



# Italy: Staff Concluding Statement of the 2017 Article IV Mission

June 12, 2017

1. **The economy is in the third year of a moderate recovery.** It has been helped by the government's policy and reform efforts, exceptional monetary accommodation, and low commodity prices. Unemployment and nonperforming loans (NPLs) have declined somewhat from their crisis-driven peaks. Public debt has stabilized, albeit at a very high level. However, weak productivity and low aggregate investment remain key challenges for faster growth, held back by structural weaknesses, high public debt, and impaired bank balance sheets. Despite some improvement, further progress in reducing vulnerabilities and raising real incomes will require enhanced policy efforts. A decade after the global financial crisis, real disposable incomes per capita remain below pre-euro accession levels, while the burden of the crisis has fallen disproportionately on younger generations.

2. **The recovery is expected to continue, but risks ahead are significant.** Growth is projected at about 1.3 percent this year. As favorable tailwinds—terms of trade, fiscal and monetary policies—become less supportive in the coming years, growth is projected (on current policy settings) to moderate to around 1 percent in 2018–20. Growth could surprise on the upside in the near term, including from a stronger European recovery. Nevertheless, downside risks are significant, related among others to financial fragilities, political uncertainties, possible setbacks to the reform process, and re-evaluation of credit risk in the course of monetary policy normalization. Uncertainty about U.S. policies and Brexit negotiations add to these risks. Under a moderate growth outlook, real income per capita is expected to return to pre-crisis levels only several years from now, and Italy would diverge further from its euro area peers.

3. **The key priorities are to raise growth, increase economic resilience, and protect the vulnerable.** The overarching challenge is to boost productivity, which requires more ambitious policy efforts and broad and sustained political support. In a complex economic and political environment, the authorities have advanced important reform initiatives, which have succeeded in jumpstarting the recovery and broadly stabilizing imbalances. Further steps are now needed to narrow competitiveness gaps with euro area partners, reduce imbalances, and raise incomes including for those being left behind. The current backdrop of cyclical recovery and exceptional

monetary accommodation provides a favorable, if narrowing, window to press ahead urgently with reforms.

## **Structural reforms**

**4. Ambitious and comprehensive structural reforms will help foster stronger growth.** These should build on the authorities' recent efforts that include the Jobs Act, decrees to modernize the public administration, measures to accelerate insolvency and debt enforcement procedures as well as civil justice, and an education reform to improve school outcomes. Further reforms include enhancing competition in product and service markets, improving wage bargaining to align wages with productivity at the firm level, and broadening public sector reform.

- *Liberalizing product and service markets.* Regulatory barriers to competition remain notable in sectors such as network industries, professions, and local public services. Notwithstanding a requirement to legislate annually measures that would promote competition, no law has yet been approved and a draft law has been in parliament for over two years. This draft, aimed initially at an ambitious overhaul of barriers, includes pro-competition measures in sectors such as communication and energy. However, during discussions in parliament, it has been weakened in some areas, such as insurance and professions, and introduces restrictions in tourism. Strengthening the draft in line with the recommendations of the competition commission, adhering to the requirement of legislating annual pro-competition laws, and enhancing the authority to sanction anti-competitive practices would help improve efficiency, productivity, and investment.
- *Reforming labor markets.* Wages have grown persistently above productivity under the sectoral wage bargaining framework, hindering job creation, competitiveness, and investment. Efforts to strengthen second-tier firm-level bargaining have not been effective in reversing this dynamic, owing in part to legal uncertainties and low levels of cooperation in labor-employer relations. Consideration should therefore be given to strengthening the collective wage bargaining system to better align wages with productivity at the firm level. This includes giving clear primacy to firm-level contracts, strengthening opt-outs from collective agreements, and introducing a minimum wage, possibly differentiated across regions. Other measures to strengthen labor market functioning include reducing the tax wedge on secondary earners, increasing spending on active labor market policies, and extending the new Jobs Act contract to all open-ended contracts in the private sector.
- *Modernizing the public sector.* Following the 2015 framework law to reform the public administration, important implementing decrees were issued, such as to simplify procedures and accelerate decision making. But some key actions have been delayed, such as on improving public sector management and regulating local public services (except transport), or weakened, such as on rationalizing state-owned enterprises. Broadening and completing public sector reform are important to raise productivity, lower the cost of business, and enhance the gains from other reforms. Measures are also needed to improve the skill mix of the public sector, widen the scope of procurement reform, and tackle privileges and employment in public enterprises, including through privatization and cuts in subsidies. Monitoring outcomes is essential.

## **Financial stability**

**5. Accelerating the repair of bank balance sheets will strengthen financial stability and support intermediation** . Encouraging progress is being made, market pressure on banks has eased recently, and credit supply conditions are improving. This reflects, inter alia, important actions taken regarding strengthening the capital buffers of some large banks and plans for sizable NPL sales, procedures initiated for the precautionary recapitalization of some weak banks, and bank consolidation. The Single Supervisory Mechanism has also issued guidance to significant institutions to tackle NPLs. Complementary measures can help to accelerate addressing the weak asset quality and profitability problems, so that vulnerabilities do not linger and monetary transmission is repaired. These include: improving the capacity to materially tackle NPLs, enhancing banks' operational efficiency, addressing weak banks, and fully aligning governance rules to EU standards.

- *Resolving NPLs.* (i) *Oversight:* banks' NPL reduction strategies and targets need to be ambitious and credible, aided by supervisory assessments of banks' capacity to resolve NPLs in a realistic and timely manner. Banks with weak internal capacity should be required to take the necessary actions, such as engaging specialist collection and workout firms, to achieve their targets. NPL guidance should be extended to less significant institutions. (ii) *Effective insolvency procedures* : progress in accelerating corporate insolvencies in practice has been limited. The authorities' plans for a comprehensive insolvency overhaul can rationalize the present complex framework and address shortcomings. It should be adopted, maintaining ambitious steps for corporate restructuring. Implementation requires considerable efforts to improve court functioning and develop uniform practices. It should be complemented with more intensive use of out-of-court restructuring.
- *Enhancing efficiency.* (i) *Rationalization:* elevated operating costs weaken banks' ability to generate capital through retained earnings. The supervisor should seek to ensure—through intensive and assertive supervisory challenges—that banks have realistic and coherent business model assumptions, so that capital destructive practices are recognized, streamlined, divested, or closed. (ii) *Consolidation:* consolidation of Italy's fragmented banking system is planned and can help increase efficiency. Three new banking groups are expected to emerge by end-2018 from the consolidation of over 300 cooperative banks. Supervisors should ensure that these groups start with a clean bill of health, are well governed, and profitable over the long term. This involves undertaking an asset quality review of the emerging groups and ensuring robust governance and risk management structures. Issues identified in the process could be followed up in the remaining smaller banks as well.
- *Addressing problem banks.* Finding timely and low cost solutions to problem banks has proven difficult. This is due in part to the need to clarify expectations and processes of the new bank recovery and resolution framework, the complex coordination challenges across multiple authorities both at the national and the EU levels, and concerns about resolving banks and applying bail-in. These issues should be addressed. For problem banks, swift recapitalization or the timely and effective use of the resolution framework is essential to avoid weaknesses from lingering too long, burdening the rest of the system, and threatening stability. Where burden sharing or bail-in is required, protection should be provided for vulnerable households. Any cases of mis-selling should be addressed by the regulatory and supervisory authorities as well as the banks.

- *Improving governance.* Legislative gaps in Italy's implementation of the EU fit and proper rules for bank management should be closed.

## **Fiscal sustainability**

- 6. The ongoing recovery and improving financial conditions provide a favorable backdrop to implement the needed fiscal adjustment.** High public debt leaves Italy exposed to shocks, with little room to respond and at risk of a sharp, pro-cyclical correction. A gradual adjustment, as announced in the authorities' multi-year budget plans in April and aiming for an overall deficit of 1.2 percent of GDP in 2018 and a broadly balanced budget by 2019, is appropriate to ensure debt is on a firmly declining trajectory. Thereafter, a small structural surplus of about ½ percent of GDP would provide valuable insurance for a declining debt path against shocks. In line with this, utmost priority needs to be placed on permanent, growth-friendly measures to underpin the consolidation.
- *Revenue rebalancing.* Tax rates on productive factors could be lowered gradually, taxation shifted toward properties and consumption, and the tax base broadened. VAT policy and compliance gaps are among the highest in the euro area; reducing these gaps, together with lowering further the labor tax wedge, would support jobs and growth. The reform of cadastral values should be accelerated and a modern real estate tax introduced. A comprehensive rationalization of tax expenditures and stronger enforcement of collections would enhance the design and efficiency of the tax system. Reducing tax uncertainty would improve the investment climate.
  - *Spending measures.* Notwithstanding efforts in recent years, further steps are needed to reduce current spending, albeit with targeted support for the vulnerable. This includes fully implementing procurement reform and improving the efficiency of health spending. Italy has done more than most to put its pension system on a firm footing. Nevertheless, consideration should be given to reducing the high levels of pension spending over the medium term, so as to address fiscal pressures that would persist before the savings from pension reforms materialize over the very long run. Pockets of excesses exist in the pension system that need to be rationalized, related not least to the grandfathering of generous benefits. Pension parameters could also be reviewed and adjusted as necessary, consistent with current policy settings. On the other hand, the share of transfers to those with low incomes is the lowest in the euro area. Targeting should be improved, social protection programs rationalized, and the income inclusion program expanded into a universal anti-poverty scheme.

*The mission would like to thank the authorities and other interlocutors for their time, helpful discussions, and hospitality.*