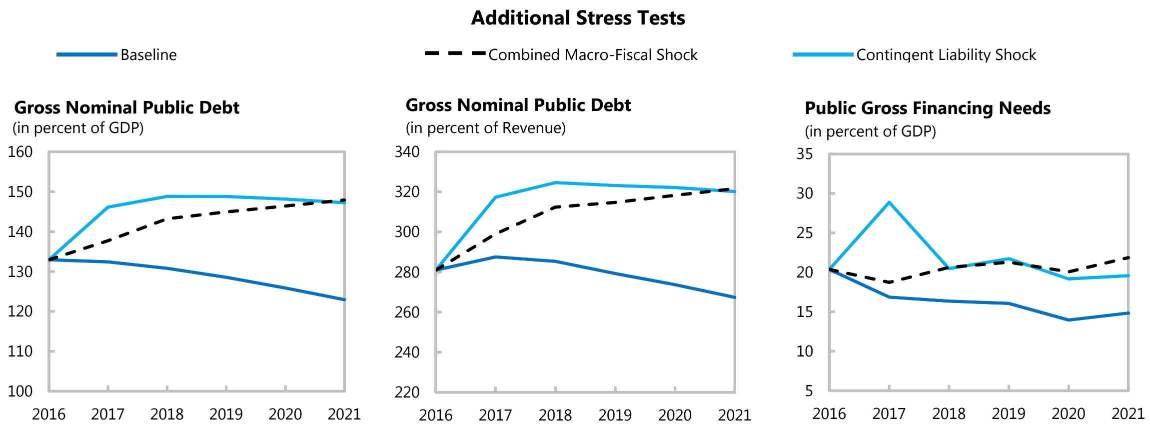
Baseline Scenario	2016	2017	2018	2019	2020	2021
Real GDP growth	1.1	1.3	1.2	0.8	0.8	0.8
Inflation	0.5	0.6	0.9	1.1	1.2	1.3
Primary Balance	1.5	1.8	2.4	3.1	3.4	3.5
Effective interest rate	3.1	3.0	2.8	2.8	2.7	2.8
Constant Primary Balance Scenario						
Real GDP growth	1.1	1.3	1.2	0.8	0.8	0.8
Inflation	0.5	0.6	0.9	1.1	1.2	1.3
Primary Balance	1.5	1.5	1.5	1.5	1.5	1.5
Effective interest rate	3.1	3.0	2.8	2.8	2.7	2.8

Historical Scenario	2016	2017	2018	2019	2020	2021
Real GDP growth	1.1	-0.5	-0.5	-0.5	-0.5	-0.5
Inflation	0.5	0.6	0.9	1.1	1.2	1.3
Primary Balance	1.5	1.2	1.2	1.2	1.2	1.2
Effective interest rate	3.1	3.0	2.9	2.9	3.0	3.1

Source: IMF staff.

Figure A2.5. Italy: Public DSA—Stress Tests





Underlying Assumptions
(in percent)

	2016	2017	2018	2019	2020	2021
Primary Balance Shock						
Real GDP growth	1.1	1.3	1.2	0.8	0.8	0.8
Inflation	0.5	0.6	0.9	1.1	1.2	1.3
Primary balance	1.5	1.5	1.8	2.4	3.1	3.4
Effective interest rate	3.1	3.0	2.8	2.8	2.8	2.8
Real Interest Rate Shock						
Real GDP growth	1.1	0.9	0.8	0.4	0.4	0.4
Inflation	0.5	0.6	0.9	1.1	1.2	1.3
Primary balance	1.5	1.8	2.4	3.1	3.4	3.5
Effective interest rate	3.1	3.0	3.1	3.2	3.4	3.6
Combined Shock						
Real GDP growth	1.1	-1.1	-1.2	0.4	0.4	0.4
Inflation	0.5	0.0	0.3	1.1	1.2	1.3
Primary balance	1.5	0.5	-0.2	0.5	0.9	1.0
Effective interest rate	3.1	3.0	3.1	3.2	3.4	3.6

	2016	2017	2018	2019	2020	2021
Real GDP Growth Shock						
Real GDP growth	1.1	-1.1	-1.2	0.8	0.8	0.8
Inflation	0.5	0.0	0.3	1.1	1.2	1.3
Primary balance	1.5	0.5	-0.2	0.5	0.9	1.0
Effective interest rate	3.1	3.0	2.9	2.9	2.9	3.0
Real Exchange Rate Shock						
Real GDP growth	1.1	1.3	1.2	0.8	0.8	0.8
Inflation	0.5	1.0	0.9	1.1	1.2	1.3
Primary balance	1.5	1.8	2.4	3.1	3.4	3.5
Effective interest rate	3.1	3.0	2.8	2.8	2.7	2.8
Contingent Liability Shock						
Real GDP growth	1.1	0.1	0.0	0.8	0.8	0.8
Inflation	0.5	0.3	0.6	1.1	1.2	1.3
Primary balance	1.5	-9.8	1.1	1.8	2.2	2.3
Effective interest rate	3.1	3.1	3.4	3.3	3.2	3.2

Source: IMF staff.

Appendix. Progress Against IMF Recommendations

Italy: Progress Against IMF Recommendations

	2015 Article IV Policy Advice	Actions since 2015 Article IV	Next steps
		Structural Reforms to Improve the Business Environment	
Product markets	Legislate and implement the Annual Competition Law (ACL). Implement the relevant legislation to eliminate existing regulatory barriers in sectors outside the ACL (e.g. transport). Fully implement already legislated reforms by all levels of government.	The Annual Competition Law was approved by the Chamber of Deputies in October 2015 and is currently under discussion in the Senate. The Constitutional reform, expected to be completed in 2016, should help strengthen implementation as some of the responsibilities currently assigned to local authorities will be brought back to the central government.	Strengthen several provisions of the law in line with the recommendations of the competition authority, and ensure an annual process of adopting pro-competition laws. Consideration should also be given to enhancing competition in other areas, including in local public service provision, transport, legal and professional services, as well as to full implementation of existing legislation (e.g., retail sector).
Public Services	Reform local public services and rationalize local public enterprises to improve efficiency.		
	Rationalize the legal framework related to local public services with a view of improving competition in services awards.	Enabling Law on reforming the Public Administration (L 124/2015), approved in August 2015, envisions reform of local public services and rationalization of local public enterprises. Some implementing decrees were approved by the Council of Minister in January 2016.	
	Increase the autonomy and accountability of public sector managers; strengthen benchmarking and performance-based budgeting; and improve mobility of workers and wage differentiation across agencies and geographical areas.		Advance reforms aimed at improving the skill-mix in the public sector, matching positions with skills, aligning wages with productivity, simplifying functions and procedures, rationalizing procurement, and tackling privileges and employment in public enterprises, including through privatization.
	Further improve tendering procedures and standardization of service contracts.	An enabling law for public tenders was approved in January 2016, which brings Italy in line with European directives. It simplifies and rationalizes existing legislation governing public procurement and introduces a less regulated system. The new system will provide more soft law instruments (such as standard contracts and guidelines) and strengthen the power of the Anti-Corruption Authority.	
Judicial System	Conduct a comprehensive review of court fees, which remain modest and capped.	After some reforms on court fees, the DL 83/2015 (converted in law 132/2015), extended the possibility that the losing party in litigation pays for the court fees.	There is a reform project on civil procedure that establishes penalties for frivolous litigation, beyond the payment of the court fees.
	Develop performance indicators and use them for court management and accountability purposes.	Strasbourg Program 2.0 under implementation.	Monitor progress with the program.
	Rationalize appeals system and align with international best practice.	Proposal for legislative delegation on civil procedure, passed by the Council of Ministers (2/10/2015), and pending approval by Parliament.	The reform on civil procedure contemplates a single judge in appeal cases.
EU-level	Strengthen common market through implementation of the Services Directive.	In 2014, the infringements procedures have been reduced by 25% and the mechanisms for a swift and sound implementation of EU law have been further improved.	

Italy: Progress Against IMF Recommendations

	2015 Article IV Policy Advice	Actions since 2015 Article IV	Next steps
		Structural Reforms to Improve the Business Environment	
Labor market	Monitor take-up of new open-ended contract, recourse to legal action, and judges' interpretation of new legislation. Implement legislative decree on streamlining of contracts and monitor use of enhanced flexibility in allocation of labor within the firm.	An independent monitoring committee of the implementation of the Jobs Act was set up by the Prime Minister and the Ministry of Labor and Social Policy and publishes monthly reports on activations and terminations of various types of contracts. The handful of cases of termination of new open-ended contracts were settled within days. A legislative decree, enacted in September 2015, reviews existing temporary contracts and allows for more flexible use of labor within the firm, while promoting the use of the new open ended contract as the main form of labor contract for employees.	Monitor new open-ended contract take up, recourse to legal action, judges' interpretation of new legislation, and use of enhanced flexibility in allocation of labor within the firm.
	Shift to a more universal support system conditional on job search and training; finalize and implement legislative decrees reforming the current wage supplementation scheme.	The introduction of NASPI and two additional schemes on an experimental basis (Dis-Col and ASI) in May 2015 broadened the coverage of unemployment insurance. The implementation of greater conditionality will be done through the National Employment Agency, thus will be effective once the National Employment Agency is fully operational. A legislative decree for reforming the wage supplementation scheme (DL 148/2015) was approved in September 2015.	
	Improve active labor market policies through better coordination and information sharing, by establishing the proposed National Employment Agency.	The legislative decree on the National Employment Agency and ALMP (DL 150/2015) was approved in September 2015, and the National Agency was established in January 2016. Implementation of ALMP strategies according to regional agreements and issuance of activation vouchers to unemployed individuals is expected in 2016.	Monitor effectiveness of National Employment Agency.
	Boost female labor participation; monitor effectiveness of measures taken to improve work-life balance	A legislative decree, which reviews parental benefits and introduces new provisions for more flexible work arrangement, was adopted in June 2015 as part of the Jobs Act.	Continue to monitor effectiveness of measures taken to raise female labor force participation. Remove fiscal disincentives for female employment; enhance provision of childcare and elderly care services.
	Promote the use of firm-level bargaining.	Social partners should come up with a proposal that will strengthen firm-level bargaining by end 2016.	Modernize the wage bargaining system—by broadening the scope for firms, specifically smaller enterprises as well as many in the South, to engage in effective firm-level negotiations.

Italy: Progress Against IMF Recommendations

	2015 Article IV Policy Advice	Actions since 2015 Article IV	Next steps
		Rebalancing fiscal adjustment and reducing public debt	
Rebalancing the budget	Lower tax rates on labor and capital.	The 2016 budget reduced the tax burden on labor and firms further, including by reducing the CIT rate starting in 2017.	Further reduce the labor tax wedge which remains high by international standards, including through stronger efforts in lowering current primary spending (such as high social spending). Introduce a modern real estate tax.
	Increase spending efficiency and target spending increases in areas such as infrastructure and R&D. Identify possible efficiency gains in areas such as procurement, transfers to public enterprises, and health.	The 2016 budget envisages some increase in investment spending. Steps are being taken to streamline procurement processes, including by cutting the number of expenditure centers and introducing e-procurement.	Implement the government budget reform that integrates the spending review process into the budget in a multi-year fiscal framework. Seek further efficiency and quality improvements in the delivery of public services.
	Fully implement the *delega fiscale* , including by completing the review of tax expenditures.	The *delega fiscale* 's timeframe ended in September 2015; large part of the law was acted upon. A commission was appointed to review tax expenditures, submit recommendations for their reorganization prior to the 2017 budget, and monitor them.	Systematically review and streamline tax expenditures, including to broaden the tax base.
Fiscal Stance	In 2016, the safeguard clause should be fully offset by spending cuts and flexibility under the SGP should be used very modestly (about 0.2 percent of GDP).	The safeguard clause for 2016 was eliminated and partially offset by spending cuts. Significant flexibility under the SGP was approved (about 0.85 percent of GDP).	The sizable relaxation in 2016 provides an opportunity to push ahead with decisive structural reform implementation this year, including in the fiscal area.
	Build a primary surplus buffer over the medium-term by targeting a 1/2 percent of GDP structural surplus.	The latest medium-term fiscal plans envisage approaching a structural balance by 2019.	Implement evenly-phased structural adjustment over 2017-19, net of any remaining upfront costs from structural reforms, that achieves a structural surplus of about 1/2 percent of GDP to build buffers against shocks and bring debt down faster.
Public Financial Management	Enhance policy prioritization with a medium-term expenditure framework and the institutionalization of spending reviews.	Legislative decrees have been approved to make spending reviews an integral part of the regular budget process in a multi-annual planning framework.	Complete the reform of the state budget process and, starting with the 2017 budget, implement the new framework with spending targets. Make the budgetary framework more binding by having enforceable multi-annual expenditure ceilings.
Tax evasion	Stronger efforts to curb tax evasion, including through greater use of the anti-money laundering framework. Increase information sharing, e.g., between the Financial Intelligence Unit (FIU) and the "fiscal registry" (anagrafe tributaria).	Information sharing has improved. There is ongoing work in the development of guidance for financial institutions to report transactions related to tax evasion.	Implementation and follow-up of improved reporting for money-laundering transactions related to tax evasion.

Italy: Progress Against IMF Recommendations

	2015 Article IV Policy Advice	Actions since 2015 Article IV	Next steps
		Banking Sector—Repairing Balance Sheets to Revive Lending	
Tackling NPLs	Resolve remaining uncertainty about banks' asset quality by applying the new EU wide harmonized asset classification framework to all banks operating in Italy. Strict supervisory enforcement is essential for ensuring correct classification and adequate provisioning.	New asset classification framework (Circolare n. 272 del 30 luglio 2008 (Matrice dei conti), 7 Aggiornamento, 20 January 2015), harmonized on the EU level, has been introduced in January 2015, and is applicable to all banks operating in Italy.	Asset quality should be assessed systematically for those banks not already subject to the European Central Bank comprehensive assessment, with follow-up actions in line with regulatory requirements. Furthermore, guidance should be provided on banks' approaches to loan provisioning and loan restructuring practices.
	Increase the tax deductibility of loan losses.	The period has been shortened to a year (DL 83/2015, converted into law 132/85)	No further action needed.
	Expedite judicial process by increasing the effectiveness of asset sales and reducing litigation within the insolvency process. Establish qualifications for insolvency practitioners and expand use of specialized insolvency courts and of on-line filing.	The Rordorf Commission published extensive reform proposals in December 2015 (including assigning the competence on insolvency cases to the enterprise courts and to the larger civil courts), and the Government has prepared a project for the design for delegate legislation (February 2016). There have been reforms of the insolvency framework by the Decree law n.59 (May 3rd, 2016), including the adoption of on-line tools in the insolvency process.	Monitor the implementation of the reforms, including the attribution of competence on insolvency matters to the enterprise courts, and the implementation of on-line tools in the insolvency process. Promote the adoption of debt restructuring principles.
	Accelerate write-offs. Introduce supervisory actions that effectively introduce time limits for write-off of vintage NPLs to encourage banks to deal faster with the problem.	By end-2016, the supervisor is implementing a new reporting framework.	Banks should be required to produce comprehensive NPL strategies, committing to operational targets to reduce NPL levels markedly over the medium term (via more efficient internal workout procedures, outsourcing to external servicers, and sales). Intensified supervisory oversight of banks' internal management of NPL resolution should include an additional regular NPL reporting requirement on progress achieved and an intensive schedule of on-site monitoring led by collections and workout experts.
	If properly designed, a centralized, system-wide, state-backed AMC that is consistent with the EU state aid rules and within the limited available fiscal space could help jumpstart the market for bad assets.	Two initiatives were introduced instead of a public AMC, discussions on which had stalled due to state aid concerns: (i) GACS, which allows transfer of NPLs to external vehicles at market prices with government guarantee for the senior tranche of the SPV; (ii) Atlante fund to backstop capital issuances and which can invest in junior and mezzanine tranches of securitized bad debts, also leveraging on GACS guarantee mechanism.	Although Atlante is privately run, supervisors should ensure that banks' future investments are based solely on commercial considerations, and the use of funds is tied with strict governance improvements in the banks they invest in.

Italy: Progress Against IMF Recommendations

	2015 Article IV Policy Advice	Actions since 2015 Article IV	Next steps
		Banking Sector—Repairing Balance Sheets to Revive Lending	
Corporate Governance	Resolve remaining issues in the governance of banking foundations and smaller cooperative banks.	Foundations: Memorandum between Treasury and ACRI (independent association of banking foundations) to foster the diversification of investments and limit their participation in the capital of banks. The memorandum guarantees that foundations comply fully with the ban on investee banks' control (also jointly or de facto). Cooperative banks. Popolare Banks (March 2015): The reform forces the largest 10 popolare banks to convert into joint stock companies by end 2016. Mutual bank reform (February 2016): Mutual banks must consolidate under joint-stock (holding) companies with at least €1 billion in equity in 18 months.	Ensure that reforms are implemented decisively, and that the reform of mutual banks results in adequate corporate governance standards. Regulations of banking foundations' portfolio management and governance arrangements should have binding, legally enforceable (instead of intentional) character. The supervisor needs to take a lead role in the consolidation of the smaller banks that are not under the supervision of the SSM. The supervisor also needs to set clearer bank consolidation requirements in terms of viability and time-bound operational cost reductions. The emerging banking groups need to be assessed ex ante as sound from capital, assets, management, earnings and liquidity perspectives.
Supporting SMEs	Implement a "triage" approach for distressed SMEs, by establishing standard criteria for assessing loans and introducing guidelines for restructuring viable firms. Improve further the insolvency regime by streamlining procedures and accelerating the start of the insolvency process to facilitate the swift exit of nonviable firms. Address remaining gaps in pre-insolvency and reorganization procedures.	The insolvency process has been streamlined by recent reforms (DL 83/2015, transformed into law 132/2015, and DL 59/2016).	Triage should be done by the banking sector. Acceleration of the start of insolvency proceedings is a pending issue. Coordination among different options of debt restructuring is also pending.
	Monitor the effectiveness of the measures introduced and continue encouraging alternative market funding sources, through, among others, enhanced use and enforcement of collateral. Enhance sharing of credit information to improve credit monitoring and lending.	To increase supply of credit, insurance, securitization companies and credit funds are now allowed to lend directly to funds. There has also been liberalization of bonds issuance by unlisted companies. To encourage stock market listing, minimum capital requirements were reduced, tax credit for large capital increases was introduced; and multiple voting shares and loyalty shares can now be listed. The 2016 Stability Law further strengthens the SME credit guarantee fund. The DL 59 (May 2016) has introduced new security interests over enterprise assets.	Monitor implementation of the secured transactions reform (including the registry infrastructure).
	Remove obstacles to SME start-up and up-scaling. Monitor the effectiveness of the measures adopted and keep on encouraging the creation and growth of innovative SMEs.	The program for supporting innovative startups was expanded to include non-startup SMEs of high technological value. The Innovative Startup and SME scheme encompasses: flexible corporate management tools; exemption from the regulations on companies reporting systematic losses and on dummy companies; flexible remuneration systems; tax incentives for investments; equity crowdfunding; fast-track and free access to public guarantees on bank loans.	

INTERNATIONAL MONETARY FUND

ITALY

June 20, 2016

STAFF REPORT FOR THE 2016 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

Prepared By

European Department
(In consultation with other departments)

CONTENTS

FUND RELATIONS 2

STATISTICAL ISSUES 4

FUND RELATIONS

(As of May 31, 2016)

Mission: Milan and Rome, May 10–23, 2016. The concluding statement of the mission is available at http://www.imf.org/external/np/ms/2016/052316.htm.

***Staff team*:** Mr. Rishi Goyal (head), Mmes. Bersch and Weber, Mr. Raissi (all EUR), Mr. Garrido (LEG), and Mr. Monaghan (MCM). Mr. Arvanitis (EUR) joined for several days. Mr. Cottarelli and Ms. Quaglierini (OED) attended the policy meetings.

***Country interlocutors*:** Finance Minister Padoan, Bank of Italy Governor Visco, Justice Minister Orlando, other senior officials from Ministry of Economy and Finance; Bank of Italy; Ministry of Economic Development; Ministry of Labor and Social Policies; Ministry of Justice; Ministry of Public Administration and Simplification; Fiscal Council; Association of Italian Labor Lawyers; Association of Municipalities—Fondazione IFEL; major Italian and international banks; major Italian and international law firms; the Securities and Exchange Commission (CONSOB); Social Security Institute (INPS); the Antitrust Authority; Consiglio Nazionale Forense; High Council of the Judiciary; Insolvency Court; Supreme Court; Special Commission for the Reform of Insolvency Laws; Civil Courts; Consiglio Nazionale Dei Dottori Commercialisti; representatives of trade unions (CGIL, CSIL, and UIL); market participants; Confederation of Italian Industry (Confindustria); Italian Banking Association (ABI); research centers; parliament and academic representatives.

***Fund relations*:** The previous consultation discussions took place during May 5–18, 2015. The associated Executive Board's assessment is available at: http://www.imf.org/external/np/sec/pr/2015/pr15321.htm and the staff report and other mission documents at: http://www.imf.org/external/pubs/cat/longres.aspx?sk=43046.0. 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 (Table 1).

Membership Status: Joined March 27, 1947; Article VIII.

General Resources Account:	SDR Million	Percent Quota
Quota	15,070.00	100.00
Fund holdings of currency	14,692.33	97.49
Reserve Tranche Position	377.81	2.51
Lending to the Fund		
New arrangements to borrow	1,243.25	

SDR Department:	SDR Million	Percent Allocation
Net cumulative allocation	6,576.11	100.00
Holdings	5,108.99	77.69

Outstanding Purchases and Loans: None

Financial Arrangements: None

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

	Forthcoming				
	2016	2017	2018	2019	2020
Principal					
Charges/Interest	0.37	0.96	0.96	0.96	0.96
Total	0.37	0.96	0.96	0.96	0.96

Exchange Rate Arrangement: Italy entered the final stage of European Economic and Monetary Union on January 1, 1999, at a rate of 1,936.27 Italian lire per 1 euro. The euro floats freely and independently against other currencies.

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

Article IV Consultations: Italy is on the standard 12-month consultation cycle. The previous consultation discussions took place during May 5–18, 2015, and the staff report (IMF Country Report No. 15/166, 06/16/15) was discussed on July 1, 2015.

ROSCs/FSAP:

Standard Code Assessment	**Date of Issuance**	**Country Report**
Fiscal Transparency	October 9, 2002	No. 02/231
Data	October 18, 2002	No. 02/234
Fiscal ROSC update	November 2003	No. 03/353
Fiscal ROSC update	February 2006	No. 06/64
FSAP	September 2013	No. 13/300

Technical Assistance:

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

STATISTICAL ISSUES

ITALY—STATISTICAL ISSUES APPENDIX (As of June 6, 2016)
I. Assessment of Data Adequacy for Surveillance
General: Data provision is adequate for surveillance. Italy's economic and financial statistics are comprehensive and of generally high quality. Data are provided to the Fund in a comprehensive manner (Table 1). The authorities regularly publish a full range of economic and financial data, as well as a calendar of dates for the main statistical releases. Italy is also subject to the statistical requirements of Eurostat and the European Central Bank (ECB), including the timeliness and reporting standards, and it has adopted the *European System of Accounts 2010* (*ESA2010*).
National Accounts: Further improvements should be considered regarding changes in inventories in the quarterly national accounts, which are currently derived as a residual and lumped together with the statistical discrepancy.
Price Statistics:
Government Finance Statistics:
Monetary and Financial Statistics:
Financial Sector Surveillance: Participates in the IMF's Coordinated Direct Investment Survey (CDIS), Coordinated Portfolio Investment Survey (CPIS), and financial soundness indicators (FSIs) databases.
External Sector Statistics: The Bank of Italy adopted the standards for reporting Balance of Payments (BOP) and International Investment Position (IIP) data on the basis of the *Balance of Payments and International Investment Position Manual, 6th edition (BPM6)* in the second half of 2014.

II. Data Standards and Quality	
Italy has subscribed to the Special Data Dissemination Standard (SDDS) since 1996 and posts its metadata on the Dissemination Standards Bulletin Board (DSBB). In 2015 Italy subscribed to SDDS Plus, together with the first group of adherents. **Implementing G-20 DGI recommendations:** The authorities have implemented all of the recommendations. Further progress in the near future is likely to be made on the reporting frequency of Financial Soundness Indicators.	A data ROSC was disseminated in 2002.

Table 1. Italy: Common Indicators Required for Surveillance

(As of June 6, 2016)

	Date of latest observation	Date received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of Publication[7]	Memo Items: Data Quality – Methodological soundness[8]	Memo Items: Data Quality – Accuracy and reliability[9]
Exchange Rates	June 2016	June 2016	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	April 2016	May 2016	M	M	M		
Reserve/Base Money	March 2016	May 2016	M	M	M	O,O,LO,LO	O,O,O,O,LO
Broad Money	March 2016	May 2016	M	M	M		
Central Bank Balance Sheet	March 2016	May 2016	M	M	M		
Consolidated Balance Sheet of the Banking System	March 2016	May 2016	M	M	M		
Interest Rates[2]	June 2016	June 2016	D	D	D		
Consumer Price Index	April 2016	May 2016	M	M	M	O,O,O,O	LO,O,LO,O,O
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	Q4 2015	April 2016	Q	Q	Q	LO,O,LO,O	LO,O,O,O,LO
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	May 2016	June 2016	M	M	M		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	April 2016	May 2016	M	M	M		
External Current Account Balance	March 2016	May 2016	M	M	M	O,LO,LO,O	LO,O,LO,O
Exports and Imports of Goods and Services	April 2016	May 2016	M	M	M		
GDP/GNP	Q1 2016	May 2016	Q	Q	Q	O,O,O,O	LO,LO,O,O,O
Gross External Debt	Q4 2015	March 2016	Q	Q	Q		
International Investment position[6]	Q4 2015	March 2016	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

ITALY

July 1, 2016

STAFF REPORT FOR THE 2016 ARTICLE IV CONSULTATION—SUPPLEMENTARY INFORMATION

Prepared By The European Department

This supplement provides information that has become available since the issuance of the staff report on June 22, 2016. The thrust of the staff appraisal remains unchanged.

1. The staff report identified a vote by the U.K. electorate to leave the European Union (Brexit) as a downside risk for the Italian economy. This risk has now materialized. Since the U.K. referendum, equity prices have been under renewed pressure. Italy's main stock index, the FTSE MIB, has fallen by 9 percent; bank equity prices declined by about 25 percent (and are down for the year by over 50 percent). Bank CDS spreads widened by about 23 bps to 281 bps. Although spreads over Bunds on the 10-year government bond widened by 5 bps, yields have declined to 1.23 percent. So far, no major liquidity pressures have been observed.

2. Staff is revising down slightly the growth outlook, against the backdrop of heightened uncertainty. While the recovery is expected to continue, increased financial market volatility and higher general uncertainty could weigh on investment and growth in the period ahead. Even though direct trade and financial sector exposures vis-à-vis the U.K. are relatively limited, staff's preliminary assessment is that growth could remain just under 1 percent in 2016 and at about 1 percent in 2017, with downside risks having increased somewhat.

3. Separately, banks have had mixed success in raising capital recently. Veneto Banca was unable to attract enough investment from either new or existing shareholders in its public offering that ended on June 24, 2016. Atlante, the private sector backstop facility for ongoing banks' capital increases, purchased about 98 percent of the €1 billion capital increase and is set to become the bank's controlling shareholder. In contrast, Banco Popolare completed successfully a €1 billion capital increase on June 23 that was required by the SSM in advance of the planned merger with Banca Popolare di Milano.

4. In the context of final revisions to the External Stability Report, some minor changes have been made to Italy's page. A revised page is attached.

5. These developments do not alter the thrust of the staff appraisal. The advice presented in the staff appraisal remains valid in the face of heightened downside risks. Comprehensive pro-growth reforms, including to foster competition in product and services markets, measures to accelerate bank balance sheet repair, as well as growth-friendly fiscal measures to lower debt are critical to support growth and job creation while building buffers.

	Italy: External Sector Assessment	Overall Assessment
Foreign asset and liability position and trajectory	**Background**. Italy's net international investment position (NIIP) has deteriorated significantly since joining the Euro area, with net liabilities of 24 percent of GDP (December 2015) as compared with 7 percent at end 2000, reflecting mainly current account deficits and valuation adjustments. Gross assets and liabilities grew steadily during this period, reaching 144 and 169 percent of GDP respectively, 47 and 64 percentage points higher than in 2000. External debt represents about ¾ of gross external liabilities. While the level of external debt is in line with the Euro area as a whole, its composition—half is owed by the public sector—underscores the vulnerabilities related to the high level of government debt. Looking forward, modest current account surpluses forecast over the medium term should gradually shrink Italy's net liability position as a share of GDP. **Assessment**. In light of the current account's shift into a surplus, overall external sustainability is not a major concern. Nonetheless, further strengthening of balance sheets is desirable, as Italy is vulnerable to financial contagion given its large stock of government debt.	**Overall Assessment**: *The external position in 2015 was broadly consistent but likely still weaker than suggested by medium-term fundamentals and desirable policy settings.* While there was an improvement in 2015 on price-based competitiveness indicators, the overall assessment reflects Italy's continued weak productivity growth and need for balance sheet repair. Stronger growth, consistent with reducing high unemployment and public debt, while strengthening the external balance sheet, would require a modest weakening of the real effective exchange rate from average 2015 levels. The recent small appreciation of the REER does not alter the overall assessment for 2015. **Potential policy responses**: Continued implementation of structural reforms as well as efforts to strengthen bank balance sheets will be critical to improving competitiveness and boosting potential growth. Further progress in medium-term fiscal consolidation will also help improve competitiveness and maintain investor confidence. Combined, these measures will support growth and employment over the medium term.
Current account	**Background**. Italy's current account (CA) averaged a deficit of 1¼ percent of GDP in the decade following the adoption of the euro. Starting in 2013, it moved into balance and by 2015, it registered a surplus of 2.2 percent of GDP (as compared to 1.9 percent of GDP in 2014). The improvement in the current account is mainly driven by Italy's growing trade surplus, which reached 3.2 percent of GDP in 2015. In terms of saving and investment, declining investment accounted for ⅔ of the improvement in the CA since 2010, while higher public saving contributed most of the rest. **Assessment**. Despite the recent improvement in the current account, the EBA model suggests that the cyclically-adjusted level, which stood at 1.1 percent of GDP in 2015, was about 1.8 percent of GDP below the norm implied by medium-term fundamentals and desirable policy settings. Given these estimates and the need for stronger growth to reduce public debt and unemployment over the medium term, while improving the external balance sheet, staff assesses a gap of -2 to 0 percent of GDP for 2015.	
Real exchange rate	**Background**. Stagnant productivity and rising labor costs had led to a gradual appreciation of the real effective exchange rate (REER) since Italy's joining the Euro area both in absolute terms and relative to the Euro area average (by about 0 to 10 percent using price-based REER indices). In 2015, the fall in the value of the euro contributed to a sizable depreciation of the REER, bringing its value close to 1999 levels.1/ As of June 2016, the REER has appreciated 1 percent over its 2015 average. **Assessment**. The EBA methodologies provide a relatively wide range of REER gap estimates in 2015. The REER regression methods suggest an overvaluation of 0.7 percent (EBA Level REER model) and –0.4 percent (EBA Index REER model) in 2015. The CA regression method yields an overvaluation of about 7 percent. On balance, and consistent with the staff assessment of the CA in 2015, staff assesses that a modest real effective depreciation of 0–10 percent would support further adjustment and address economic imbalances over the medium term.	
Capital and financial accounts: flows and policy measures	**Background**. Portfolio and other-investment inflows typically have financed the current account deficits of the past, despite a modest net FDI outflow, without much difficulty. Italy's financial account posted net outflows of about 2 percent of GDP in 2015, largely reflecting residents' net purchases of foreign assets, even as foreign investment in Italian portfolio securities continued. TARGET2 liabilities, accumulated by banks over 2011-12, widened in 2015, reflecting the creation of liquidity by the Bank of Italy within the framework of the Eurosystem's asset purchase program. **Assessment**. While supported by QE, Italy remains vulnerable to market volatility, owing to the large refinancing needs of the sovereign and banking sectors, and the potentially tight credit conditions from the high stock of NPLs in the banking sector.	
FX intervention and reserves level	**Background**. The euro has the status of a global reserve currency. **Assessment**. Reserves held by the euro area are typically low relative to standard metrics, but the currency is free floating.	
Technical Background Notes	1/ Depending on the measure used, Italy's REER depreciated by 3–10 percent between 2014 and 2015 (year average on year average).	

Statement by Mr. Carlo Cottarelli, Executive Director for Italy
July 6, 2016

I thank staff for extensive discussions during the Art. IV Consultation with Italy as well as for a set of well-focused papers.

The staff report identifies well the key challenges confronting the Italian economy. My authorities are firmly committed to meet these challenges and the actions undertaken so far prove it. Perhaps, the staff report could have recognized more what has already been done and the effect that this will have on economic performance. Staff notes that implementation will be critical but, as I noted last year, implementation has already started and indeed has been completed for many policy actions. Not all results of these actions are yet evident, but this is because it takes time for structural measures (even when fully implemented) to yield results. The rest of this buff elaborates these points and provides additional information to complement that provided in the staff report.

1. *Real sector*

The short term growth outlook

Last year the Italian economy has started recovering, with a GDP growth rate of 0.8 percent. This is obviously not a spectacular rate but is considerably better than what staff anticipated (the January 2015 WEO update projected a growth rate of 0.4 percent), one of the few positive surprises we had since then (as we know growth has disappointed for most countries in the world).

Staff projects a growth rate of 1.1 percent in 2016. The staff report could have usefully noted that this projected growth rate implies a rapid closing up of the growth rate gap vis-à-vis the euro area: indeed, while growth would still be below the euro area average, the 2016 gap would be less than half the average gap since 2001. So Italy is catching up at least in terms of growth rates.

The Italian authorities' projections for 2016, as well as 2017, are only slightly better than the staff's, as pointed out in paragraph 13. There are instead more significant differences for medium-term growth projections.

The medium-term growth outlook

Despite a recognized "multi-pronged" structural reform strategy, according to staff potential growth would remain low over the medium term. Absent further reform actions, staff envisages a medium-term growth of 0.8 percent, including a boost from the impact of past structural reforms of 0.3 percentage points. My authorities' long-term growth projections are more sanguine, while still fairly conservative (1.3-1.4 percent).

My authorities consider reasonable to expect a higher payoff from the substantial reforms put in place, including those already fully implemented. According to research conducted

at the Bank of Italy, 0.2 percentage points is the estimated contribution from the services sector reforms already implemented, and this does not take into account the growing impact of reforms over time.[1] On top of that, the implemented reforms in the judicial sector, public administration, education and labor market should be incorporated. Based on the official projections, the macroeconomic impact of the already implemented reforms would amount to 2.2 higher GDP level by 2020, 3.4 percent by 2025 and 8.2 percent in the long-term.[2]

As to the growth rate in the absence of the recent reforms (0.5 percent in the staff's view), before the crisis Italy's potential growth was estimated by IMF staff at 2 percent.[3] In spite of the shocks of the last 8 years, it seems unlikely that the potential growth rate of the Italian economy dropped from 2 to 0.5 percent, especially in light of the reforms that were in any case approved and implemented before the most recent round.

Altogether, a less pessimistic medium-term outlook than the one considered by staff seems fully justified, although further efforts are certainly needed to continue to boost potential growth in Italy.

Unemployment, social conditions and income distribution

The staff report appropriately notes that labor market conditions have improved, with a surge in permanent contracts. It is also worth noting the reduction in the unemployment rate to 11.5 percent last May; among the young the unemployment rate is now lower by more than 4 percentage points compared with a year ago. Positive signs are also coming from female employment creation. Regarding income distribution and social conditions, paragraph 7 of the staff report argues that income inequality has increased (the time period over which this has supposed to occur is not specified in the staff report but presumably it refers to developments in the last few years) but analysis conducted by the Bank of Italy does not seem to confirm this.[4] This said, cognizant of the increased hardship due to the post 2008 recession, the authorities adopted a Social Act to fight poverty of vulnerable households with children by allocating in the budget law €1 billion as of 2017, and other specific measures to support education initiatives for children in poor families together with provisions for disabled persons.

On policy developments affecting the labor market, we would underscore that the Jobs Act has been implemented, and is not "being implemented" as argued in paragraph 4. Regarding the wage bargaining system, my authorities agree on the need for reform and the staff report could have usefully mentioned that in 2016 the authorities plan to focus on a reform of the second-level bargaining system to make these agreements effective

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[1] Andrea Gerali, Alberto Locarno, Alessandro Notarpietro, Massimiliano Pisani (2015), WP no. 1010, "Every cloud has a silver lining. The sovereign crisis and Italian potential output" (https://www.bancaditalia.it/pubblicazioni/temi-discussione/index.html?com.dotmarketing.htmlpage.language=1)

[2] 2016 Italy's National Reform Program, Table II.2 (http://www.tesoro.it/documenti-pubblicazioni/doc-finanza-pubblica/index.html#cont1).

[3] 2010 Italy's Art. IV Consultation, p. 70.

[4] See 2015 Annual Report, Bank of Italy, Ch. 15.

and able to derogate to the national contract for matters related to production and work organization[5]. Additionally, past fiscal incentives for the productivity bonuses agreed at decentralized level to better align wage and productivity developments have already been renewed.

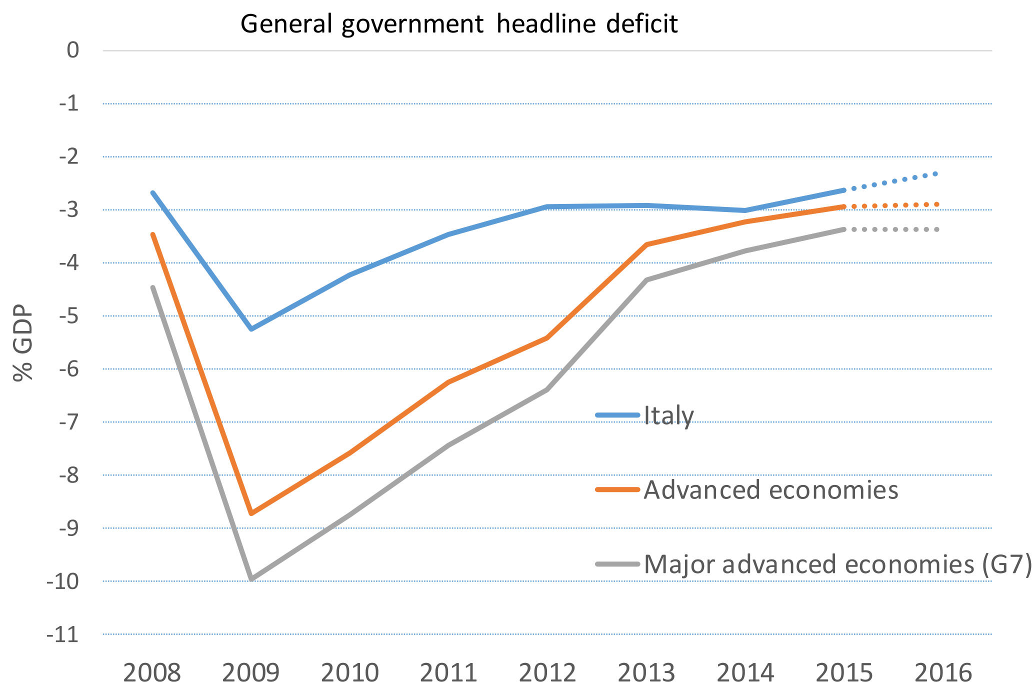
2. *Fiscal policy*

Overall trends

The staff report underscores the fiscal relaxation that took place in 2015 and 2016. This relaxation has to be put into proper context, as my authorities remain entirely committed to implement fiscal consolidation within the SGP framework.

First, Italy consolidated very rapidly its fiscal accounts in the aftermath of the crisis, with the structural primary balance improving from -0.1 in 2009 to 4.1 percent in 2013. Starting from 2013, given the persistent weakness of economic activity, my authorities used the flexibility allowed by the Stability and Growth Pact, and agreed upon with the European institutions to strike the right balance between consolidating the fiscal accounts and supporting, to the extent possible, the recovery.

However, the headline deficit continued to decline and, at a targeted 2.3 percent this year, is at present one of the lowest among the G7(see chart below).



Source: WEO Database. For 2016 the figure for Italy shows the fiscal target.

[5] 2016 Economic and Financial Document, National Reform Program, pp. 7-8. (http://www.mef.gov.it/documenti-pubblicazioni/doc-finanza-pubblica/)

Moreover, staff's assessment of the magnitude of the fiscal easing this year, based on the change in the structural balance, is partly misleading, as it relies on very low estimates of potential output growth in 2016 (implying, for example, that this year a reduction of the headline deficit of 0.3 percent of GDP corresponds to an increase in the structural deficit by 0.4 percent of GDP, in the staff's assessment), an issue that has oftentimes been mentioned by this chair, and could have at least been mentioned in the staff report.[6]
Incidentally, the fact that the authorities have reservations on potential growth estimates is a long standing issue and not just a recent one as argued in paragraph 37 of the staff report.
Finally, the fiscal consolidation recommended by staff would likely have negative sizable impact on GDP and debt dynamics, as indicated in the charts in paragraph 36.

Public expenditure restraint

With regard to staff's views on public expenditure restraint (paragraph 35), the following points are worth underscoring:

- the reduction in the wage bill should be regarded as structural in nature, not as a stop-gap measure. It reflected a decline in public employment by some 250,000 units which is not going to be reversed, as well as wage restraint that lowered public wages from an historical peak that was unsustainable: even now the ratio between average public and private sector wages stands at some 1.22, against an average for advanced economies of 1.05, suggesting there is room for further savings.
- Significant results have already been achieved on public consumption: public consumption has stabilized in nominal terms in recent years, after a steady increase in the 2000-2010 decade; public consumption deflator has considerably moderated to an average of 0.7 percent in 2010-2015, well below the average inflation rate. The reform of procurement, which has been already implemented, will make these results sustainable over time and allow further savings.
- Savings have been achieved in health care spending as well as in pension spending, owing to the increase in the retirement age.
- As staff notes, investment spending was reduced but, before the cuts, capital expenditure as a share of GDP was nearly 1 percentage point higher than in Germany, suggesting that there was room for structural savings in this area, including through price containment.
- Altogether, Italy's increase of primary expenditure between 2009 and 2015 was below 2 percent (for the whole period). This compares to about a rise of 16 percent in Germany, 22 percent in Finland, 32 percent in UK (see chart).

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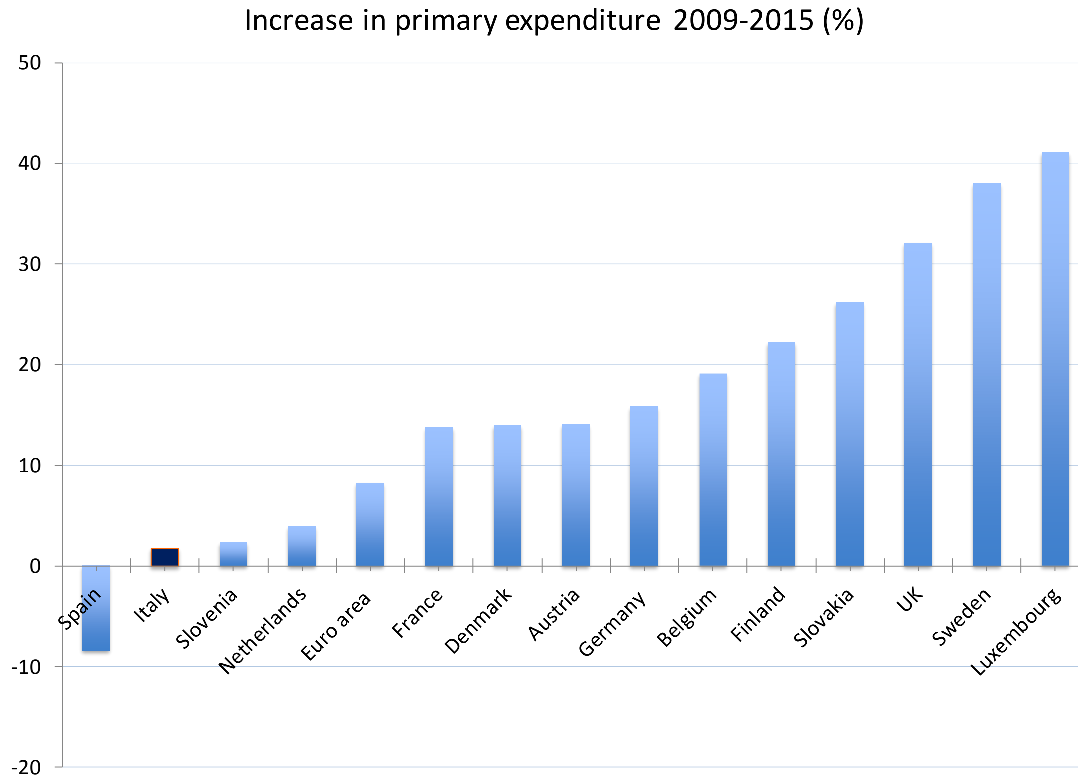
[6] As indicated in Table 1 of the staff report the growth rate of potential GDP in 2016 is just 0.1 percent, according to staff. With a projected GDP growth rate of 1.1 percent, the output gap is projected to decline sharply, with a large negative impact on the computed structural deficit, which deteriorates significantly. The same reasoning explains also the weakening of the structural deficit in 2015, in spite of the 0.4 percentage point improvement in the headline deficit.



Reform of the judicial sector: some positive outcomes

Regarding the efficiency of the judiciary, there are already positive outcomes from past reforms (legislated and implemented). Here are some figures which could have been usefully included in the report:

- The number of judicial offices has been rationalized: from a total of 1,398 the network is now composed of about 650 offices, and 750 units have been closed.
- The backlog of civil trials has been reduced from 6 to 4.5 million since 2009. The time needed to complete a trial has been on a decreasing trend.
- Breakthrough measures were undertaken, including the *processo telematico*, which are powerful and effective. The time to issue telematic cease-and-desist orders hovers now from 23 to 31 days, depending on the town, down from a range of 42-50 days compared to a year before.
- 22 specialized firms' tribunals at regional level have been established, 11 of which are competent for foreign firms; 80 percent of the trials at the firms' courts has been settled within a year time in the 2012-2014 period.

Of course much remains to be done, but the improvement is encouraging.

Other fiscal reforms

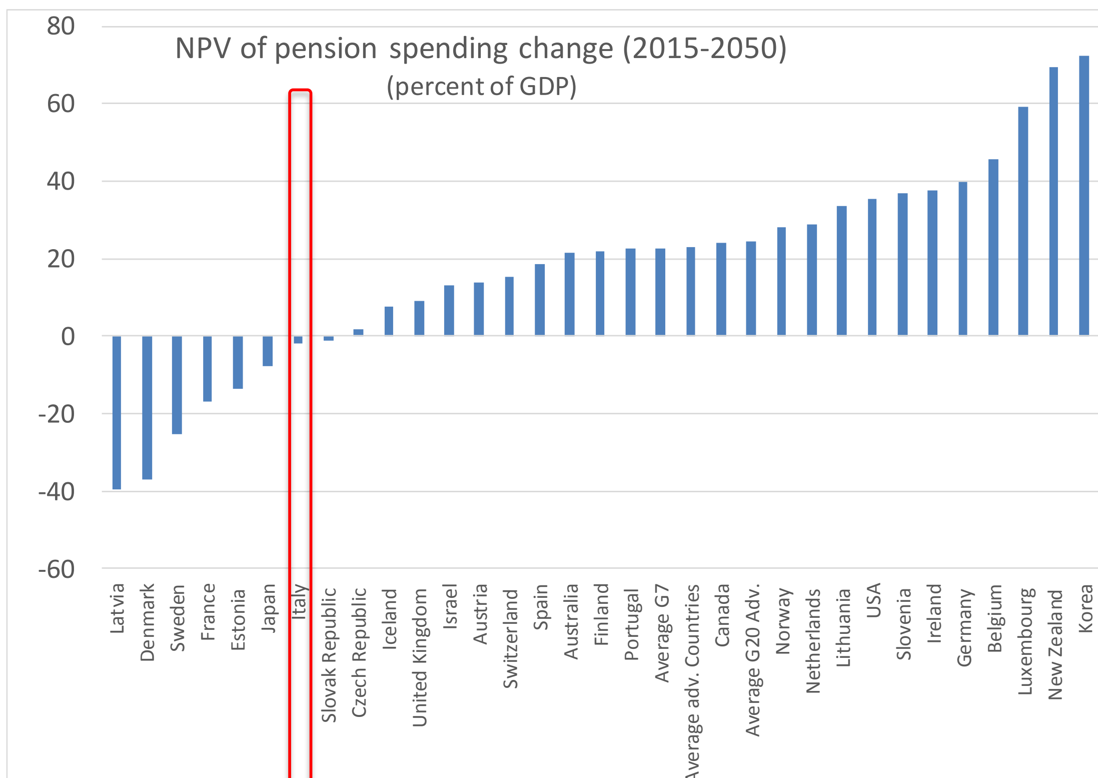
The staff report appropriately points at the ongoing public administration reform as a pillar of my authorities' program (paragraph 25). The legislative path of the reform will

be completed before the summer break. However, some important aspects of the public administration have been reformed over the last few years: an important outcome that could have been usefully highlighted in the staff report has been the dramatic reduction in payment time by the public administration. According to Bank of Italy estimates, in 2015 there has been a further reduction in payment time to 115 days for the whole public sector (against almost 200 days in 2010).

In paragraph 20, on the provision on local public services, a decree for a rationalization and reduction in the number of publicly-owned enterprises has just been approved. The decree spells out the sectors in which such companies may operate and sets minimum size and performance standards, below which existing ones must be closed down. The same decree sets criteria for a rationalization and reduction in the number of publicly owned enterprises.

Regarding paragraph 23 on privatization, Eni, Enel and Finmeccanica are listed companies subject to market discipline and regulation. Poste Italiane is on the process of being privatized. The other three companies operate in very different sectors and it is not clear what kind of "rationalization" they should be subject to.

Finally, regarding long-term sustainability of public finances, Italy is in a much better shape than most advanced countries as the Fiscal Monitor indicates, reflecting pension reforms that have been very comprehensive and fully implemented (see chart).



3. Financial sector

The Italian banking system has weathered the impact of the 2008-09 global financial crisis better than others. However, the deep and prolonged recession that affected the euro area in 2011-12 has taken a significant toll on the sector, which is now facing important challenges. Notwithstanding a very difficult economic juncture, important efforts have been pursued in recent years to enhance the resilience of the system. Capital has been raised on the market (i.e. with no recourse to public interventions): CET1 was at 12.3 percent at end-2015, higher by around 0.4 percentage points than at end-2014, and further strengthening is being pursued in 2016, thereby also complying with the ECB request following the supervisory review and evaluation process of end-2015. The leverage ratio – calculated as the ratio of tier 1 capital to total non-risk-weighted assets – is higher than the European average. Many major reforms – as described by the staff report and the SIP – have been adopted in a coordinated effort by all involved authorities and are already in force. They aim at fostering consolidation, enhancing governance, supporting profitability. Work remains to be done to continue addressing remaining vulnerabilities. The priorities are clear; the authorities' determination is firm. At the same time, in the context of a still fragile – though essential – economic recovery, it is critical to keep in mind that there is no easy and simple fix to complex problems.

Altogether, we cannot run the risk that supposedly swift solutions may actually undermine, rather than strengthen, financial stability. A difficult balance has to be struck. In what follows, I would like to provide some additional information and to clarify the Italian authorities' take on some of the issues raised in the report.

Non-Performing Loans

The large volume of non-performing loans (NPLs) – as recalled also by staff – is mostly the result of the profound recession. The following numbers, here reported for the convenience of the reader to complement the staff report, can help to put the issue in the right context (see table).

Table. Non-Performing Loans

(billions of euro at end-2015)

		Total NPLs	*Of which*: bad debt
Gross stock (A)		360	210
Provisions already booked (B)		163	123
Net stock (A)-(B)		197	87
Memo:	*- Real estate collateral*		*85*
	-Other collateral		*37*

The table shows that provisioning and collateral represent a strong protection against losses on NPLs. At end-2015 the stock of gross NPLs amounted to around € 360bn (18.1 percent of total loans; this is the figure reported in the staff report). A large portion of that stock refers to situations where the borrowers' difficulty has not led to an insolvency. The

remaining portion relates to loans in an actual state of insolvency (so called ‘bad loans’), amounting to € 210bn. Net of value adjustments that banks have already made (provisions), the stock of these bad loans decreases to € 87bn (4.8 percent of total loans). While considerable, such a burden has to be evaluated against the backdrop of a sizeable amount of both real estate collateral and personal guarantees (€ 85bn and 37bn, respectively).[7]

It is worth considering, more closely than was perhaps possible in the concise staff report, the measures introduced by the reforms implemented in 2015 and 2016 to increase the speed and efficiency of insolvency procedures and property foreclosures.

Among others, the new out-of-court mechanism (so called “patto Marciano”) – which can be agreed upon between firms and financial institutions for corporate loans secured by real estate collateral – allows the transfer of the property of the collateral to the lender if the debtor defaults (provided that real estate collateral is not the debtor’s residence). The “patto Marciano” can be agreed for the new loans contracts and can be included in existing loan contracts through renegotiation (where bankruptcy procedure is not already in place). The repossession of the collateral by the lender could take only few months (6-8 months) instead of more than three years (already reduced from four years by the 2015 reform) as previously estimated. This should reduce the duration of the recovery procedure accordingly.

Regarding the stock of existing bad loans, the measures adopted could also apply to younger bad loans (i.e. those recorded in the books for less than two years, for which it can be assumed that the foreclosure proceedings have not been started or are at an early stage). Even if the impact of the reform is difficult to quantify (as it depends on different factors: a) the incentives to renegotiate; b) the share of corporate bad loans potentially affected by the application of the “patto Marciano”; c) the percentage of these loans that will actually be renegotiated) assuming that renegotiations take place for around half of the potentially outstanding contracts, the bid-ask gap (between the value at which these assets are booked in banks’ balance sheets and the price potential investors would offer to buy them) would decrease by about 15 per cent.

Against this backdrop, while NPLs-related concerns are justified – and taken very seriously by the authorities – they should not be overestimated. Moreover, the economic recovery is helping: in Q1 of 2016 the flow of new NPLs decreased to 2.9 percent of total loans (as against 3.7 in 2015 and 4.8 in 2014), the lowest level since the second quarter of 2008. In parallel, the stock of NPLs has declined as a ratio of total loans both in Q4 of 2015 and in Q1 of 2016. Therefore, a turning point has now been reached.

This improvement also reflects the measures implemented by the Italian authorities on several fronts to tackle the issue of NPLs. The disposal of bad debts could be further facilitated by the state guarantee scheme for securitized bad debts (Gacs), which will help to raise the sale price by making the senior tranches of securitizations more attractive for investors. The growth of the market in non-performing assets will also receive a boost from the investments of Atlante, a private fund that can concentrate on the riskiest securitization tranches. Even with relatively modest resources for the moment, Atlante

[7] Bank of Italy, *Financial Stability Report*, no. 1 2016.

can demonstrate that buying bad debts at higher prices than those now offered by specialized investors can in fact produce attractive returns. All conditions are now in place for the fund to meet this challenge; the more it succeeds, the more it will become possible to raise fresh resources, creating a virtuous circle.

These measures are mutually consistent and complement each other. Their number and breadth speak to the authorities' determination, clear strategic vision, and right set of priorities. The authorities maintain high vigilance and stand ready to adopt further measures, as needed.

At the same time, they stress that – given the constraints posed by the present circumstances – the reduction of NPLs can only be gradual. While they fully concur that a high stock of NPLs is the source of significant negative effects, they caution against conveying the misleading impression – as at times the staff report and SIP do – that a swift solution would be readily available without running the risk of aggravating, rather than solving, the problem. For example, in the absence of a liquid market for NPLs, forcing fast and generalized sales of non-performing exposures would lead to a sale price much lower than the book value, thereby causing immediate and sizeable losses on banks' balance sheets. In turn, this would be conducive to a renewed credit squeeze, with adverse feedbacks on the modest/fragile recovery and on nominal growth.

Similarly, an excessive acceleration in write-offs would be a drag on the (already squeezed) profitability, with implications for the ability of banks to access both debt and equity capital markets and, hence, on their capacity of supporting the economic recovery.

Finally, the high stock of NPLs is not preventing the Italian credit market from performing its functions in this economic juncture. The evidence points to an improvement in credit market conditions and, specifically, to a reduction of financial frictions on the supply side of the market in line with the other euro area economies. Loans to households have been growing. For nonfinancial firms the contraction of credit has almost fully receded and bank loans have expanded in sectors with positive economic performance, for example manufacturing. Problems in terms of credit availability are limited to microenterprises, or to sectors where the economic climate is less favorable, e.g. construction and real estate services.

Profitability and banking structure

Like other European banking systems, also the Italian one is suffering from weak profitability. The average cost-to-income ratio for Italian banks is only slightly above the EU average (in line with the UK, and below the values for Germany and France). However, efficiency gains, cost containments, diversification of income sources, adjustments to the business models are all of the essence and are being pursued.

Improvements in bank profitability are emerging, also thanks to the cyclical recovery: in 2015 Italian banks' ROE was 3.1 percent (up from -0.3 percent in 2014). To better evaluate this result, it should be taken into account that the outcome was curtailed by the 4.8 percent increase in operating expenses due to the extraordinary contributions paid by banks into the National Resolution Fund in December (€ 2.3bn) for the resolution of four banks.

Staff argues in favor of much needed consolidation in the Italian banking system, highlighting the presence of around 640 banks. My authorities agree on the need to pursue this objective. The recent major reforms of the cooperative and mutual banks go in this direction. Going forward, further adjustment might take place, in the number of both banks and their branches, leveraging also on a greater use of technology and digitization.

However, some more information about context and dynamics can be useful to assess the situation. In particular, while at 640, the number of banks is on a declining trend (they were almost 800 at end 2008). The same holds true for the number of branches, which last year declined to around 30,000 or 11 percent less than in 2008. The latest ECB banking structure report shows that the ratio of branches to population in Italy is close to the European average (higher than in Germany, but lower than in France and Spain).

Resolution framework

Several parts of the report refer to the need for an effective framework for the prompt resolution of failing banks and highlight the relevant damages potentially borne by a delayed or reactive resolution, both for individual banks and the system as a whole (e.g. pages 22, 24, 27, 33). These statements might suggest that the European resolution framework has not been fully implemented in Italy and that the authorities are reluctant to implement it. The reality is that the Italian legal framework is fully compliant with the BRRD and fully operational. As to implementation, the Governor of the Bank of Italy has recently reiterated the need to promptly address problematic situations in order to prevent irreversible deterioration in a banks' balance sheet from persisting too long and worsening the effects of its collapse. Adjustments may be suggested to make the crisis resolution procedures more effective and less likely to generate instability, not to prolong irreparable situations but to resolve them in an orderly manner.[8]

Moreover, responsibility for resolution matters for significant banks are within the remit of the Single Resolution Board, that takes resolution decisions upon the ascertainment of the failure/likely failure situation by ECB, thus leaving very small room for discretion for national Authorities.

My authorities' full commitment in applying the resolution framework (as shown in the resolution of the four banks) does not prevent us from highlighting the weaknesses of the framework. We have not been alone in advocating them. The need to assess the degree of flexibility of the BRRD during the review of the directive scheduled to take place by June 2018 was recalled, among others, by the IMF itself in its last GFSR. Indeed, the GFSR highlighted the necessity of applying the new rules (including those on state aid) with flexibility and caution during the changeover to the new regime, when public intervention is no longer admissible but the banks have not yet put in place sufficient buffers to absorb losses without undesired effects on systemic stability.

[8] The Governor's Concluding Remarks, *Bank of Italy Annual Report 2015*, page 24.

4. Additional information on OECD and World Bank Competitiveness Indicators

In Box 1 of the report staff notes that while Italy is the sixth least regulated economy among the 31 OECD economies according to the OECD product market regulation (PMR) indicator, the World Bank Doing Business Indicators based on a de facto rather than the jure measure would paint a different picture, with Italy at 29th place in 2015. The OECD ranking is routinely used by staff (see for example UK 2016 Art. IV papers). Instead, once more, we reiterate our concerns on using the Doing Business Indicators. In last year's Buff we noted that those "indicators refer to central Italy, whose efficiency is not representative of the national average weighted by regional GDP". In this respect, it is indeed frustrating that the staff report highlights again one particular indicator that is particularly misleading, the one that would imply that it takes 124 days to get an electricity connection in Italy. To raise doubts on the soundness of this indicator last year in my buff I noted that the figure was not that different from the one available for Los Angeles (now 134 days), Canada (now 137), Netherlands (now 110) or Japan (now 97).

According to the OECD indicators, the overall Italy competition framework in product and service markets is in line with the OECD average. In network services as a whole (which include transport, energy and communications) between 2008 and 2013 Italy improved its ranking in these areas by 4 positions respectively, rising to an intermediate position among the OECD countries considered. Italy is among the best performers as regard the regulation of energy sectors (Electricity and Gas), as also acknowledged in Box 1. In professional services between 2008 and 2013 Italy improved its ranking by 12 positions.

5. Conclusions

Altogether, we thank staff for all the work done during the course of this Article IV consultation and hope the above information will be regarded by the Board as useful in understanding better the changing situation of the Italian economy and the ongoing reform implementation process.