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Italy: 2002 Article IV Consultation—Staff Report; Staff Supplement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Italy

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

- the staff report for the 2002 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **June 11, 2002,** 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 September 27, 2002.** The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- a staff supplement of **October 18, 2002** updating information on recent developments.
- a Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its October 21, 2002 discussion** of the staff report that concluded the Article IV consultation.
- a statement by the Executive Director for Italy.

The documents listed below have been or will be separately released.
- Selected Issues Paper
- Report on the Observance of Standards and Codes

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

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

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ITALY

Staff Report for the 2002 Article IV Consultation

Prepared by the Staff Representatives for the 2002 Consultation with Italy

Approved by Michael Deppler and Michael Hadjimichael

September 27, 2002

- The Article IV discussions were held during May 28–June 11, 2002. The staff—Messrs. Cottarelli (head), Krueger, Kent, Milesi-Ferretti, Vamvakidis (all EU1), and Mr. Keen (FAD)—met with the Ministers of Economy and Finance, Health, Productive Activities; the Governor of the Bank of Italy; and other officials and representatives of regulatory agencies, financial markets, research institutions, and labor and business organizations. Mr. Padoan, Executive Director, participated in the meetings.

- Italy has accepted the obligations of Article VIII, Sections 2, 3, and 4, and maintains an exchange system free of restrictions, apart from those related to UN resolutions (Appendix I).

- For Directors' considerations at the conclusion of the latest Article IV consultation on November 5, 2001, see http://www.imf.org/external/np/sec/pn/2001/pn01121.htm.

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I. KEY ISSUES

1. **Italy faces two key economic challenges**:

- *Fiscal consolidation*: Italy's public debt ratio, at 110 percent of GDP, is the highest in the EU, the deficit remains well above the Stability and Growth Pact's (SGP) medium-term requirements, and aging-related spending (pensions and health care) will rise substantially over time.

- *Raising employment*: though rising since the late 1990s, Italy's employment rate remains the lowest among OECD countries—a critical factor behind Italy's relatively low per capita income.

2. **The government in power since June 2001 has formulated an ambitious program to address these challenges**. The program focused on labor market reform and a retrenchment of the economic role of the state, including through further fiscal consolidation, tax cuts, and privatization—areas that have been at the center of previous Fund advice (Box 1). **But progress on this difficult agenda has so far been limited, especially on fiscal consolidation and public expenditure reform**.

II. REPORT ON THE DISCUSSIONS

A. Short-Term Outlook

3. **As elsewhere in the EU, the economic slowdown of 2001 has been followed by only a modest rekindling of growth**:

Box 1. Policy Recommendations and Implementation

Since Italy's entry into the euro area, the Fund's advice has focused on reducing the high public debt ratio through cutting primary expenditure (in relation to GDP); reforming the pension system, in anticipation of the impending demographic shock; reducing the tax burden, as well as structural rigidities in labor and product markets, so as to boost employment and growth.

Over this period, the pace of fiscal consolidation and of structural reform has fallen short of Fund advice, but good progress has been made on a number of fronts. Although the debt ratio has declined somewhat, fiscal consolidation has stalled, with primary spending rising (as a share of potential GDP) and the cyclically-adjusted fiscal deficit (net of asset sales) remaining above its level in 1999. After major reform steps earlier in the 1990s, no significant further savings were secured with respect to aging-related expenditures; and public sector employment reductions have also proven elusive. Limited progress was made in lowering some marginal tax rates in recent years, including on capital income.

More significant progress has been made on structural reforms in the labor and product markets, but Directors have noted ample scope for further steps. In the labor market, some important rigidities have been removed—especially through a relaxation of constraints on temporary and part-time jobs; but regional wage differentiation has not been secured, despite very large regional unemployment disparities. Significant progress has been made on privatization (notwithstanding a pause in 2001) and in the liberalization of some product markets. In the financial sector, in 2001 the Fund supported the authorities' call to reverse the trend decline in banks' capital ratios—and a turnaround appears to have started in late 2001.

Selected Economic Indicators, 2001-03
(Real growth rates, in percent, unless otherwise noted)

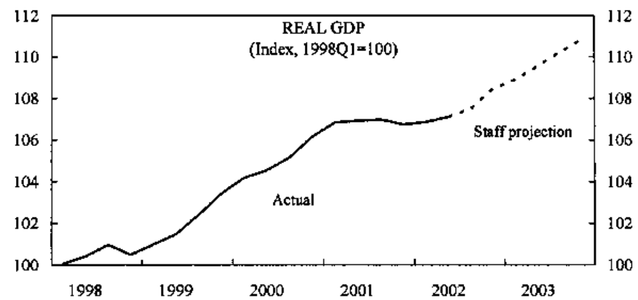
	Italy	Euro area	Italy	Euro area	Italy	Euro area
	2001		2002		2003	
GDP						
Annual average	1.8	1.6	0.6	1.0	2.3	2.3
Fourth quarter (y-o-y)	0.6	0.4	1.6	1.9	2.2	2.3
Output gap 1/	-1.0	-0.4	-2.4	-1.7	-2.1	-1.8
Total domestic demand	1.6	1.0	0.9	0.7	2.1	2.5
Employment	2.1	1.6	1.2	0.5	0.7	0.8
CPI (percentage change)	2.7	2.7	2.4	2.2	1.8	1.7

Sources: ISTAT; and Fund staff estimates and projections.

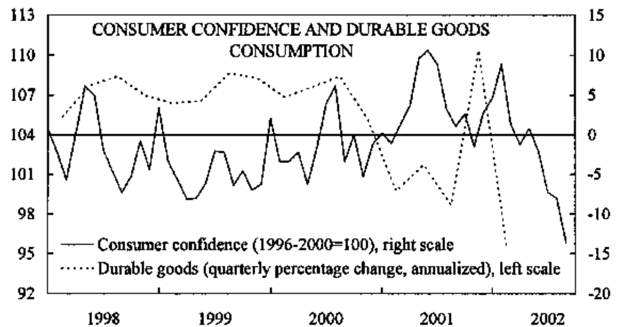
1/ In percent of potential GDP.

- After a decade of growth below the euro-area average, Italy's growth slowed in 2001 along with the euro area, with GDP rising by 1¾ percent (Figure 1; and Table 1). As weaker external demand spilled into domestic activity, the economy stagnated during the last three quarters of 2001, notwithstanding a fiscal relaxation (Table 2). Slowing exports reflected foremost weak world demand; price and cost competitiveness remained broadly stable in the two years prior to the euro's recent appreciation, with the external current account in broad balance (Figures 2–3).

- GDP growth turned marginally positive in the first half of 2002 (0.7 percent, annualized)—although final domestic demand (notably for consumer durables and investment) remained weak, as did industrial production, notwithstanding a rebound in business confidence from its 2001 trough.

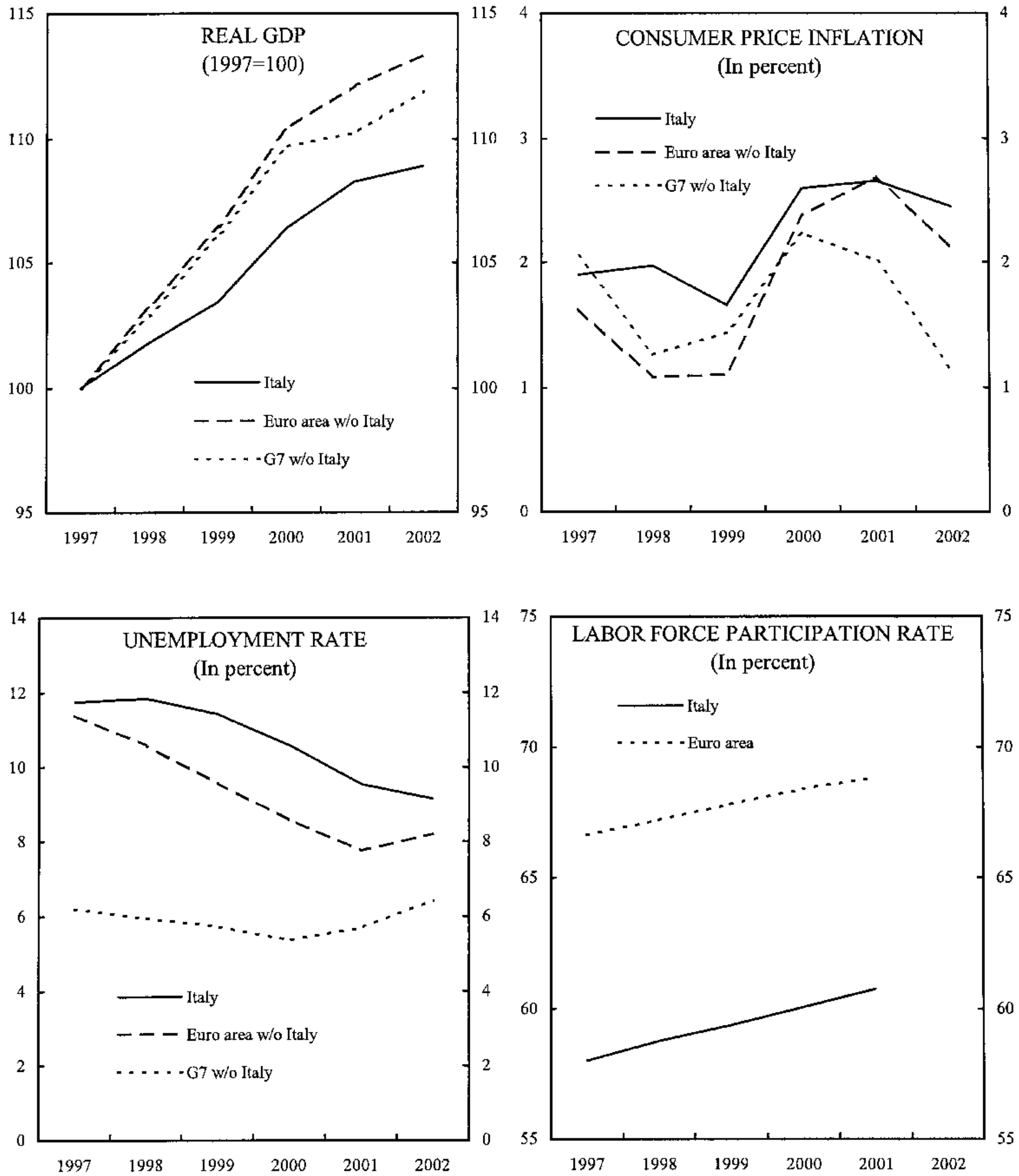


4. **The authorities conceded that the marked growth acceleration envisaged in the 2002 budget was no longer feasible—and they and staff expect now an only moderate rebound in 2002/03.** In mid-September, the government revised further downward its growth projections and, at ½ percent for 2002 and 2¼ percent for 2003, these are now in line with staff's (and similar to the latest Consensus Forecasts).[1] They reflect the persistent weakness in leading indicators of economic activity (including electricity



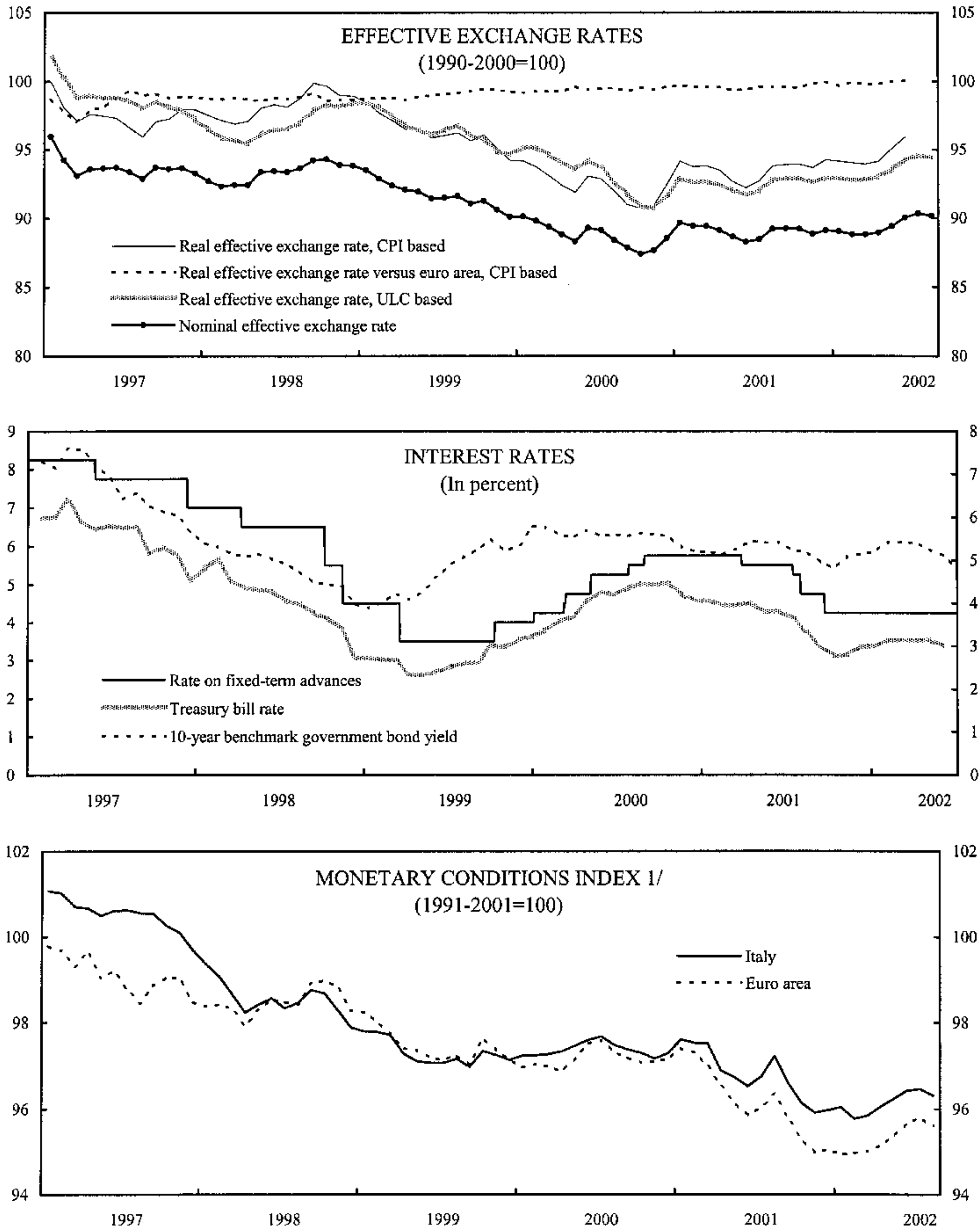
[1] The authorities' new medium-term program (*Documento di Programmazione Economico-Finanziaria*, DPEF)—presented after the mission in July—had already lowered the projected 2002 GDP growth rate to 1¼ percent (1 percentage point below the 2002 budget projection), while leaving broadly unchanged, at about 3 percent, the 2003 GDP growth projection (Table 3).

Figure 1. Italy: International Comparisons of Macroeconomic Performance, 1997-2002



Source: IMF, *World Economic Outlook* (October 2002, forthcoming); OECD *Labor Market Statistics*; and Fund staff estimates for 2002.

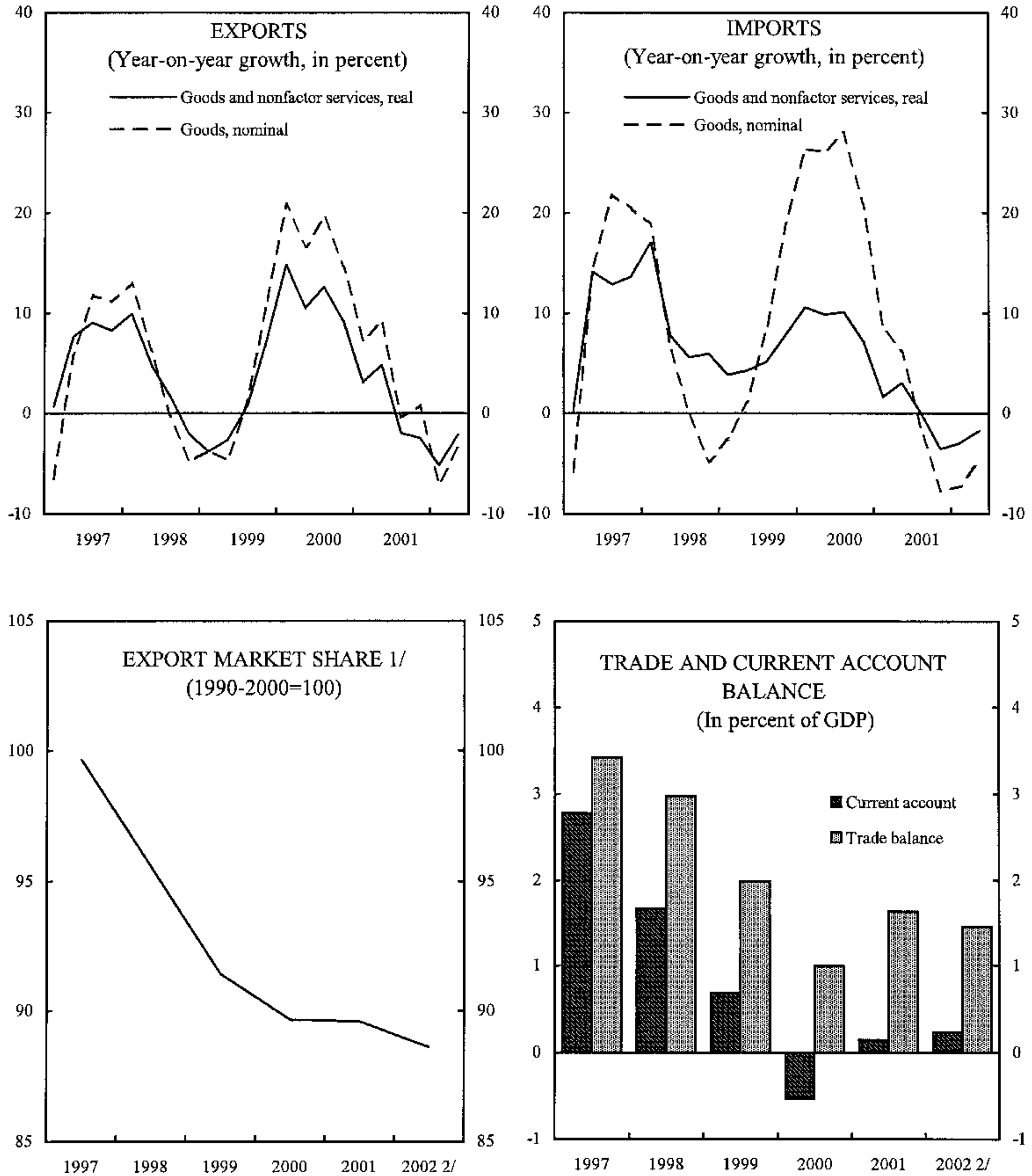
Figure 2. Italy: Effective Exchange Rates, Selected Interest Rates, and Monetary Conditions Index, 1997:1-2002:8



Sources: IMF, *International Financial Statistics*; Bank of Italy; Bloomberg; and Fund staff calculations.

1/ The index is defined as a weighted average of the real short-term interest rate and the real effective exchange rate, using WEO weights.

Figure 3. Italy: External Performance, 1997-2002

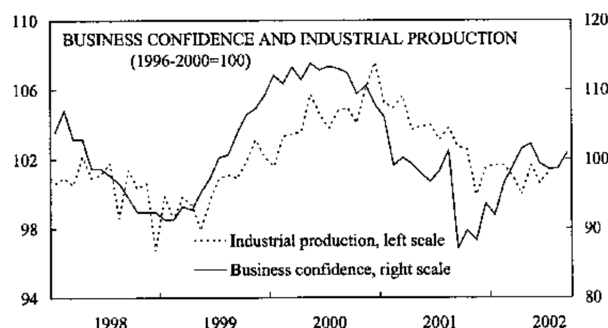


Sources: Bank of Italy; ISTAT; and IMF, *World Economic Outlook*.

1/ As measured by real growth of exports of goods and nonfactor services less growth of import demand in partner countries.

2/ Fund staff estimates for 2002.

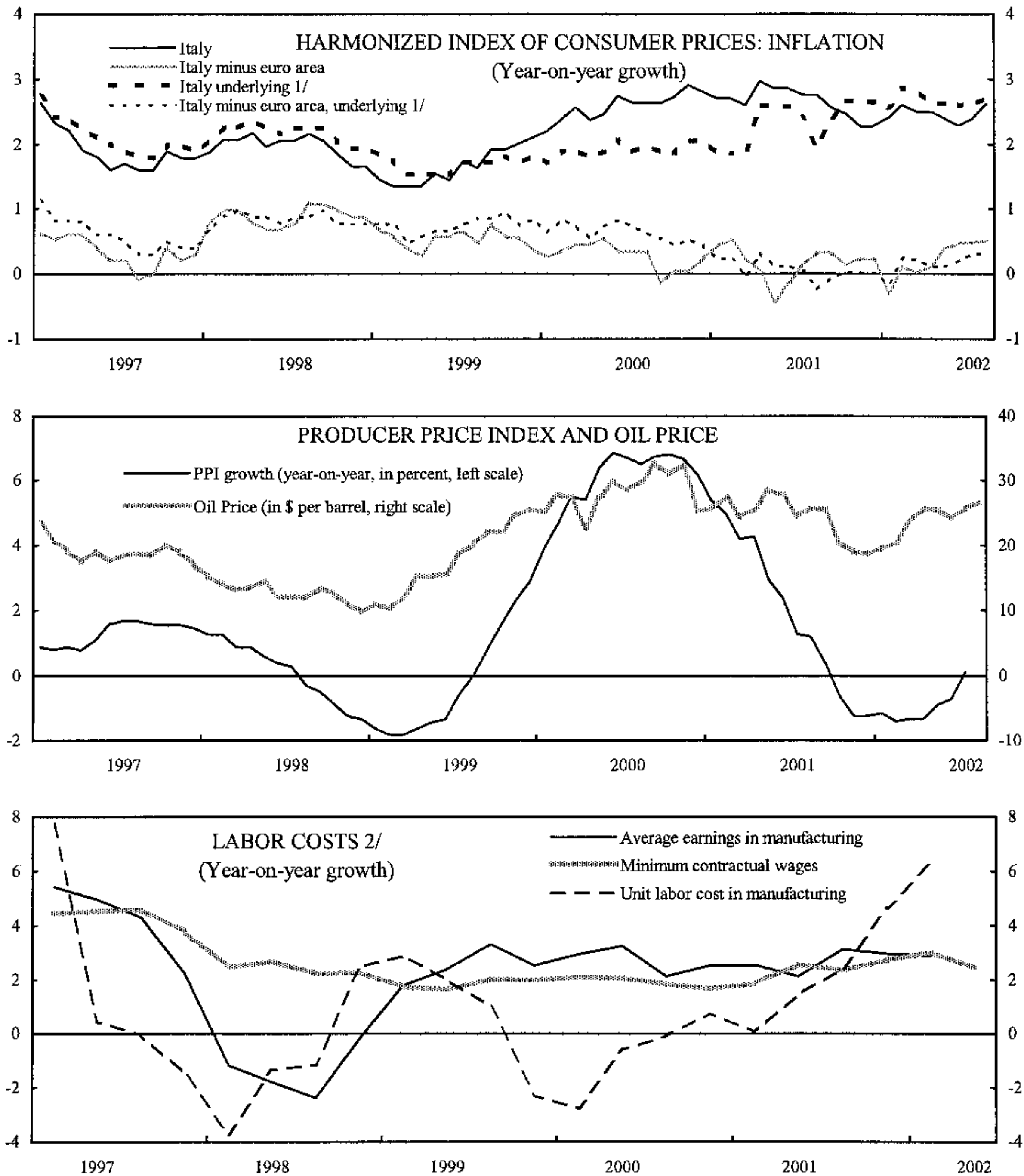
consumption) over the summer, and additional declines in consumer confidence. Moreover, export markets did not recover as earlier envisaged, and equity prices have fallen some 27 percent from end-2001 to late September 2002 (following a 25 percent drop during 2001), adding to sizable emerging market losses (retail losses on Argentinean bonds alone were about 1 percent of GDP).



5. **While some rebound of economic growth remains the most likely scenario, the outlook is subject to sizable downside risks.** Staff agreed that several factors were likely to underpin stronger growth in the period ahead, including supportive monetary conditions and tax incentives for investment (set to expire at end-2002). At the same time, downside risks have intensified, concerning the robustness of the projected recovery in external activity, including in other major European countries; additional spillovers from international equity markets—though the demand impact should be less than in most industrial countries, given Italy's lower market capitalization; and the euro's potential to appreciate further. As to domestic risks, the investment response to temporary tax incentives in 2002 remains especially uncertain, also in light of weakening business sentiment over the summer. The authorities noted also upside risks, relating to the supply impact of fiscal reform, and to prospects for employment and monetary policy. While employment growth decelerated to less than ½ percent in the third quarter of 2002 (quarter-on-quarter, annualized), the authorities saw their labor market reforms as possibly supporting faster employment growth than staff. Moreover, a euro appreciation would reduce inflationary pressures and could delay monetary tightening.

6. **Inflation is still somewhat above the EU average** (Figure 4). With steady, albeit moderate, wage growth, and cyclically declining productivity, unit labor costs have accelerated, contributing to underlying inflation above 2½ percent since late 2001. Key labor market contracts are expiring in the fall, and the authorities agreed that continued wage moderation was critical to lower inflation and sustain employment growth. After the mission, the authorities indicated that "programmed inflation" (the inflation rate used as a reference for wage discussions in both the private and public sectors) would be 1½ percent in 2003. While this target is somewhat below the staff's projections on current policies (1¾ percent), its achievement would be facilitated not only by wage moderation but also by increased competition in sheltered sectors (Section D). However, to help contain inflation, in late August the authorities froze electricity, gas, water, and postal services tariffs for three months.

Figure 4. Italy: Indicators of Inflation, 1997:1-2002:08
(In percent)



Sources: Bank of Italy; ISTAT; and EUROSTAT.

1/ Excluding energy, and seasonal food.
2/ Data for 1998, which suggest a decline of 1.5 percent in unit labor costs, reflect the removal of various contributions in the context of the introduction of IRAP. If the portion of IRAP revenues attributable to labor is added to wages, labor costs effectively borne by firms increased 2.3 percent in 1998.

B. Fiscal Challenges

7. **Discussions on fiscal issues focused on three aspects**: (i) the appropriate medium-term fiscal balances and the speed of fiscal adjustment; (ii) tax and expenditure reform; and (iii) fiscal transparency. The need to proceed with fiscal consolidation was not in dispute—but staff regretted the lack of progress so far, including in 2002, and called for more ambitious medium-term targets, absent further aging-related spending reform. Within the context of their overall strategy, the authorities stressed the pivotal role of tax reductions, starting in 2003—an area where staff cautioned against moving ahead before durable expenditure reductions had been secured.

Fiscal policy: medium-term targets

8. **The authorities considered broad budget balance an appropriate medium-term objective, gradually reducing the high public debt**. They concurred that fiscal consolidation was far from complete: the public debt ratio exceeded those in other EU countries, and pension expenditures (in relation to GDP) were among the highest in the OECD, even ahead of the most adverse impact of population aging. In the authorities view, these constraints were adequately addressed by achieving medium-term budget balance (and some entitlement reforms were also under consideration; see below). They noted that the public debt-to-GDP ratio would gradually decline under their program, reaching 94 percent by 2006 (from almost 110 percent at present), with considerable further declines in subsequent years.

9. **Staff argued, however, for more ambitious medium-term balance targets—absent further substantial reforms of aging-related spending—reflecting a stronger weighing of concerns related to Italy's high public debt and pending demographic shock**. Underlying these concerns was the view that government debt should act as an intertemporal buffer, rising in relatively "bad" times but falling in "good" times (or, in the case of a high-debt country, falling faster in good times than in bad times). This principle argued against entering the "bad" period of rapid population aging with the debt ratio still very high by international comparisons. Maintaining a balanced budget after 2004 would, in the staff's view, not be sufficient to meet these requirements: the public debt ratio would still be above 75 percent early in the next decade (assuming potential growth of 2 percent, and privatization receipts of some 5 percent of GDP over the next five years, the ambitious government target).[2] This is when the most adverse fiscal impact of population aging would set in: notwithstanding earlier reforms—which would limit pension spending increases to

[2] Somewhat higher growth would not make a major difference *under the balanced budget assumption* (for example, the debt ratio would still be 70 percent at the end of decade for a growth rate of 3 percent). This assessment could change, however, if growth-related revenue gains were applied to strengthening the fiscal budget balance (while keeping nominal expenditure growth unchanged).

below those expected for most industrial countries—staff projected aging-related outlays to increase by some 3½ percentage points of GDP during 2011–30.[3] The discussions also covered concerns related to the Stability and Growth Pact's (SGP) requirement that the debt ratio had to fall at a sufficient pace if it exceeded 60 percent. Under the authorities' public debt and deficit scenario, the obligation to continue to lower the debt ratio could force a substantial rise in taxation from an already high level, once the aging-related spending pressures set in.

10. **Against this background, discussions focused on possible strategies to address the demographic shock: securing sizable fiscal surpluses, or further reforming aging-related spending.** Staff noted that relying entirely on large surpluses would require a major fiscal effort: budget surpluses would have to average about 1½ percent of GDP during this decade, to bring the debt ratio to below 60 percent (for further details on alternative scenarios, see last year's *Country Report* No. 01/207; the Annex covers standard public debt sustainability issues). Achieving such surpluses would be a daunting task, particularly if, at the same time, the government's ambitious tax-reduction agenda was to be implemented. The need for large surpluses could be alleviated, however, by substantial further progress on entitlement reform. The room in this area remained considerable, as illustrated by Italy's low effective retirement age and its high replacement rate. In any case, in the staff's view, it was important not to procrastinate and to aim at sizable medium-term surpluses until further aging-related spending reforms had been secured. The authorities concurred that containing aging-related spending was of importance: indeed, it would be difficult to raise sizable surpluses without containing these expenditures. They thought, however, that the need for sizable surpluses could be reevaluated at a later stage, focusing first on balancing the budget over the medium term. They also counted on some entitlement reforms, introducing moderate—and in the staff's view insufficiently ambitious—incentives to encourage people to retire later.[4]

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[3] Based on Eurostat's demographic projections (including a more than doubling of the old-age dependency ratio over the next four decades) and productivity growth of 1¼ percent per annum. The authorities' central projection is based on productivity growth of 1¾ percent—resulting in a smaller increase in aging-related spending (2½ percentage points of GDP).

[4] Proposals before parliament allow greater flexibility for choosing the retirement age and expand private pension accounts, using the present severance payment system to build a second, fully funded and private pension pillar. Most observers have noted that these steps would not result in significant savings, as the planned incentives for raising the retirement age were insufficient to significantly impact workers' retirement decisions.

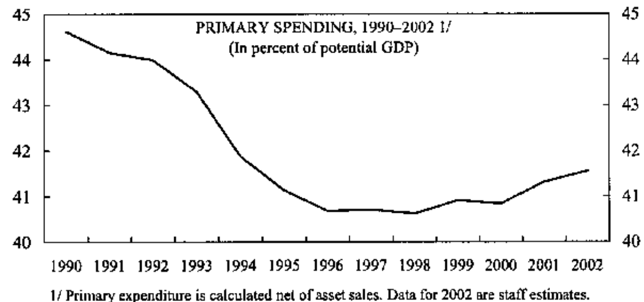
Fiscal targets: recent developments and the speed of fiscal adjustment

11. **Progress toward medium-term budget balance has so far proved elusive.** In 2001, the SGP-relevant deficit widened to 2¼ percent of GDP, well above target (see text table), reflecting not only weaker-than-anticipated growth, but also overly optimistic revenue projections by the previous government and insufficient progress in containing spending (including on health care and wages). Developments in 2002 are clouded by lack of direct data on the SGP-deficit. But various indicators, including the sizable government borrowing requirement (*fabbisogno*), suggest that the deficit will be around 2 percent of GDP—a view broadly shared by the authorities in revised estimates presented in mid-September. The substantial overruns vis-à-vis the original target of ½ percent of GDP (and the 1.1 percent in the July *DPEF*) reflect revenue shortfalls (only partly due to cyclical developments) and some primary expenditure overruns. Moreover, the deficit estimate for 2002 includes sizable—and still unrealized—one-off revenues from asset sales (¾ percent of GDP).[5] The cyclically-adjusted deficit net of asset sales would be around 1¾ percent of GDP—essentially unchanged from 2001, and well above the level at the outset of monetary union in 1999. This lack of progress reflects difficulties in containing primary spending—which indeed has risen in relation to GDP (see text figure)—and risks interrupting in 2002 the trend decline in the public debt-to-GDP ratio (Table 1).[6]

General Government Balance: Outcomes and Staff Projections, 1999–02
(In percent of GDP)

	1999	2000	2001	2002
Overall balance	-1.8	-0.5	-2.2	-2.0
Original target (respective budgets)	-1.9	-0.3	-0.8	-0.5
Overall balance (cyclically adjusted) 1/	-0.8	-0.1	-1.7	-1.0
Overall balance (cyclically adjusted) net of asset sales 1/	-0.9	-1.3	-1.8	-1.7

1/ In percent of potential GDP.



1/ Primary expenditure is calculated net of asset sales. Data for 2002 are staff estimates.

12. **At the time of the mission, the authorities planned to balance the budget in 2003—a view supported by staff.** This implied a cyclically-adjusted deficit net of asset sales

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[5] These are expected to consist primarily of sales of real estate assets. The 2002 revenues also include minor one-off revenues from tax amnesties (0.1 percent of GDP; see below). In the euro area, the SGP has been accompanied by a proliferation of operations involving one-off savings and "decentralization" of spending (a forthcoming staff study will review related issues in a cross-country context).

[6] The debt ratio may not decline in 2002 also because of a number of items that have kept the gross borrowing requirement well above the deficit, including payment by the state of suppliers' credits to local governments and hospitals, as well as tax refunds.

of ¼ percent of GDP (given the staff's GDP projections). The required effort with respect to 2001 was sizable—a cumulative 1½ percentage points of GDP over 2002–03. But this effort was seen as consistent with cyclical considerations, given the expected pick up in output. And, after the lack of progress during the past few years in approaching the medium-term targets, further delays in fiscal consolidation were seen as inappropriate. Moreover, a stronger fiscal effort early in the legislature was justified by political economy considerations. Staff also argued that the adjustment should have started already in the second half of 2002, limiting the slippage from this year's target and avoiding an abrupt squeeze next year.

13. **Following the mission, however, the authorities opted for a slower pace of fiscal consolidation**. The July DPEF revised the 2003 deficit target to ¾ percent of GDP, against the original balanced budget objective (see Table 3). In discussions following the publication of these new targets, the authorities explained that the revision reflected the more uncertain cyclical outlook: balancing the 2003 budget could have jeopardized the recovery. Indeed, with the further downward revision of growth made in mid-September, the authorities' 2003 deficit target may be further revised (a supplement to this report will provide information on the 2003 budget, to be finalized by end-September). Staff conceded that balancing the budget in 2003 was no longer appropriate—in view of the large fiscal slippage expected for 2002, which had not been reined-in as argued at the time of the mission, and of weaker growth. With no progress on fiscal consolidation now likely in 2002, this argued for shifting the structural adjustment of 1½ percentage point of GDP, previously envisaged for 2002–03, to 2003–04. Equally spacing the improvement called for reducing the cyclically-adjusted deficit by ¾ percent of GDP in 2003. Measures in the 2003 budget would not only have to cover the structural improvement in the deficit, but also a planed reduction of the tax pressure, targeted in the DPEF at ½ percent of GDP with respect to 2002.

Financing tax cuts while proceeding with fiscal consolidation

14. **Reducing the tax burden, while proceeding with fiscal consolidation, is a central element of the government's reform agenda.** The tax reform aims at lowering the tax burden and simplifying the tax system (Box 2). Tax levels remain comparatively high in Italy and, provided sufficient expenditure savings are secured, staff supported the intention to reduce them over time to complement other employment-enhancing policies. The reform is to be implemented gradually, starting in 2003—and while its broad goals have been decided, many important aspects still remain to be determined.

Box 2. Tax Reform

The government's tax reform focuses on four areas (see Chapter IV of the Selected Issues Paper):

- *Personal income tax*: The number of tax brackets will be reduced from six to two, with the lowest marginal rate to decline from 23 percent to 18 percent, and the highest from 44 percent to 33 percent. The authorities also intend to replace the extensive range of tax credits with income-related allowances—but concurred that this would achieve little if the latter merely replicated the former.

- *Corporate tax*: The average tax rate is expected to stay roughly constant, in spite of a number of changes including: (i) the abolition of the "Dual Income Tax"—under which reduced rates applied on imputed returns to equity; (ii) changes in the tax treatment of dividends; (iii) provisions for the consolidated tax treatment of company groups; and (iv) cuts in the statutory rate from 36 percent to 33 percent. The new system will reintroduce a bias toward debt financing, but, the authorities noted, will be closely aligned with regulations in several other EU countries.

- *Capital income tax*: A single flat rate of 12½ percent will apply, with the previous, innovative system for the taxation of capital gains removed. Staff pointed to tax arbitrage possibilities created by the wide gap between tax rates on corporations and financial incomes—a feature already present, but amplified by the reform—and the authorities were reviewing ways for more closely aligning these rates.

- *Regional tax on value added (IRAP)*: IRAP, the main source of finance for the regions, will be phased out. Alternative regional funding sources have still to be identified.

The implementation of the reform will start in 2003, with tax reductions amounting to ½ percent of GDP—mostly consisting of personal income tax cuts for lower-income individuals, as well as a 2 percentage point reduction in the corporate income tax and the exclusion of some labor costs from the IRAP tax base. Other features of the tax reform remain to be decided, including the amount and structure of personal income tax deductions and the basic tax exemption.

15. **While supporting the goal of lowering the tax burden, staff noted that the plans for lowering spending had not yet been spelled out in equal detail, and that, in their absence, spending was increasing**. The July 2001 DPEF envisaged a decline of public spending of some 7 percentage points of GDP during 2002–06, the bulk of which would consist of cuts in primary spending. A later update to the DPEF postponed the beginning of the spending cuts to 2003, but still envisaged a fall in total spending by some one percentage point of GDP per year during 2003–06. Against these targets, primary spending is now projected to rise significantly in 2002 (see above), primarily reflecting increased spending for health and lack of progress in containing other spending items, such as public wages, following wage increases well above inflation granted in 2001 to part of the public sector. Moreover, the July 2002 DPEF was not very specific on expenditure reform plans, did not specify a target for the reduction in public spending for the general government over the medium term, and envisaged only a modest decline in primary spending of the central government in 2003 (0.3 percent of GDP).

16. **The authorities acknowledged that more needed to be done and were taking steps to proceed more speedily.** They noted that expenditure pressures in 2002 partly reflected decisions taken by the previous government, such as the cut in co-payment for pharmaceuticals. Others reflected difficulties in ensuring fiscal discipline at subnational levels. For example, the 2001 DPEF's goal of cutting public employment by 1 percent per annum was undermined by hiring at the subnational level (as well as other exceptions). Moreover, they acknowledged that the agreements with regions on health expenditure (the latest one in August 2001) had yielded mixed results.[7] Looking ahead, procedures were being put in place to monitor regional health expenditure monthly, and, during the summer, the government took some steps to contain health spending (amounting, however, to less than 0.1 percent of GDP). In September, the government also strengthened the Treasury's powers to regulate public spending. More generally, in June 2002, parliament adopted a resolution calling for clearer rules and better information to ensure the consistency between fiscal discipline and devolution.[8] As to plans for the 2003 budget, the authorities expected substantial expenditure savings by extending the centralization and standardization for the procurement of goods and services. The program had already yielded significant savings in 2001 for the few expenditure categories to which it had been applied. Staff welcomed this step, but noted that goods and services represented only a small share of total spending, and that more broad-based measures were needed, including strict discipline in the forthcoming public wage negotiations, and more determination in pursuing the goal, set forth in the 2001 DPEF, of reducing enterprise subsidies and containing social spending.

17. **Staff also expressed concern about the increased attention that the government seemed to pay to temporary or less reliable alternatives to expenditure cuts.** These included, in addition to the revenues from asset sales mentioned above: (i) the expectation of a strong reform dividend in terms of higher GDP and tax revenue growth; (ii) tax amnesties; (iii) increased yield from government assets; and (iv) a decentralization of public investment through public-private partnerships. Staff saw severe risks in relying on these alternatives. More specifically:

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[7] The agreement required regions to raise taxes to cover any slippage in health expenditure, but not all regions had done so, possibly financing the slippages through suppliers' credit.

[8] Maintaining this consistency will be increasingly important following a constitutional amendment enacted in late 2001 to enhance fiscal decentralization. The amendment extends responsibilities of subnational governments for health, education, public safety, and welfare. Subnational governments will be free to set their own taxes and tax rates, "in line with the constitution and in coordination with the general public finance framework and the tax system." The amendment also stipulates that borrowing will only be used to finance investment expenditure, and that the state will not provide debt guarantees. Estimates by the research institute ISAE suggest that, as a result of the amendment, the share of expenditures undertaken by subnational governments will rise from 30 percent to 45 percent of general government spending.

- **The authorities' medium-term fiscal plan assumed a considerable increase in potential growth.** Their reform agenda, including the tax cuts and labor market reforms, was expected to gradually raise potential output growth over time to close to 3 percent.[9] Staff acknowledged that, in principle, this could have sizable implications for fiscal balances—provided that the growth-related revenue "dividend" were applied to strengthening the fiscal balance. But staff also stressed that the amount and timing of the growth effects were uncertain. Moreover, these effects would materialize only if the tax cuts were seen as sustainable: proceeding with the tax cuts without expenditure reform, in the expectation that those cuts would be self-financing, was very risky. Altogether, it would be prudent to base the medium-term fiscal plan on the assumption of broadly unchanged potential output growth, until there was firm evidence to the contrary.

- **After a hiatus of several years, new tax amnesties had been introduced in 2001.** A first involved the cancellation of all tax liabilities related to assets held abroad, as long as they were repatriated or declared and a penalty equal to 2½ percent of capital was paid. Some €60 billion had emerged, resulting in 0.1 percent of GDP in budget revenues. A second amnesty concerned the "emersion" of enterprises from the underground economy, facilitated by favorable tax treatments. But few enterprises seized this opportunity. The authorities explained that the purpose of these amnesties had not been to raise revenues, but, respectively, to boost the supply of resources for investment, and to reduce the underground economy. Staff cautioned that regardless of their purpose, these amnesties risked weakening tax compliance, especially with Italy's history of repeated amnesties—a factor that, in combination with repeated rumors about new amnesties, may partly explain recent revenue weakness.

- **A new agency—*Patrimonio S.p.A.*—was charged with managing state properties.** The authorities noted even a modest yield on these properties (which they estimated to be worth some 40–70 percent of GDP) could provide permanent savings. Staff cautioned against budgeting large revenue increases from this source before they materialized, as previous attempts in this direction had generated only modest results.

- **Another new agency—*Infrastrutture S.p.A.*—was set up to finance infrastructure investment in cooperation with the private sector.** Financing from this agency was not expected to be included in the SGP deficit definition, in line with the experience of similar agencies in the EU (such as the German KfW). It was agreed that public-private partnerships in infrastructural investment might yield useful synergies, but that safeguards were needed to avoid quasi-fiscal deficits and contingent liabilities arising from these operations.

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[9] Absent such reforms, the authorities saw potential growth at 2¼ percent—in line with assessments by the EU and the OECD. Staff's analysis suggests lower rates (2 percent), reflecting less optimistic views on productivity growth, notwithstanding some projected rebound relative to recent years (see Chapter II of the Selected Issues paper).

Fiscal transparency

18. **While fiscal transparency has significantly improved in recent years, further progress is needed in several areas.** As described in a separate fiscal Report on the Observance of Standards and Codes (ROSC), Italy meets the standards of the fiscal transparency code in many respects, but the quality of fiscal data falls short of code requirements. A large discrepancy between the cash deficit (*fabbisogno*)—the only indicator of fiscal developments available at a monthly frequency and with short lags—and the accruals-based SGP deficit (*indebitamento netto*), hampered the monitoring of fiscal developments. Progress has been made in reconciling these two items ex post (a reconciliation that was accompanied by substantial upward revisions in the SGP-deficit), but staff noted that, as in other countries, more needed to be done to make SGP-based figures available at a higher frequency. The ROSC also recommended: (i) increasing the influence of the initial budget by limiting the carry-forward of unspent appropriations; (ii) strengthening the procedures for budget preparation, execution, and control; and (iii) improving the quality, timeliness, and transparency of fiscal information—by adopting common accounting and reporting procedures across all levels of government. The authorities are reviewing several specific recommendations, including for a systematic and timely reconciliation of different fiscal aggregates; more detailed analysis of fiscal risks; and the completion of an integrated financial management information system for the general government.

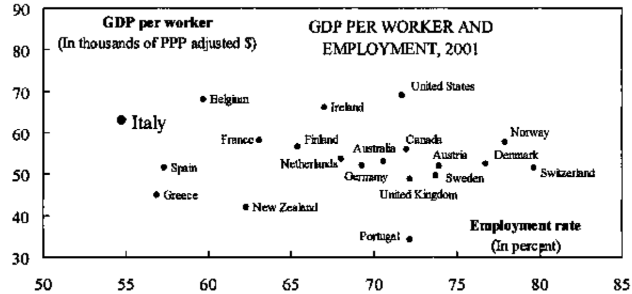
C. Raising Employment

19. **Government, employer, and trade union representatives concurred that Italy's low employment ratio was probably the most critical structural factor behind its relatively low per capita income** (Box 3; and Table 4).

Box 3. Employment, Productivity, and Per Capita Income

- In 2000, Italy ranked only eighteenth in terms of (purchasing-power-parity adjusted) income per capita among OECD countries. This does not reflect low per capita productivity, but rather the low level of employment: the Italian worker is highly productive, but few people work (see figure below).

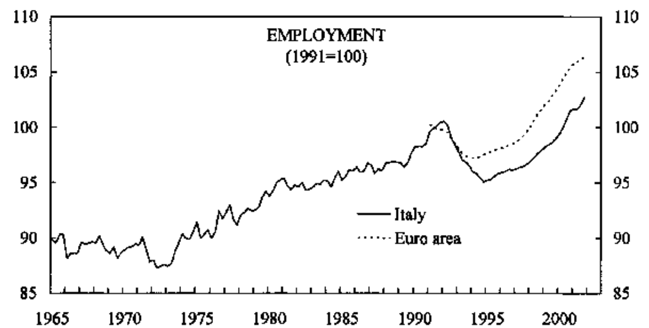
- Only 54 out of 100 Italians of working age have a job; this is the lowest employment ratio in the OECD, reflecting both low labor force participation and high unemployment: labor force participation (61 percent in 2001) is the lowest in the EU; and, at 9 percent, the unemployment rate is the third highest in the EU.



- Labor market performance is particularly weak in the South, where the unemployment rate is close to 20 percent, and even higher among the young (Figure 5). This, coupled with levels of productivity below the Italian average, results in a per capita income lower than in the poorest EU countries. The North benefits from higher productivity and virtually full employment, but even there the employment rate is below the EU average.

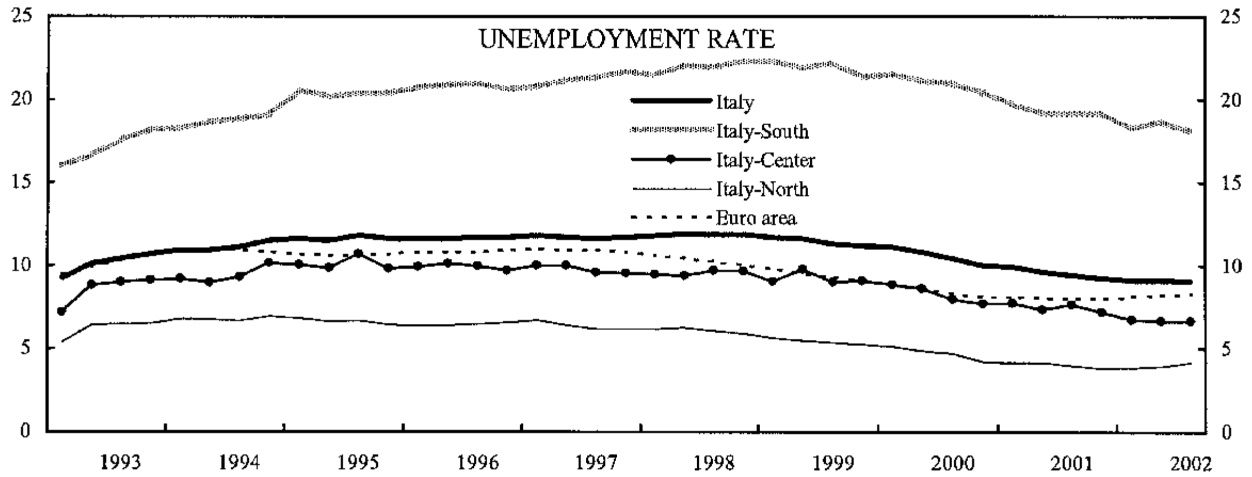
The combination of high productivity and low employment, while possibly influenced by the size of the underground economy and related measurement problems, reflects at least partly labor market rigidities that since the 1960s encouraged labor-saving investments (the capital-labor ratio is among the highest in the OECD, raising labor productivity).

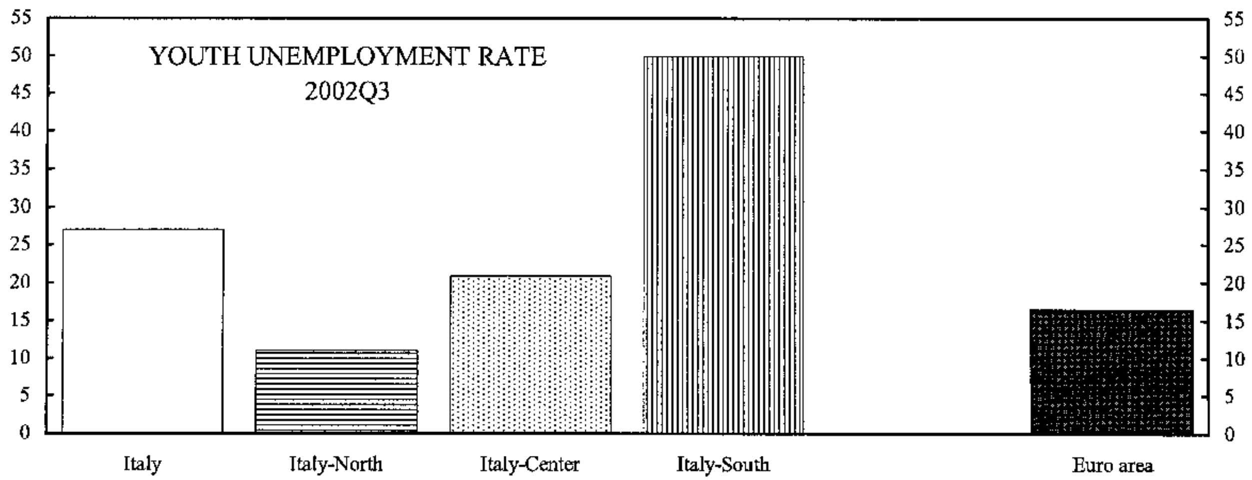
20. **The experience since the late 1990s shows, however, that wage moderation and the removal of labor market rigidities can have a large payoff.** Staff's previous analysis pointed at the important role of wage moderation, which began later in Italy than in most large EU countries, in stimulating employment growth.[10] Moreover, far-reaching constraints on temporary and part-time jobs ("atypical contracts") were relaxed in the late 1990s, a process that culminated in late 2001 with the adoption of the principle that temporary labor contracts are permitted, except when explicitly prohibited. The authorities and the social partners stressed that these reforms had been critical in boosting employment

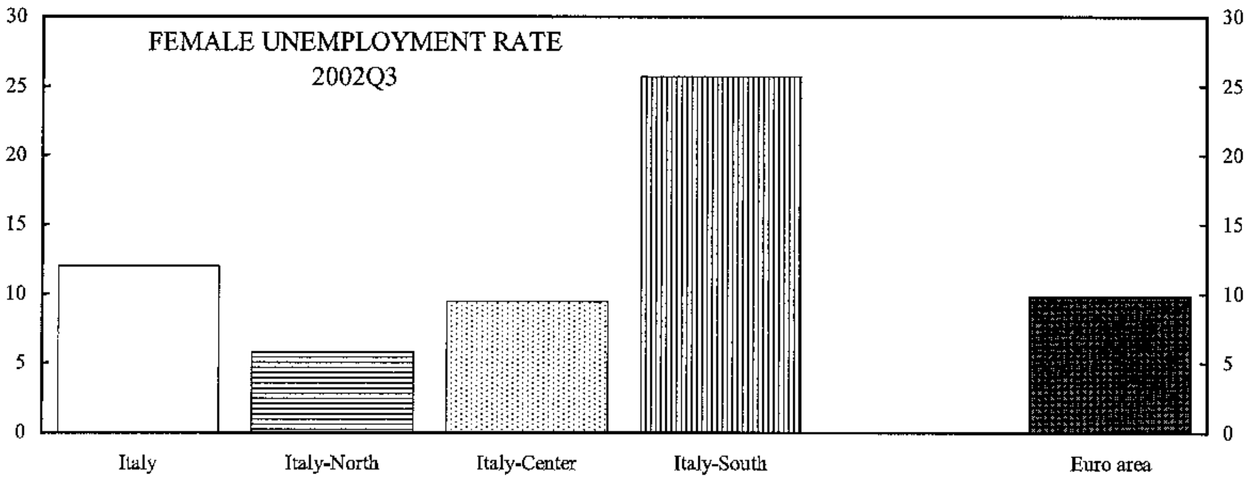


[10] See *Selected Euro-Area Countries: Rules Based Fiscal Policy and Job-Rich Growth in France, Germany, Italy, and Spain*, Chapter II (Country Report No. 01/203).

Figure 5. Italy: Unemployment in Italy and the Euro Area, 1997-2002
(In percent, seasonally adjusted)





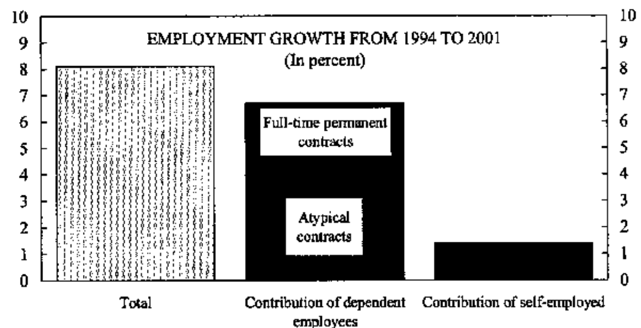


Sources: ISTAT and EUROSTAT.

in the late 1990s, when its elasticity with respect to output had far exceeded the historical average. Employment growth, initially limited to "atypical" contracts, had extended to open-ended contracts in 2000 and 2001, following modest tax incentives that facilitated the conversion.

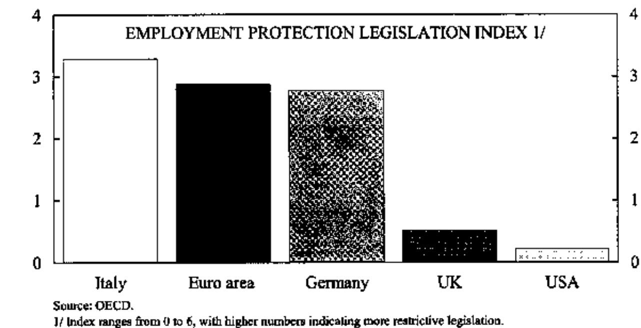
21. **Against this background, staff pointed at five causes of continued labor market weakness:**

- Insufficient regional wage differentiation: regional wage variation was the second lowest in the EU, even though the variation of regional unemployment was the highest, as wage setting in Italy tended to be dominated by lower unemployment regions (in the North). This reflected excessively centralized wage bargaining structures.[11]



- Notwithstanding recent reforms, employment protection legislation (EPL) was among the strictest in the OECD, with more adverse effects in the South (Box 4).

- The tax wedge on labor income—primarily reflecting differences between firms' labor costs and workers' after-tax income—was the sixth highest in the OECD.



Source: OECD.
1/ Index ranges from 0 to 6, with higher numbers indicating more restrictive legislation.

- Spending on active labor market policies (as a percentage of GDP) was the second lowest in the euro area, and mainly benefiting workers in the North.

- Product market impediments, were also likely to have important adverse effects on employment (Section D).

[11] Chapter III of the Selected Issues paper explores the implications of Italy's centralized bargaining system within a cross-country framework and finds that countries with more decentralized wage bargaining systems tend to have higher regional wage differentiation.

Box 4. Why Does Strict Employment Protection Hamper Labor Market Performance More in the South?

While EPL is the same across regions, labor market outcomes exhibit vast regional differences. Three factors explain why the same EPLs may have more adverse effects in the South:

- The cost of losing a dismissal case for an employer in the South is higher than in the North. This is because legal proceedings last on average longer in the South; and a worker that is wrongly dismissed will eventually receive payments for the whole period of the duration of the trial. There are also additional penalties for late payments of social security contributions.

- EPL rules may be more strictly applied in the South. Empirical evidence indicates that higher unemployment rates in the South influence the courts' decisions: the same misconduct by the worker may be considered sufficient for separations in the tight labor market of the North, but insufficient in the high unemployment regions of the South.[1]

- Strict EPL slows labor market adjustments following adverse shocks and can extend periods of higher unemployment.[2] This problem may be particularly relevant for the South, which has been subject to larger idiosyncratic shocks (see Chapter III of the Selected Issues paper), including sizable public expenditure cuts in the early 1990s.

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[1] See A. Ichino, M. Polo, and E. Rettore, "Are Judges Biased by Labor Market Conditions?", *European Economic Review*, forthcoming.

[2] See O. Blanchard and J. Wolfers, 2000, "The Role of Shocks and Institutions in the Rise of European Unemployment: the Aggregate Evidence," *The Economic Journal* 110, 1–33; and T. Boeri, G. Nicoletti, and S. Scarpetta, 2000, "Regulation and Labour Market Performance," Centre for Economic Policy Research, Discussion Paper No. 2420.

22. **These arguments elicited different responses from the various interlocutors**:

- The authorities broadly concurred with the staff's analysis. Indeed, it was consistent with their multi-pronged labor market strategy as formulated in the employment program presented to the EU that aimed at raising the employment rate from 54½ percent in 2001 to 58½ percent by 2005. The authorities noted, however, that the degree of centralization of wage bargaining was up to the social partners: no regulation prevented the latter from agreeing on more flexible wage contracts. In this respect, staff suggested that wage differentiation in the private sector could be encouraged by introducing regional wage differentiation in the public sector, for example, through cost-of-living allowances. It was also time that the central statistical office (ISTAT) started producing regional cost-of-living data, so as to facilitate wage agreements that reflected differences in the cost of living.[12] The

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[12] Anecdotal evidence suggests that there are marked differences in the cost of living across regions, but official information has so far been lacking.

authorities agreed with the latter suggestion, noting that work was underway, but considered it politically difficult to break with a tradition of equal pay for equal work in the public sector.

- Employers' representatives largely agreed with the staff's analysis, but saw a risk that increased decentralization in the wage bargaining system could raise labor costs in the North, where labor conditions were tighter.

- Trade union representatives concurred with some aspects of the staff's analysis (notably the need to reduce the tax wedge and to strengthen active labor market policies). They noted, however, that much had been done to liberalize the labor market (including through atypical contracts) and feared that further major steps, in particular major revisions in EPL, would violate workers' basic rights. Moreover, they thought that any labor market reform would have to include a strengthening of unemployment benefit, which staff acknowledged was underdeveloped in Italy.[13] As to regional wage differentiation, the trade unions did not oppose a close link between future wage and productivity increases (including any arising from regional differences), but were against revising wage *levels* to reflect regional differences in the cost of living or local labor market conditions. They noted that what prevented growth in the South was not so much the cost of labor, but the lack of infrastructure, and relatively poor law enforcement and governance.

23. **Following the mission, a labor market accord was reached between the authorities, two of the three main trade unions, and the employers' association**. The agreement included:

- Labor market reforms to: (i) ease some dismissal restrictions; (ii) facilitate job matching, including through measures to strengthen public employment agencies and improve their cooperation with private-sector agencies; and (iii) improve employability, through job-oriented education.[14] These measures—included in enabling legislation to be approved by parliament—are in addition to steps further liberalizing part-time contracts, fully implementing the EU directives.

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[13] Unemployment benefits in Italy were only 0.3 percent of GDP in 2001, less than in the United States, in spite of an unemployment rate almost twice as high.

[14] The first measure was particularly controversial, replacing with a monetary compensation the mandatory re-hiring of workers fired without "just cause" in firms with more than 15 employees. Following a general strike, the accord confined the liberalization to firms whose employment would increase above the 15-worker threshold in the future, with the liberalization applying for a 3-year period.

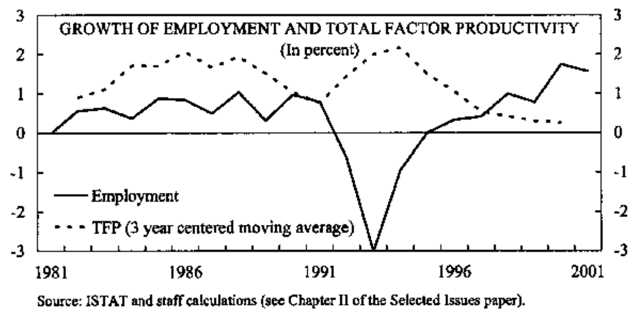
- The government's commitment to reduce the tax wedge on lower incomes, through personal income tax reductions.

- A government pledge for continued initiatives supporting the South, including for infrastructure.

- An expansion of the unemployment insurance system: benefits will be increased, applied more uniformly across sectors, and extended to cover up to one year, with declining replacement rates (60 percent in the first semester, falling to 30 percent by the last quarter). Ahead of the specific regulations, budgetary costs were difficult to project—but were put at below 0.1 percent of GDP for 2003 in government estimates.

D. Boosting Productivity and Other Issues

24. **Stronger employment growth in recent years has been associated with a decline in productivity growth** (see text chart). The authorities intend to boost productivity not only through a retrenchment of the public sector, but also through more competitive product markets, regional policies supporting the South, and maintaining a vigorous yet stable financial system.[15] Benefits in these areas depend also on enforcing the rule of law.



Source: ISTAT and staff calculations (see Chapter II of the Selected Issues paper).

25. **Discussions focused first on ways to reinvigorate product market reforms.**

- With the reconstitution of a privatization committee, the privatization process is to be revived. After stalling during the past year, the government has targeted receipts of €20 billion in 2002–03. Limited progress was expected at the local level, although local governments controlled a sizable share of public properties. And equity market developments have accentuated risks to the government's revenue target.

- To enhance competition in the energy sector, plans call for separating the ownership of transmission from production assets. However, regulators noted that incumbents would

[15] S., Scarpetta, P. Hemmings, T. Tressel and J. Woo ("The Role of Policy and Institutions for Productivity and Firm Dynamics: Evidence from Micro and Industry Data," OECD Economics Department Working Papers, No. 329, 2002) find that strict product market regulations hamper productivity.

still enjoy dominant positions in production, while prices typically remained among the highest in the EU.

- For the provision of local public services, central guidelines have been issued to increase competitive pressures through private sector tendering, although local governments will set operating guidelines and own the infrastructure.

- Little progress has been achieved toward increased competition in retail trade, and the Anti-Trust Authority noted that its limited sanctioning powers hampered efforts to foster competition in professional services.

26. **Building on recent progress, new initiatives aim at accelerating real convergence of the South.** Recent initiatives are beginning to bear fruit, and growth rates in the South have exceeded those in the North since the mid-1990s, with important contributions from private investment. The authorities expected that their labor market reforms would have particularly beneficial effects for the South, as would the envisaged private-public sector cofinancing of infrastructure projects. Further steps were also underway to improve law enforcement and judicial efficiency and to reduce bureaucratic procedures for investment—measures that should also facilitate the "emersion" of the large underground economy. Other steps aimed to improve the quality of public investment, including through performance-based pay and extensive monitoring.

27. **Discussions on banking centered on the recent decline in profitability, and on moves to raise capital ratios and reduce control of banks by nonprofit foundations.** Bank profitability was lowered by sizeable domestic and international shocks in 2001, including the downturn in equity markets (Table 5)—reducing asset-management income significantly—and problems arising from a number of sizable exposures, including in Latin America. Despite this, the banking system's capital ratio rose in 2001, reversing a trend that had left Italy below many of its peers. This turnaround was fostered by the Bank of Italy establishing capital-ratio targets above minimum international standards, and was apparently achieved without a significant impact on credit growth—which has slowed in line with weaker economic activity. The share of nonperforming loans to total loans—still high relative to partner countries, reflecting earlier loan losses and a slow resolution process—had fallen further, though the Bank concurred that credit losses typically emerge with a considerable lag following economic slowdowns. Even so, both supervisors and market participants thought that losses would not be substantial, pointing to relatively low household indebtedness and robust corporate profitability. New legislation aimed at improving governance of financial institutions will force nonprofit foundations to place their holdings with asset management companies by June 2003, and relinquish control of financial institutions by 2006.

28. **Discussions also covered corporate governance issues more generally.** Legislative changes in 1998 had improved the rights of minority shareholders, and were conducive to the decline in the market share of major shareholders and the increased role of institutional investors. The securities market regulator stressed, however, that more could be done in this

area, including improving disclosure, especially for unusual and related party transactions. A reform of the bankruptcy law, before parliament, is aimed at better protecting the value of firms in difficulty and reducing resolution costs.

29. **A new coordinating body has been established to assist in combating the financing of terrorism (CFT).** The recent EU directive to extend anti-money laundering (AML) and CFT efforts to nonfinancial entities is expected to be transposed into Italian law by mid-2003. Italy continues to provide both finance and personnel for technical assistance on AML to other countries, and is a signatory to the **OECD anti-bribery convention**.

III. Staff Appraisal

30. **The authorities have laid out a bold agenda, targeted at addressing Italy's key economic weaknesses—but it needs to be complemented by comparably bold fiscal consolidation in both the short- and longer-term.** The agenda's key elements—labor and product market reform, cuts in taxes and public spending, and further fiscal consolidation—have long been at the core of Article IV recommendations, and remain critical for achieving major inroads in spurring growth and raising Italy's low employment rate. Progress is being made in reforming the labor market and plans have been formulated for lowering the tax burden, with implementation starting in 2003. But no progress will be made in 2002 in lowering primary government spending and the cyclically-adjusted deficit net of asset sales. Moreover, for the first time in several years, the public debt ratio may not decline.

31. **The July labor market accord presents an important step toward broad-based reform.** As low employment in Italy reflects a host of factors, reforms are rightly based on a broad-based strategy, involving improvements in job matching and education, cuts in the tax wedge on labor, and increased labor market liberalization. However, as unemployment is distributed very unevenly, progress in raising employment also requires wage structures that reflect more closely regional differences in labor market conditions and the cost of living. Social partners should work toward this end. In the public sector, consideration could be given to regional cost-of-living allowances, once comparable regional price level data are collected.

32. **Fiscal developments have been disappointing.** In 2002, the deficit will exceed the original target by a wide margin. This reflects not only cyclical developments, but also structural revenue shortfalls and overruns on some primary current expenditures. The recent decree aimed at avoiding expenditure overruns is useful, as a stop-gap measure, but its effectiveness remains to be seen. The interpretation of fiscal developments in 2002 has been made difficult, once again, by the lack of higher-frequency deficit estimates on an accruals basis, and of a timely reconciliation between cash-based and accruals-based deficit estimates. Progress in this area is needed, in line with the recommendations in the fiscal *Review of Standards and Codes* (ROSC).

33. **Delays in introducing corrective measures during 2002 make it now inevitable to delay the pace of fiscal consolidation.** Italy's fiscal consolidation process is far from complete, as highlighted by the highest public debt ratio in the EU, medium-term spending pressures arising from the forthcoming demographic shock, and the increase in the cyclically-adjusted deficit net of asset sales since the beginning of monetary union. Against this background, it would have been preferable to initiate adjustment steps already in 2002 and approach a balanced budget (cyclically adjusted and net of asset sales) in 2003. But the latter is no longer feasible in view of the lack of progress in addressing the 2002 slippages, and also in light of weaker growth. It is now imperative that structural adjustment in 2003 does not, again, fall short of the requirements for substantially strengthening the fiscal position. Thus, the 2003 budget should contain sufficient measures to reduce the cyclically-adjusted deficit (excluding asset sales) by at least ¾ percentage points of GDP, with a similar improvement for 2004. Around these targets, the automatic stabilizers should operate fully and symmetrically.

34. **As to the medium term, further reform of aging-related entitlements are critical to achieving the government's growth and employment targets; absent such reforms, sizable budget surpluses will be required,** so as to rapidly reduce the public debt ratio during this decade, ahead of the most adverse impact of population aging. In light of the uncertainty about the magnitude and the timing of any structural reform dividend, medium-term fiscal plans should be based on prudent growth assumptions and not count on steady gains in potential output growth, as in the government's current program.

35. **The immediate fiscal challenge is to implement long-delayed expenditure cuts.** Such cuts—which are now expected to be initiated in the 2003 budget—are needed not only to proceed with fiscal consolidation, but also to allow for the planned tax cuts and the loss of the sizable one-off revenue measures of the last few years. Specific measures are required in all areas identified in the government's reform agenda, including steps to contain the wage bill through public employment cuts and moderate wage increases, and health care costs by strengthening the enforcement of regional spending ceilings. On pensions, the government's plan to develop a second, fully funded and private pillar is welcome, but consideration should be given to raise the effective retirement age substantially and shorten the transition to the contribution-based pension regime. Some expenditure savings are also expected from the creation of the new public entity aimed at financing private-public sector partnerships for infrastructure projects. This partnerships could yield efficiency gains in public spending, benefiting in particular the South; at the same time, careful monitoring and full transparency in the operation of these entities is critical to ensure that future public sector liabilities are avoided.

36. **Durable expenditure cuts would allow a gradual reduction of Italy's high tax burden.** The authorities' personal income tax reform rightly targets initial relief at lower income groups, which should help employment growth in the most disadvantaged segments. For the corporate income tax, care needs to be taken to limit distortions between alternative financing sources. The recent recourse to new tax amnesties—which risk weakening the

efforts to enhance tax administration—is regrettable, and should be avoided in the future. The implementation of the tax reform, particularly of those components that involve a reduction in the overall tax burden, should, however, advance only in tandem with expenditure cuts, so as to proceed speedily on the road of fiscal consolidation.

37. **Recent steps to reinvigorate the privatization process and expand product market reforms are welcome, and could underpin stronger productivity growth**. After stalling for some time, the privatization process should proceed both at the central and local level. The plan to split the ownership of transmission and production assets in energy markets is a positive step, but strong competition requires greater divestiture by incumbents of production assets. Raising competition in local public service provision depends on better coordination between different levels of government—a need illustrated by insufficient progress in achieving more competition in retail trade. Giving additional sanctioning powers to the Anti-Trust Authority could foster competition in professional services. The recent temporary freeze of some utility prices is regrettable: it risks undermining market-oriented reforms more generally, and it goes against the need to increase competitive pressures under the guidance of independent and transparent regulators.

38. **The Bank of Italy rightly undertook efforts to boost banks' capital**. Flexible use of target capital ratios should help to align Italian banks with their international peers without unduly restricting the supply of credit. Changes to prevent foundations from controlling financial institutions could enhance governance, but implementation details will need to be carefully considered, especially to ensure that the relationship between foundations and asset management companies is truly at arms' length. Governance of all corporations could improve by further increasing minority shareholder rights. The pending bankruptcy law reform is long overdue.

39. Italy remains a strong supporter of abolishing **trade barriers** for exports from the least developed countries, but efforts are needed to further increase its relatively paltry **official development assistance**.

40. Italy's **economic data** are adequate for surveillance. Statistical and fiscal ROSCs identified, however, weaknesses related in particular to general government data (Appendix II), and the authorities' intention to quickly address these weaknesses is welcome.

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

Table 1. Italy: Selected Economic Indicators, 1997–2003

(Percentage changes, except as otherwise indicated)

	1997	1998	1999	2000	2001	2002 1/	2003 1/
Domestic economy							
GDP	2.0	1.8	1.6	2.9	1.8	0.6	2.3
Domestic demand	2.7	3.1	3.0	2.1	1.6	0.9	2.1
Consumption (households)	3.2	3.2	2.4	2.7	1.1	0.2	2.3
Public consumption	0.3	0.3	1.4	1.7	2.3	2.0	0.7
Gross fixed investment	2.1	4.0	5.7	6.5	2.4	0.0	2.8
Machinery and equipment	5.5	7.2	7.7	7.1	1.5	-0.7	2.8
Construction	-1.9	-0.2	2.8	5.6	3.7	0.9	2.8
Inventories (contribution)	0.3	0.3	0.1	-1.1	0.0	0.4	0.0
Foreign sector (contribution)	-0.6	-1.2	-1.3	0.8	0.2	-0.3	0.2
Exports	6.4	3.4	0.3	11.7	0.8	0.8	5.6
Imports	10.1	8.9	5.3	9.4	0.2	1.7	5.4
Employment	0.4	1.1	1.3	1.9	2.1	1.2	0.7
Unemployment	11.7	11.8	11.4	10.6	9.5	9.1	8.9
Manufacturing value added	2.7	0.4	1.5	4.0	2.9	-0.9	1.7
Labor costs	4.2	-1.4	2.5	2.7	2.7	2.4	2.6
Unit labor costs in manufacturing	1.9	0.3	0.3	-1.2	-0.5	2.9	1.2
Consumer prices (period average)	1.9	2.0	1.7	2.6	2.7	2.4	1.8
GDP deflator	2.4	2.7	1.7	2.1	2.6	2.4	1.9
Output gap	-1.6	-1.7	-2.0	-1.0	-1.0	-2.4	-2.1
External accounts 2/							
Export volume	6.4	3.4	0.3	11.7	0.8	0.8	5.6
Import volume	10.1	8.9	5.3	9.4	0.2	1.7	5.4
Export unit value	0.1	0.6	-0.5	6.8	3.3	-1.6	0.1
Import unit value	0.5	-2.6	-0.5	13.6	1.6	-2.0	0.0
Trade balance (in percent of GDP)	3.4	3.0	2.0	1.0	1.6	1.5	1.5
Current account (in percent of GDP)	2.8	1.7	0.7	-0.5	0.1	0.2	0.2
Nominal effective exchange rate	0.7	-0.4	-1.7	-3.2	0.4	...	...
Real effective exchange rate 3/	2.2	-2.0	-0.4	-3.4	-0.7	...	...
Public finances (in percent of GDP) 4/							
General government							
Revenues	48.0	46.5	46.7	45.9	45.8	45.7	45.9
Expenditures	50.7	49.3	48.4	46.5	48.0	47.7	47.4
Balance	-2.7	-2.8	-1.8	-0.5	-2.2	-2.0	-1.5
Structural balance (in percent of potential GDP)	-1.9	-2.0	-0.9	-1.3	-1.8	-1.7	-1.2
Primary balance	6.7	5.2	5.0	5.9	4.1	3.9	4.4
Structural primary balance (in percent of potential GDP)	7.3	5.9	5.7	5.1	4.4	4.0	4.5
Debt	120.2	116.4	114.5	110.6	109.8	109.8	106.6
Financial variables							
Contribution to euro area M3 5/	...	1.6	3.4	4.1	7.1	11.9	...
Private sector credit 6/	5.2	7.9	13.7	19.0	10.1	9.6	...
Bank lending to private sector 7/	...	7.5	10.2	13.1	7.1	5.7	
Six-month rate on treasury bills 8/	6.4	4.6	3.0	4.5	4.1	3.3	...
Prime lending rate 8/	8.9	6.4	6.3	7.3	7.7	7.4	...

Sources: Data provided by the Italian authorities; and Fund staff estimates and projections.

1/ Staff estimates and projections, unless otherwise indicated.

2/ Volumes and unit values are customs basis; trade balance and current account are balance of payments basis.

3/ Based on unit labor costs.

4/ For 2000, including UMTS receipts of 1.2 percent of GDP, for 2001, 2002, and 2003 including asset sales of 0.2, 0.8, and 0.7 percent of GDP, respectively, as a negative entry under capital expenditure; however, these receipts are removed for the purpose of calculating the structural balance. The fiscal balance projections for 2003 reflect the authorities' targets as presented in the 2003–06 DPEF, adjusted for staff's macroeconomic scenario.

5/ End-of-period data; data for 2002 refer to July; data break in 1998, and 2002.

6/ End-of-period data; data for 2002 refer to March; data break in 1998.

7/ End-of-period data; data for 2002 refer to July.

8/ Period average; data for 2002 are available up to July.

Table 2. Italy: General Government Accounts, 1997–2002

	1997	1998	1999	2000	2001	2002		
						Authorities		Staff Proj.
						Budget 1/	DPEF 2/	
	(In percent of GDP)							
Total expenditures	50.7	49.2	48.4	46.5	48.0	46.7	47.3	47.7
Current expenditures	47.2	45.5	44.5	43.9	43.9	43.2	43.9	44.3
Wages and salaries	11.6	10.7	10.7	10.5	10.6	10.5	10.7	10.8
Purchases of goods and services	6.8	6.9	7.1	7.3	7.5	7.2	7.4	7.6
Social transfers	17.3	17.0	17.2	16.8	16.7	16.9	17.0	17.1
Interest payments	9.4	8.0	6.7	6.5	6.3	5.7	5.9	5.9
Capital expenditures	3.5	3.8	3.9	3.8	4.1	3.5	3.4	3.4
Of which: asset sales	0.0	0.0	0.0	-1.3	-0.1	-0.6	-0.8	-0.8
Total revenues	48.0	46.4	46.6	45.9	45.8	46.2	46.2	45.7
Direct taxation	16.0	14.4	15.0	14.6	15.1	15.2	15.2	14.7
Indirect taxation	12.4	15.3	15.1	15.0	14.6	14.5	14.5	14.6
Social contributions	15.3	12.8	12.7	12.7	12.7	12.6	12.6	12.7
Other current revenues	3.2	3.2	3.3	3.1	3.2	3.2	3.3	3.3
Capital revenues	1.0	0.7	0.5	0.4	0.3	0.5	0.5	0.5
Overall balance	-2.7	-2.8	-1.8	-0.5	-2.2	-0.5	-1.1	-2.0
Primary balance	6.7	5.2	5.0	5.9	4.1	5.1	4.7	3.9
Memorandum items:								
	(In percent of potential GDP)							
Structural overall balance	-2.0	-2.0	-0.8	-0.1	-1.7	-0.4	-0.5	-1.0
Net of asset sales	-2.0	-2.1	-0.9	-1.3	-1.8	-1.0	-1.3	-1.7
Structural primary balance	7.2	5.9	5.8	6.3	4.6	5.3	5.4	4.8
Net of asset sales	7.2	5.8	5.7	5.1	4.4	4.7	4.6	4.0
Nominal GDP (in billions of euros)	1,026.3	1,073.0	1,108.5	1,164.8	1,216.7	1,276.4	1,265.1	1,253.5

Sources: ISTAT; Ministry of Economy and Finance, *Relazione Trimestrale di Cassa* (April 2002) and *Documento di Programmazione Economica e Finanziaria 2003-06*(July 2002); and Fund staff calculations.

1/ Authorities' revised budget estimate in the Relazione Trimestrale di Cassa (April 2002). Components (but not the overall balance) differ from the Stability Program targets shown in other tables.

2/ Authorities' estimate in the Documento di Programmazione Economica e Finanziaria 2003-06 (July 2002). Estimates of the structural balance are based on the authorities' output gap and cyclical adjustment method. In mid September, the authorities revised the 2002 deficit estimate from 1.1 percent to close to 2 percent of GDP. The revenue and expenditure details for this revised estimate are not yet available (see forthcoming supplement to this report).

Table 3. Italy's Stability Program, 2001–05 and Medium-Term Program, 2003-06

(In percent of GDP, except as otherwise indicated)

	2001		2002		2003		2004		2005		2006	
	Stability Program	Actual	Stability Program	DPEF 2003-06	Stability Program	DPEF 2003-06	Stability Program	DPEF 2003-06	Stability Program	DPEF 2003-06	Stability Program	DPEF 2003-06
Nominal GDP (percentage change)	5.0	5.0	4.7	4.0	4.9	4.8	4.5	4.8	4.6	4.8	...	4.8
Real GDP (percentage change)	2.0	1.8	2.3	1.3	3.0	2.9	3.0	2.9	3.1	3.0	...	3.0
CPI (percentage change)	2.8	2.7	1.7	2.2	1.3	1.7	1.0	1.5	1.0	1.5	...	1.5
Overall balance	-1.1	-2.2	-0.5	-1.1	0.0	-0.8	0.0	-0.3	0.2	0.1	...	0.2
Primary balance	5.1	4.1	5.3	4.7	5.7	5.1	5.4	5.5	5.5	5.8	...	5.7
Gross debt	107.5	109.8	104.3	108.5	101.0	104.5	98.0	99.8	...	97.1	...	94.4
Memorandum items:												
Nominal GDP (percentage change, staff projection)	n.a.	n.a.	3.3		4.5		4.4		4.4		4.1	
Real GDP (percentage change, staff projection)	n.a.	n.a.	0.8		2.4		2.7		2.6		2.3	
CPI (percentage change, staff projection)	n.a.	n.a.	2.4		1.9		1.6		1.6		1.6	

Sources: Ministry of Economy and Finance, *Italy's Stability Program* (December 2001), and *Documento di Programmazione Economica e Finanziaria 2003-06* (July 2002); and Fund staff projections.

Table 4. Labor Market Characteristics in Italy and Other Selected Economies, 1998 1/

	Italy	Euro Area 2/	Italy's Rank in the Euro Area 2/ 3/	United Kingdom	United States
Labor market conditions (2001)					
Natural rate of unemployment	8.7	8.3	5	5.5	4.8
Unemployment rate	10.0	8.5	3	5.1	4.8
Labor force participation rate	60.8	68.8	11	76.0	79.8
Employment growth (1991–2001)	2.1	6.1	8	6.1	14.7
Employment protection legislation					
Overall	3.3	2.7	3	0.5	0.2
Collective dismissals	4.1	3.1	1	2.9	2.9
Regular employment	2.8	2.6	3	0.8	0.2
Temporary employment	3.8	2.8	2	0.3	0.3
Dismissals protection					
Overall strictness of protection against dismissals	2.8	2.6	3	0.8	0.2
Regular procedural inconveniences	1.5	2.9	10	1.0	0.0
Notice and severance pay for no-fault individual dismissals	2.9	1.8	2	1.1	0.0
Difficulty of dismissal	4.0	3.3	2	0.3	0.5
Regulation of temporary contracts					
Overall strictness of regulation	3.8	2.8	2	0.3	0.3
Fixed-term contracts	4.3	2.7	1	0.0	0.0
Temporary work agencies	3.3	3.0	5	0.5	0.5
Collective dismissal protection					
Overall strictness relative to individual dismissals	4.1	3.1	1	2.9	2.9
Definition of collective dismissal	4.0	3.2	2	2.0	1.0
Additional notification requirements	1.5	0.9	2	1.5	2.0
Additional delays involved (in days)	44.0	30.0	2	57.0	59.0
Other special costs to employers	1.0	1.0	3	0.0	0.0
Replacement rate					
Couple with two children	54.0	70.8	10	64.0	61.0
Single	36.0	60.6	10	50.0	60.0
Tax wedge 4/					
In percent of wage	54.5	55.4	5	46.6	36.8
Duration of unemployment (more than 1 year, in percent) 4/					
Overall duration	60.8	48.8	1	28.0	6.0
Young	57.9	27.2	1	14.4	3.8
Women	60.9	50.0	2	19.0	5.3
Older than 55	62.1	65.4	6	42.1	16.6
Unions					
Union members/employees	39.2	26.4	4	33.4	...
Union density	38.8	26.2	4	33.4	...
Coverage of wage bargaining	82.0	89.4	8	47.0	18.0
Active labor market policies spending (in percent of GDP) 5/					
Overall	1.3	3.1	10	0.9	0.4
Active measures	0.6	1.2	8	0.4	0.2
Passive measures	0.6	1.7	10	0.6	0.3
Labor market training	0.1	0.3	9	0.1	0.0
Training for unemployed adults and those at risk	0.1	0.3	10	0.0	0.0
Training for employed adults	0.0	0.1	10	0.0	...
Youth measures	0.3	0.2	7	0.2	0.0
Measures for unemployed and disadvantaged youth	0.0	0.1	3	0.0	0.0
Support of apprenticeship and related forms of general youth training	0.2	0.1	11	0.1	...
Subsidized employment	0.3	0.4	3	0.0	0.0
Subsidies to regular employment in the private sector	0.2	0.1	8	0.0	...
Support of unemployed persons starting enterprises	0.0	0.0	5	...	...
Direct job creation (public or nonprofit)	0.1	0.2	10	...	0.0
Unemployment compensation	0.6	1.6	10	0.6	0.3
Early retirement for labor market reasons	0.1	0.1	9	...	...
Regional labor markets					
Unemployment rate (coefficient of variation)	75.3	45.9	1	53.0	...
Compensation per employee (coeficient of variation)	10.2	16.8	10	...	...

Sources: OECD, Labour Market Statistics (2001); Eurostat (2002); and IMF, *WEO* (2002).

1/ Data are for 1998, except where indicated otherwise.

2/ Excluding Luxembourg.

3/ The rank decreases as the value of each variable increases. For example, Italy has the lowest labor force participation rate in the Euro area and is ranked as eleventh, while it has the highest coefficient of variation of regional unemployment rates and is ranked as first.

4/ 2000.

5/ 1999.

Table 5. Italy: Indicators of External and Financial Vulnerability 1/

(In percent of GDP, unless otherwise indicated)

	1997	1998	1999	2000	2001	2002	
						Latest est.	Date
External indicators 1/							
Exports (annual percentage change, in U.S. dollars)	-3.2	0.9	-5.0	0.1	2.4	4.7	
Imports (annual percentage change, in U.S. dollars)	1.7	4.1	-0.1	5.2	0.0	5.2	
Terms of trade (annual percentage change)	-1.1	2.3	-0.6	-6.8	1.7	0.4	
Current account balance (settlement basis)	2.8	1.7	0.7	-0.5	0.1	0.2	
Capital and financial account balance	-1.5	0.5	-0.6	0.8	-0.2	...	
Of which : Inward portfolio investment (debt securities, etc.)	6.3	9.3	8.8	5.3	2.5	...	
Inward foreign direct investment	0.3	0.2	0.6	1.2	1.4	...	
Other investment liabilities (net)	1.2	0.8	3.3	2.5	1.7	...	
Official reserves (in U.S. dollars, billions, end-of-period) 2/	55.7	29.9	22.4	25.6	24.4	24.3	July
Contribution to euro area M3 (in percent of reserves) 3/	13.6	27.5	32.5	27.5	29.2	31.5	July
Central Bank foreign liabilities (in U.S. dollars, billions) 2/	1.1	1.0	6.3	0.2	2.2	...	...
Foreign assets of the financial sector (in U.S. dollars, billions)	198.5	225.1	175.4	175.5	152.6	...	
Foreign liabilities of the financial sector (in U.S. dollars, billions)	239.2	268.9	248.7	278.1	275.8	...	
Official reserves (ratio to average monthly imports) 2/	2.6	1.3	1.0	1.1	1.0	...	
Total external debt	59.0	71.1	72.0	82.6	81.8	...	
Of which : General government debt	25.4	31.1	29.7	35.2	35.1	...	
Total external debt to exports (ratio)	2.2	2.7	2.9	3.0	2.9	...	
External investment income payments to exports (in percent)	18.0	19.9	19.0	16.5	15.6	...	
Exchange rate (per U.S. dollars, period average)	0.88	0.90	0.94	1.09	1.12	1.01	July
Financial market indicators							
Public sector debt (Maastricht definition)	120.2	116.4	114.5	110.6	109.8	109.8	
3-month T-bill yield	6.3	4.6	3.0	4.5	4.1	3.4	July
3-month T-bill yield (real)	4.4	2.6	1.3	1.9	1.4	1.0	July
Stock market index (year end)	55	78	96	100	75	67	Aug.
Share prices of financial institutions (year end)	51	79	82	100	71	63	Aug.
Spread of 3-month T-bills with Germany (percentage points, period average)	3.0	1.2	0.1	0.2	0.4	0.6	July
Financial sector risk indicators 4/							
Foreign exchange loans (in billions of U.S. dollars)	67.1	73.7	45.4	50.0	45.8	...	
Share of foreign exchange loans in total lending (percent)	9.4	9.1	5.9	6.1	5.5	...	
Deposits in foreign exchange (in billions of U.S. dollars)	24.1	25.8	21.8	22.3	22.1	...	
Share of foreign deposits in total deposits (percent)	3.9	4.0	3.9	4.2	4.1	...	
Share of real estate sector in private credit	7.6	8.4	9.8	11.6	11.4	...	
Share of nonperforming loans in total loans	9.4	9.1	8.5	7.7	6.7	...	
Share of nonperforming loans in total assets	4.0	4.3	3.6	3.3	2.9	...	
Risk-based capital asset ratio	11.4	11.3	10.6	10.2	10.6	...	
Return on equity	1.4	7.2	8.7	11.3	8.7	...	
Return on assets	0.09	0.48	0.61	0.79	0.61	...	

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

1/ The interpretation of some indicators is affected by the launch of monetary union in 1999.

2/ Reserves and foreign liabilities refer to the Bank of Italy, both before and after EMU; excluding gold.

3/ Definition of M3 changes January 2002, to exclude currency held by the public.

4/ Data refer to banks, including cooperative and mutual banks.

ITALY: FUND RELATIONS

(As of August 31, 2002)

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

II **General Resources Account**:	SDR Million	Percent Quota
Quota	7,055.50	100.0
Fund holdings of currency	4,220.28	59.82
Reserve position in Fund	2,835.22	40.18
Financial Transaction Plan Transfers (net)	394.00	

III. **SDR Department**:	SDR Million	Percent Allocation
Net cumulative allocation	702.40	100.0
Holdings	95.60	13.61
Designation Plan	0.00	

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

V. **Financial Arrangements**: None

VI. **Projected Obligations to Fund:** None

VII. **Exchange Rate Arrangement**:

- Italy entered the final stage of European Economic and Monetary Union on January 1, 1999, at a rate of 1,936.27 Italian lire per 1 euro.

- Italy retains restrictions vis-à-vis Iraq pursuant to UN resolutions, notified under Decision No. 144 (EBD/90/244, 8/13/90 and EBD/92/187, 8/28/92).

VIII. **Article IV Consultations**:

Italy is on the standard 12-month consultation cycle. The previous consultation discussions took place during July 2001 and the staff report (SM/01/207, 10/17/01) was discussed on November 5, 2001 (EBM/01/112).

ITALY: STATISTICAL INFORMATION

Italy's economic database is comprehensive and of generally high quality. Italy has subscribed to the Special Data Dissemination Standard (SDDS) and has posted the metadata for the Bulletin Board. Data are provided to the Fund in a comprehensive manner (see attached table), and the authorities regularly publish a full range of economic and financial data, as well as a calendar of dates for the main statistical releases. Italy is also subject to the statistical requirements and timeliness and reporting standards of Eurostat and the European Central Bank (ECB), and has adopted the European System of Integrated Economic Accounts 1995 (ESA95).

Notwithstanding these strengths, weaknesses are evident in a number of areas. First, in the national accounts, inventory accumulation is derived as a residual and lumped together with the statistical discrepancy: this hampers an analysis of the business cycle. Second, no quarterly data are available for the general government balance, expenditure, and revenue on an accruals basis (that is, in line with ESA95): as a result, it is difficult to precisely assess fiscal developments and policies during the year. And third, as highlighted by a recent fiscal transparency Report on Observance of Standards and Codes (ROSC) mission, the quality and timeliness of some fiscal data, particularly on expenditure by local governments, falls short of the code's requirements, notwithstanding some improvements of late.

A recent data dissemination ROSC mission found Italy's macroeconomic statistics to be of generally high quality, but also identified some shortcomings that hindered an accurate and timely analysis of economic and financial developments: (i) no statistical agency had the responsibility to compile and disseminate an integrated, comprehensive statement of government finances, and a large difference had emerged between the several distinct measures of government deficit/financing; (ii) source data and/or statistical techniques could be strengthened in several areas, most importantly, by raising response rates on the enterprise surveys used in the national accounts and producer price index (PPI), making price collection for the CPI more efficient, improving the coverage of cross-border financial transactions that do not go through domestic banks, and widening the use of revision studies to shed light on sources of errors in provisional estimates; and (iii) monetary, balance of payments, and the existing portions of government finance statistics could come closer to the internationally accepted methodological guidelines on concepts and definitions, scope, classification and sectorization, and/or valuation. The mission also noted that resources were under pressure in some parts of the National Institute of Statistics in the face of the statistical requirements of the European Union and the euro area.

Italy: Core Statistical Indicators
(As of September 11, 2002)

	Exchange Rates	International Reserves	Central Bank Balance Sheet	Reserve/ Base Money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Government Balance 1/	GDP/ GNP
Date of Latest Observation	9/11/02	7/02	7/02	7/02	7/02	9/11/02	8/02 2/	6/02	6/02	6/02	2002 Q2
Date Received	9/11/02	mid-August	8/30/02	8/30/02	8/30/02	9/11/02	8/28/02	9/4/02	mid-August	begin-August	9/10/02
Frequency of Data	Daily	Monthly	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Monthly	Monthly	Quarterly
Frequency of Reporting	Daily	Monthly	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Monthly	Monthly	Quarterly
Source of Update	Reuters, Bloomberg	BoI, IFS	BoI	BoI, IFS	BoI	Reuters, Bloomberg	ISTAT Press Release	ISTAT Press Release	UIC	BoI	ISTAT Press Release
Mode of Reporting	Electronic	Cable	Internet, Publication	Internet, Publication	Internet, Publication	Electronic	Electronic	Electronic	Publication	Internet, Publication	Electronic
Confiden-tiality	None	Until data off. released	None	None	None	None	None	None	None	None	None
Frequency of Publication	Daily	Monthly	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Monthly	Monthly	Quarterly

1/ Central government on a cash basis. Overall government accounts are published once a year in February/March; the latest figure is for 2001 and was published March 1, 2002.
2/ Provisional estimate.

Public Debt Sustainability[1]

1. **This annex compares the staff's baseline projection for Italy's public debt against scenarios based on historical averages for the key underlying variables.** The sensitivity of the debt dynamics to a number of shocks is also considered. The shocks are applied as temporary deviations from the baseline, without consideration of feed-back effects, and with magnitudes based on historical developments over the past 10 years.

2. **The baseline scenario envisages a gradual reduction in Italy's high public debt—and the staff's policy advice calls for a more rapid reduction** (as discussed in the main report). The baseline scenario is premised, from 2002 onward, on the authorities' medium-term economic program (as presented in the July 2002 *Documento di Programmazione Economico-Finanziaria*, DPEF), adjusted for deviations from the staff's macroeconomic scenario. In particular, it builds on the authorities' targets for the fiscal balance, but adjusts these for the staff's (somewhat lower) growth projections (the staff's growth projections for 2002–06 are on average about ½ percentage point per annum lower than those in the DPEF; see also Chapter II of the forthcoming Selected Issues paper). The public debt ratio would decline gradually to about 93 percent of GDP by 2007. In view of Italy's high public debt and pending demographic shock, the staff has advised a more rapid decline in the public debt ratio—until further reforms of aging-related expenditure have been implemented.

3. **The analysis of shocks to the baseline underlines the sensitivity of the debt dynamics to a sharp deterioration in the economic environment—although some of the risks have clearly been attenuated by Italy's membership in monetary union.** In view of the size of the public debt, its dynamics would be particularly affected by sharp increases in the real interest rate (stress tests 1, 2, and 5). However, risks of returning, for example, to the interest rate levels associated with the ERM crises of the 1990s seem remote in view of Italy's membership in the euro area. A sharp deterioration in near-term growth prospects (scenario 3) would leave the debt ratio some 7 percentage points above the baseline scenario in 2007. By contrast, the small size of Italy's non-euro denominated debt makes it relatively resilient to exchange rate fluctuations, with public debt ending only 1 percentage point of GDP above the baseline projection for a 30 percent real depreciation (stress test 6).

4. **Italy's debt dynamics is obviously sensitive to progress on fiscal adjustment—but no major deviations from the baseline scenario would be expected, provided that the *Stability and Growth Pact* commitments are met.** While the debt dynamics would deteriorate vis-à-vis the baseline with a sharp worsening of the primary balance (scenarios 1 and 4), risks in this regard are severely limited by the authorities' commitments under the *Stability and Growth Pact* (SGP). For example, if the primary deficit in 2003 and 2004 were 2 standard deviations (i.e., some 3 percentage points of GDP) below the historical averages, the fiscal deficit in those years would be far above the SGP's 3 percent deficit ceiling (stress test 4).

5. **While this Annex reports standardized stress tests, these do not encompass some important considerations for assessing Italy's public debt dynamics.** As noted in the main report, of particular importance is the potential impact of population aging on the public finances: absent further reforms, aging-related expenditures may rise by some 3½ percent of GDP over the next decades. Further details, including longer-run simulations under alternative assumptions for productivity, were reported in earlier staff papers (see, for example, the last two *Country Reports*, No. 01/207 and No. 00/71).

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[1] This Annex reports standardized stress tests for public debt sustainability.

Italy: Public Sector Debt Sustainability Framework, 1997–2007

	Actual					Projections					
	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
I. Baseline Medium-Term Projections											
1. Public debt/revenues 1/	250.3	250.4	245.4	240.8	239.9	240.2	231.6	225.0	217.1	210.5	204.5
2. Public debt/GDP 1/	120.2	116.4	114.5	110.6	109.8	109.8	106.3	102.6	99.1	96.0	93.2
3. Change in public debt/GDP	-2.5	-3.9	-1.9	-3.9	-0.7	0.0	-3.5	-3.7	-3.5	-3.1	-2.8
4. Net debt-creating flows/GDP (5+6)	-2.5	-2.4	-2.0	-5.0	-2.5	-1.2	-3.3	-3.7	-4.0	-3.6	-3.3
5. Overall deficit, excluding net interest payments/GDP (=primary deficit)	-6.7	-5.2	-5.0	-5.9	-4.1	-3.9	-4.7	-4.7	-5.0	-5.0	-5.0
6. ((r - p) - g (1+p))/(1+g+p+gp))debt/GDP (8/7) 2/	4.1	2.8	3.0	0.9	1.6	2.7	1.4	1.0	1.0	1.4	1.7
7. Adjustment factor: 1+g+p+gp	1.0	1.0	1.0	1.1	1.0	1.0	1.0	1.0	1.0	1.0	1.0
8. ((r - p) -g (1+p))debt/GDP (9+10)	4.3	2.9	3.1	1.0	1.7	2.7	1.4	1.0	1.0	1.4	1.7
9. (r - p) times debt/GDP	6.9	5.1	5.0	4.3	3.7	3.4	4.0	4.1	3.9	3.8	3.7
10. minus g (1 + p) times debt/GDP	-2.5	-2.2	-1.9	-3.4	-2.0	-0.7	-2.5	-3.1	-2.9	-2.4	-2.0
11. Residual, including asset changes, privatization receipts (negative), and valuation changes in external debt/GDP (3-4)	0.0	-1.4	0.1	1.0	1.8	1.2	-0.3	0.0	0.5	0.5	0.5
Memorandum Items: Key macro and external assumptions											
Nominal GDP (local currency)	1,026	1,073	1,108	1,165	1,217	1,253	1,307	1,366	1,428	1,488	1,545
Real GDP growth (in percent per year)	2.0	1.8	1.6	2.9	1.8	0.6	2.3	2.8	2.7	2.3	2.0
Consumer price index (change, in percent per year)	1.9	2.0	1.7	2.6	2.7	2.5	1.8	1.6	1.6	1.6	1.6
Exchange rate (LC per U.S. dollar)	0.9	0.9	0.9	1.1	1.1	1.1	1.0	1.0	1.0	1.0	1.0
Nominal appreciation of local currency against U.S. dollar	-9.3	-1.9	-4.5	-13.4	-3.0	4.9	4.2	0.5	0.6	0.3	0.3
GDP deflator (change, in percent per year)	2.4	2.7	1.7	2.1	2.6	2.4	1.9	1.7	1.8	1.8	1.8
Average interest rate on public debt (percent per year)	8.0	7.0	6.0	5.9	6.0	5.5	5.6	5.5	5.5	5.6	5.6
Average real interest rate (nominal rate minus change in GDP deflator, percent)	5.6	4.3	4.3	3.8	3.4	3.1	3.6	3.8	3.8	3.8	3.9
Growth of revenues (deflated by GDP deflator, in percent per year)	7.0	-1.5	2.0	1.2	1.5	0.5	2.6	2.2	2.8	2.3	2.0
Growth of noninterest expenditure (deflated by GDP deflator, in percent per year)	1.9	1.5	2.6	-1.3	5.9	1.2	0.7	2.1	2.0	2.3	1.9
Public sector balance	-2.7	-2.8	-1.8	-0.5	-2.2	-2.0	-1.2	-0.9	-0.4	-0.4	-0.2
Public sector revenue (in percent of GDP)	48.0	46.5	46.7	45.9	45.8	45.7	45.9	45.6	45.6	45.6	45.6
Public sector expenditure (in percent of GDP)	50.7	49.3	48.4	46.5	48.0	47.7	47.1	46.5	46.1	46.0	45.8
II. Stress Tests											
1. If real interest rate, real GDP growth rate, and primary balance (in percent of GDP) in 2003–2007 are at average of past 10 years	...	...	...	...	...	109.8	109.4	109.3	109.7	110.0	110.4
2. If real interest rate in 2003 and 2004 is average plus two standard deviations, others at baseline	...	...	...	...	...	109.8	112.3	114.5	111.1	108.2	105.6
3. If real GDP growth rate in 2003 and 2004 is average minus two standard deviations, others at baseline	...	...	...	...	...	109.8	109.5	109.7	106.2	103.2	100.6
4. If primary balance (in percent of GDP) in 2003 and 2004 is average minus two standard devations, others at baseline	...	...	...	...	...	109.8	109.9	109.8	106.3	103.4	100.7
5. Combination of 2-4 using one standard deviation shocks	...	...	...	...	...	109.8	114.3	119.4	116.0	113.1	110.6
6. One time 30 percent real depreciation in 2003, others at baseline 3/	...	...	...	...	...	109.8	107.5	103.8	100.3	97.2	94.4
7. If debt ratio in 2003 rises by (additional) 10 percent of GDP, others at baseline	...	...	...	...	...	109.8	116.3	112.7	109.3	106.3	103.7
Memorandum Items:											
Primary deficit (percent of GDP, average of past 10 years) 4/	...	...	...	...	...	-4.2	-4.2	-4.2	-4.2	-4.2	-4.2
Primary deficit (percent of GDP, standard deviation of past 10 years) 4/	...	...	...	...	...	1.6	1.6	1.6	1.6	1.6	1.6
Real interest rate (nominal rate minus change in GDP deflator, average of past 10 years)	...	...	...	...	...	5.5	5.5	5.5	5.5	5.5	5.5
Real interest rate (nominal rate minus change in GDP deflator, standard deviation of past 10 years)	...	...	...	...	...	1.9	1.9	1.9	1.9	1.9	1.9
Nominal interest rate (average of past 10 years)	...	...	...	...	...	8.9	8.9	8.9	8.9	8.9	8.9
Nominal interest rate (standard deviation of past 10 years)	...	...	...	...	...	2.7	2.7	2.7	2.7	2.7	2.7
Real GDP growth rate (average of past 10 years)	...	...	...	...	...	1.6	1.6	1.6	1.6	1.6	1.6
Real GDP growth rate (standard deviation of past 10 years)	...	...	...	...	...	1.1	1.1	1.1	1.1	1.1	1.1
GDP deflator (average of past 10 years)	...	...	...	...	...	3.4	3.4	3.4	3.4	3.4	3.4
GDP deflator (standard deviation of past 10 years)	...	...	...	...	...	1.3	1.3	1.3	1.3	1.3	1.3

Sources: Ministry of Finance, *Documento di Programmazione Economica e Finanziaria* (July 2002); and Fund staff calculations and projections.

1/ Indicate coverage of public sector.
2/ Defined as: r = interest rate; p = GDP deflator, growth rate; g = real GDP growth rate.
3/ Real appreciation is approximated by nominal appreciation against U.S. dollar plus increase in domestic GDP deflator.
4/ A negative deficit indicates a surplus.

INTERNATIONAL MONETARY FUND

ITALY

Staff Report for the 2002 Article IV Consultation
Supplementary Information

Prepared by the European I Department

(In consultation with the Policy Development and Review Department)

Approved by Michael Deppler and Michael Hadjimichael

October 18, 2002

1. This supplement to the staff report for the 2002 Article IV consultation with Italy (SM/02/304, 9/28/02) provides an update of developments—in particular, details on the 2003 budget—and of the staff appraisal, following a staff visit to Rome during October 9–10.

Recent developments

2. Recent **economic activity indicators** point to a continuation of the slow growth recorded in the first half of 2002—and, thus, somewhat lower growth than expected in the staff report. Industrial production in August rebounded from low levels (but is likely to have stagnated in September, based on electricity consumption data). Sizable lay-offs were announced in the automobile sector, service sector confidence fell sharply in the third quarter, and volatility in equity markets has increased markedly (as elsewhere in Europe). In all, the staff has revised down its GDP growth projections to ½ percent for 2002 and 2 percent for 2003 (versus the staff report's and the budget's projections of just above ½ percent for 2002 and 2¼ percent for 2003). The authorities agreed that the growth outlook was subject to sizable downside risks, in particular related to external developments.

3. The **2002 fiscal outlook** remains broadly as anticipated in the staff report—with staff still expecting a cyclically-adjusted deficit, net of asset sales, of 1.7 percent of GDP, broadly unchanged relative to the previous year. A larger deficit would have materialized without measures adopted in September, (i) limiting some discretionary spending on goods and services and (ii) raising corporate taxation. The latter aims at stemming larger-than-budgeted revenue losses, which the authorities attributed to tax changes introduced by the previous government. The headline deficit figure is somewhat higher than projected in the staff report (2.3 percent versus 2.0 percent of GDP), because the authorities have lowered their target for revenues from asset sales by ¼ percentage point, to ½ percent of GDP. The authorities expect a somewhat lower headline deficit (2.1 percent of GDP; see table below), reflecting higher estimates for direct and indirect tax revenues as well as lower current expenditure.

4. In the **2003 budget**, the authorities aim to reduce the headline deficit from 2.1 percent in 2002 to 1.5 percent (Table 1). They noted that the cyclically-adjusted deficit would decline by at least ½ percentage point—consistent with the recent decision of finance ministers in the Eurogroup.[1] The cyclically-adjusted deficit net of asset sales would fall by a similar amount (text table). The authorities intend to allow the full and symmetric play of automatic fiscal stabilizers in 2003, should growth deviate from their 2¼ percent projection. The budget documents also revise the medium-term fiscal outlook, with the cyclically-adjusted deficit targeted to decline by an additional ½ percentage point of GDP in 2004.

General Government Balances, 2001–03
(In percent of GDP)

	2001	2002		2003
		Staff	Authorities	Authorities
Overall balance	-2.2	-2.3	-2.1	-1.5
Overall balance (cyclically adjusted) 1/	-1.7	-1.2	-1.1	-0.6
Overall balance (cyclically adjusted) net of asset sales 1/	-1.8	-1.7	-1.6	-1.1

1/ In percent of potential GDP. Estimation reflects staff assumptions about potential growth and cyclical adjustment.

5. The budget foresees the following adjustments:

- **Expenditure cuts** of 0.5 percentage point of GDP relative to 2002, to be secured despite a rise in several sub-categories. The cuts rely primarily on: (i) reductions in goods and services spending (amounting to 0.1 percentage point of GDP), through savings from expanded centralized purchasing, the reintroduction of copayments for some health services, and reductions in pharmaceutical reimbursements; (ii) savings of 0.2 percentage points by shifting below the line (i.e., no longer affecting the deficit) transfers to a public agency, which was recently incorporated; (iii) the conversion of some grants to enterprises into subsidized loans recorded below the line (0.1 percent of GDP); and (iv) cuts in transfers to the railways and postal service (0.1 percent of GDP), which these entities are to offset through their own resources.

- **Tax cuts**, amounting to 0.4 percent of GDP relative to 2002. As foreshadowed in the staff report, the budget implements the first part of the government's tax reform program—covering reductions of the personal and corporate income taxes and of the regional tax on productive activities

[1] In the authorities' estimate, the cyclically-adjusted deficit declines by almost ¾ percent of GDP, somewhat more than estimated by staff because of different assumptions for potential and actual growth.

- **Tax amnesties** expected to yield 0.6 percent of GDP, including a reopening of the amnesty to facilitate the repatriation or declaration of capital held abroad; and several other measures, whereby, for example, past "errors" in tax declarations could be settled at a substantial discount. Combining the tax cuts and amnesties, the budget envisages total revenues to remain broadly unchanged (in relation to GDP) in 2003 relative to 2002.

6. The budget continues to rely extensively on **one-off measures**: revenues from asset sales and tax amnesties together total 1¼ percent of GDP (similar to estimates of one-off measures in 2002[2])—measures that will need to be replaced in subsequent years. Moreover, of the budgeted reduction in the structural deficit by some ½ percent of GDP, about half reflects deficit-reducing **accounting changes**, which may not lead to substantive changes in the underlying economic transactions nor in the general government borrowing requirement. This concerns, in particular, the reclassification of transfers from above to below the line, related to the incorporation of one public agency; and the conversion of grants to enterprises into subsidized loans.[3] In addition, the budgeted **cut in transfers** to the railways and postal service would lead to durable savings only if their cost recovery and efficiency improved correspondingly. The authorities acknowledged that more will have to be done to lower structural expenditure, but explained that major expenditure reforms were politically not feasible in the current environment of weak growth; in the interim, the approved measures provided a useful bridge to advance fiscal consolidation.

7. A new entity—**Infrastrutture S.p.A.**, outside the general government definition—will finance sizable infrastructure investments through private-public sector partnerships. In 2003, Infrastrutture S.p.A.'s financing share for new projects is expected to reach almost 1 percent of GDP (although only a fraction of this amount would be disbursed in 2003, due to the lengthy execution period for infrastructure projects). The authorities were determined to prevent future liabilities for the state from these operations.

8. **The 2003 budget is based on more realistic assumptions than the previous one, but it is still subject to important risks**. The growth assumptions were in line with the Consensus Forecasts at the time of the 2003 budget's presentation. Using the staff's latest, somewhat lower, growth projections, the 2003 deficit would exceed the authorities' by less than ¼ percent of GDP. There are also risks related to the carry-over from expected slippages in 2002 (close to ¼ percent of GDP, as discussed in paragraph 3 above), but these may be offset by margins in some expenditure items, notably on interest payments. Thus, leaving aside cyclical factors, the main areas of risk concern the yield from the tax amnesties and those related to the accounting changes and cuts in transfers mentioned in paragraph 6.

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[2] In addition to asset sales, the 2002 budget included a number of temporary tax revenues.

[3] The conversion would result in public sector savings only if the subsidy on the loans is lower than the previous grant amount. The exact size of the subsidy remains to be decided.

Staff assessment

9. **The 2003 budget targets a sizable reduction in the overall fiscal deficit, but relies on several measures of questionable quality**. Leaving aside the issue of the quality of the measures, the targeted decline in the structural deficit, while slightly below the ¾ percent of GDP recommended in the staff report, appears to be consistent with the recent decision by the Eurogroup. The budget is also based on a more realistic macroeconomic framework, a welcome change from the past; and some steps may result in a durable reduction of procurement and health care expenditures. However, the budgeted reduction in the deficit relies largely on accounting reclassifications and transfer cuts to public entities; but these would result in durable reductions of public-sector spending only if accompanied by improved economic performance in the concerned enterprises—which is not assured. In addition, the size of one-off measures remains very substantial, as in 2002. Among those, particularly regrettable is the recourse to tax amnesties, which not only have an uncertain revenue yield, but also undermine tax compliance. Against this background, the quality of the fiscal adjustment measures should be strengthened during the process of parliamentary approval—aiming at substantial, further structural reductions in spending in 2003.

Table 1. Italy: General Government Accounts, 2001–03

(In percent of GDP)

	2001	2002		2003
		Authorities 1/	Staff	Authorities 1/
Total expenditures	48.0	48.0	48.1	47.5
Current expenditures	43.9	44.0	44.2	43.8
Wages and salaries	10.6	10.8	10.8	10.8
Purchases of goods and services	7.5	7.4	7.5	7.2
Social transfers	16.7	17.2	17.2	17.1
Interest payments	6.3	6.0	5.9	6.0
Other current expenditures	2.8	2.7	2.7	2.7
Capital expenditures	4.1	4.0	3.9	3.7
Of which: asset sales	-0.1	-0.5	-0.5	-0.6
Total revenues	45.8	45.9	45.8	46.0
Direct taxation	15.1	14.7	14.6	14.4
Indirect taxation	14.6	14.7	14.6	14.7
Social contributions	12.7	12.8	12.8	12.8
Other current revenues	3.2	3.3	3.3	3.2
Capital revenues	0.3	0.4	0.4	1.0
Overall balance	-2.2	-2.1	-2.3	-1.5
Primary balance	4.1	3.8	3.6	4.5
Memorandum items:				
Structural overall balance	-1.7	-1.1	-1.2	-0.6
Net of asset sales	-1.8	-1.6	-1.7	-1.1
Structural primary balance	4.6	4.8	4.6	5.3
Net of asset sales	4.4	4.2	4.1	4.8
Nominal GDP (in billions of euros)	1,217	1,253	1,252	1,305

Sources: ISTAT; Ministry of Economy and Finance, 2003 Draft Financial Law; and Fund staff estimates.
1/ Estimates of the structural balance are based on the authorities' output estimates and on the staff's potential output and cyclical adjustment method.

INTERNATIONAL MONETARY FUND

Public Information Notice

EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 02/120
FOR IMMEDIATE RELEASE
October 25, 2002

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

IMF Concludes 2002 Article IV Consultation with Italy

On October 21, 2002, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Italy.[1]

Background

As elsewhere in the euro area, the economic slowdown in Italy in 2001 has been followed by only a modest resumption of growth in the first half of 2002. As weaker external demand spilled over into domestic demand, economic growth stagnated in the last three quarters of 2001. GDP growth turned marginally positive in the first half of 2002 (0.7 percent annualized), although final domestic demand (notably for consumer durables and investment) remained weak, as did industrial production, notwithstanding a rebound in business confidence from its 2001 trough. Equity prices have fallen by over 20 percent from end-2001 to mid October 2002. Partly in response to this, as well as to concerns regarding employment, consumer confidence fell over recent months. Employment growth has decelerated to 0.4 percent (quarter-on-quarter, annualized) in the third quarter of 2002, following growth of around 2 percent in each of the past two years. Unemployment—though declining—remains high at 9 percent (and is especially high in the South and among women and the young). With steady, albeit moderate, wage growth, and cyclically declining productivity, unit labor costs have accelerated, contributing to underlying inflation above 2.5 percent since late 2001 (somewhat above the euro-area average).

Fiscal consolidation did not progress in 2001, and the sizable cyclically-adjusted deficit is not expected to decline in 2002. In 2001, the deficit widened to 2.2 percent of GDP, well above the target of 0.8 percent, reflecting, in part, weaker-than-anticipated growth and failure to contain

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. This PIN summarizes the views of the Executive Board as expressed during the October 21, 2002 Executive Board discussion based on the staff report.

spending. While developments in 2002 are clouded by lack of timely data on the deficit, various indicators, including the sizable government borrowing requirement, suggest that the deficit will be above 2 percent of GDP, against an initial target of 0.5 percent. This estimate reflects revenue shortfalls (only partly cyclical), expenditure overruns, and, moreover, includes sizable one-off revenues from asset sales (0.5 percent of GDP). Staff estimates that the 2002 cyclically-adjusted deficit net of asset sales will be 1.7 percent of GDP—around the level of 2001, and above that of 1999. The lack of progress since the outset of monetary union reflects difficulties in containing primary spending, and risks raising the public debt-to-GDP ratio in 2002.

Some rebound of economic growth remains the most likely scenario—with staff expecting growth of 0.5 and 2.0 percent in 2002 and 2003, respectively—however, the outlook is subject to sizable downside risks. Several factors are likely to underpin stronger growth in the period ahead, including supportive monetary conditions and tax incentives for investment (set to expire at end-2002). At the same time, sizable downside risks include weaker-than-projected external demand; additional spillover effects from international equity markets; the oil price persisting at its current high level; and the potential for further euro appreciation. As to domestic risks, the investment response to temporary tax incentives in 2002 remains especially uncertain, also in light of weakening business sentiment over the summer.

Executive Board Assessment

Executive Directors noted that economic growth in Italy has slowed markedly, due to weaker domestic and external demand, and on average has lagged behind that of other euro-area countries. Directors agreed that the policy agenda laid out by the authorities—including labor and product market reforms, tax and spending cuts, and fiscal consolidation—contains critical elements necessary to improve Italy's growth prospects and raise the employment rate, but stressed that it will need to be followed up by bold and timely implementation backed by public support for the measures. They noted the progress in the areas of labor and product market reforms, and welcomed plans to reduce the tax wedge on labor. However, they expressed concern at the lack of fiscal consolidation in recent years and called for significant and steady progress through structural expenditure reforms.

Directors agreed that a rebound in economic growth remains the most likely near-term scenario, but noted the existence of significant downside risks. Recent indicators suggest that the impact of temporary tax incentives for investment (expiring at end-2002) is likely to be muted, given uncertainty about economic prospects domestically and abroad. Directors viewed monetary conditions as supportive of growth in Italy, and believed that growth in 2003 should also benefit from the anticipated economic recovery in partner countries. But external developments, including those affecting oil prices, remain important downside risks to growth in 2003. Over the medium term, Directors considered that strong growth will depend critically upon further structural reforms.

Directors noted that inflationary pressures have not abated as earlier anticipated—with inflation still somewhat above the euro-area average, and unit labor costs rising recently. However, they also observed that price and cost competitiveness had remained broadly stable in the past two years, and that the current account was broadly in balance.

Directors agreed that the recent labor market accord represents an important step toward the broad-based reform that is needed to raise the employment rate from its relatively low level. The strategy behind the accord—of improved job matching and education, cuts in the tax wedge on labor, and increased labor market liberalization—was viewed as broadly appropriate. Directors noted, however, that unemployment is concentrated in the South—notwithstanding higher growth in the South over recent years. Most Directors considered that employment growth would be facilitated by a wage structure that better reflected regional differences in productivity and labor market conditions. They called on social partners to work toward this goal, and on the authorities to consider regional cost-of-living allowances in the public sector (and to collect and publish regional price level data). Directors also noted the importance of further improvements to infrastructure, law enforcement, and judicial and bureaucratic efficiency in the South.

Directors maintained that the fiscal outcome in recent years has been weaker than planned, and that the cyclically adjusted deficit (net of asset sales) has risen as a share of GDP since monetary union. In 2002, the deficit is again likely to exceed the original target by a sizeable margin. This reflects cyclical developments, but also structural revenue shortfalls and overruns on some primary expenditures. Directors regretted delays in introducing timely corrective measures in 2002, but welcomed more recent steps to prevent larger deficit slippages, including the limits on some discretionary spending on goods and services. Turning to the 2003 budget, Directors welcomed the targeted significant reduction in the headline deficit—but they expressed concern about the quality of measures and noted major risks to achieving the envisaged adjustment. Directors observed that the cyclically-adjusted deficit is targeted to decline by at least ½ percent of GDP, consistent with the recent Eurogroup statement. Directors thought that a somewhat faster pace of fiscal consolidation would have been preferable in light of Italy's high debt level. Some Directors were also of the view that the budget made use of accounting changes, which were unlikely to reduce the public sector borrowing requirement, unless accompanied by improved economic performance in the concerned enterprises. Directors noted the undue reliance on one-off measures, as in 2002, including on asset sales and new tax amnesties. The latter put at risk future tax compliance, and Directors urged the authorities to refrain from renewed tax amnesties.

For the medium term, Directors saw the need for sizable budget surpluses—unless further aging-related reforms are implemented. Increased regional devolution presents special challenges toward the achievement of overall fiscal consolidation. Several Directors considered it important to monitor closely the evolution of spending at the sub-national level and reiterated the need to pay attention to accountability of the local authorities. With Italy's public debt (in relation to GDP) the highest in the euro area and pending population aging, further reform of aging-related spending was seen as critical—notwithstanding important progress secured by earlier reforms. Directors welcomed plans to develop a second, fully funded and private pension pillar, but they thought that consideration should also be given to raising the effective retirement age. Expenditure reductions in coming years are also needed to offset the loss of one-off revenue measures. To this end, Directors urged early progress in the areas identified in the government's agenda, including steps to contain the public employment wage bill and health care costs. Directors noted the planned expansion of private-public sector partnerships, but cautioned the authorities to avoid, as planned, related future liabilities for the state.

Directors supported reducing Italy's high tax burden—provided that expenditure reductions are also put in place to secure the needed fiscal consolidation. Directors commended the emphasis in the first phase of the authorities' tax reform on reducing personal income taxes for lower income groups—which should help to spur employment among the most disadvantaged segments of the labor market.

Directors welcomed recent steps to expand product market reform. Progress in this area, and also on privatization and increasing efficiency in the service and energy sectors would play an important role in boosting productivity growth, which had slowed sharply in Italy over recent years. In this regard, Directors considered that the recent temporary freeze of some utility prices runs counter to the government's general agenda of strengthening market-oriented reforms.

Directors welcomed efforts to raise Italian banks' capital ratios so as to align them more closely with those of their international peers. The authorities' efforts to enhance banks' governance through restrictions on the control of financial institutions by foundations were also welcome. Some Directors thought that measures were needed to enhance minority shareholder rights, and that the authorities need to press ahead with bankruptcy law reform. Directors urged Italy to further increase official development assistance from its relatively low level. They welcomed the authorities' support for abolishing trade barriers for exports from least developed countries. They also commended the authorities for adopting additional measures to counter money laundering and the financing of terrorism, and for their continued assistance to international anti-money laundering efforts.

Directors noted that Italy's statistics are adequate for surveillance. Nevertheless, recent statistical and fiscal Report on Standards and Codes identified some areas of weakness—particularly regarding the quality and timeliness of fiscal data. Directors welcomed the authorities' intentions to address these in a timely fashion in order to increase fiscal transparency.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board. The Staff Report for the 2002 Article IV Consultation with Italy is also available.

Italy: Selected Economic Indicators

	1999	2000	2001	2002 1/
Real economy (change in percent)				
GDP	1.6	2.9	1.8	0.5
Domestic demand	3.0	2.1	1.6	0.8
CPI	1.7	2.6	2.7	2.4
Unemployment rate (in percent)	11.4	10.6	9.5	9.1
Public finances (general government; in percent of GDP)				
Overall balance 2/	-1.8	-0.5	-2.2	-2.3
Primary balance 2/	5.0	5.9	4.1	3.6
Gross debt	114.5	110.6	109.8	109.8
Money and credit (end of year, percent change)				
Contribution to euro-area M3 3/	3.4	4.1	7.1	11.9
Private sector credit 4/	13.7	19.0	10.0	9.6
Interest rates (year average)				
Six-month rate on treasury bills 5/	3.0	4.5	4.1	3.0
Government bond rate, ten-year	4.7	5.6	5.2	5.3
Balance of payments (in percent of GDP)				
Trade balance	2.0	1.0	1.6	1.4
Current account	0.7	-0.5	0.1	0.2
Fund position (as of September 31, 2002)				
Holdings of currency (in percent of quota)		60.15		
Holdings of SDRs (in percent of allocation)		8.36		
Quota (in millions of SDRs)		7,055.5		
Exchange rate				
Exchange rate regime		Euro-area member		
Present rate (October 21, 2002)		US$0.97 per euro		
Exchange rate (change in percent)				
Nominal effective 6/	-1.7	-3.2	0.4	0.4
Real effective (based on unit labor cost) 7/	-0.4	-3.4	-0.7	1.0

Sources: Data provided by the Italian authorities; International Financial Statistics; and IMF staff estimates and projections.

1/ IMF staff estimates and projections.

2/ For 2000, including UMTS receipts of 1.2 percent of GDP. For 2001 and 2002, including estimated receipts from asset sales of 0.1 and 0.5 percent of GDP, respectively.

3/ For 2002, year-on-year change for July. Data break in 2002.

4/ For 2002, year-on-year change for March.

5/ For 2002, average up to August.

6/ For 2002, based on monthly average to August.

7/ For 2002, based on monthly average to July.

Statement by Pier Carlo Padoan, Executive Director for Italy
October 21, 2002

At the outset, on behalf of my authorities, I would like to thank staff for their very useful and highly professional work during this consultation, which is reflected in the high quality of the reports.

I. Consolidation continues, in spite of the heavy slowdown.

As is the case of other EU countries the Italian economy has been hit by a sequence of adverse shocks that have worsened the global slowdown and have depressed expectations of both households and firms. Prospects for recovery in the coming months remain optimistic although the pick up might be weaker than previously expected. Early indications suggest that business expectations are improving as activity starts to pick up.

In spite of the deterioration in the cycle budget consolidation continues, in line with the requirements of the EU agreements. At the same time, as a first step to a more comprehensive tax reform, tax cuts are being undertaken to support low income households and boost consumption. Structural measures are being introduced to enhance control of spending procedures, and new initiatives to extract value from state owned assets are being implemented.

In spite of encouraging employment growth, reflecting progress in labor market reforms, employment creation remains a key policy priority, given the overall low employment levels. These, however, largely reflect long-lasting regional imbalances that are being addressed by a comprehensive strategy.

II. The Cycle. International and country specific factors.

Growth is hit by weaker global activity, wealth losses, and deteriorating expectations.

A number of EU-wide and country specific shocks have led, over the current year, to downward revisions of growth prospects. During the first half of 2002 GDP growth has remained flat on a yearly basis. The second half of the year promises to be more encouraging, leaving, however, overall growth for 2002 well below 1 percent. Authorities' forecasts are in line with staff projections. Disappointing demand growth is the result of reduced activity as well as sizable wealth losses. Estimates of the Ministry of the Economy indicate that, had the stock market index remain unchanged with respect to 2001, GDP in 2002 would have been higher by 0.4 percent. International and domestic shocks have hurt confidence and increased uncertainty both in corporations and households, as indicated in the decrease in the propensity to consume.

International and country specific factors account for the slowdown.

Recent developments reflect both international and country specific factors. Among the latter are the, still to be clearly identified, consequences of the crisis in Latin America, and in Argentina in particular, given that Italian investors have acquired Argentinean assets for a value of about 1 percent of Italy's GDP.

In addition, Italy has suffered from the geographic and sectoral characteristics of its export structure. Germany and other major EU countries account for a very large part of Italy's exports, which have been negatively affected by the slowdown in these countries. Also, as Italy's share of high-tech production is limited, export performance has not benefited from the acceleration of world demand for high tech goods. As a consequence Italy's exports have increased less than those of other EU member states.

Possibly, other sector-specific events, such as those that have hit the largest auto producer, may contribute to downside risks.

On the positive side. Confidence is improving, and employment is growing.

There are however, signs that business confidence is beginning to recover, as orders pick up, driven by foreign demand, and the degree of capacity utilization increases. Household confidence remains weak, but it is expected to recover as the one-off price effects of the introduction of euro notes and coins vanish and lower-income households begin to benefit from tax cuts included in the budget law.

Prospects for recovery will also be enhanced by the contribution to infrastructure and public works that the new company—Infrastrutture SpA—will provide.

In spite of the slowdown employment continues to increase, although at a lower pace. This will lead to a further fall of the unemployment rate—in contrast to the overall EU trend—that should be just above 9 percent in 2002.

III. The Budget and Fiscal Consolidation.

Fiscal consolidation continues, in spite of the slowdown. Expenditure control is being strengthened.

The intensity of the slowdown has made it necessary to revise budget projections for 2002 and 2003 in line with lower expected growth, and the consequent drop in revenues. The revenue shortfall is, in part, the consequence of reimbursements on personal income tax, and, to a larger extent, the consequence of lower tax revenues from large firms that have benefited from tax reductions introduced in previous legislation as well.

To cope also with the consequences of the slowdown on the budget and to strengthen the budget, a decree, presented by the Government in early September, introduces more rigorous

rules in expenditure control, including: the prohibition to implement spending decisions without the appropriate financing, the mandate for Government to return to Parliament if previously approved expenditure decisions require new funds, a shortening of the time period that funds can be left idle in the budget ("residui di stanziamento"). The new measures will significantly increase transparency in expenditure procedures and lead to the elimination of discrepancies in the budget in terms of cash and accrual.

The Budget.

The budget law, recently presented to Parliament is based on the following guiding principles: a) structural spending cuts; b) measures to improve the efficiency and transparency of public spending, including centralization of procurement (which will improve the terms of trade for the administration) and an increase in the utilization of flexible contracts for public employment; c) tax cuts, especially targeted at low income and representing a first step towards a comprehensive fiscal reform. These tax cuts will boost household demand and strengthen incentives to labor participation; d) tax amnesties, which are not seen by Authorities as alternative to spending cuts, aim at increasing revenues and, especially, at obtaining permanent increases in the tax base. Historical experience of past amnesties shows that up to one quarter of additional revenue is permanent as a result of emersion of previously submerged activities; e) reinforced social safety nets, as agreed with social partners ("Patto per l'Italia"); and f) two new agencies to improve the management of public real estate assets and obtain additional resources (Patrimonio SpA), and to finance infrastructure investment in cooperation with the private sector through project financing (Infrastrutture SpA).

These measures will lead to a continuation of structural adjustment in the budget and debt reduction, which will also benefit from an improvement in the structure of debt.

Privatization will progress.

The Ministry of Economy and Finance holds stakes in 20 industrial corporations and companies. The total value of these holdings is estimated at about 80 billion euro. Central and local governments also hold assets and real estate, the latter estimated between 23 billion and 30 billion euro. Other public bodies, such as municipalized firms, also have holdings.

In 2000 and 2001, the privatization process slowed down as a consequence of the fall in equity markets. The privatization strategy in the new, less favorable circumstances in financial markets, will be based on the following steps: a) postponement of global offerings, b) unbundling of networks in regulated utilities before their sale, c) strengthening of institutional investors. Intermediate steps include: a) restructuring of state-owned enterprises in view of future privatization; b) market liberalization (liberalization in electricity, natural gas, telecom, is quite advanced with respect to other European countries. Municipal utilities will be liberalized and privatized following the separation between infrastructure and service provision); c) improvement of corporate governance by fostering the development of pension funds, improving protection for minority shareholders and fostering equity culture.

The Government plans to complete sale of all remaining stakes by the end of 2003 (including Telecom Italia, Seat, ETI, Mediocredito Friuli Venezia Giulia, Coopercredito, Tirrenia, and Fincantieri) with the exception of ENEL, Terna, Gestore della Rete di Trasmissione, and Alitalia. For the latter it will reduce its holdings to a 30 percent ceiling. The total amount of shares to be sold by end 2003 is worth 20 billion euro. This includes 37.58 percent of ENEL, if market conditions allow.

The Postal Service Company, Poste Italiane SpA, which was transformed into a joint-stock company in February 1998, is progressing in financial consolidation, restructuring of postal services, and development of new financial services. It could achieve market listing in 2003.

Ferrovie dello Stato (the railroad corporation) has been restructured. It now holds 100 percent participation in two new companies, Trenitalia (operating medium- and long-distance trains) and Rete Ferroviaria Italiana (operating the track network). Sale of Trenitalia is being considered.

The overall privatization program will amount to around 60 billion euros between 2002 and 2006 and it will have a significant debt-reduction impact leaving public debt at about 94 pecent of GDP at the end of 2006.

Securitization.

In 2002 and 2003, if market conditions allow, the Government will carry out securitizations of real estate assets expected to yield proceeds of 14-15 billion euro. In December 2001 the first securitization of residential real estate assets belonging to the Enti Previdenziali was launched, covering 27,292 residential homes and 262 commercial units, amounting to a market value of 5.4 billion euro. The securitization operation amounted to a bond issuance worth 2.3 billion euro. A second operation will be launched before the end of the current year, including 54,000 homes belonging to the Enti Previdenziali, for a market value of about 20 billion euro. In 2003, via securitization, residential houses will be sold belonging to the Ferrovie dello Stato, Poste Italiane, Ministry of Defense, and Demanio (State Property). Assets are worth about 3-3.5 billion euro.

Less favorable conditions impose lower speed. But the direction towards budget adjustment remains unchanged.

The revised budget figures reflect the growth revision due to the slowdown. However, structural adjustment continues in 2002, showing clear progress. The cyclically-adjusted deficit shrinks over the current year. The table reports the evolution of the budget balance from 1999 to 2003 both in nominal and cyclically-adjusted terms. The output gap figures are those included in the EC Commission 2002 Spring Forecasts. Figures for 2001 are presented before and after Eurostat decisions not to include revenues from lottery and housing sales in the computation of the financing requirement.

The table indicates that, starting from 2000 and neglecting the effects of Eurostat decisions, the cyclically-adjusted balance shows a steady improvement. Furthermore, starting in 2001, the cyclically-adjusted balance shows a declining path of at least 0.5 percent, in line with the recent Commission recommendation. My authorities consider the potential output values used to compute the cyclically-adjusted budget balance in line with those of the EC Commission (confirmed in a recently-published Report) to be conservative, and therefore leading to conservative cyclically-adjusted balance figures.

Budget Balance In Italy, 1999-2003

	1999	2000	2001		2002	2003
Budget Balance(% of GDP)	-1.8	-1.7	-2.2**	-1.6***	-2.1	-1.5
Cyclically-Adjusted Budget Balance (% of GDP)*	-1.5	-1.8	-2.1**	-1.5***	-1.2	-0.5

* Based on the last official series on Output Gap provided by the Commission
** After the Eurostat decision
*** Before the Eurostat decision

Output gap estimation

The selected issues paper presents new, and lower, potential output estimates and compares the results with those of the EC, the OECD, and the Italian Authorities. Much of the difference is accounted for by the different treatment of employment figures in staff estimates. Both the Authorities' and staff estimates do not include the effects of future labor market reforms. However, staff estimates also neglect the impact of recent labor market reforms, the effects of which are beginning to be felt on employment growth, and which show a comparatively better performance in Italy with respect to the rest of the Euro area. As a consequence staff suggest that, once the impact of cyclical factors is completed, employment will converge to past trends.

In addition, while we recognize the difficulty of providing satisfactory TFP estimates having to rely on a limited number of observations and hence on the need to use growth forecasts to 2007, we would caution against excessive reliance on such estimates.
Overall, my authorities remain unconvinced of the extent to which the new estimates presented by staff can offer a robust alternative to existing estimates, and look forward to further refinements of the analysis.

Tax reform.

My Authorities stress the pivotal role of tax reductions for fiscal consolidation. As mentioned, tax cuts included in the Budget Law, concentrated on low-income families, represent the first step towards a comprehensive tax reform. The guiding principle of the reform is a change in tax progressivity that will move from the current system, based on several tax rates, to a system based on tax allowances, which will be inversely related to income brackets. The new structure will generate a lower marginal tax rate that will boost

labor supply, reduce the underground economy and tax evasion, and improve transparency.

The proposed tax amnesty (*concordato)* should be considered in this perspective. It differs from traditional tax amnesties as it does not envisage penalties on the tax due in previous periods but it focuses on tax due in the current period. My authorities believe that such an approach will improve the relationship between taxpayers and the administration, and the increase in revenue will be, for a significant amount, permanent.

Finally, as for corporate taxation, the overall goal is to eliminate the bias against small and medium firms while softening the relative advantage large firms have so far benefited from. The average tax rate on firms will remain unchanged.

Pension reform.

Over the nineties, Italy has been one of the few EU Member States to implement a wide ranging reform of the pension system, that will guarantee the long-term financial sustainability of public pension expenditure. The BEPG 2001 Implementation Report presented by the European Commission recognized the positive impact of the Italian pension strategy stating that "*... the reforms of the pension system of the 1990s have helped contain the growth of ageing-related expenditure as a percentage of GDP and recent projections suggest that the budget can absorb such pressures without imbalances*...".

Long term projections carried out by the Governement show that, given current legislation, pension spending over GDP would rise from 13.8 percent in 2000 to 16 percent in 2033 and, subsequently, decline to13.6 percent by 2050.

On international comparison this is one of the smallest increases, in spite of the substantial increase in the dependence ratio that is due to reach 60 percent by 2050. In fact, the replacement ratio will decline substantially after 2010, and the ratio between average pension and labor productivity will decline in the central part of the projection period, as the system shifts to a defined contribution mechanism.

Debt sustainability analysis in the staff report considers the impact of population ageing on public finances. The assessment is in line with the Authorities' projections that show that Italy's long term pension position is among the most robust in the EU.

My Authorities, however, recognize that the overall cost of the system, also in comparison with other EU cases, imposes a heavy burden on the budget and on the economy, and represents an obstacle to higher growth. They remain committed to tackling the issue in the near future. As a matter of fact a "Legge Delega," currently under review in the Parliament, strongly focuses on the appropriate incentives to increase the retirement age. However they note that the adverse cyclical conditions do not allow for enough space in the current year, given a possible negative short-term impact on income and demand as well.

IV. Employment, growth, and regional disparities.

In spite of recent progress, employment remains disappointingly low...

As mentioned, employment is increasing at non-negligible rates and unemployment continues to decline—in spite of the adverse cyclical conditions and the overall Euro area evolution—thanks to employment reforms and wage moderation.

The slowdown has, nonetheless, weakened the favorable dynamics of the recent past. Growth in permanent employment contracts, which had accelerated until recently, also supported by tax incentives, is slowing down, while employment through flexible contracts (atypical) is increasing at a faster pace.

Employment rates remain low in terms of EU averages and targets set at the Lisbon EU Council. Impediments to stronger employment growth include elements of employment protection legislation, product market regulation, and the tax wedge.

The "Patto per l'Italia," agreed on with trade unions and business representatives, aims at increasing labor market participation and employment rates. The agreement is based on four pillars: a) tax reform, b) improvement in private and public job placement systems, c) reform of income support measures towards active measures, aimed at encouraging job search, d) measures in support of new employment and targeted at increasing employment levels in small firms.

...but it reflects largely a regional problem.

Differences in employment and unemployment rates are wide on a regional basis. The rate of unemployment stands at less than three percent in the north-east, and slightly above four percent in the north-west, virtually full employment and well below the Euro area average. It is slightly above six percent in the center, and close to 18 percent in the south. Employment rates vary from close (or even above) 70 percent in the northeast to around 45 percent in the south. Such differences reflect long standing structural impediments (accumulated idiosyncratic shocks) that involve diverse regional aspects, including the way employment protection legislation is applied in the south by the judiciary, the dramatic lack of infrastructure, higher law enforcement costs, and specialization in low growth sectors.

Mezzogiorno is growing faster than the rest of the country...

Notwithstanding these long lasting structural differences, which make Italy a highly differentiated economy, it is encouraging to note that, over the recent past, the growth rate of the Mezzogiorno has exceeded that of the rest of the country. Growth has been driven by private investment, in the non agricultural sector in particular, and by exports, both of which have grown faster than in the north, and should continue to do so, given the healthier state of business confidence in the south with respect to the rest of the country. On the other hand,

consumer confidence, traditionally more buoyant in the south, is now converging to lower levels, in line with the rest of the country.

Over the current year private investment has substantially benefited from tax incentives that have been further streamlined and strengthened.

Employment growth has significantly picked up since 1997 and has exceeded that in the rest of the country. In addition, over the past decade, the share of employment in manufacturing has significantly increased, improving the composition as well as the amount of employment.

...but an acceleration of catching up will require additional effort and resources.

The medium-term strategy of the Government aims at achieving a growth rate that, in a few years, should be well above that of the rest of the country and the EU average. This target, while ambitious, is not out of line with recent experiences of catching up of backward EU regions, and will require both new financial resources and a better implementation of spending procedures. This, together with an acceleration of the use of EU funds, aims at allocating to the Mezzogiorno 45 percent of total capital account spending.

Measures to improve employment perspectives in the south should also include wage differentiation to better reflect productivity differentials. The selected issues papers suggest that insufficient wage differentiation may be due to excessive wage centralization, implying that wage setting in the south is determined by labor market conditions in the north. To this respect it is worth recalling that, according to both official and non official sources, wage differentials have widened over the past decade.

This not withstanding, enhancing regional differentiation in wage formation (but productivity differentials also carry a firm specific dimension, which is already accounted for in the Italian bargaining system), is up to social partners to decide. However, future work should concentrate on the effective impact of wage differentiation on employment, and on the interaction of appropriate wage negotiation mechanism with other factors affecting growth and employment creation.

It should be kept in mind that, as far as employment and potential growth are concerned, the dualistic nature of the Italian economy has to be duly taken into account in order to derive appropriate policy prescriptions, and that dualism is not just the consequence of the wage-bargaining mechanism.