



# ITALY

July 2017

## 2017 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR ITALY

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2017 Article IV consultation with Italy, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its July 21, 2017 consideration of the staff report that concluded the Article IV consultation with Italy.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on July 21, 2017, following discussions that ended on June 12, 2017, 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 July 6, 2017.
- An **Informational Annex** prepared by the IMF staff.
- A **Statement by the Executive Director** for Italy.

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

Selected Issues

The IMF's transparency policy allows for the deletion of market-sensitive information and premature disclosure of the authorities' policy intentions in published staff reports and other documents.

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INTERNATIONAL MONETARY FUND



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July 27, 2017

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## **IMF Executive Board Concludes 2017 Article IV Consultation with Italy**

On July 21, 2017, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation<sup>1</sup> with Italy.

The Italian economy is in the third year of a moderate recovery. Supported by exceptionally accommodative monetary policy, fiscal easing, low commodity prices, and the government's reform efforts, the economy grew by 0.9 percent in 2016 and continued to expand in the first quarter of 2017. Unemployment and nonperforming loans have declined somewhat from their crisis-driven peaks. Public debt appears to be stabilizing at about 133 percent of GDP. 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. 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.

The recovery is expected to continue, but risks ahead are significant. Growth is projected at about 1.3 percent this year and around 1 percent in 2018–20 as favorable tailwinds—terms of trade, fiscal and monetary policies—become less supportive. Growth could surprise on the upside in the near term, including from a stronger European recovery. However, downside risks are significant, related among others to political uncertainties, possible setbacks to the reform process, financial fragilities, and re-evaluation of credit risk during monetary policy normalization. Uncertainty about U.S. policies and Brexit negotiations add to these risks. This moderate growth path would imply a return to pre-crisis per capita income levels only by the mid-2020s and a widening of Italy's income gap with the faster growing euro area average.

The authorities have advanced important reform initiatives, which have succeeded in supporting the recovery and broadly stabilizing imbalances. Further progress in reducing imbalances, narrowing competitiveness gaps, raising productivity and supporting incomes of

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<sup>1</sup> 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.

(continued...)

the most vulnerable will require more ambitious policy efforts and broad and sustained political support. The current backdrop of cyclical recovery and exceptional monetary accommodation provides a favorable, if narrowing, window to press ahead with structural, fiscal, and financial reforms.

### **Executive Board Assessment<sup>2</sup>**

Executive Directors noted that the Italian economy has been recovering steadily in recent years, supported by accommodative policies, a favorable global environment, and the authorities' reform efforts. Notwithstanding the progress made, long-standing structural weaknesses, high public debt, and impaired bank balance sheets continue to pose challenges.

Directors commended the authorities for their ongoing efforts to reform the economy. They stressed that the current backdrop of cyclical recovery and exceptional monetary accommodation provides a favorable, if narrowing, window to advance structural reforms, accelerate the repair of bank balance sheets, and carry out the needed fiscal adjustment. Decisive implementation of such a comprehensive strategy can support the economy in the near term, put public debt on a firm downward path, narrow competitiveness gaps, and yield notable output gains in the medium term. Directors agreed that broad and sustained political support will be essential in this regard.

Directors agreed that structural reforms are essential to raise potential growth and improve competitiveness. In this context, they welcomed the passage of decrees on public administration reform. They also encouraged the authorities to press ahead with ambitious product and service market reforms, modernize the wage bargaining system to better align wages with productivity at the firm level, strengthen active labor market policies, accelerate insolvency and civil justice reforms, and broaden and complete public administration reforms.

Directors noted that progress is underway to safeguard financial stability. They called for additional measures to enhance banks' operational efficiency and materially reduce NPLs. Directors highlighted that banks' NPL reduction and restructuring strategies should be ambitious, and credible, aided by supervisory assessments. Undertaking an asset quality review of all emerging consolidated banking groups and ensuring robust governance and risk management structures will also be important going forward. While acknowledging the reduction in tail risks related to the recent decisions to liquidate two weak banks and recapitalize another institution, Directors emphasized the importance of prompt actions to address problems in banks, with appropriate burden sharing involving banks' shareholders and creditors, and protection as needed for the most vulnerable retail bondholders. This is especially important in view of Italy's limited fiscal space to minimize costs to taxpayers.

Directors considered that the ongoing recovery and favorable financial conditions provide an opportunity for a credible and sizable fiscal consolidation strategy to reduce the public debt

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<sup>2</sup> At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: <http://www.imf.org/external/np/sec/misc/qualifiers.htm>.

ratio. They supported a gradual but substantial fiscal adjustment in 2018-19 toward a structurally balanced budget. For the medium term, many Directors thought that targeting a small structural surplus would provide valuable insurance for a declining debt path against shocks. At the same time, many other Directors felt that a balanced budget was appropriate. Directors underscored that the adjustment effort should be underpinned by permanent, growth-friendly, and inclusive measures, including so as to not jeopardize the recovery. The focus should be mainly on further cutting current primary spending, including reducing pension spending over the medium term, expanding the income inclusion program into a universal anti-poverty scheme, increasing capital spending, broadening the tax base, and gradually lowering tax rates on productive factors.

### Italy: Selected Economic Indicators 1/

	2015	2016	2017	2018	2019	2020
<b>Real Economy (change in percent)</b>						
Real GDP	0.8	0.9	1.3	1.0	0.9	1.0
Final domestic demand	1.1	1.5	1.4	0.9	0.7	0.9
Exports of goods and services	4.4	2.4	4.3	4.3	3.8	3.6
Imports of goods and services	6.8	2.9	5.8	4.3	3.6	3.6
Consumer prices	0.1	-0.1	1.4	1.2	1.4	1.4
Unemployment rate (percent)	11.9	11.7	11.4	11.0	10.6	10.3
<b>Public Finances</b>						
General government net lending/borrowing 2/ 3/	-2.7	-2.4	-2.2	-1.3	-0.3	-0.1
Structural overall balance (percent of potential GDP)	-0.9	-1.1	-1.4	-0.7	0.1	0.1
General government gross debt 2/ 3/	132.1	132.6	133.0	131.6	129.0	126.0
<b>Balance of Payments (percent of GDP)</b>						
Current account balance	1.4	2.6	1.9	1.6	1.4	1.2
Trade balance	3.0	3.6	3.1	2.9	2.8	2.6
<b>Exchange Rate</b>						
Exchange rate regime			Member of the EMU			
Exchange rate (national currency per U.S. dollar)	0.9	0.9	...	...	...	...
Nominal effective rate: CPI based (2000=100)	96.9	98.4	...	...	...	...

Sources: National Authorities; and IMF staff calculations.

1/ IMF staff estimates and projections are based on the fiscal plans included in the government's 2017 budget and April 2017 Economic and Financial Document.

2/ Percent of GDP.

3/ State aid following the liquidation of two banks in June 2017 is reflected in public debt (0.6 percent of GDP), but not in net lending/borrowing, pending clarity on their statistical treatment.



# ITALY

## STAFF REPORT FOR THE 2017 ARTICLE IV CONSULTATION

July 6, 2017

### KEY ISSUES

**Context.** The economy continues to recover, unemployment and nonperforming loans have declined somewhat from their crisis peaks, and public debt appears to be stabilizing. Growth remains moderate, however, despite exceptional monetary accommodation and fiscal easing, and Italy continues to underperform its euro area peers, owing to persistent structural weaknesses, imbalances, and financial fragilities. Thin policy buffers leave the economy exposed, including to the start of withdrawal of monetary accommodation. Meanwhile, real disposable incomes per capita have fallen below pre-euro accession levels and the distribution of the burden of adjustment has been uneven, potentially contributing to public discontent.

**Recommendations.** Raising productivity and growth and enhancing economic resilience are of utmost priority to address Italy's inter-related challenges and decisively reduce risks. Mutually-reinforcing reforms can raise productivity, revive investment, and support growth in the near term, facilitating the needed adjustment and balance sheet cleanup. A credible and comprehensive policy package would include:

- *Structural reforms:* implementing ambitious product and service market liberalization; modernizing wage bargaining to align wages with productivity at the firm level; and broadening public administration reforms.
- *Financial stability:* establishing ambitious targets with individual banks to reduce nonperforming loans and improve insolvency and debt enforcement procedures; encouraging bank rationalization and consolidation, accompanied by proactive supervision and better governance to raise profitability; and making timely and effective use of the resolution framework to minimize costs to taxpayers and the rest of the financial system.
- *Fiscal policy:* following the fiscal relaxation of recent years, including in 2017, achieving the balanced budget target by 2019 as announced by the authorities in April is appropriate and necessary. Underpin this adjustment with growth-friendly and inclusive measures—by cutting current primary spending, lowering tax rates on productive factors, and broadening the tax base.

Approved By  
**Thanos Arvanitis and  
 Tamim Bayoumi**

The mission visited Rome, Milan, and Frankfurt during May 29–June 12, 2017, and comprised Rishi Goyal (head), Alvar Kangur, Mehdi Raissi, and Anke Weber (all EUR), José Garrido (LEG), and Dermot Monaghan (MCM). Poul Thomsen (EUR) attended the concluding meetings. Carlo Cottarelli and Cristina Collura (OED) also participated. The mission met Finance Minister Padoan, Bank of Italy Governor Visco, Public Administration and Simplification Minister Madia, other senior government officials, SSM officials, as well as financial sector, private sector, academic, parliamentary, and trade union representatives. Barbra Licudine and David Velazquez-Romero assisted from headquarters.

## CONTENTS

<b>CONTEXT: MODEST GROWTH AMID IMBALANCES</b>	<b>4</b>
<b>RECENT DEVELOPMENTS</b>	<b>7</b>
<b>OUTLOOK AND RISKS</b>	<b>11</b>
<b>POLICY DISCUSSIONS</b>	<b>12</b>
A. Structural Reforms	12
B. Financial Stability	17
C. Fiscal Policy	23
<b>STAFF APPRAISAL</b>	<b>27</b>
<b>BOXES</b>	
1. Competitiveness and Wage Bargaining	16
2. Bank Consolidation and Efficiency	22
3. Pension Issues	25
<b>FIGURES</b>	
1. Economic Performance Remains an Issue	5
2. Burden of Adjustment has been Uneven	6
3. High Frequency and Real Economy Developments	29
4. Financial Sector Developments	30
5. Fiscal Developments and Issues	31
6. External Developments	32
7. Risk Assessment Matrix	33

**TABLES**

1. Summary of Economic Indicators, 2014–22	34
2. Statement of Operations-General Government (GFSM 2001 Format), 2009–22	35
3. Summary of Balance of Payments, 2014–22	36
4. Financial Soundness Indicators, 2011–16	37

**ANNEXES**

I. External Sector Assessment	38
II. Debt Sustainability Analysis	40
III. Progress Against IMF Recommendations	49

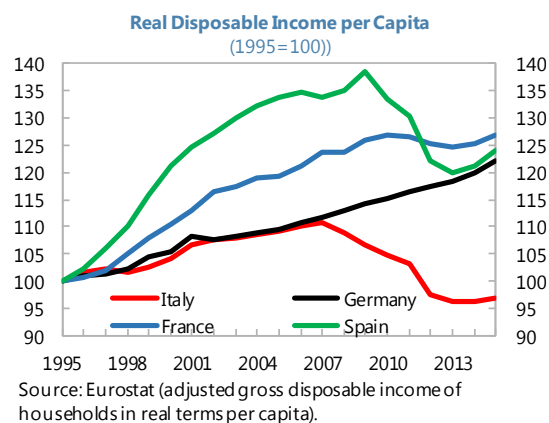
## CONTEXT: MODEST GROWTH AMID IMBALANCES

**1. Italy is in the third year of a moderate recovery, supported by notable monetary and fiscal stimulus.** Exceptional monetary easing has contributed to a significant decline in sovereign and corporate spreads in recent years. Fiscal relaxation has amounted to about 2 percent of GDP in structural primary terms since 2013. And very favorable commodity terms of trade have been the equivalent of transfers of about 1½ percent of GDP since 2013.<sup>1</sup> These sizable tailwinds, alongside the reform efforts of recent governments, have helped lift the economy from the double-dip recessions of 2008–09 and 2011–13. However, growth in 2015–16 averaged just 0.8 percent, considerably below euro-area peers. Growth has been held back by impaired balance sheets, imbalances, and structural weaknesses, such as high unit labor costs, high taxation, barriers to competition, an inefficient public sector, and a large share of small- and medium-scale enterprises (SMEs) that have struggled to adapt to global technology and trade developments.

**2. Financial fragilities remain significant.** Current policy efforts amid modest growth have arrested, although not reversed, financial vulnerabilities. Public debt appears to be stabilizing at around 133 percent of GDP, the second highest in Europe. Nonperforming loans (NPLs) of banks have declined marginally, but at about 21 percent of GDP are among the highest in the EU. As the tailwinds that have supported the economy subside, the economy faces the risk of stalling output growth and rising fiscal and financial vulnerabilities.

**3. Nearly a decade after the global financial crisis, real disposable incomes per capita are still below pre-euro accession levels and have fallen behind other euro area countries.** Average take-home pay lagged those in European peers prior to the crisis, but has since declined in absolute levels.

This reflects the persistent under-performance of Italy's economy, particularly productivity (Figure 1). On current projections, real incomes per capita are expected to return to pre-crisis (2007) levels only a decade from now—a period during which euro area partners are expected to pull even further ahead in Europe's multi-speed economy.

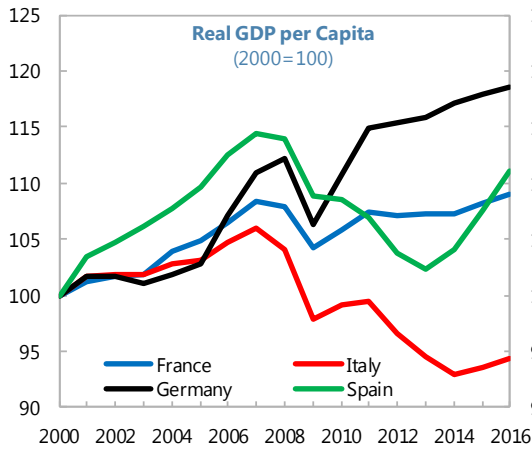


**4. The cost of the crisis has fallen disproportionately on the working age and younger population.** Unemployment is high at over 11 percent, though it has come down somewhat from the crisis peak of nearly 13 percent. Youth unemployment is at about 35 percent, among the highest in Europe. The share of the population at risk of poverty has increased. According to the Bank of Italy's biennial Survey of Household Income and Wealth, real incomes of employees and other workers are notably below pre-euro accession levels, as is the real wealth of younger and middle-

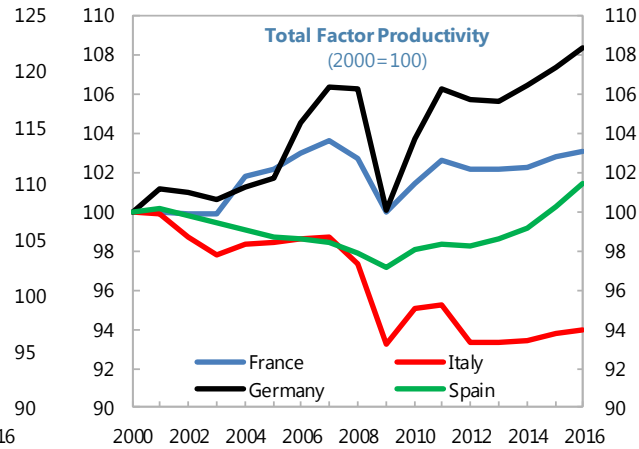
<sup>1</sup> The output impact of terms of trade is calculated based on Cavalcanti, T., K. Mohaddes, and M. Raissi, 2014, "Commodity Price Volatility and the Sources of Growth," *Journal of Applied Econometrics*, Vol. 30, pp. 857–73.

**Figure 1. Italy: Economic Performance Remains an Issue**

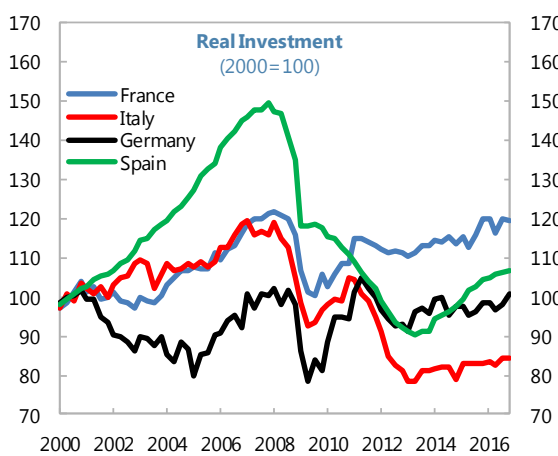
*Real income per capita in Italy has lagged...*



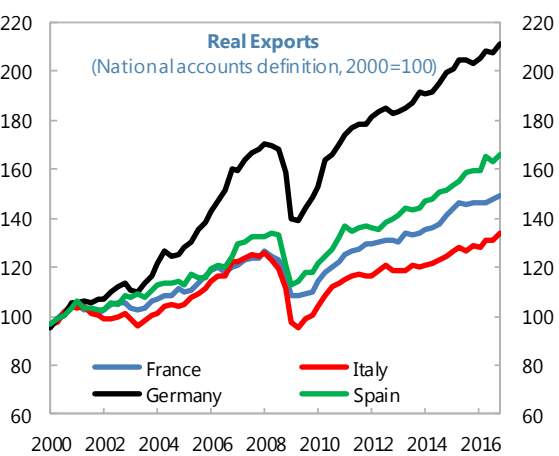
*...partly reflecting weak productivity.*



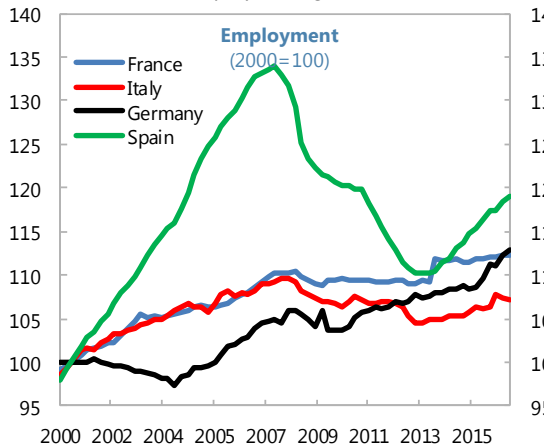
*Since the crisis, investment has contracted sharply, ...*



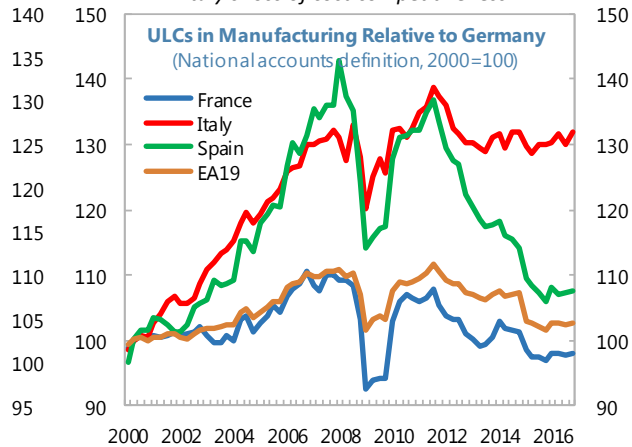
*...while the recovery of exports has trailed...*



*...as has employment generation.*



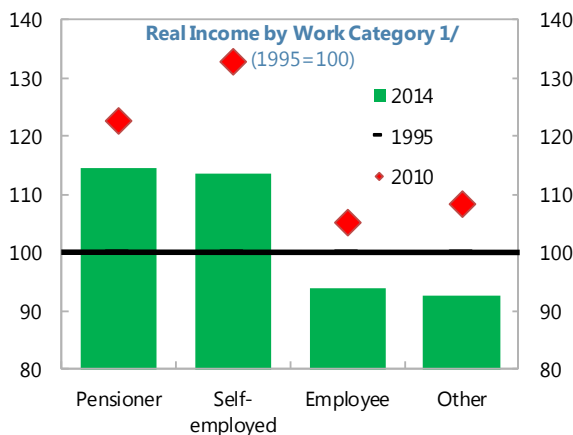
*A key contributing factor of this underperformance is Italy's loss of cost competitiveness.*



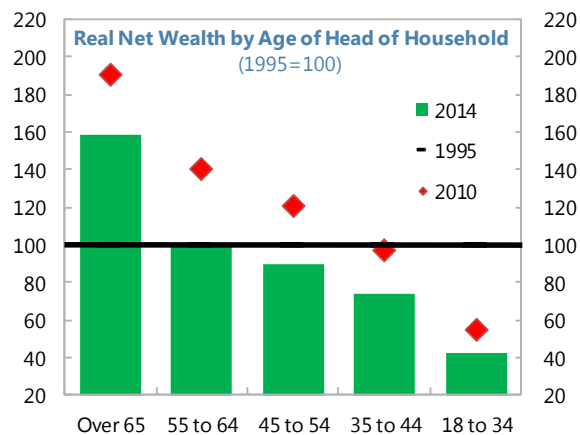
Sources: IMF, WEO; Eurostat; and IMF staff estimates.

**Figure 2. Italy: Burden of Adjustment has been Uneven**

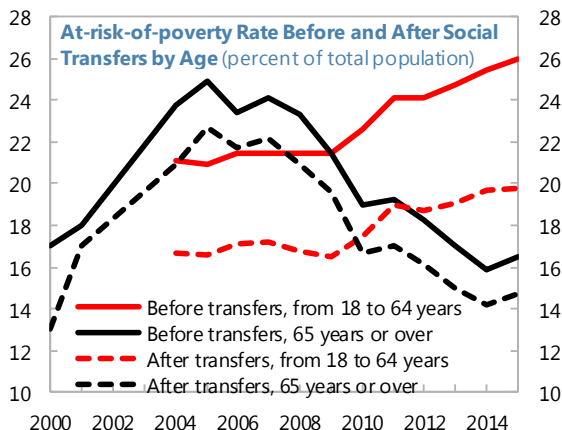
*Real incomes of pensioners and the self-employed remain above pre-euro levels, unlike for other groups.*



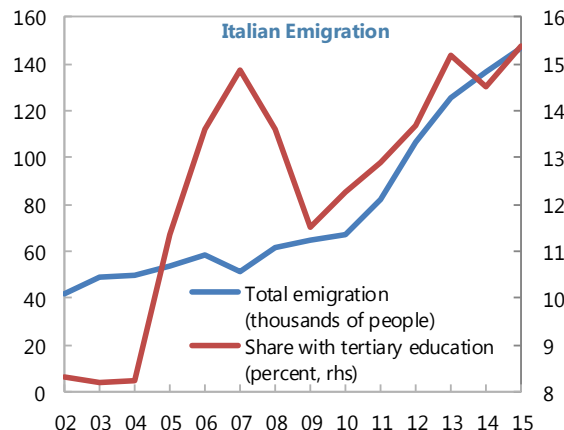
*The real wealth of younger and middle-aged households has also declined below pre-euro levels.*



*The share of the working age population at risk of poverty has risen.*



*Emigration has risen sharply, notably of skilled workers.*



Sources: Bank of Italy, Survey of Household Income and Wealth; ISTAT; and IMF staff estimates.  
 1/ Denotes mean equivalent income which is defined as the income required by a member of a household to attain the same level of welfare if they were living alone.

aged households. On the other hand, the real wealth and incomes of older households and pensioners remain well above the levels of two decades ago. This is due in part to poorly targeted transfers, a fragmented safety net, and high structural unemployment that have disproportionately affected poorer households. Reflecting these conditions and the weak prospects going forward, emigration from Italy remains high, including for skilled workers, which will weigh further on the economy's potential (Figure 2).

**5. The urgent priorities therefore are to raise productivity and growth, increase economic resilience, and protect the vulnerable.** The authorities recognize the urgency of meeting these challenges and are, therefore, keen to press ahead with the reform agenda of recent years. However, the electoral calendar complicates the task of policymakers. Prime Minister Renzi resigned in

December 2016, following the outcome of the referendum that rejected the proposed constitutional reform. The new government, under Prime Minister Gentiloni, has maintained broadly the policy agenda of the previous government. A new electoral law needs to be adopted to underpin the next general elections, which must be held by early 2018 but could be called earlier. Current polls point to a deeply divided electorate, which inevitably complicates prospects for reforms and adjustment.

## RECENT DEVELOPMENTS

**6. The economy is growing at a moderate pace.** Growth reached 0.9 percent in 2016, similar to 2015, and about one-half the rate of the euro area. It picked up in the first quarter of 2017 to 1.2 percent (year-on-year), somewhat better than expected but still lower than in the euro area:

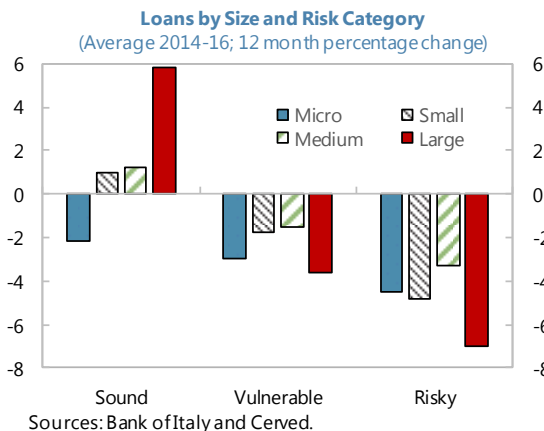
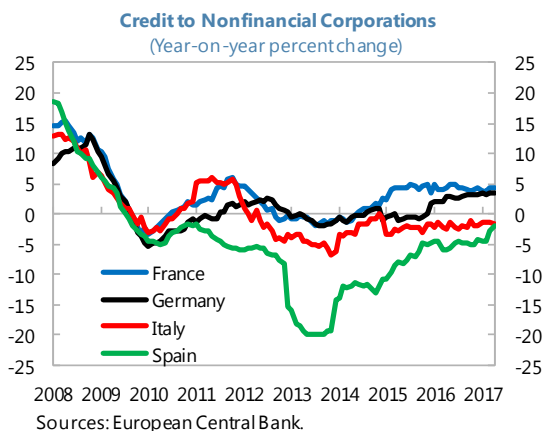
- On the demand side (Figure 3), consumption has been the main engine of growth, supported by low oil prices, higher wages and employment, bank credit, and fiscal stimulus. The recovery of investment has remained sluggish and uneven, notwithstanding fiscal incentives. Net exports remain a drag on growth, as import growth continues to outpace export growth.
- Labor market conditions have improved on the back of modest upticks in employment and labor force participation by almost 1 p.p. each, benefiting in part from tax incentives for new hires and the new permanent contract under the Jobs Act. Unemployment moderated to 11.1 percent in April 2017; while high, this is not far from the long-run average of about 9½ percent and reflects a significant structural component. There is notable regional variation: from 7.1 percent in the North to 20.4 percent in the South in Q1. Wage growth has continued to exceed productivity, leading to a further increase in unit labor costs.
- Core inflation has remained subdued, registering 0.9 percent year-on-year in May 2017, while headline inflation was higher at 1.6 percent, reflecting increased energy prices. This partly reflects a still sizable output gap, which for 2016 is estimated at 2.7 percent of potential GDP, one of the largest in the euro area.<sup>2</sup>
- Key social indicators are challenging. At around 29 percent (in 2015, before social benefits), the share of the population at risk of poverty or social exclusion is well above the euro area average, especially for children, temporary workers, and migrants. Regional disparities are substantial, with poverty rates reaching 44 percent in the South.

**7. There has been some progress in improving the health of the banking system, but banks continue to be strained by high NPLs and weak profitability.** Banks' market capitalizations

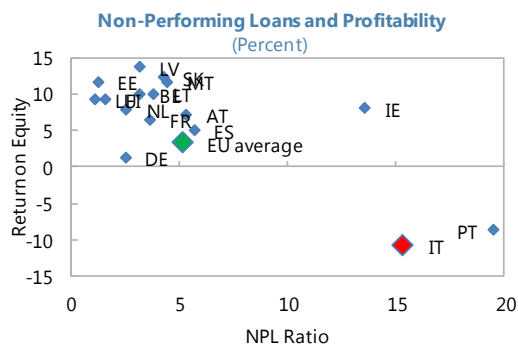
<sup>2</sup> There is uncertainty around the output gap estimate. An unemployment rate of 11 percent and low core inflation argue for a large gap, while high structural unemployment (the NAIRU is estimated at around 9½ percent) and persistently declining total factor productivity argue for deep-rooted structural problems and a small gap. Staff estimates potential output directly from the Research Department's multivariate filter that incorporates information from the Phillips curve (cyclical unemployment and inflation) and Okun's law (cyclical unemployment and the output gap). This contrasts with indirect estimates of potential output, derived for instance from a production function. Staff's estimate for 2016 is similar to that of the Italian Ministry of Finance but larger than the EC's estimate of about 1¾ percent (who calculate a higher equilibrium unemployment rate) and thus forecast a quicker closing of the gap.

since November have recovered a substantial fraction of the losses of last year, in line with those of other European banks (Figure 4). In recent days, actions were taken to deal with three weak banks and enhance financial stability—through precautionary recapitalization and restructuring of one bank and the liquidation of two banks with state aid (details are in ¶25).

- Overall, adequate liquidity in the banking system has continued to support a modest expansion of credit to households. Credit to the corporate sector is still declining (–1.6 percent year-on-year in April 2017), however. Italian corporates in general are less well capitalized than those in other euro area countries and thus are less resilient to adverse shocks. But there are some encouraging signs. Corporate leverage has fallen by about 5 p.p. during 2011–16Q3, including among SMEs. Recently, the number of rating upgrades exceeded those of rating downgrades, while the share of risky or vulnerable companies has fallen below 50 percent (source: Cerved).
- Gross NPLs fell marginally from €360 billion (18.1 percent of gross loans) at end-2015 to €349 billion (17.3 percent) at end-2016, provisions for NPLs improved to over 50 percent, and new NPL formation returned to pre-crisis levels. Bad loans (*sofferenze*), denoting loans to insolvent borrowers, remained high at about €203 billion (10.9 percent) in April 2017, despite bad loan sales of about €8 billion.<sup>3</sup> Several large sales—over €60 billion in total—are planned for the coming months.



- High NPLs and the relatively high operating costs of Italian banks continue to weigh on profitability. Profitability was among the lowest in Europe in 2016—about 14 p.p. below the weighted average in a sample of large European banks compiled by the European Banking Authority (EBA), partly because of substantial write-downs.



Source: EBA Risk Dashboard 2016Q4. The EBA sample consists of 198 banks, of which 15 are Italian. Greece, Cyprus, and Slovenia are excluded.

<sup>3</sup> GACS, the mechanism launched last year to provide government guarantees for NPL securitization, has been used in one transaction so far.

- Capital ratios of significant banks improved slightly but remain notably below the European average. The common equity tier 1 ratio stood at 10.4 percent in Q4 2016, about 3.7 p.p. below the average in a sample of large European banks compiled by the EBA. Including the successful capital increase of €13 billion in early 2017 by Unicredit, Italy's largest bank, the ratio would stand at about 11.6 percent.<sup>4</sup> The latest annual supervisory review resulted in additional capital requirements for a few other banks.

## **8. Fiscal policy has remained expansionary, with a focus on lowering the tax wedge.**

Despite spending restraint since the crisis, there is little progress in reducing current primary spending (Figure 5).

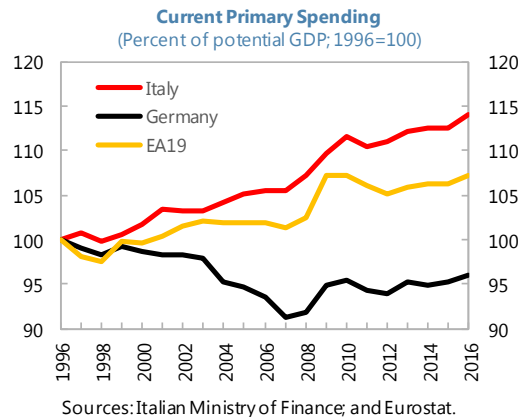
- The authorities achieved their overall deficit target of 2.4 percent of GDP in 2016, an improvement of about  $\frac{1}{4}$  percent of GDP over the previous year, having obtained approval from the European Commission for flexibility under the structural reform and investment clauses, and for additional spending on refugees and security. Capital spending declined. However, controlling for the economic cycle, the (structural) primary surplus deteriorated by about  $\frac{1}{2}$  percent of GDP. Public debt edged up to 132.6 percent of GDP at end-2016. Privatization proceeds were less than 0.1 percent of GDP, falling short of the planned 0.5 percent of GDP.
- In 2017, following supplementary budget measures of 0.2 percent of GDP largely to tackle tax evasion, the authorities are targeting a revised deficit of 2.1 percent of GDP. But the structural primary balance is set to ease further. The budget continues the recent trend of lowering the fiscal burden. It cuts the corporate income tax rate from 27.5 percent to 24 percent, introduces a simpler tax (flat rate of 24 percent) for the self-employed, targets reduced social security contributions to certain new employees, and repeals previously legislated increases in the VAT and other taxes. A range of incentives are offered to boost investment. Although efforts are underway to restrain current spending, social benefits, which largely reflect pension spending that is an outlier in the euro area, continue to rise. The budget further increases spending on pensioners and facilitates pathways to early retirement, partially reversing the objectives of the 2011 pension reform.<sup>5</sup> The renewal of public sector wage contracts and greater public investment may add to spending pressures.

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<sup>4</sup> The July 2016 EU-wide stress test of the EBA included five Italian banks. The results pointed to an improvement in Italian banks' metrics relative the 2014 ECB Comprehensive Assessment. However, in the adverse scenario, one large bank had a mild capital vulnerability while another large bank had a capital shortfall.

<sup>5</sup> The 2017 budget included measures that increase pension expenditures (e.g., raising minimum pensions, facilitating early retirement for specific categories of employees, and lowering, as of 2018, penalties for early retirement under the old generous defined benefits scheme). An enabling law on inclusion income has been legislated, amounting to about €2 billion (0.1 percent of GDP), to be partly implemented by regions.

- Overall, and notwithstanding the spending restraint since the crisis and numerous spending reviews, Italy has been unable to reverse the significant spending buildup of previous years. Current primary spending grew above potential GDP in the years following euro accession, reflecting principally social benefit (pension) spending, and remains above the euro area average.

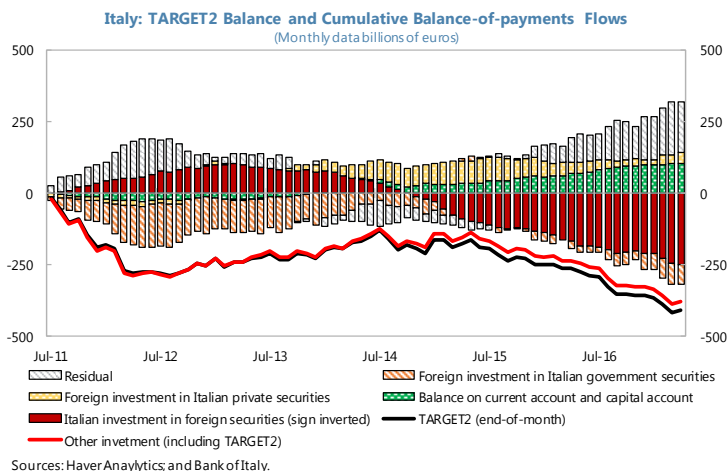


**9. Efforts to narrow Italy’s competitiveness gap with its peers have not yet succeeded (Figure 6).**

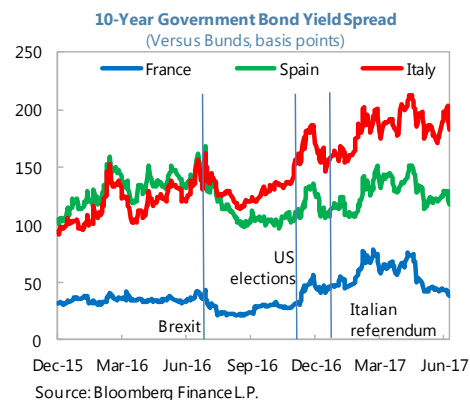
Although the external current account in 2016 improved on the back of still favorable terms of trade, the external position is assessed to be moderately weaker than suggested by fundamentals and desirable policy settings. The real effective exchange rate (REER) is overvalued by close to 10 percent (Annex I).

- This is particularly evident in manufacturing where a gap in unit labor costs (ULCs) vis-à-vis Germany and the euro area of around 30 percent was built up pre-crisis and has been sustained since, reflecting high wages relative to productivity. Price-based measures of the REER have returned to levels from two decades ago, but with an enduring gap of about 5–15 percent against Germany and the euro area. Structural indicators point to a low integration with global value chains.
- It is not surprising therefore that Italy’s recovery of real exports has lagged that of European peers, while investment by non-financial corporations has fallen below 9 percent of GDP, significantly below the euro area average.

- TARGET2 net liabilities have risen further to a record 25 percent of GDP at end-May 2017. It mirrors BoP financial outflows, as Italy has been running a current account surplus. It reflects an increase in Italian residents’ portfolio investments abroad and a decrease in foreign exposure to Italy’s private and public sectors. Private financial outflows suggest lower risk-adjusted returns domestically, given Italy’s vulnerabilities and lagging growth.



**10. Citing the weak growth outlook and insufficient progress in fiscal consolidation and addressing banking sector weaknesses, Italy’s credit rating was downgraded recently.** Italy’s sovereign rating was downgraded by Fitch and DBRS by one notch to the “BBB” category. DBRS’ downgrade resulted in an increase in the ECB’s collateral haircuts and in bank funding costs as it had previously been the only agency rating Italy as “A”. Reflecting subdued market sentiment and increased uncertainty, the 10-year sovereign yield has doubled to about 2 percent from its historic low of 1 percent in August 2016.



## OUTLOOK AND RISKS

**11. Under current policies, growth is expected to remain moderate.** Real GDP growth is projected at about 1.3 percent this year. As previously favorable factors—terms of trade, fiscal and monetary policies—become less supportive, and in view of still notable financial sector challenges, real GDP growth is projected at about 1 percent in 2018–19. Growth is driven mainly by domestic demand, with investment recovering moderately from historically low levels and benefiting somewhat from existing and new fiscal incentives. The contribution of net exports is slated to become positive by 2018, mirroring the strengthening in global trade. Core inflation should rise as the output gap closes gradually over the medium term, albeit slower than in key euro area partners, given lagging productivity and thus slower assumed wage increases to maintain competitiveness levels. Relatively low nominal growth will imply a slower speed at which Italy can grow out of its imbalances, leaving it vulnerable to adverse shocks over a protracted period.

**12. Risks are significant and tilted to the downside** (Figure 7).

- Growth could surprise on the upside in the near term, including from a stronger European recovery and better than anticipated effects of monetary and fiscal easing.
- Downside risks relate domestically to uncertainties surrounding the forthcoming general elections, possible setbacks to the reform process, and financial fragilities. Monetary tightening, in the absence of fiscal effort, could raise debt sustainability and financial stability concerns. Uncertainty on the scope of U.S. policy shifts and Brexit negotiations add to these risks.

In the event downside risks materialize, regional and global spillovers could be very significant, given the size of Italy’s economy and sovereign bond market and the prospect of renewed sovereign-bank strains. This amplifies the urgency of addressing Italy’s imbalances. Further strengthening euro area policies and architecture would also be helpful in this regard (see staff report for the 2017 Article IV consultation on euro area policies).

**13. The authorities considered Italy’s growth to be catching up to the rest of the euro area.** Following the better-than-expected first quarter outcome, they are in the process of revising

their forecasts. They anticipate growth to exceed staff's projections, including over the medium term, boosted not least by investment. They view risks as notable, stemming largely from external factors but also from political uncertainty domestically. They disagreed with the change in staff's external assessment relative to last year, pointing to a structural improvement in the external position and better growth outlook. They considered the REER to be in line with fundamentals.

## POLICY DISCUSSIONS

### 14. Notwithstanding some recent progress, the economy is vulnerable to adverse developments.

- The authorities' strategy has been to gradually advance reforms, while taking advantage of the flexibility afforded under the Stability and Growth Pact and supportive monetary policy. They have broadly succeeded in jumpstarting the recovery and stabilizing imbalances. However, they have not been able so far to notably reduce imbalances, turn around the weak productivity performance, and raise incomes including for those being left behind.
- Staff argued that as the time of monetary policy tightening comes closer and while conditions still remain favorable, it is important to implement bolder and comprehensive structural reforms, clean up bank balance sheets faster, and adopt a growth-friendly fiscal adjustment. All these remain a *sine qua non* for stronger, balanced, and sustainable growth (Annex III). Staff simulations suggest that front-loaded implementation of such a reform package can support the economy in the near term, put public debt on a firm downward trajectory, and achieve an overall gain in competitiveness of around 8 percent over the medium term (Selected Issues Part 3).<sup>6</sup> While the precise quantification of yields is model dependent and subject to some uncertainty, the results clearly suggest that implementing reforms as a package is mutually reinforcing, enhancing the yield of individual efforts, raising growth, and facilitating adjustment.

**15. The authorities emphasized their commitment to carrying out their current strategy.** They noted that, should the current legislature reach its scheduled end in early 2018, they would seek to implement further their existing reform agenda in the coming months to ensure continued support for the recovery while aiming to lower debt and safeguarding financial stability.

### A. Structural Reforms

**16. The authorities' focus is to complete the implementation of recently legislated reforms.** Over the past few years, efforts to address Italy's challenges have included the Jobs Act that seeks to address, among other things, duality in the labor market, a framework law to

<sup>6</sup> Staff estimates potential growth in steady state at about 0.8 percent, including a reform dividend of about 0.3 percent from the sustained implementation of legislated and planned measures. This is broadly in line with the authorities' estimates presented in the April 2017 Economic and Financial Document. Potential growth rises slowly from 2017 to 2022, assuming a gradual cleanup of bank balance sheets. Implementation of staff's recommended reform package is estimated to further increase growth by at least ½ p.p. annually over the medium term.

modernize the public administration, measures to enhance the efficiency of civil justice, and an education reform to improve school outcomes. Following the rejection of constitutional reform in the December referendum, which aimed to facilitate reforms by streamlining Italy's legislative structures and transferring competencies from regions to the center, the new government is focused on taking forward the implementation of already legislated reforms, including addressing challenges raised by the constitutional court to some of them.

**17. Staff underscored the need to broaden and deepen the reform efforts to create the requisite critical mass to address Italy's inter-related structural challenges.** The existing initiatives go some way toward tackling underlying imbalances and structural weaknesses, but do not facilitate the needed internal devaluation to restore competitiveness and foster near-term growth. Some initiatives have stalled or been weakened (e.g., reforms of education, product markets, and public administration), including from pushback from vested interests. Bolder reforms are needed to: open product and service markets, which would increase investment and efficiency; modernize the wage bargaining framework to align wages with productivity at the firm level, which would bolster employment and competitiveness; implement additional measures to support the functioning of the labor market; broaden public administration reform, including to tackle local vested interests and improve efficiency; and further strengthen the performance of civil justice, including the management of courts.

### **Liberalizing Product and Service Markets**

**18. Regulatory impediments and barriers to competition remain significant in some sectors,** such as network industries (e.g., transport), professional services, retail and local public services, and in the distribution of permits. Despite a requirement to legislate annually a competition law since 2009, none has yet been approved. The authorities have made some progress in taking forward a draft law that has been in parliament for over two years. Aimed initially at a more ambitious overhaul of regulatory barriers to entry and competition, the draft currently retains pro-competition measures in sectors such as communication and energy. However, during discussions in parliament, it has been weakened, including in the areas of insurance, professional services, and fuel distribution, and it introduces new restrictions in tourism. The removal of restrictive legislation on the energy sector is delayed further to mid-2019. The draft should be strengthened in line with the recommendations of the Competition Authority and approved expeditiously. An annual process of legislating pro-competition laws and enhancing the authority to sanction anti-competitive practices are essential to tackle remaining impediments and new ones that might arise.

### **Reforming Wage Bargaining**

**19. The current sectoral wage bargaining has resulted in persistent wage growth above productivity.** It has also resulted in binding national wage limits and compressed the wage distribution, with broadly similar wages across regions and firms, notwithstanding wide productivity differentials. Wage-setting institutions are thus contributing to large regional disparities in unemployment and lagging competitiveness.

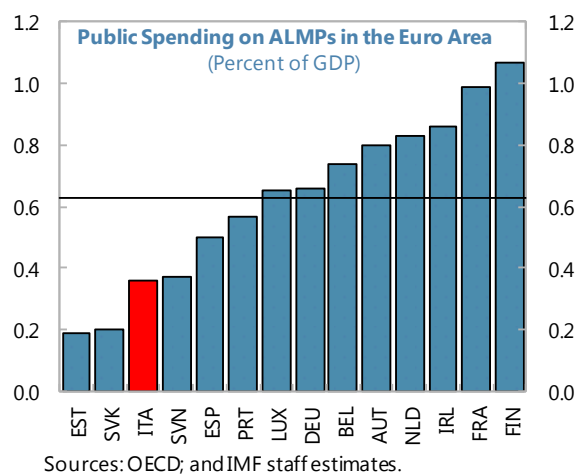
**20. A more effective approach would entail decentralizing wage bargaining to the firm level, complemented with a minimum wage that could be differentiated across regions.**

Although in theory reforms to strengthen the effectiveness of opt-outs (to weaken the favorability principle) and limit the extensions of collective agreements can also better align wages with productivity at the firm level, attempts to strengthen second-tier firm-level bargaining within the current framework have delivered negligible results. Thus, within the prevailing institutional set up, aiming for better outcomes is likely to require giving primacy to firm-level contracts and defining clearly the principles for stakeholder representation. Illustrative simulations of such reforms point to the potential for almost 5 percent higher employment and 2½ percent improvement in competitiveness indicators in the medium term (Selected Issues Part 1 and Box 1).

**Advancing Other Supportive Labor Market Reforms**

**21. Complementary measures could enhance the functioning of the labor market:**

- To help address the high gender employment gap, the labor tax wedge on secondary earners should be lowered and the supply of childcare increased.
- To enhance support for job seekers and help unemployed and discouraged workers, spending on active labor market policies (ALMPs) should be scaled up. Italy spends among the lowest in the euro area on ALMPs.
- Delivery of ALMPs also needs to be enhanced. A new agency to coordinate ALMPs and the new system of unemployment benefits across regions was set up. As its design was predicated on passage of the constitutional reform referendum and the transfer of responsibilities from regions to the center, however, its coordination and enforcement vis-à-vis local authorities remains limited. To enhance effectiveness, consideration could be given to delivering ALMPs alongside passive labor market policies through the social security agency.
- As the economy strengthens, consideration should be given to extending the new single open-ended contract of the Jobs Act to all existing open-ended work arrangements in the private sector<sup>7</sup> and reducing the compensation for dismissals, which is high in OECD comparison: two



<sup>7</sup> Empirical evidence in the OECD Employment Outlook (2016) suggests that reforms to lower employment protection do not entail initial costs if implemented in countries with high labor market dualism or during an economic upswing. Moreover, regulatory approaches, such as tackling job protection and facilitating firm-level bargaining, are more efficient instruments than fiscal incentives to promote new open-ended contracts and efficiency wages, which are fiscally costly, poorly targeted, and provide windfall gains for companies. Time-limited voucher-type programs could be maintained only when targeted to immigrants to facilitate their integration into the labor force.

monthly wages per year of service with a minimum of 4 and a maximum of 24 (at 12 years of service), compared with the OECD average of 14 monthly wages at 20 years of service.

## Reforming Public Administration

**22. The quality of Italy's public sector has generally ranked among the lowest in Europe** across measures such as the World Bank governance indicators, the World Economic Forum indicators, the EC Eurobarometer, and the European Quality of Government Index. The average age of civil servants and skills mismatches are high, the use of electronic technology is low, and perceptions of corruption remain notable. Public sector inefficiencies, including pushback from local vested interests, weigh directly on productivity and prevent the gains from reforms from materializing, particularly where policies are designed centrally but implementation is delegated to regions. Recognizing these challenges, an enabling reform of the public administration was adopted in 2015, aiming to simplify procedures, streamline and accelerate decision making, rationalize local public enterprises, and improve the recruitment and management of staff, among others.

**23. While several implementing decrees have been issued, key actions have effectively stalled,** after a Constitutional Court ruling in November 2016 mandated close coordination and agreement with local governments on issues such as regulating public employment, disciplinary dismissals, state owned enterprises, and local public services. Thus, for instance, there has been no progress in reorganizing public sector management and regulating local public services (except transport). Rationalizing of more than 9,000 public enterprises has been weakened or delayed; in most cases, these enterprises are shielded from competition and receive service contracts without an open tender process while, despite substantial state transfers, more than one-third operate with losses. The procurement reform of 2016 provides for considerable simplification and lowers the administrative burden, but has been hampered by implementation challenges and legal uncertainties, resulting in lowered volumes. Broadening and completing public sector reform, including addressing these issues, remains important. Transparent and detailed monitoring of outcomes will facilitate assessment of the reforms and accountability.

**24. The authorities agreed that the overarching challenge is to modernize production structures and raise productivity.** They considered that reforms already implemented or underway would go a long way toward raising growth, and noted that steadfast efforts needed to continue. The draft Annual Competition Law recently passed a vote in the Chamber of Deputies and is being re-considered by the Senate; its passage depends in part on whether the legislature will complete its term. The authorities agreed with the merits of aligning wages with productivity at the firm level, but felt that the current system of second-tier bargaining—with incentives for productivity-linked bonuses—needed to be studied and pursued further. Work is underway on ALMPs, which requires coordination with local authorities. The authorities expressed optimism that public sector reforms will yield notable results in time. Assuming elections are held when due, they aim to address the decrees not implemented (on management and accountability in the public sector and regulation of local service providers other than transport).

### Box 1. Competitiveness and Wage Bargaining<sup>1</sup>

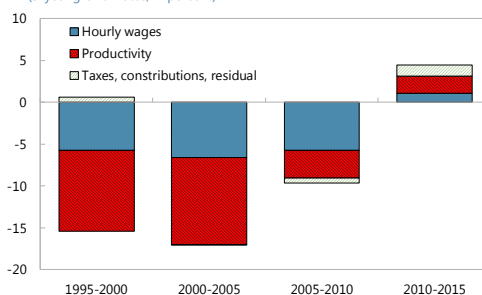
**The ULC gap between Germany and Italy grew rapidly prior to the crisis and has since stabilized, but not meaningfully reversed.** Around 45 percent of the widening ULC gap in the manufacturing sector over the past two decades is attributable to hourly wages, with the rest largely being lagging productivity. Adjustment has occurred in quantities—cuts in labor and investment—rather than by reducing relative wages and prices. Exports have not been able to lead the recovery; structural indicators point to a high sensitivity to competitive pressures. Such adjustment stands in contrast to a textbook wage moderation exercise and/or productivity gains that a successful internal devaluation might be expected to bring about.

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**Wage-setting institutions in Italy impose strong rigidities.** Wage bargaining is conducted at the sector level and extended nationally. Second-tier (firm-level) bargaining has been subordinated to national contracts. Attempts to decentralize wage setting have thus far been largely ineffective; evidence indicates that only 12 percent of companies show interest in derogative options provided by the 2011 law, owing to prevailing legal uncertainty. Resistance by unions to firm-level bargaining is strong as the level of cooperation in labor-employer relations in Italy is the lowest in the euro area. Sector-level bargaining with low coordination, however, is recognized to be the worst institutional setting as both internalization of negative wage externalities as well as competitive pressures are weak. Unsurprisingly, the outcome has been a compressed wage distribution and persistent wage growth over productivity growth.

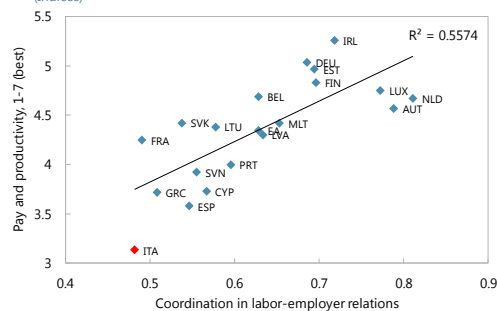
**Moving from sector- to firm-level bargaining can result in significant employment gains.** To quantify the (un-)employment gains from moving from sector- to firm-level wage bargaining, a search-and-match DSGE model by Jimeno and Thomas (2013) is parameterized to the Italian labor market. In a baseline parameterization, the model predicts a reduction in the steady-state unemployment rate by 3.5 p.p. that in turn translates into an almost 4 percent increase in employment. Within the IMF’s Global Integrated Monetary and Fiscal Model (GIMF), this result is equivalent to a competitiveness gain in the medium term of around 2½ percent. When combined with other structural reforms (including product market, other labor market, and public administration reforms—for an illustrative medium-term competitiveness gain of 1½ percent), banking sector cleanup (about 1½ percent), and fiscal reforms (around 2½ percent), Italy can achieve an overall competitiveness improvement of around 8 percent over the medium term.<sup>2</sup>

**Decomposition of Competitiveness vis-a-vis Germany**  
(5-year growth rates, in percent)



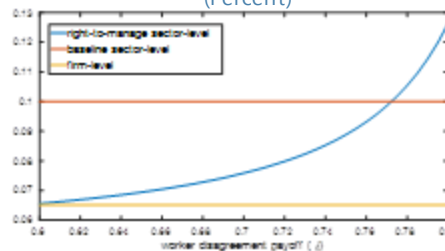
Sources: Haver Analytics, OECD, and staff calculations

**Institutions versus Productivity-Pay Correspondence**  
(Indices)



Sources: WEF (2016); and staff calculations.

**Unemployment Rate**  
(Percent)



<sup>1</sup> See Kangur, A., 2017, “Competitiveness and Wage Bargaining Reforms in Italy,” Selected Issues Part 1.

<sup>2</sup> See Andrle, M., Kangur, A., and M. Raissi, 2017, “Quantifying the Benefits of a Comprehensive Reform Package,” Selected Issues Part 3.

## B. Financial Stability

**25. Against the backdrop of high NPLs and weak profitability, the authorities have been taking actions to stabilize the banking sector.** This includes efforts to deal with weak banks, bank consolidation frameworks, and lowering the stock of NPLs.

- *Dealing with weak banks.* Three banks failed to raise sufficient capital from the private sector, after performing poorly in the 2016 EBA and ECB stress tests. Each bank has undergone multiple recapitalizations in recent years; two were rescued early last year by Atlante, a fund created by Italian financial institutions, which invested about €3.5 billion. Finding a market-based solution proved challenging, and to cope with deposit outflows, the authorities established a backstop of €20 billion (1¼ percent of GDP) to finance their rescue or liquidation and to guarantee up to €150 billion of bank liquidity, which the banks tapped for about €20 billion in government-guaranteed bank bonds. Recently, agreement was reached on the precautionary recapitalization of one bank (accounting for about 5 percent of total system assets) with state aid up to €5.4 billion, including its restructuring and disposal of its bad loan portfolio.<sup>8,9</sup> The two other banks (accounting for about 2 percent of total assets) were deemed to be failing or likely to fail. As they were not considered to provide critical functions and their failure was not expected to adversely impact financial stability, the banks will be liquidated under Italian insolvency legislation—a process that is not subject to the BRRD bail-in provisions. The European Commission approved the provision of state aid of €4.8 billion, with guarantees of up to €12 billion, to avoid regional economic disruptions.<sup>10</sup> Both operations would add to public debt.<sup>11</sup>
- *Consolidating banks.* Eight of the ten largest popolari banks converted to joint-stock companies by end-2016, but successful court challenges by dissenting investors has stalled the conversion of the remaining two. Two large popolari banks have merged to create the third-largest banking

<sup>8</sup> Under precautionary recapitalization, the state can recapitalize a solvent bank that is not deemed to have adequate capital under the adverse scenario of a stress test. Such capital should be provided for a temporary period, and is to be accompanied by burden sharing. Unlike resolution under the Bank Recovery and Resolution Directive (BRRD), there does not need to be bail in of 8 percent of liabilities, which would normally include senior debt.

<sup>9</sup> In December 2016, the government passed a decree for the precautionary recapitalization of one bank that aimed to compensate retail investors, in cases of mis-selling. Most institutional investors' holdings of subordinated debt were to be converted into shares at 75 percent of face value, significantly above their market value at the time.

<sup>10</sup> All depositors and senior bondholders are protected. Shareholders and subordinated bondholders will contribute to the costs of liquidation, although most retail investors of subordinated debt are expected to be compensated. The good assets and some liabilities of the two banks will be acquired by Italy's second largest bank for a token price of €1. The government will provide €4.8 billion to preserve the acquiring bank's capital ratios and cover restructuring costs. The banks' NPLs will be transferred to a liquidation vehicle owned by the Italian Treasury. Government guarantees of up to €12 billion are provided: for bridge financing for the liquidation vehicle from the acquiring bank, to cover risks related to loans transferred to the acquiring bank, and for legal and other risks.

<sup>11</sup> The state aid is expected to raise debt by €10.2 billion or 0.6 percent of GDP. For the two banks being liquidated, the government has a claim on the liquidation vehicle of around €5 billion that is senior to the subordinated debt and equity of the two banks. The statistical treatment is under consideration by Eurostat. For now, staff have reflected the state aid in public debt, but not in net lending/borrowing.

group in Italy. Smaller cooperative banks are required to consolidate under joint-stock (holding) companies with at least €1 billion in equity by May 2018. Three new banking groups are expected to emerge from the consolidation of more than 300 cooperative banks by end 2018, two of which will fall under direct ECB/SSM supervision and be subject to an asset quality review. The authorities have allocated €500 million over the next three years to help banks' downsizing efforts through assistance with early retirement schemes.

- *Tackling NPLs:*
  - *Supervisory oversight:* the SSM issued guidance to significant institutions for strategies to tackle high NPLs. Such banks need to agree with the SSM on ambitious NPL reduction targets in the coming months, although sanctions are not envisaged for missing the targets. Separately, the Bank of Italy is drafting streamlined NPL guidance for the smaller banks and has launched a survey requiring banks to report detailed data on their bad loans, collateral, and ongoing recovery procedures.
  - *Insolvency, debt enforcement, and civil justice:* following recent reforms, some of which affected new NPLs rather than the existing stock, progress has largely stalled. The overhaul announced early in 2016 to replace the insolvency law of 1942 (which has been amended multiple times) has not materialized. Limited progress was achieved in reducing the backlog and length of commercial and civil litigation (European Justice Scoreboard, 2017). The average time in 2016 for enforcement of real state collateral was 4.25 years and for insolvency cases 7.5 years (*Consiglio Superiore della Magistratura* and Ministry of Justice). The "Program Strasbourg 2" has not bridged the gap in the duration of procedures in courts across regions, which remains up to six times between the best and worst performers. The authorities are aiming for a unified and comprehensive reform that rationalizes the complex insolvency framework, increases options for restructuring, addresses shortcomings such as procedural inefficiencies and excessive creditor priorities, and adopts new rules for the insolvency of enterprise groups and consumers.

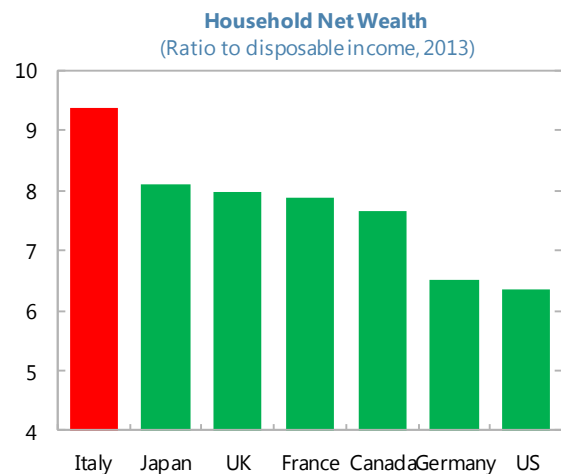
**26. While the authorities' approach includes important elements, the repair of the banking system is proceeding very slowly, permitting vulnerabilities to linger and hindering monetary transmission.** According to staff calculations, much of the banking system has profitability that is persistently below the cost of equity (Box 2), leaving the system exposed to adverse shocks. A cyclical recovery alone is unlikely to suffice in restoring large parts of the sector to healthy profitability, as projected growth remains modest.<sup>12</sup> Timely steps are thus needed—as part of a comprehensive and proactive strategy—to swiftly tackle challenges in problem banks in a cost-effective manner, cut costs through strong restructuring plans, ensure banks lower NPLs credibly

<sup>12</sup> Mohaddes, K., M. Raissi, and A. Weber, 2017, "Can Italy Grow Out of its NPL Overhang? A Panel Threshold Analysis," IMF Working Paper 17/66 shows that, in the absence of active policy measures, sustained real GDP growth above 1.2 percent, or nominal growth above 3 percent, is needed to decisively lower NPLs over the medium term. Conversely, Selected Issues Part 3 shows that reducing the NPL ratio to more normal levels (5–6 percent) over the medium term would correspond to higher real GDP by about 2–3 percent.

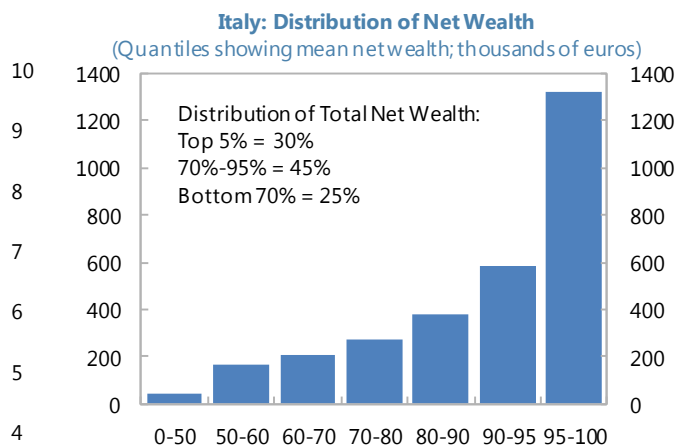
and decisively over the medium term, and improve governance. This will ensure banks can fully support the economic recovery.

## Resolution and Burden Sharing

- Effective resolution.* Finding timely and cost effective solutions to problem banks has proven difficult, resulting in additional costs to the budget in a country that lacks fiscal space and to the rest of the financial system. The protracted process is due in part to domestic concerns about resolving banks and applying bail-in, the need to clarify expectations and processes of the new bank recovery and resolution framework, and the complex coordination challenges across multiple authorities both at the national and the EU levels. Nonetheless, delays in effectively addressing problems, which were evident for some time, added to costs. For example, in the case of the two banks being liquidated, the solution imposed notable costs on taxpayers—through government-guaranteed bank bonds that replaced private investors who fled the banks, and state aid in liquidation (about €5 billion in cash support and up to €12 billion in guarantees, for a total of up to 1 percent of GDP). It also imposed costs on the rest of the system, e.g., through investments via the Atlante fund that are being wiped out just months after institutions were encouraged to invest in it. 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 taxpayers and the rest of the system, and threatening stability.
- Burden sharing.* According to the Bank of Italy, the vast majority of non-equity instruments eligible for bail-in (over 86 percent by value) are held by the wealthiest 10 percent (Financial Stability Report 1/2016). Italian households in general have among the highest ratios of net wealth in international comparison. Thus, bail-in should be considered from an efficiency and equity perspective, as well as to break sovereign-bank links and minimize costs to the budget. Well-targeted social safety nets should be used to assist vulnerable households. Cases of mis-selling should be addressed ex-ante by the regulatory and supervisory authorities and banks.



Source: OECD.



Source: Bank of Italy, Survey of Household Wealth and Income.

## Restructuring and Efficiency

- *Rationalization.* Following the recent example of Italy's largest bank in recognizing losses, raising capital and rationalizing operations, the viability of other banks could benefit from similar restructuring. Intensive and assertive supervisory challenge would promote more coherent and realistic business modeling, so that capital destructive business lines are recognized and subsequently streamlined, divested, or wound-down. Banks' industrial plans and formal restructuring plans would benefit from a similar level of supervisory challenge to ensure they are realistic and durable.
- *Consolidation.* Consolidation of Italy's fragmented banking system can help increase efficiency, but needs to be accompanied by proactive supervision (Box 2). Bank supervisors should undertake a rigorous analysis to ensure the three emerging banking groups start with a clean bill of health and are profitable over the long term. This includes undertaking an asset quality review of all emerging groups, ensuring robust governance and risk management structures, and following up on issues found in the remaining smaller banks as well. Each bank should set ambitious and credible targets for risk management and branch/staff rationalization, with a viability assessment to ensure sufficient income-generating capacity to build capital through retained earnings, even in a downside scenario.

## Lowering NPLs

- *Supervisory oversight.* To secure the effectiveness of the recent NPL guidance, the supervisor needs to ensure NPL reduction strategies and targets are ambitious and credible through an assessment of banks' capacity to resolve NPLs using internal tools and resources. To this end, independent NPL management experts could be engaged, and banks with weak internal capacity required to engage specialist collection and workout firms, sell NPLs in the open market, and/or enter joint ventures with specialized distressed asset managers.
- *Loan loss buffers.* Market participants have long argued that Italian banks need substantial additional reserves to tackle NPLs.<sup>13</sup> With several banks recently booking heavy provisions to effect NPL portfolio sales, the question arises as to whether banks have over-estimated their internal workout capability and whether the portfolios are adequately provisioned. Supervisors should review internal workout capacity, and provide feedback on banks' approaches to provisioning and loan restructuring practices.
- *Insolvency, debt enforcement, and out-of-court restructuring.* The authorities' timeframe for adopting and implementing comprehensive insolvency reforms does not appear to be commensurate with the urgency to address the stock of NPLs. The proposed reforms should be

<sup>13</sup> The literature provides a range of estimates based on different methodological approaches. Simple back-of-the-envelope calculations based on pricing gaps between book and market values of NPLs suggest a range of 2–3 percent of GDP. More rigorous methodologies suggest 6–8 percent of GDP (see Acharya, V.V., D. Pierret, and S. Steffen, 2016, "Capital Shortfalls of European Banks since the Start of the Banking Union," NYU Working Paper; and Jobst, A., and A. Weber, 2016, "Profitability and Balance Sheet Repair of Italian Banks," IMF Working Paper 16/175).

adopted promptly, while maintaining ambitious goals for the rationalization of corporate debt restructuring and special procedures for large enterprises. Implementation requires considerable efforts to improve court functioning, the qualification of insolvency administrators, and the development of registries and platforms for the sale of collateral. The reform of civil procedures also needs to be accelerated to simplify processes, facilitate collateral sales, and incentivize courts to reduce backlogs. Consistent implementation across Italy will require development of uniform practices and attention to resource allocation. These reforms should be complemented with more intensive use of out-of-court restructuring.

### **Improving Governance**

- Legislative gaps in Italy's implementation of the EU fit and proper rules for bank management (from the EU Capital Requirements Directive or the so-called CRD-IV) should be closed. When implemented, the 2015 EBA and 2016 ECB guidance relating to fit and proper assessments can be applied in full.

### **27. The authorities highlighted the progress underway in safeguarding financial stability.**

- There was broad agreement about the need for finding timely solutions to problem banks and that the process for the three problem banks had been protracted. The European and Italian authorities considered that each stakeholder acted according to their respective mandates. In the case of the liquidation of the two banks, the authorities noted that, notwithstanding the time taken earlier, swift decisions were made over a weekend within the existing state aid framework to safeguard stability once the banks were deemed to be failing or likely to fail. The Italian authorities noted that, having found a solution for the three banks, the tail risks in the banking sector have largely been addressed. They argued that costs to taxpayers have been limited through burden sharing involving shareholders and subordinated debt holders, while state aid in liquidation has avoided notable economic and financial costs, including on the deposit guarantee scheme. They expressed optimism that the liquidation vehicle will further reduce costs to taxpayers, as a patient approach is expected to enhance the value recovered from NPLs. They strongly felt that bail-in, regardless of the wealth distribution, exacerbates systemic risk, including to the smaller banks in the system, until MREL (or minimum requirements for own funds and eligible liabilities) is fully met. In that regard, they view the scheduled review of the BRRD in 2018 as an opportunity to assess and improve its effectiveness.
- The authorities considered the NPL guidance for significant banks and the planned streamlined guidance for less significant ones to notably improve banks' focus on NPL reduction. They pointed to the aggressive plans for NPL sales in several banks. However, the Italian authorities noted that the risk of the NPL overhang is generally overstated considering provisioning levels, collateral and guarantees, and cautioned against too rapid a reduction in NPLs, as fire sales would destroy value. They argued that credit to sound firms is not hampered by the high NPLs.
- There was broad agreement on the need to rationalize costs and adapt business models to the regulatory and evolving industrial environment. Regarding the consolidation of small

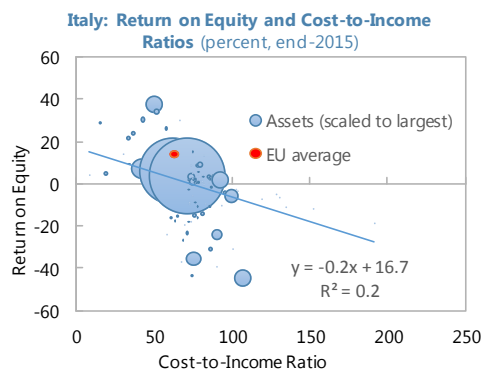
cooperative banks, the Italian authorities considered it sufficient to apply an asset quality review to the two largest groups, pointing also to the small share of these banks in the sector.

**Box 2. Bank Consolidation and Efficiency<sup>1</sup>**

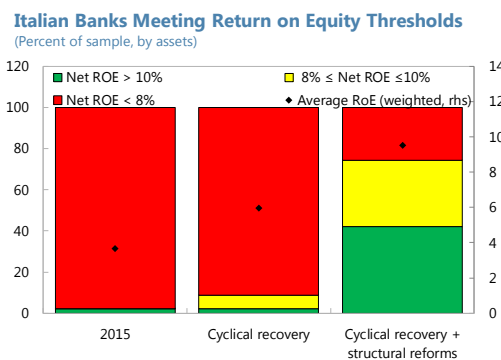
**The Italian banking system is fragmented and in varying states of health.** Italy had 575 domestic credit institutions in 2015. Market concentration is lower than in most other euro area countries. The market share of the largest 5 credit institutions was 41 percent, compared to an EU unweighted average of 63 percent in 2015.<sup>2</sup> While some Italian banks have higher profitability ratios and lower cost-to-income ratios than the EU average, other parts however—including large and small banks—are lagging. As noted earlier, many are also suffering from high NPLs.

**To restore large parts of the banking system to healthy profitability, operational efficiency gains and measures to clean up bank balance sheets are needed.** A bottom-up analysis of 386 Italian banks suggests that, while profitability improves as the economy recovers, operational efficiency gains are needed to restore large parts of the banking system to healthy profitability. Even if all banks can achieve cost-to-income ratios in line with the EU median, significant parts of the banking sector are still projected to be challenged or weak, indicating that other factors that are dragging down profitability, such as the high stock of legacy NPLs, also need to be addressed.

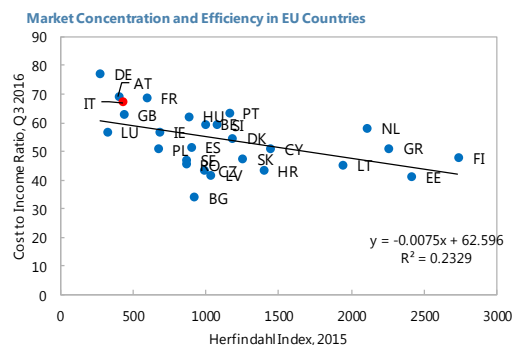
**Bank consolidation can facilitate efficiency gains, though cross-country experience suggests this is likely to be achieved when decisive actions are taken to improve governance and address rigidities.** Significant consolidation is planned. Experience from other countries and the literature highlight the importance of enhancing governance (including from the ownership structure of banks) and tackling entrenched vested interests opposed to rationalization as part of this consolidation process, strengthening supervisory oversight, taking prompt corrective action when needed, and addressing structural rigidities that could limit efficiency gains. There is a role for policies at the EU level to facilitate an equal playing field for cross-border M&As, which the literature has shown are often more efficiency enhancing than domestic M&As. Cross-border M&As, however, remain very rare in Italy.



Sources: S&P Global Intelligence; and European Banking Authority.



Sources: S&P Global Intelligence and IMF Staff Calculations



Sources: European Central Bank; European Banking Authority

<sup>1</sup> See Weber, Anke, 2017, "Bank Consolidation, Efficiency, and Profitability in Italy," forthcoming IMF Working Paper.

<sup>2</sup> Source: European Central Bank, Report on Financial Structures 2016. Data are reported on an unconsolidated basis.

## C. Fiscal Policy

**28. There is a lack of clarity on the government's fiscal plans.** Following the fiscal accommodation of recent years, in April, the authorities announced their intention to embark on a sizable consolidation in 2018–19 aiming to achieve structural budget balance. They committed to undertake a (structural) primary adjustment of 0.6 percent of GDP in 2018 and about 0.8 percent in 2019.<sup>14</sup> However, at end-May, the authorities changed course and announced their intention to consolidate only marginally in 2018 (by 0.1 percent of GDP in structural primary terms), leaving unclear their intentions for 2019.<sup>15</sup> Clarity is expected later this year, in the context of the budget discussions with the European Commission.

- *Easing stance.* The fiscal stance has been markedly expansionary in 2014–17. For example, adjusting for the economic cycle, the (structural) primary balance has deteriorated by about 2 percent of GDP over this period. This corresponds to a (headline) primary surplus in 2017 of about 1½ percent of GDP, well below the original target of 4½ percent of GDP set for 2017 in 2014. As a result, the planned reduction in public debt has not been achieved.
- *Policy intention.* While the 2018 fiscal position is not clear, the authorities intend to continue reducing the fiscal burden and, to the extent possible, cancel planned hikes in VAT and excise rates (i.e., the safeguard clause in place to achieve fiscal targets in case alternative measures are unspecified). To offset the revenue loss, areas for potential savings include tackling tax evasion, which remains high—amounting annually to at least €110 billion (about 7 percent of GDP), with unpaid tax debt of €0.6 trillion; rationalizing tax expenditures; and harnessing efficiencies from the spending review, which is being embedded in the budgetary process, and from centralizing public procurement.
- *Privatization.* To lower debt, the authorities project privatization proceeds at 0.3 percent of GDP per year in 2017–19. However, recapitalization or liquidation of weak banks, for which the authorities have earmarked €20 billion (or 1.2 percent of GDP), would add to debt, with €10.2 billion included for 2017 (about 0.6 percent of GDP).

**29. In staff's view, the ongoing recovery and favorable financial conditions provide a narrow window to start a credible and gradual consolidation.** In the 2016 Article IV consultation, staff had advised an evenly phased adjustment (in the structural primary balance) of about ½ percent of GDP per year over 2017–19. Now, with a missed opportunity to start the consolidation

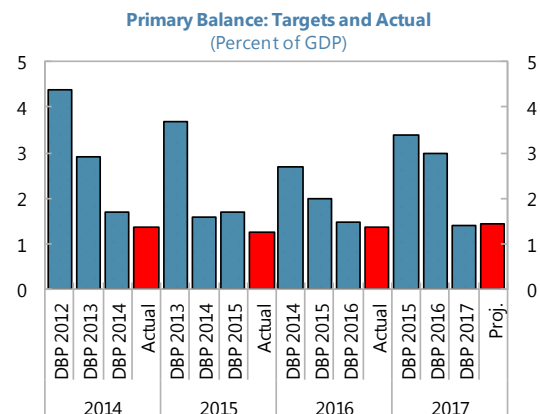
<sup>14</sup> To get to structural balance, staff assesses the need for about 1½ percent of GDP structural (primary) adjustment. This is broadly similar to the fiscal adjustment required by the EU fiscal framework, which given Italy's high debt (and depending on the precise size of the output gap) amounts to at least ½ percent of GDP per year until Italy achieves structural balance.

<sup>15</sup> At end-May, the authorities announced a targeted improvement in the structural balance for 2018 of 0.3 percent of GDP. This corresponds to a consolidation of the structural primary balance of 0.1 percent of GDP, given their anticipated reduction in the interest bill of 0.2 percent of GDP. Considering the expected yields for 2018 of the tax evasion measures in the recent supplementary budget, new consolidation measures may not be needed.

in 2017, it is important that the authorities' plans are carried out as announced in April. High debt leaves Italy vulnerable to adverse macroeconomic and confidence shocks, with limited space for stabilization purposes<sup>16</sup> or for growth-enhancing measures, such as increased spending on education or infrastructure or lower tax rates on factors of production. Absent consolidation, debt will broadly stabilize at current ratios and rise as monetary conditions normalize. Under moderate shock scenarios, debt is projected to increase further, challenging fiscal sustainability (Annex II). Considering the limited fiscal space, it is advisable to start a credible adjustment while financing conditions remain favorable and ensure public debt begins to decline firmly.<sup>17</sup> If adverse shocks materialize, automatic stabilizers should be allowed to operate.

### 30. Priority should be placed on growth-friendly and inclusive measures to underpin the needed consolidation (Selected Issues Part 2).

In recent years, Italy has undershot its two-year ahead targeted surplus. Announcing upfront high quality and permanent measures to support the planned consolidation would allay concerns that this pattern—of promised consolidation that has not materialized—is not continually repeated. Furthermore, targeting a small structural surplus of about ½ percent of GDP by about 2021, which has been long-standing Fund advice, would ensure debt is on a firmly declining trajectory, while providing valuable insurance against shocks.



Sources: Ministry of Finance; and Economics; and IMF staff estimates. Note: DBP is the draft budgetary plan.

### 31. On the spending side, cuts should be sought

#### to current primary spending, while supporting the vulnerable and raising capital spending.

While fully implementing procurement reform and other spending review recommendations could yield cuts to discretionary spending over time, options for cutting and rebalancing spending include:

- *Pension spending (Box 3)*: notwithstanding past pension reforms, pockets of excesses exist within the pension system that should be rationalized, related not least to the grandfathering of generous benefits. The parameters of the new system should be reviewed and adjusted as necessary, consistent with current policy settings: pension spending would rise notably if Italy's growth continues to lag that of the euro area as currently projected (and absent the comprehensive reform package as outlined above).
- *Health spending*: consideration should be given to improving the efficiency of health spending, especially at the local level where Italy is an outlier in the euro area.

<sup>16</sup> Large gross financing needs, upside risks to the marginal cost of borrowing, and the uncertain growth impact of further fiscal easing also point to the lack of fiscal space.

<sup>17</sup> Given limited fiscal space, any decision to provide temporary and upfront fiscal support would depend on the credibility of the government's commitment to strong implementation of comprehensive reforms and sustainable fiscal policies (see Banerji, A., and others, 2017, "Labor and Product Market Reforms in Advanced Economies: Fiscal Costs, Gains, and Support," Staff Discussion Note No. 17/03, IMF).

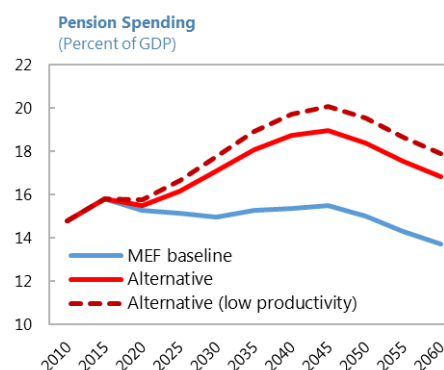
### Box 3. Pension Issues<sup>1</sup>

**The pension system in Italy has undergone multiple reforms.** These include pro-rata replacement of the old generous Defined Benefit (DB) scheme with a Notional Defined Contribution (NDC) system (1995), periodic updates based on mortality rates (2007), tightening of eligibility requirements (1992, 1995, 1997, 2004, 2007, 2011), alignment of the statutory retirement age of women with that of men (2010, 2011), and indexation of the retirement age to life expectancy. The old DB scheme is expected to be phased out fully by about 2050.

**Nevertheless, pockets of excesses remain.** The DB scheme is overly generous relative to actuarially fair values: e.g., replacement rates about 15–20 percent higher than in the EU; a weighted average accrual rate of 2 percent, compared to around 1.5 in the EU; benefits based on a relatively short earnings history; and low early retirement penalties. The internal rate of return is set considerably higher than Italy's growth potential under current policy settings. Survivors benefits are an outlier. Moreover, the 2017 budget dilutes gains from reforms, e.g., by providing for a 14<sup>th</sup> payment to low-income pensioners, raising the tax-free threshold for pensioners, and abolishing some early retirement penalties.

**The authorities project long-term pension spending to be subdued, albeit based on optimistic assumptions.** Their latest projections, based on full implementation of reforms, indicate pension spending will remain relatively flat at about 15 percent of GDP until 2045 and decline thereafter, reaching 13.7 percent of GDP by 2060. Some of the strongest savings stem from a sizable pickup in the employment rate: with the unemployment rate reaching as low as 5.5 percent of GDP by 2060, Italy is expected to move from one of the worst to among the best performers in the labor market. Immigration notably higher than euro area peers would ensure steady labor force participation over the long term. Moreover, per capita real GDP growth and real labor productivity growth is assumed at around 1¾ percent over the long term, far higher than has been observed over the last three decades.

**Relaxing some of the optimistic demographic and macroeconomic projections imply significantly higher pension spending.** Staff simulations based on less optimistic employment rates (achieving steady-state unemployment rates around 9 percent, which is still below Italy's long-term average unemployment rate) leads to an increase in pension spending of about 2¼ percent of GDP by 2060. Using demographic projections from the United Nations Population Division—the most widely used source providing consistent world-wide demographic projections—point to more rapid population aging, increasing long-run pension spending further by over ¾ percent of GDP by 2060. Moreover, a negative labor productivity shock (of ½ p.p. per year) raises spending by about 1 percent of GDP. Under current policy settings, these assumptions are more realistic, and point to notably higher pension spending (even with full implementation of past pension reforms).

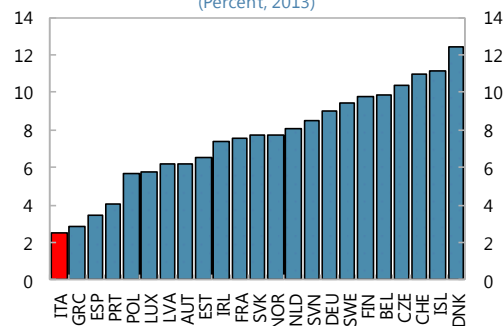


**These results highlight the importance of implementing comprehensive reforms as recommended in this report.** These reforms are critical for delivering the authorities' long-term pension projections. Even so, tackling the excesses in the current system would create space for improving the growth-friendly and inclusive mix in the near term. A prudent calibration of pension settings in line with the economy's potential would also highlight the need for a policy upgrade to avoid taking painful, large adjustments in the future.

<sup>1</sup> See M. Andrieu, S. Heubois, A. Kangur, and M. Raissi, 2017, "Toward a Growth-Friendly Fiscal Reform," Selected Issues Part 2.

- *Social safety net*: given the low share of transfers to those with low income, rationalization and improved targeting of anti-poverty programs is needed, including by expanding the income inclusion program into a universal anti-poverty scheme.
- *Wage bill*: following years of wage and employment freezes and rising shortages in certain sectors (e.g., education), the room for further cuts to the wage bill are limited, although some room exists to moderate the high premium (above private sector wages) paid to certain categories of public sector employees.

Share of Transfers Received by the Lowest Income Decile (Percent, 2013)

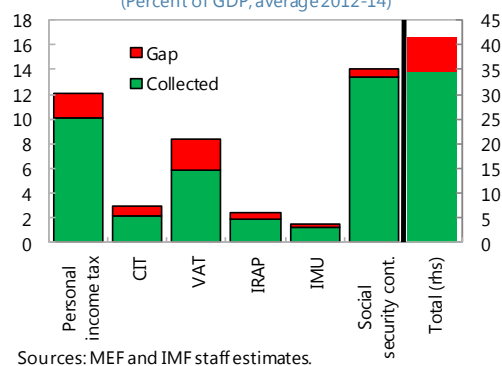


Sources: OECD 2017.

**32. On the revenue side, lowering tax rates on productive factors, shifting taxation toward property and consumption, and broadening the tax base would be pro-growth.** Such a reform would contribute to simplifying the tax system, which is complex, applies high rates on a base that has been significantly eroded with resort to exemptions and incentives, and suffers from large gaps.

- A well-designed shift to taxing consumption, including by reducing VAT gaps (both compliance and policy) that are among the highest in the euro zone, as well as to lowering the statutory tax rates on labor would support employment and production.
- High household wealth in Italy (above €9 trillion or about 5½ times GDP) and the concentration of wealth in the top quartile points to increased taxation of property as an efficient and equitable means to raise resources for achieving targets and rebalancing taxes. Owing to its unpopularity, the property tax on primary residences was eliminated. In that regard, the reform of cadastral values needs to be accelerated and a modern property tax introduced, including a real estate tax on primary residences.

Tax Gap (Percent of GDP, average 2012-14)



Sources: MEF and IMF staff estimates.

- A comprehensive review and rationalization of tax expenditures, and of the overall tax design, could enhance the efficiency and neutrality of the tax system. Tax evasion should be combated with an emphasis on stricter enforcement<sup>18</sup> and mobilization of the anti-money laundering framework. Moreover, the investment climate would be improved by reducing tax uncertainty brought on by frequent changes.

<sup>18</sup> The IMF's 2015 technical assistance report on tax administration pointed to the need *inter alia* for improving governance (e.g., by restoring the autonomy of the tax administration that had been weakened since 2001); introducing timely filing and modern VAT payment arrangements, which has been improved since; strengthening enforcement; and addressing the causes of tax debt accumulation (e.g., by bringing instalment arrangements in line with international trends and removing extended "no action" periods).

**33. The authorities noted that fiscal policy must strike a fine balance between supporting the recovery and putting debt on a firm downward trajectory.** They considered the output gap calculated under the EU fiscal framework to significantly understate the cyclical position of the economy. In that regard, they argued that a very gradual fiscal consolidation is appropriate, so as not to jeopardize the economic recovery and put social cohesion at risk. Faster growth and a return of inflation would facilitate a decline in debt, while fiscal prudence and past reforms, including of pensions, are sufficient to underpin long-run sustainability. The authorities cautioned against re-opening a discussion of pensions. They view considerable potential for savings from tackling tax evasion and improving the efficiency of spending. They are against introducing a real estate tax on primary residences; having abolished such a tax two years ago, they consider it would add to tax uncertainty and not yield sizable revenues.

## STAFF APPRAISAL

**34. The economy is recovering, but risks are significant.** The recovery has been helped by exceptional monetary accommodation, fiscal easing, low commodity prices, and the government's reform efforts. Unemployment and NPLs have declined somewhat from their crisis-driven peaks. Public debt has stabilized, albeit at a very high level. However, 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. Weak productivity and low aggregate investment remain challenges for faster growth and job creation, held back by long-standing structural weaknesses, high public debt, and impaired bank balance sheets. Downside risks are notable, related among others to financial fragilities, political uncertainties, possible setbacks to the reform process, and a re-evaluation of credit risk during monetary policy normalization.

**35. Further progress in raising real incomes and reducing vulnerabilities will require enhanced policy efforts.** The overarching challenge is to boost productivity, which requires more ambitious policy efforts and broad and sustained political support to overcome entrenched interests and institutional inertia, so that a modernized and agile economy can compete in today's global environment. In a complex domestic setting, the authorities have advanced some important reform initiatives. However, further steps are needed to narrow competitiveness gaps with euro area partners, given the assessment that the external position is moderately weaker than fundamentals, reduce imbalances decisively, and raise incomes including for those being left behind.

**36. The current backdrop of cyclical recovery and exceptional monetary easing provides a favorable, if narrowing, window to press forward urgently with reforms and adjustment.** Front-loaded implementation of a comprehensive and more ambitious program, alongside a credible and growth-friendly fiscal consolidation, can support the economy and job creation in the near term, create room for measures to accelerate bank repair, and put public debt on a firm downward path. In the medium term, it would yield notable output gains and narrow significantly competitiveness gaps.

**37. Ambitious and broader structural reforms will help foster stronger growth.** The authorities' efforts 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. These should be implemented fully and backtracking or weakening resisted firmly. Building on these efforts, further reforms are needed to enhance competition in product and service markets, align wages with productivity at the firm level, and broaden public sector reform. The draft annual competition law should be strengthened and approved expeditiously, and the requirement of legislating annual pro-competition laws adhered to. The wage bargaining system should be enhanced by giving clear primacy to firm-level contracts and introducing a minimum wage, possibly differentiated across regions. Broadening public sector reform includes regulating local public services, rationalizing state-owned enterprises, improving the skill mix of employees, tackling corruption, and widening the scope of procurement reform.

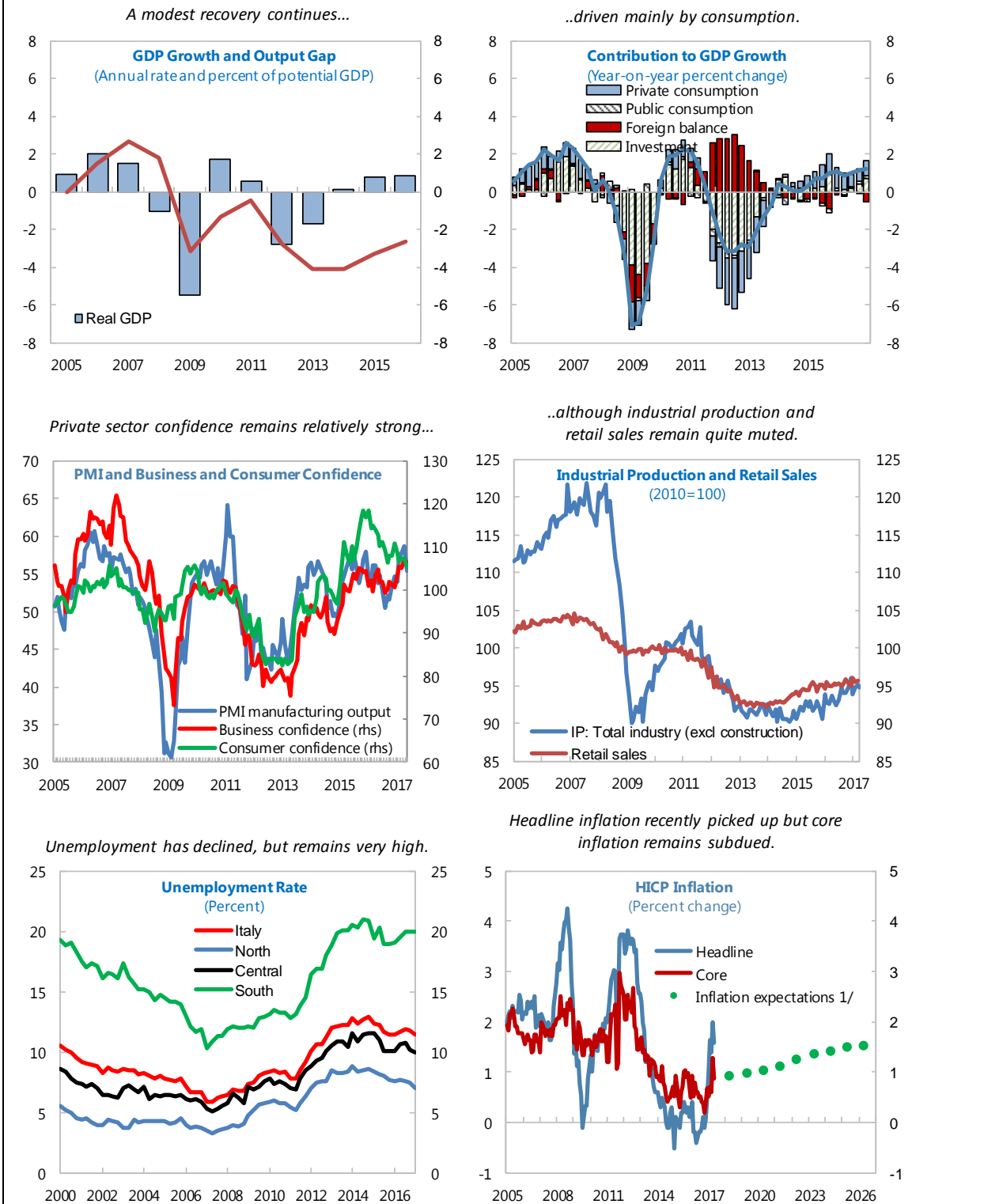
**38. Accelerating the repair of bank balance sheets will strengthen financial stability and support intermediation.** Progress is underway, reflecting *inter alia* actions to strengthen the capital buffers of some large banks, plans for sizable NPL sales, and bank consolidation. These should be complemented with additional measures to materially tackle NPLs and enhance banks' operational efficiency. To safeguard financial stability and minimize costs to taxpayers, it is critical that actions to address problems in banks are taken promptly, with appropriate burden sharing involving banks' shareholders and creditors, and protection as needed for the most vulnerable retail bondholders. This is especially important in view of Italy's limited fiscal space. Banks' NPL reduction strategies and targets need to be ambitious and credible, aided by supervisory assessments of banks' capacity to resolve NPLs in a timely manner. The supervisor should seek to ensure that banks have realistic and coherent business model assumptions, so that capital destructive practices are streamlined, divested, or closed. An asset quality review of all emerging consolidated groups should be undertaken and robust governance and risk management structures ensured. Legislative gaps in Italy's implementation of the EU fit and proper rules for bank management should be closed.

**39. A credible fiscal consolidation is essential to lower public debt.** 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 to achieve 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.

**40. Priority should be placed on permanent, growth-friendly measures to underpin fiscal consolidation**—cutting current primary spending, broadening the tax base, and lowering gradually tax rates on productive factors. High pension spending should be reduced over the medium term, to address fiscal pressures that would persist before the savings from pension reforms materialize over the very long run. On the other hand, capital spending should be increased, as should transfers to those with low incomes through better targeting and rationalizing of social protection programs. VAT collection should be improved, emphasis placed on enforcement of taxes, and a modern real estate tax introduced.

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

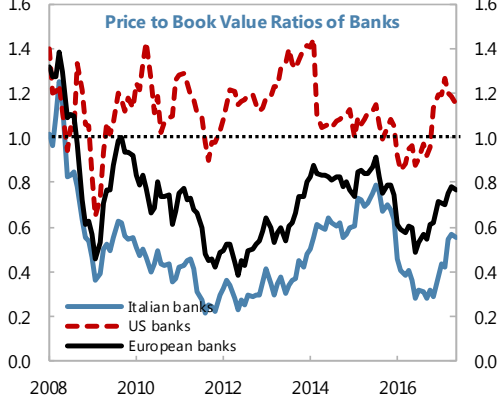
**Figure 3. Italy: High Frequency and Real Economy Developments**



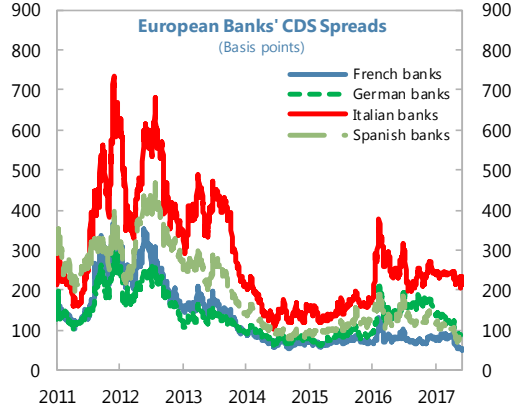
Sources: ISTAT; Bloomberg Finance L.P.; and IMF staff estimates.  
1/ Based on swap rates.

**Figure 4. Italy: Financial Sector Developments**

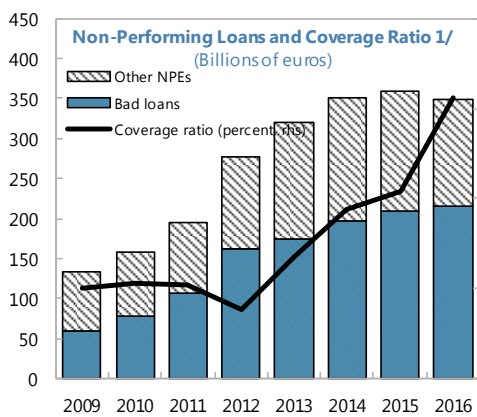
*Bank equity prices have recently started to recover, in line with developments elsewhere...*



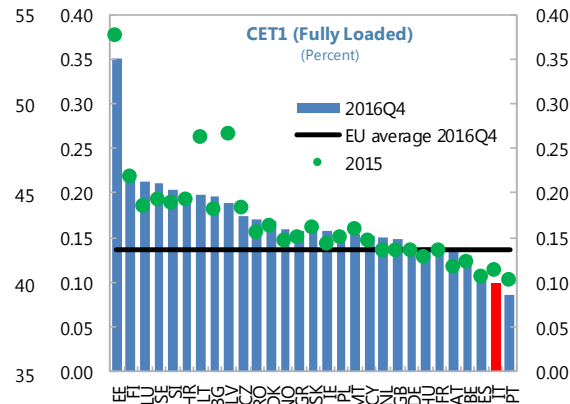
*...but CDS spreads that signal default risks continue to diverge from other countries.*



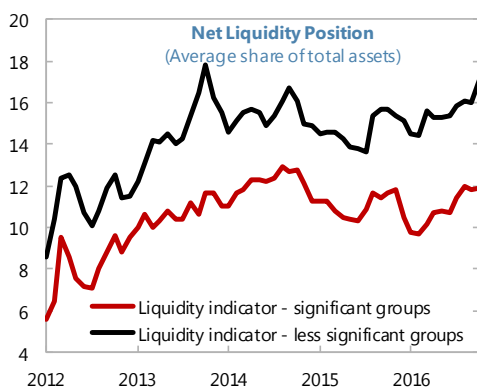
*NPLs fell marginally in 2016, while the coverage ratio improved.*



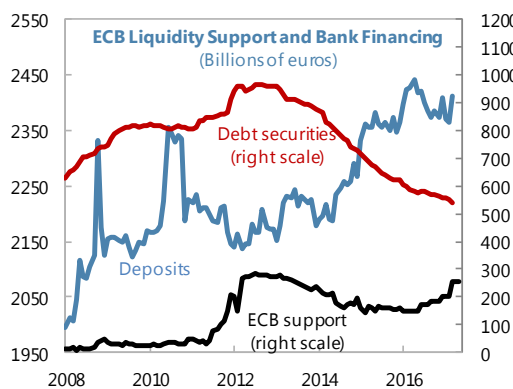
*Despite capital increases by some significant banks, Italy continues to lag behind other EU countries.*



*The system as a whole has adequate liquidity and collateral.*



*As the stock of bank bonds reduces, deposits and ECB support have increased.*

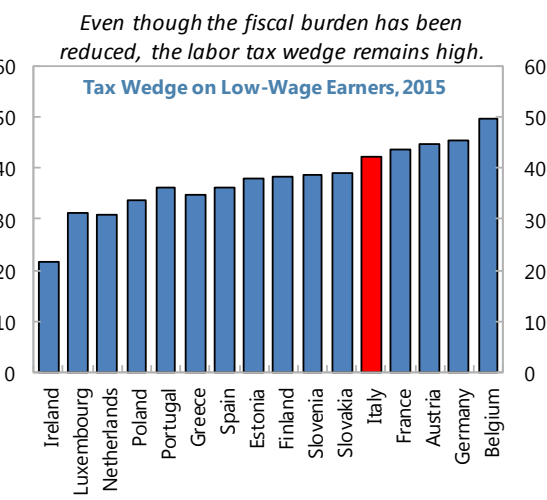
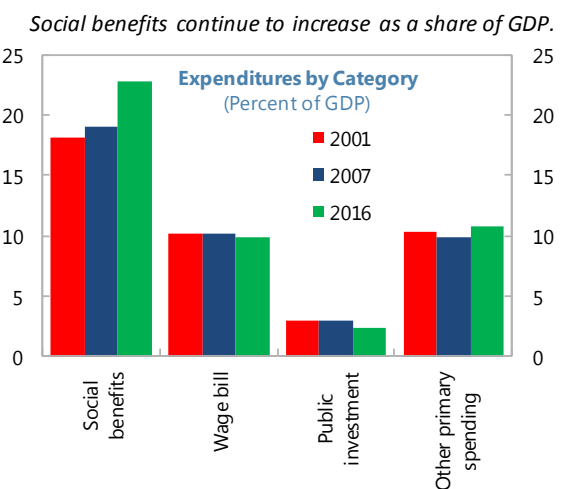
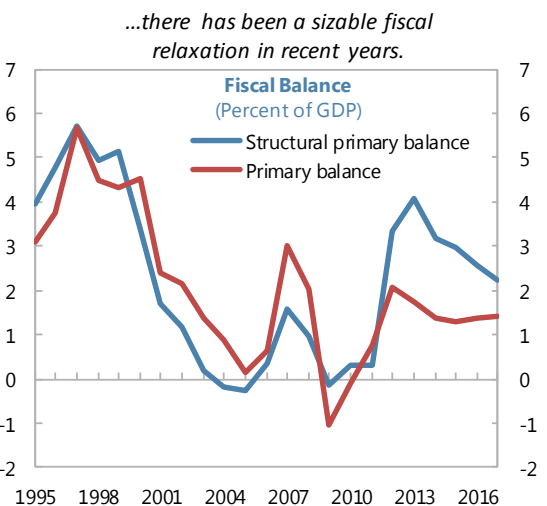
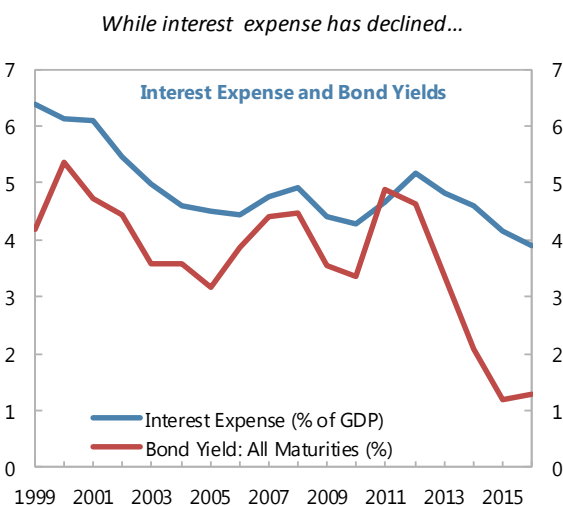
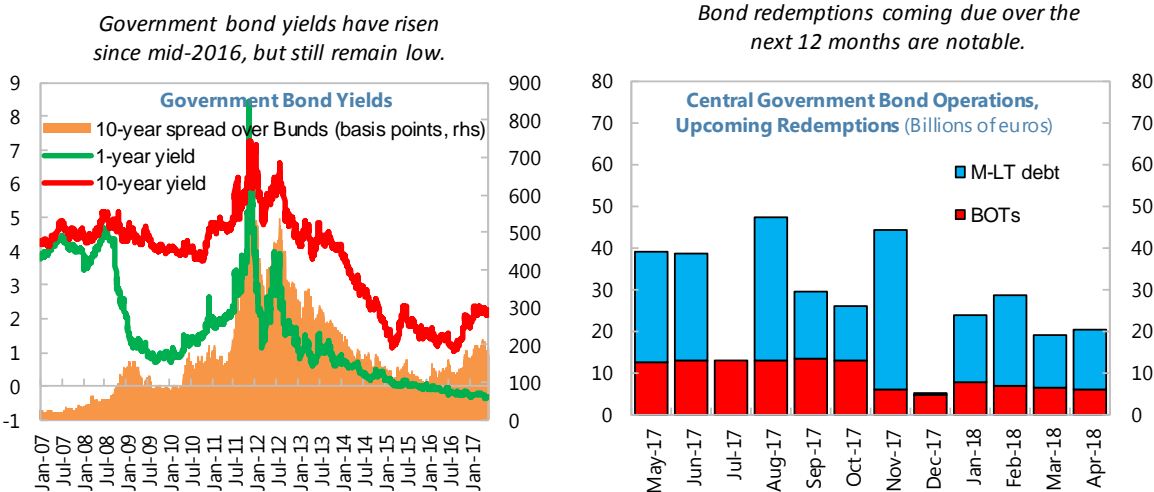


Sources: Bloomberg Finance L.P.; Bank of Italy; S&P Global Market Intelligence; ECB; European Banking Authority; and IMF staff estimates.

Notes: The net liquidity position is calculated as the difference between eligible assets for use as collateral for Eurosystem refinancing operations and cumulative expected net cash flows over the next 30 days.

1/ Bank of Italy data starting from 2012.

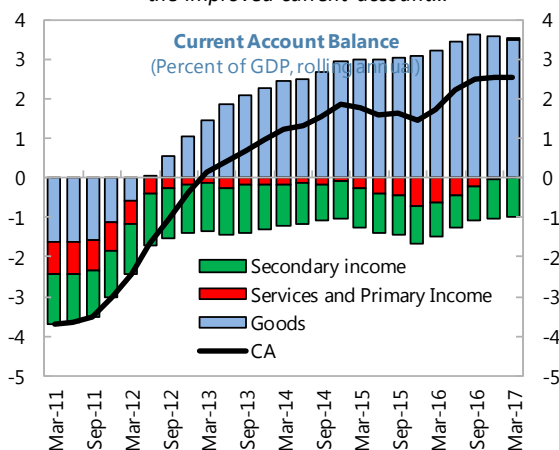
**Figure 5. Italy: Fiscal Developments and Issues**



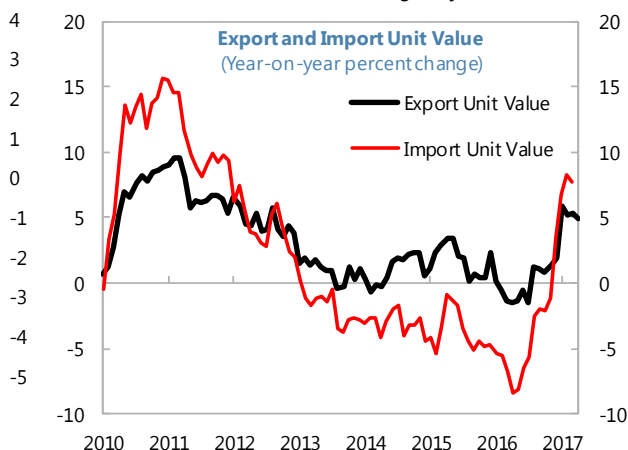
Sources: Eurostat; Bloomberg Finance L.P.; and Bank of Italy.

**Figure 6. Italy: External Developments**

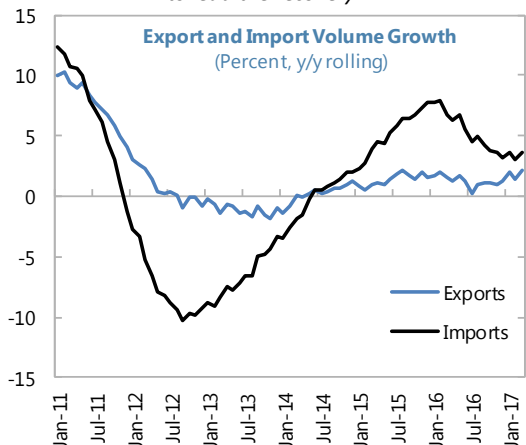
*A growing trade surplus has been supporting the improved current account...*



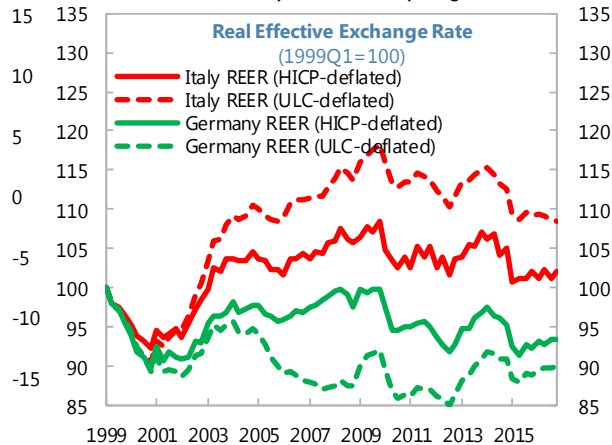
*...and has been driven by large gains in terms of trade that show initial signs of reversal.*



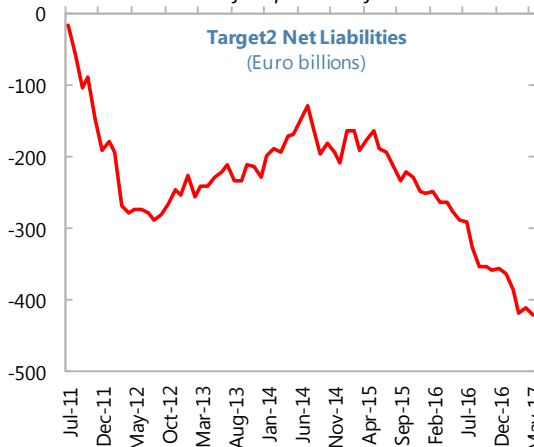
*Real exports have not been able to lead the recovery...*



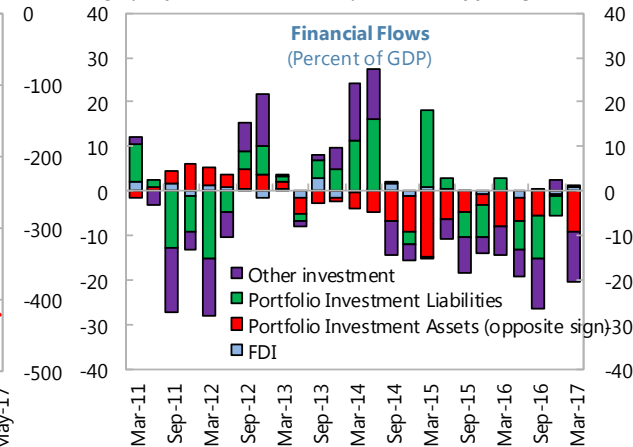
*...while the ULC-gap vis-a-vis Germany remains very large.*



*Target2 net liabilities have rapidly risen to a record level of 25 percent of GDP...*



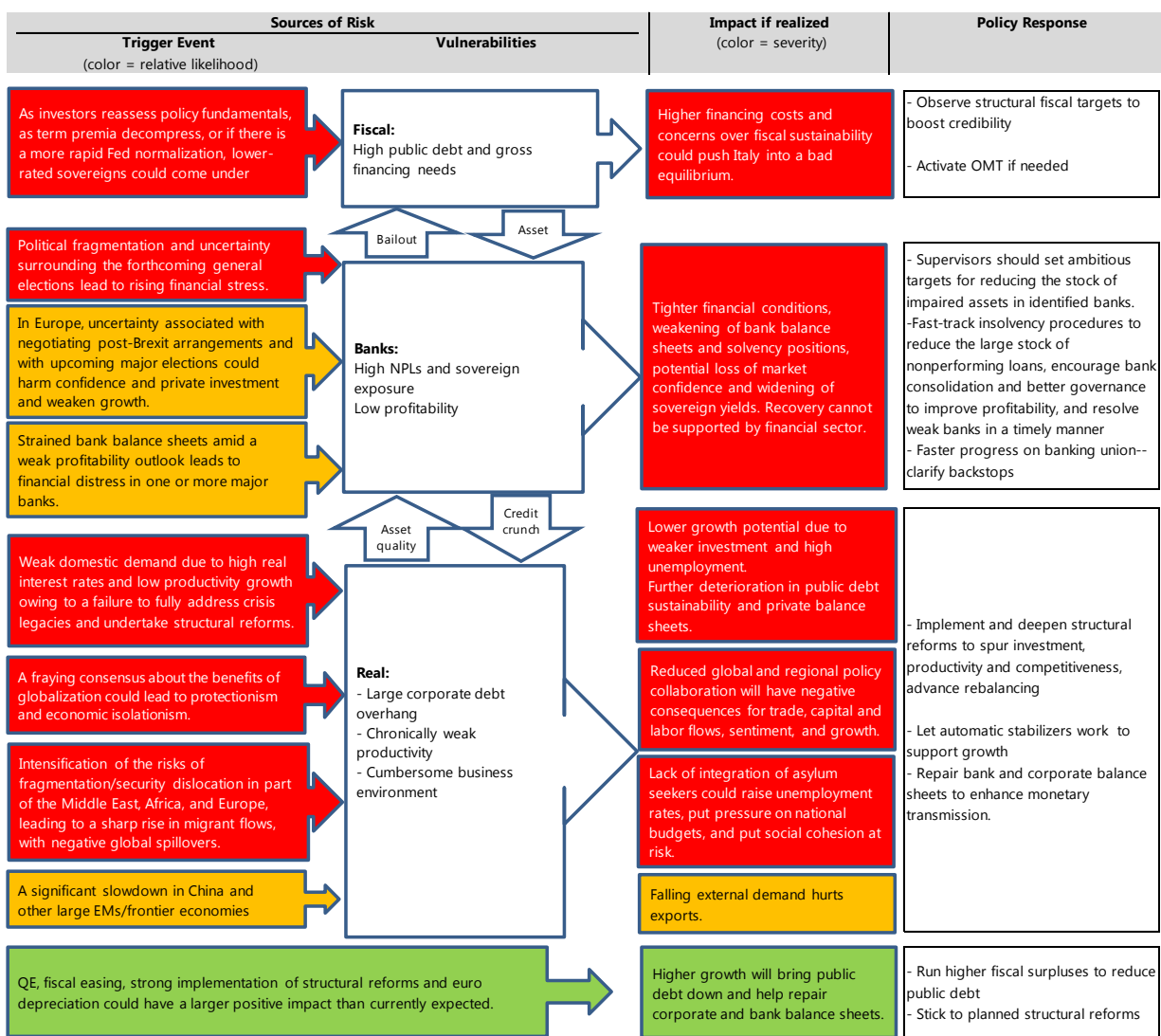
*...mirroring net outflows from financial account that largely reflect residents' net purchases of foreign assets.*



Sources: Haver; Eurostat; and IMF staff estimates.

**Figure 7. Italy: Risk Assessment Matrix**

Italy: Risk Assessment Matrix and Transmission Channels  
Potential Deviations from Baseline



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

**Table 1. Italy: Summary of Economic Indicators, 2014–22<sup>1/</sup>**

(Annual percentage change, unless noted otherwise)

	2014	2015	2016	Projections					
				2017	2018	2019	2020	2021	2022
Real GDP	0.1	0.8	0.9	1.3	1.0	0.9	1.0	0.9	0.8
Real domestic demand	0.2	1.3	1.0	1.7	0.9	0.8	0.9	0.8	0.8
Public consumption	-0.7	-0.7	0.6	0.9	-0.5	-0.6	0.0	0.0	0.0
Private consumption	0.2	1.6	1.3	1.2	0.9	0.8	1.0	0.9	0.8
Gross fixed capital formation	-2.3	1.6	2.9	2.5	2.8	1.7	1.8	1.8	1.7
Final domestic demand	-0.4	1.1	1.5	1.4	0.9	0.7	0.9	0.9	0.8
Stock building 2/	0.6	0.2	-0.5	0.3	0.0	0.0	0.0	0.0	0.0
Net exports 2/	-0.1	-0.5	-0.1	-0.3	0.1	0.2	0.1	0.1	0.1
Exports of goods and services	2.7	4.4	2.4	4.3	4.3	3.8	3.6	3.6	3.6
Imports of goods and services	3.2	6.8	2.9	5.8	4.3	3.6	3.6	3.5	3.5
Savings 3/	18.9	18.8	19.6	19.0	19.2	19.3	19.3	19.2	19.3
Investment 3/	17.0	17.3	17.0	17.2	17.6	17.9	18.1	18.4	18.7
Resource utilization									
Potential GDP	0.2	-0.1	0.2	0.3	0.4	0.5	0.6	0.7	0.8
Output gap (percent of potential)	-4.1	-3.3	-2.7	-1.7	-1.2	-0.8	-0.4	-0.1	0.0
Employment	0.4	0.8	1.3	0.9	0.9	0.9	0.7	0.7	0.7
Unemployment rate (percent)	12.6	11.9	11.7	11.4	11.0	10.6	10.3	10.0	9.7
Prices									
GDP deflator	1.0	0.7	0.8	0.6	1.2	1.4	1.4	1.4	1.4
Consumer prices	0.2	0.1	-0.1	1.4	1.2	1.4	1.4	1.4	1.4
Hourly compensation 4/	1.5	1.4	1.5	2.0	2.0	2.0	2.1	2.2	2.2
Productivity 4/	0.8	0.7	1.1	1.1	1.0	0.9	0.9	0.8	0.7
Unit labor costs 4/	0.7	0.7	0.4	0.9	1.0	1.0	1.2	1.4	1.5
Fiscal indicators									
General government net lending/borrowing 3/ 5/	-3.0	-2.7	-2.4	-2.2	-1.3	-0.3	-0.1	0.0	0.0
General government primary balance 3/ 6/	1.4	1.3	1.4	1.4	2.3	3.3	3.6	3.7	3.7
Structural overall balance (percent of potential GDP)	-1.1	-0.9	-1.1	-1.4	-0.7	0.1	0.1	0.1	0.0
Structural primary balance (percent of potential GDP) 6/	3.2	3.0	2.6	2.2	2.9	3.7	3.7	3.7	3.7
General government gross debt 3/ 5/	131.8	132.1	132.6	133.0	131.6	129.0	126.0	123.1	120.3
Exchange rate regime				Member of the EMU					
Exchange rate (national currency per U.S. dollar)	0.8	0.9	0.9	...	...	...	...	...	...
External sector 4/									
Current account balance	1.9	1.4	2.6	1.9	1.6	1.4	1.2	0.9	0.5
Trade balance	2.8	3.0	3.6	3.1	2.9	2.8	2.6	2.4	2.1

Sources: National Authorities; and IMF staff estimates.

1/ IMF staff estimates and projections are based on the fiscal plans included in the government's 2017 budget and April 2017 Economic and Financial Document.

2/ Contribution to growth.

3/ Percent of GDP.

4/ In industry (including construction).

5/ State aid following the liquidation of two banks in June 2017 is reflected in public debt (0.6 percent of GDP), but not in net lending/borrowing, pending clarity on their statistical treatment.

6/ Primary revenue minus primary expenditure.

**Table 2. Italy: Statement of Operations-General Government (GFSM 2001 Format), 2009–22**

	2009	2010	2011	2012	2013	2014	2015	2016	Projections					
									2017	2018	2019	2020	2021	2022
	(Billions of euros)													
Revenue	721.8	732.4	747.8	771.7	772.6	776.7	785.9	789.0	796.4	808.7	832.7	851.2	871.5	891.4
Taxes	446.1	453.9	464.9	488.0	484.9	488.2	494.1	495.8	497.2	504.9	516.8	529.5	542.2	554.7
Social contributions	212.1	213.7	216.3	215.8	215.3	214.3	219.1	221.4	223.4	228.1	238.5	242.5	248.2	253.8
Grants	2.7	1.7	3.4	4.2	4.6	5.4	4.1	3.7	3.7	3.7	3.7	3.7	3.7	3.7
Other revenue	60.8	63.1	63.2	63.6	67.8	68.8	68.6	68.0	72.1	72.0	73.7	75.6	77.5	79.3
Expenditure	804.7	800.5	808.6	818.9	819.1	825.5	830.1	829.7	834.5	851.2	867.8	889.8	909.8	931.8
Expense	804.5	800.3	808.4	819.1	822.0	825.0	829.8	829.7	834.5	851.2	867.8	889.8	909.8	931.8
Compensation of employees	171.7	172.5	169.6	166.1	164.8	163.5	162.0	164.1	167.2	170.7	174.6	178.9	183.1	187.2
Use of goods and services	85.6	87.4	87.2	87.0	89.6	88.9	90.1	91.2	87.8	89.9	92.2	94.4	96.6	98.8
Consumption of fixed capital	42.2	42.8	42.7	43.4	44.4	44.5	44.3	45.1	45.9	46.9	48.0	49.1	50.3	51.4
Interest	69.5	68.8	76.4	83.6	77.6	74.4	68.0	66.4	65.4	65.8	67.0	69.2	70.6	72.8
Social benefits	337.2	345.0	349.1	354.8	363.2	371.1	376.6	381.9	389.1	395.3	402.5	412.2	421.9	431.4
Other expense	98.4	83.7	83.4	84.2	82.4	82.8	88.8	81.0	79.2	82.6	83.6	86.1	87.4	90.1
Net acquisition of nonfinancial assets	0.2	0.2	0.2	-0.3	-2.9	0.5	0.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Unidentified measures 1/	...	...	...	...	...	...	...	...	0.0	19.1	29.4	37.4	38.7	40.8
Net lending/borrowing 2/	-82.9	-68.1	-60.8	-47.2	-46.5	-48.8	-44.3	-40.7	-38.2	-23.4	-5.7	-1.2	0.4	0.5
	(Percent of GDP, unless otherwise indicated)													
Revenue	45.9	45.6	45.7	47.8	48.1	47.9	47.8	47.2	46.7	46.5	46.8	46.7	46.7	46.7
Taxes	28.4	28.3	28.4	30.3	30.2	30.1	30.0	29.6	29.2	29.0	29.0	29.0	29.1	29.1
Social contributions	13.5	13.3	13.2	13.4	13.4	13.2	13.3	13.2	13.1	13.1	13.4	13.3	13.3	13.3
Grants	0.2	0.1	0.2	0.3	0.3	0.3	0.3	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Other revenue	3.9	3.9	3.9	3.9	4.2	4.2	4.2	4.1	4.2	4.1	4.1	4.1	4.2	4.2
Expenditure	51.2	49.9	49.4	50.8	51.0	50.9	50.4	49.6	49.0	48.9	48.8	48.8	48.8	48.8
Expense	51.1	49.9	49.4	50.8	51.2	50.9	50.4	49.6	49.0	48.9	48.8	48.8	48.8	48.8
Compensation of employees	10.9	10.8	10.4	10.3	10.3	10.1	9.8	9.8	9.8	9.8	9.8	9.8	9.8	9.8
Use of goods and services	5.4	5.4	5.3	5.4	5.6	5.5	5.5	5.5	5.2	5.2	5.2	5.2	5.2	5.2
Consumption of fixed capital	2.7	2.7	2.6	2.7	2.8	2.7	2.7	2.7	2.7	2.7	2.7	2.7	2.7	2.7
Interest	4.4	4.3	4.7	5.2	4.8	4.6	4.1	4.0	3.8	3.8	3.8	3.8	3.8	3.8
Social benefits	21.4	21.5	21.3	22.0	22.6	22.9	22.8	22.8	22.8	22.7	22.6	22.6	22.6	22.6
Other expense	6.3	5.2	5.1	5.2	5.1	5.1	5.4	4.8	4.6	4.7	4.7	4.7	4.7	4.7
Net acquisition of nonfinancial assets	0.0	0.0	0.0	0.0	-0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Unidentified measures 1/	...	...	...	...	...	...	...	...	0.0	1.1	1.7	2.1	2.1	2.1
Net lending/borrowing 2/	-5.3	-4.2	-3.7	-2.9	-2.9	-3.0	-2.7	-2.4	-2.2	-1.3	-0.3	-0.1	0.0	0.0
Memorandum items:														
Primary balance 3/	-1.0	-0.1	0.8	2.1	1.8	1.4	1.3	1.4	1.4	2.3	3.3	3.6	3.7	3.7
Structural primary balance 3/	-0.1	0.3	0.3	3.3	4.1	3.2	3.0	2.6	2.2	2.9	3.7	3.7	3.7	3.7
Change in structural primary balance 4/	-1.1	0.5	0.0	3.0	0.8	-0.9	-0.2	-0.4	-0.3	0.6	0.8	0.1	0.0	0.0
Structural balance 4/	-4.2	-3.7	-4.1	-1.5	-0.5	-1.1	-0.9	-1.1	-1.4	-0.7	0.1	0.1	0.1	0.0
Change in structural balance 4/	-0.4	0.5	-0.4	2.6	1.0	-0.5	0.2	-0.3	-0.2	0.7	0.8	0.0	0.0	0.0
General government gross debt 2/	112.5	115.4	116.5	123.4	129.0	131.8	132.1	132.6	133.0	131.6	129.0	126.0	123.1	120.3

Sources: National Authorities; and IMF staff estimates.

1/ Including to replace safeguard clauses.

2/ State aid following the liquidation of two banks in June 2017 is reflected in public debt (0.6 percent of GDP), but not in net lending/borrowing, pending clarity on their statistical treatment.

3/ Primary revenue minus primary expenditure.

4/ Percent of potential GDP.

Table 3. Italy: Summary of Balance of Payments, 2014–22

	2014	2015	2016	2017	2018	2019	2020	2021	2022
	Projections								
	(Billions of euros)								
Current account balance	30.5	23.7	42.8	31.5	27.3	25.2	21.9	16.1	10.2
Balance of goods and services	46.4	48.0	56.7	46.4	42.4	40.6	37.5	31.9	25.3
Goods balance	47.4	50.7	59.9	52.6	50.2	49.6	48.0	44.4	40.1
Exports	389.5	405.4	410.4	429.8	451.5	473.4	495.8	519.3	544.0
Imports	429.0	446.0	444.8	478.5	509.1	537.7	568.2	602.5	639.2
Services balance	-1.0	-2.7	-3.2	-6.1	-7.8	-9.0	-10.5	-12.5	-14.9
Credit	85.9	88.6	91.1	95.2	100.0	104.9	109.8	115.0	120.5
Debit	86.9	91.3	94.2	101.3	107.8	113.9	120.3	127.6	135.4
Primary income balance	0.0	-9.2	2.8	2.2	2.3	2.5	2.7	2.8	4.0
Credit	77.3	67.8	71.8	72.5	74.1	76.0	77.9	79.9	82.8
Debit	93.2	92.1	85.8	87.4	89.2	91.3	93.5	95.7	97.9
Secondary income balance	-15.9	-15.0	-16.8	-17.0	-17.4	-17.8	-18.2	-18.7	-19.1
Capital account balance	3.0	2.6	-2.1	1.7	1.7	1.8	1.8	1.9	1.9
Financial account	43.8	27.4	63.9	33.2	29.0	27.0	23.7	17.9	12.1
Direct investment	2.3	2.7	-5.6	7.8	8.4	9.0	9.7	10.4	11.2
Portfolio investment	-3.6	89.5	153.9	35.8	28.5	41.9	35.8	40.2	28.9
<i>of which: government debt</i>	58.8	21.1	-24.6	31.3	24.3	16.3	10.1	5.4	5.4
Other investment	49.6	-68.6	-86.5	-10.3	-7.8	-23.9	-21.7	-32.7	-28.0
Derivatives (net)	-3.6	3.4	3.2	0.0	0.0	0.0	0.0	0.0	0.0
Reserve assets	-1.0	0.5	-1.2	0.0	0.0	0.0	0.0	0.0	0.0
Net errors and omissions	10.3	1.1	23.2	0.0	0.0	0.0	0.0	0.0	0.0
	(Percent of GDP)								
Current account balance	1.9	1.4	2.6	1.9	1.6	1.4	1.2	0.9	0.5
Balance on goods and services	2.9	2.9	3.4	2.7	2.4	2.3	2.1	1.7	1.3
Goods balance	2.9	3.1	3.6	3.1	2.9	2.8	2.6	2.4	2.1
Services balance	-0.1	-0.2	-0.2	-0.4	-0.4	-0.5	-0.6	-0.7	-0.8
Primary income balance	0.0	-0.6	0.2	0.1	0.1	0.1	0.1	0.2	0.2
Secondary income balance	-1.0	-0.9	-1.0	-1.0	-1.0	-1.0	-1.0	-1.0	-1.0
Capital account balance	0.2	0.2	-0.1	0.1	0.1	0.1	0.1	0.1	0.1
Financial account	2.7	1.7	3.8	2.0	1.7	1.5	1.3	1.0	0.6
Direct investment	0.1	0.2	-0.3	0.5	0.5	0.5	0.5	0.6	0.6
Portfolio investment	-0.2	5.4	9.2	2.1	1.6	2.4	2.0	2.2	1.5
<i>of which: government</i>	3.6	1.3	-1.5	1.8	1.4	0.9	0.6	0.3	0.3
Other investment	3.1	-4.2	-5.2	-0.6	-0.5	-1.3	-1.2	-1.8	-1.5
Derivatives (net)	-0.2	0.2	0.2	0.0	0.0	0.0	0.0	0.0	0.0
Reserve assets	-0.1	0.0	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Net errors and omissions	0.6	0.1	1.4	0.0	0.0	0.0	0.0	0.0	0.0
Gross external debt	124.3	126.0	125.7	124.6	122.5	119.6	116.5	114.5	112.7
Public sector	63.8	66.6	69.8	68.5	66.3	63.3	60.2	58.3	56.5
Private sector	60.5	59.4	55.9	56.1	56.2	56.3	56.2	56.2	56.2

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

**Table 4. Italy: Financial Soundness Indicators, 2011–16<sup>1/</sup>**

	2011	2012	2013	2014	2015	2016
Core FSIs for Deposit-taking institutions						
Regulatory capital to risk-weighted assets	12.7	13.4	13.7	14.3	14.8	15.0
Regulatory tier 1 capital to risk-weighted assets	9.5	10.5	10.6	11.9	12.3	12.5
Nonperforming loans net of provisions to capital	64.6	79.7	89.9	93.4	89.0	84.3
Nonperforming loans to total gross loans	11.7	13.7	16.5	18.0	18.1	17.5
Sectoral distribution of loans to total loans:						
Loans to Residents	75.5	75.5	75.7	75.3	74.3	75.4
Loans to Deposit takers	2.6	2.6	2.7	2.5	2.5	2.4
Loans to Central Bank	1.0	1.1	0.8	0.6	0.8	1.2
Loans to Other financial corporations	3.7	6.0	6.1	6.6	7.4	7.7
Loans to General government	2.5	2.6	2.5	2.4	2.0	2.1
Loans to Nonfinancial corporations	39.0	37.2	36.8	36.8	35.4	34.9
Loans to Other domestic sectors	26.7	25.9	26.9	26.5	26.2	27.1
Loans to Nonresidents	24.5	24.5	24.3	24.7	25.7	24.6
Return on assets	-0.9	-0.1	-0.8	-0.2	0.3	0.1
Return on equity	-13.0	-0.9	-11.5	-2.8	3.4	1.4
Interest margin to gross income	57.1	53.8	49.1	50.4	47.7	47.5
Net open position in foreign exchange to capital	1.7	1.2	2.0	0.0	0.3	1.4
Encouraged FSIs for Deposit-taking institutions						
Capital to assets	5.4	5.4	5.4	5.9	6.2	6.1
Large exposures to capital	89.2	91.8	81.9	210.3	205.6	222.3
Gross asset position in financial derivatives to capital	112.3	76.7	70.2	70.8	84.4	74.0
Gross liability position in financial derivatives to capital	117.9	83.2	75.5	71.6	85.8	77.3
Personnel expenses to noninterest expenses	56.5	55.7	57.7	55.0	52.8	53.0
Spread between reference lending and deposit rates (basis points)	305.2	263.9	284.1	292.1	272.5	263.2
Spread between highest and lowest interbank rates (basis points)	87.6	12.4	19.7	0.1	33.6	12.2
Customer deposits to total (noninterbank) loans	58.2	67.9	70.5	70.6	75.2	77.7
Foreign-currency-denominated loans to total loans	8.9	8.3	8.8	9.5	10.0	9.7
Foreign-currency-denominated liabilities to total liabilities	30.7	27.8	28.7	32.0	34.4	39.1

Sources: Bank of Italy; ECB; IMF, Financial Soundness Indicators and IMF staff calculations.

1/ Data from the IMF Financial Soundness Indicators database have been updated, when possible, with Bank of Italy's or ECB's data. 2016Q2 data is latest available.

## Annex I. External Sector Assessment

	Italy	Overall Assessment
<p><b>Foreign asset and liability position and trajectory</b></p>	<p><b>Background.</b> Italy's net international investment position (NIIP) has deteriorated since Italy joined the Euro area. Compared with a position of -6 percent of GDP at end 2000, the NIIP deteriorated to about -25 percent of GDP in 2013. It has since recovered to around -15 percent of GDP in end-2016, driven by stronger current account balances and modest nominal GDP growth. Gross assets and liabilities have grown notably, reaching 149 and 164 percent of GDP respectively, 51 and 59 percentage points higher than in 2000. TARGET2 liabilities rose from about 15 to 25 percent of GDP between end-2015 and May 2017, in part reflecting residents' net purchases of foreign assets and the creation of liquidity by the Bank of Italy within the framework of the Eurosystem's asset purchase program. External debt represents about ¾ of gross external liabilities. While the level of external debt is in line with the Euro area as a whole, its composition—half is owed by the public sector—underscores the vulnerabilities related to the high level of government debt. Modest current account surpluses forecast over the medium term should gradually shrink Italy's net liability position as a share of GDP.</p> <p><b>Assessment.</b> Although the current account has shifted into a surplus, further strengthening of balance sheets is desirable, given the high levels of public debt and the potential negative feedback loops between the debt stock and debt servicing costs.</p>	<p><b>Overall Assessment:</b></p> <p><i>The external position in 2016 was in the upper range of moderately weaker than suggested by medium-term fundamentals and desirable policy settings.</i></p> <p>The overall assessment reflects Italy's continued weak productivity growth and need for balance sheet repair. Stronger growth, consistent with reducing high unemployment and public debt, while strengthening the external balance sheet, would require a weakening of the real effective exchange rate from average 2016 levels and sustained improvements in competitiveness.</p>
<p><b>Current account</b></p>	<p><b>Background.</b> Italy's current account (CA) averaged a deficit of 1¼ percent of GDP in the decade following the adoption of the euro. Starting in 2013, it moved into balance and, by 2016, it registered a surplus of 2.6 percent of GDP (as compared to 1.4 percent of GDP in 2015). The improvement in the CA is driven mainly by Italy's growing trade surplus, which reached 3.6 percent of GDP in 2016, owing to a large commodity terms of trade gain in the last three years. In terms of saving and investment, declining investment accounted for ¾ of the improvement in the CA since 2010, while higher public saving contributed most of the rest.</p> <p><b>Assessment.</b> Notwithstanding the recent improvement in the current account, the EBA model suggests that the cyclically-adjusted level, which stood at 1.5 percent of GDP in 2016, was about 2.5 percent of GDP below the EBA norm implied by medium-term fundamentals and desirable policy settings. Demographics is the largest contributor to the CA norm of 4 percent of GDP and its increase by about one percentage point relative to 2015 (reflecting faster-than-previously-expected population aging). Given these estimates and the need for stronger growth to reduce public debt and unemployment over the medium term, while improving the external balance sheet, staff assesses a CA gap of about -3 to -1 percent of GDP for 2016.1/</p>	<p><b>Potential policy responses:</b></p> <p>Strong implementation of structural reforms, including to improve the wage bargaining mechanism to better align wages with productivity at the firm level, as well as efforts to strengthen bank balance sheets will be critical to improving competitiveness and boosting potential growth. Progress in fiscal consolidation will also help narrow the external gap and maintain investor confidence. Combined, these measures will support growth and employment over the medium term.</p>
<p><b>Real exchange rate</b></p>	<p><b>Background.</b> The CPI-based and the ULC-based real effective exchange rates appreciated by about 1 percent and 0.4 percent from 2015 to 2016, respectively. From a longer-term perspective, stagnant productivity and rising labor costs has led to a gradual appreciation of the real effective exchange rate (REER) since Italy joined the Euro area both in absolute terms and relative to the euro area average (by about 0 to 10 percent using price-based REER indices). As of May 2017, the REER is unchanged relative to 2016 average.</p> <p><b>Assessment.</b> The EBA methodologies provide a relatively wide range of REER gap estimates in 2016. The REER regression methods suggest gaps of -3.1 percent (EBA Level REER model) and -0.2 percent (EBA Index REER model), while the CA regression method, which has a generally better fit, implies an overvaluation of about 10 percent. ULC-based indicators also point to sizable and persistent wage-productivity differentials vis-à-vis key trading partners; these differentials, alongside nominal rigidities, have contributed to a slower recovery of real exports and investment. Taken together, staff assesses an REER gap of 6–12 percent.</p>	

<b>Italy (continued)</b>	
<b>Capital and financial accounts: flows and policy measures</b>	<p><b>Background.</b> Portfolio and other-investment inflows typically have financed the current account deficits of the past, despite a modest net FDI outflow, without much difficulty. Italy's financial account posted net outflows of about 3 percent of GDP in 2016, largely reflecting residents' net purchases of foreign assets, even as foreign investment in Italian portfolio securities continued.</p> <p><b>Assessment.</b> While supported by exceptional monetary accommodation by the ECB, Italy remains vulnerable to market volatility, owing to the large refinancing needs of the sovereign and banking sectors, and the potentially tight credit conditions from the high stock of NPLs in the banking sector.</p>
<b>FX intervention and reserves level</b>	<p><b>Background.</b> The euro has the status of a global reserve currency.</p> <p><b>Assessment.</b> Reserves held by the euro area are typically low relative to standard metrics, but the currency is free floating.</p>
<b>Technical Background Notes</b>	<p>1/ Staff assesses the current account norm at 3.5 percent of GDP, reflecting the automatic adjustment of retirement age in 2016 and its expected future revisions as legislated that for 2016 can outweigh otherwise lower effective retirement age.</p>

## Annex II. Debt Sustainability Analysis

*Italy's public debt is very high at about 133 percent of GDP, and subject to notable risks. It is projected to start declining, once the government delivers the necessary adjustment toward achieving its balanced budget target and if growth and inflation materialize as currently assumed. If, however, the fiscal effort or growth disappoint or contingent liabilities materialize, debt will continue to rise. In a no-adjustment scenario where the fiscal stance remains broadly neutral, debt will remain close to its current levels before starting to rise again as monetary conditions normalize. This would leave Italy in a difficult position, significantly exposed to adverse developments and changes in investor sentiment.*

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

- Debt increased from about 100 percent of GDP in 2007 to 132.6 percent of GDP in 2016.<sup>1</sup> In percent of GDP, it is the second highest, after Greece.
- Gross financing needs are sizable, related to still large rollover needs (14–17 percent of GDP). The structure of debt partially mitigates refinancing risks. About two-thirds of debt is held by domestic investors. Average maturity is around 6¾ years and about 70 percent of debt is at fixed interest rates, which moderates the pass-through to the budget of rising interest rates.
- The ECB's exceptionally accommodative stance has helped to keep yields down, and its sovereign bond purchasing program mitigates refinancing risk. During 2015–16, the ECB's net purchases of Italian public debt were about €210 billion, compared with rollover needs on medium- to long-term debt of about €400 billion. The purchases are continuing in 2017, albeit by a smaller amount from April to December.

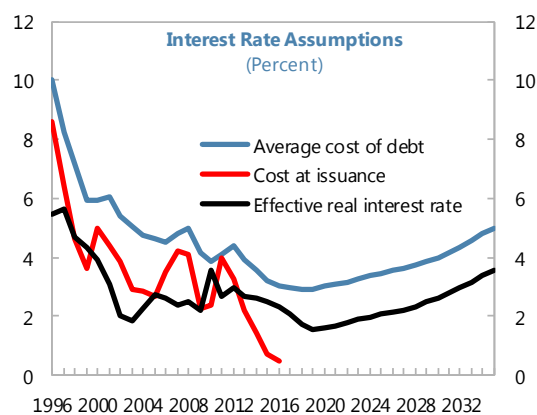
**2. Assuming the government reaches its structural balance target by 2019 and nominal GDP growth exceeds 2 percent annually, public debt is projected to decline.** Debt is projected to remain around 133 percent of GDP in 2017 before it starts to decline in 2018 and reach about 120 percent of GDP in 2022. The assumptions underpinning the baseline:

- Real GDP growth is projected to average 1 percent annually during 2017–22. This rate of growth is higher than what it has been over the past two decades. The GDP deflator is projected to rise from 0.6 percent in 2017 to around 1½ percent over the next few years. Inflation and the deflator are assumed to lag the euro area average over the medium term, reflecting Italy's slower (productivity) growth rate.
- The government is assumed to take the measures necessary to achieve structural balance by 2019. This corresponds to an improvement in the primary balance of about 2 percent of GDP.

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

- Over the medium term, staff projects an effective nominal interest rate of about 3 percent, or an average interest bill of about 3¾ percent of GDP. Spreads are assumed at around 200 bps. The average cost of debt rises gradually as monetary policy normalizes, with the effective nominal interest rate increasing to around 5 percent by 2035 (about 3½ percent in real terms).
- An effective real interest rate of 3½ percent, with real GDP growth of 1 percent, implies a debt stabilizing primary balance of 3¾ percent of GDP.
- In 2016, privatization proceeds were about 0.1 percent of GDP, compared to a target of 0.5 percent of GDP. No projection is made for 2017–22, given uncertainties in the timing and amount of sales. The cost of the precautionary recapitalization of one large bank and liquidation of two mid-sized banks is considered.



Sources: Haver, and IMF staff estimates.

**Debt Stabilizing Primary Balance**  
(At 133 percent of GDP)

		Real GDP growth rate (in percent)			
		0.0	0.5	1.0	1.5
Real interest rate (in percent)	2.5	<b>3.3</b>	2.7	2.0	1.3
	3.0	3.9	<b>3.3</b>	2.7	2.0
	3.5	4.5	3.9	<b>3.3</b>	2.6
	4.0	5.1	4.5	3.9	<b>3.3</b>

**Privatization Receipts: Objectives and Outturns, 2013–20 1/**  
(Percent of GDP)

	2013	2014	2015	2016	2017	2018	2019	2020
<b>Objectives</b>								
2013 DEF (April 2013)	1.0	1.0	1.0	1.0	1.0	...	...	...
Update to the 2013 DEF (September 2013)	...	0.5	0.5	0.5	0.5	...	...	...
2014 DEF (April 2014)	...	0.7	0.7	0.7	0.7	...	...	...
Update to the 2014 DEF (September 2014)	...	0.3	0.7	0.7	0.7	0.7	...	...
2015 DEF (April 2015)	...	...	0.4	0.5	0.5	0.3	...	...
Update to the 2015 DEF (September 2015)	...	...	0.4	0.5	0.5	0.5	...	...
2016 DEF (April 2016)	...	...	...	0.5	0.5	0.5	0.3	...
Update to the 2016 DEF (September 2016)	...	...	...	0.1	0.5	0.5	0.3	...
2017 DEF (April 2016)	...	...	...	...	0.3	0.3	0.3	0.3
<b>Outturns</b>	0.1	0.2	0.4	0.1	...	...	...	...

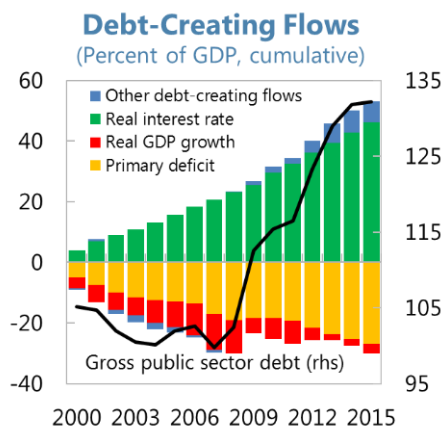
1/ The objectives expressed as a percentage of GDP are those indicated in the various planning documents.

**3. Important risks are embedded in the baseline assumptions.** There is no evidence of a systematic bias in the baseline assumptions. Italy's forecast track record in recent years is comparable to that of other surveillance countries, with the forecast errors for real GDP growth and inflation close to the median among all surveillance countries. However, Italy's projected fiscal adjustment is larger and subject to risks.

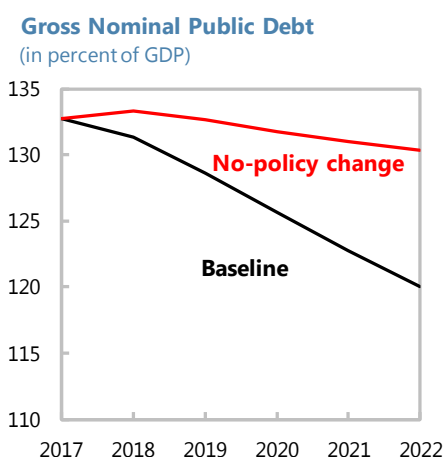
- Sizable primary surpluses of about 3¾ percent of GDP will be needed in the baseline to maintain structural balance for several years. Italy has a history of running primary surpluses. Primary surpluses averaged 1¼ percent of GDP during 2001–16, although these were insufficient to ensure debt would not rise.
- Running primary surpluses of 3¾ percent of GDP for several years through economic and political cycles will be challenging. Lower primary surpluses than assumed will have a significant impact on debt. As a no-adjustment scenario illustrates—with the primary balance remaining around 1¾ percent of GDP—public debt would decline very modestly and be 10 percentage points higher by 2022 than in the baseline.
- On the upside, the impact of the authorities' policies and of ECB monetary easing, euro depreciation, and low oil prices for longer could have a larger positive impact than currently expected, with a stronger recovery lowering debt somewhat faster.

#### 4. Materialization of moderate shocks could put at risk the goal of reducing debt, e.g.:

- *Standard growth shock.* Real output growth rates are assumed to be lower by one standard deviation for two years starting in 2018, resulting in an average growth of  $-1\frac{1}{2}$  percent in 2018–19. Furthermore, for every 1 percentage point decline in growth, inflation is assumed to decline by 25 bps. The primary balance improves more slowly than in the baseline, reaching only  $1\frac{1}{2}$  percent of GDP by 2022. Debt increases rapidly to about 140 percent of GDP and fails to come down over the projection period.
- *Interest rate shock.* Spreads could increase, for instance, from an earlier and more rapid exit from accommodative monetary policies in the United States and euro area, political uncertainty, or a re-emergence of concerns about debt sustainability. An increase in spreads of 200 bps is assumed, which is moderate compared to the 2011–12 episode when spreads increased above 500 bps. Higher borrowing costs are passed on to the real economy, depressing growth by 0.4 p.p. for every 100 bps increase in spreads. The implicit average interest rate on debt rises to 3.8 percent by 2022. Debt declines but only very modestly to around 128 percent by 2022.
- *Contingent liability shock.* Negative surprises, such as from the financial system, could lead to a standardized one-time increase in non-interest expenditure of about 10 percent of banking sector assets. This is assumed to depress domestic demand, lower growth for two consecutive years by  $-1\frac{1}{2}$  percentage points, and lower inflation by  $\frac{1}{2}$  percent. The primary balance is

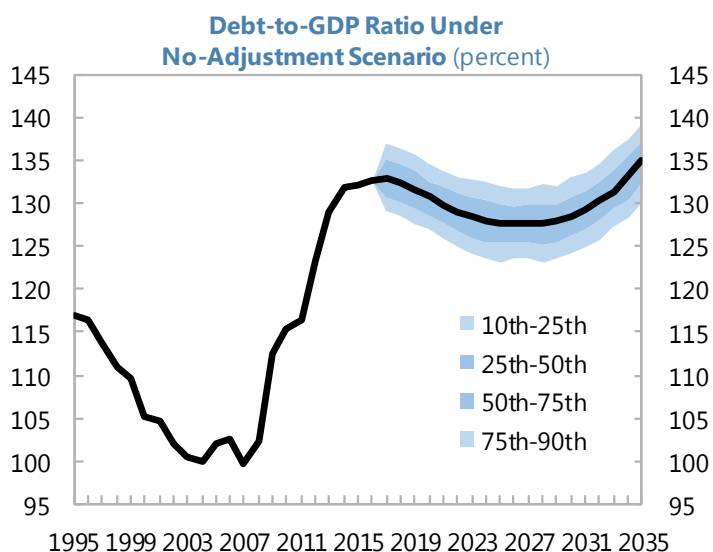


Source: ISTAT; staff estimates.



assumed to worsen by 10 percent of GDP in 2018. Debt rises to 153 percent of GDP by 2022. Gross financing needs would be significantly higher.

**5. In a no-adjustment scenario, Italy's public debt would rise over the long term once monetary conditions normalize.** A steady state real GDP growth of 0.8 percent, a structural primary balance of 1¾ percent of GDP, and a gradually increasing average cost of borrowing (reaching a nominal rate of 6 percent in 2035 or about 4½ percent in real terms—which is higher than in the baseline because of the lower primary surpluses and thus higher projected debt) are assumed. Debt/GDP is projected to decline slightly to about 130 percent in the coming years, thanks to the effect of exceptional monetary stimulus on the interest bill. After that, as monetary conditions gradually normalize, debt/GDP keeps rising. Gross financing needs would remain notably above 20 percent of GDP, above the threshold considered safe under the MAC-DSA.



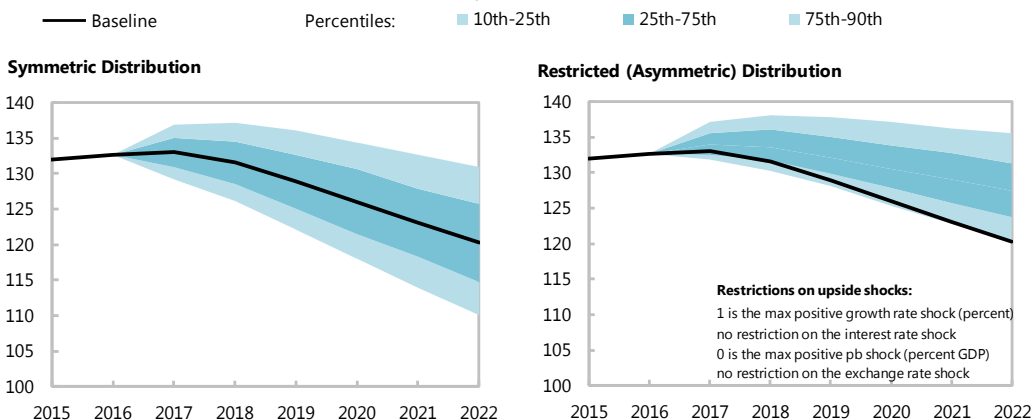
**Figure A2.1. Italy: Public DSA Risk Assessment**

**Heat Map**

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

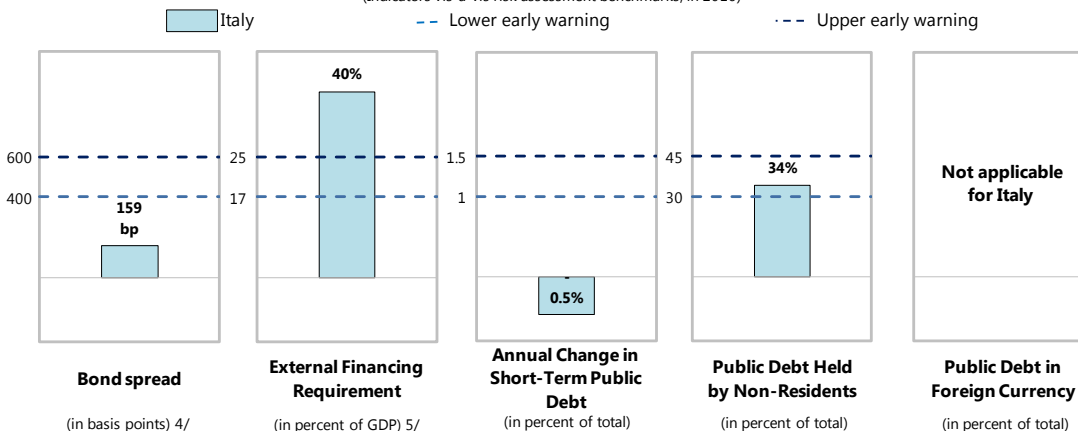
**Evolution of Predictive Densities of Gross Nominal Public Debt**

(in percent of GDP)



**Debt Profile Vulnerabilities**

(Indicators vis-à-vis risk assessment benchmarks, in 2016)



Source: IMF staff.

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

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

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

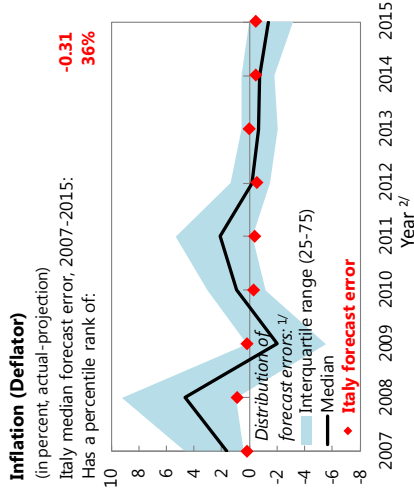
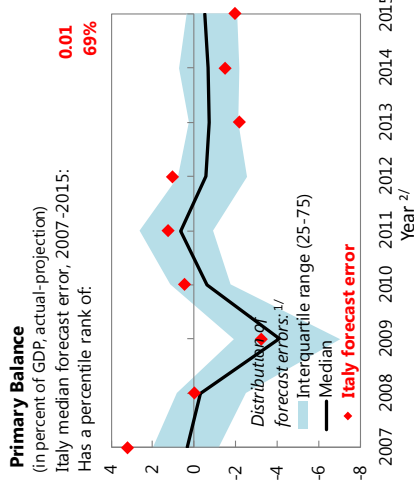
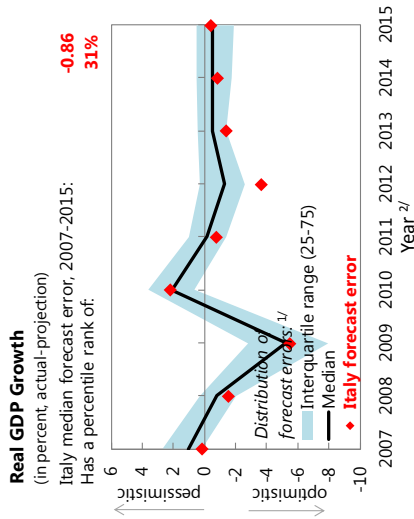
400 and 600 basis points for bond spreads; 17 and 25 percent of GDP for external financing requirement; 1 and 1.5 percent for change in the share of short-term debt; 30 and 45 percent for the public debt held by non-residents.

4/ Long-term bond spread over German bonds, an average over the last 3 months, 03-Dec-16 through 03-Mar-17.

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

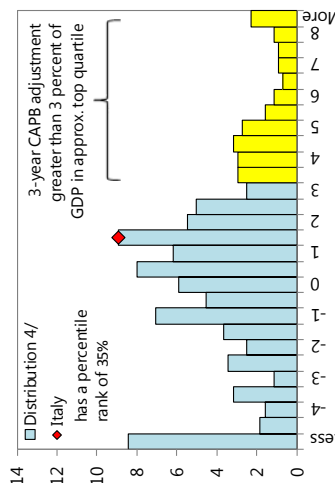
Figure A2.2. Italy: Public DSA—Realism of Baseline Assumptions

Forecast Track Record, versus all countries

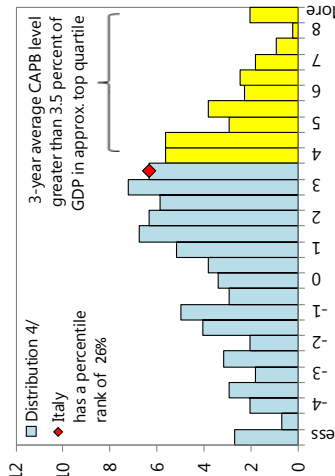


Assessing the Realism of Projected Fiscal Adjustment

**3-Year Adjustment in Cyclically-Adjusted Primary Balance (CAPB)**  
(Percent of GDP)

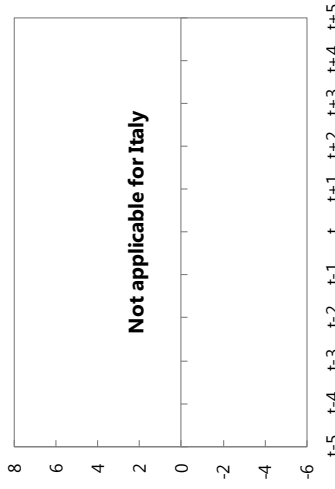


**3-Year Average Level of Cyclically-Adjusted Primary Balance (CAPB)**  
(Percent of GDP)



Boom-Bust Analysis <sup>3/</sup>

**Real GDP growth**  
(in percent)



Source : IMF Staff.

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

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

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

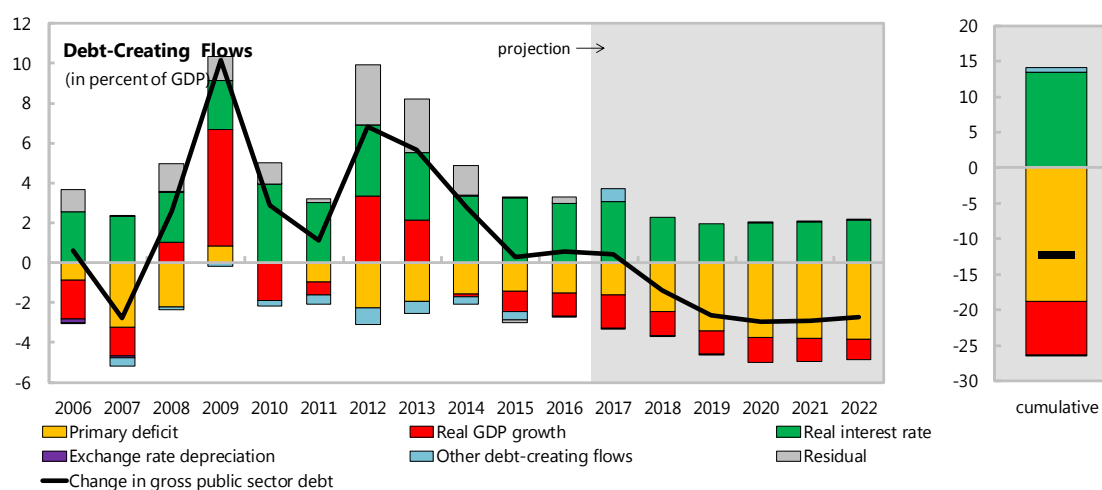
4/ Data cover annual observations from 1990 to 2011 for advanced and emerging economies with debt greater than 60 percent of GDP. Percent of sample on vertical axis.

**Figure A2.3. Italy: Public Sector Debt Sustainability Analysis (DSA)—Baseline Scenario**  
(in percent of GDP unless otherwise indicated)

	Debt, Economic and Market Indicators <sup>1/</sup>										As of March 03, 2017			
	Actual			Projections										
	2006-2014 <sup>2/</sup>	2015	2016	2017	2018	2019	2020	2021	2022					
Nominal gross public debt	114.8	132.0	132.6	133.0	131.6	129.0	126.0	123.1	120.3				Sovereign Spreads	
Public gross financing needs	28.5	26.5	23.9	20.9	20.4	19.6	18.2	19.1	18.8				EMBIG (bp) <sup>3/</sup>	178
Net public debt	98.2	112.5	113.3	114.1	113.1	110.9	108.3	105.8	103.4				5Y CDS (bp)	160
Real GDP growth (in percent)	-0.6	0.8	0.9	1.3	1.0	0.9	1.0	0.9	0.8				Ratings	Foreign Local
Inflation (GDP deflator, in percent)	1.6	0.7	0.8	0.6	1.2	1.4	1.4	1.4	1.4				Moody's	Baa2 Baa2
Nominal GDP growth (in percent)	1.0	1.5	1.6	1.9	2.1	2.3	2.4	2.4	2.3				S&P's	BBB BBB
Effective interest rate (in percent) <sup>4/</sup>	4.3	3.2	3.1	2.9	2.9	2.9	3.0	3.1	3.2				Fitch	BBB BBB

**Contribution to Changes in Public Debt**

	Actual			Projections							cumulative	debt-stabilizing primary balance <sup>9/</sup>
	2006-2014	2015	2016	2017	2018	2019	2020	2021	2022			
Change in gross public sector debt	3.3	0.3	0.6	0.4	-1.4	-2.7	-3.0	-2.9	-2.7	-12.3		
Identified debt-creating flows	2.0	0.4	0.3	0.4	-1.4	-2.7	-3.0	-2.9	-2.7	-12.3		
Primary deficit	-1.4	-1.4	-1.5	-1.6	-2.4	-3.4	-3.7	-3.8	-3.8	-18.9	1.1	
Primary (noninterest) revenue and grants	46.2	47.8	47.2	46.7	46.5	46.8	46.7	46.7	46.7	280.1		
Primary (noninterest) expenditure	44.8	46.3	45.6	45.1	44.0	43.3	43.0	42.9	42.9	261.3		
Automatic debt dynamics <sup>5/</sup>	3.7	2.3	1.8	1.4	1.0	0.8	0.8	0.9	1.1	6.0		
Interest rate/growth differential <sup>6/</sup>	3.7	2.2	1.8	1.4	1.0	0.8	0.8	0.9	1.1	6.0		
Of which: real interest rate	3.0	3.3	3.0	3.1	2.3	1.9	2.0	2.0	2.1	13.5		
Of which: real GDP growth	0.7	-1.0	-1.1	-1.7	-1.2	-1.2	-1.3	-1.2	-1.0	-7.5		
Exchange rate depreciation <sup>7/</sup>	0.0	0.0	0.0	...	...	...	...	...	...	...		
Other identified debt-creating flows	-0.4	-0.4	-0.1	0.6	0.0	0.0	0.0	0.0	0.0	0.6		
Privatization Receipts (negative)	-0.1	-0.4	-0.1	0.6	0.0	0.0	0.0	0.0	0.0	0.6		
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		
Other debt flows (incl. ESM and Euro)	-0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		
Residual, including asset changes <sup>8/</sup>	1.4	-0.2	0.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0		



Source: IMF staff.

1/ Public sector is defined as general government.

2/ Based on available data.

3/ Long-term bond spread over German bonds.

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

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

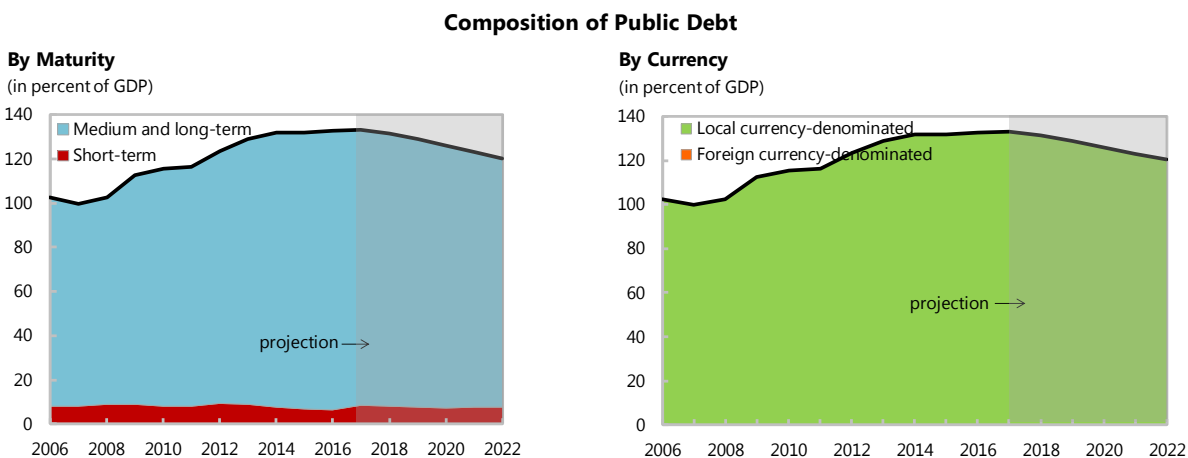
6/ The real interest rate contribution is derived from the numerator in footnote 5 as  $r - \pi(1+g)$  and the real growth contribution as  $-g$ .

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

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

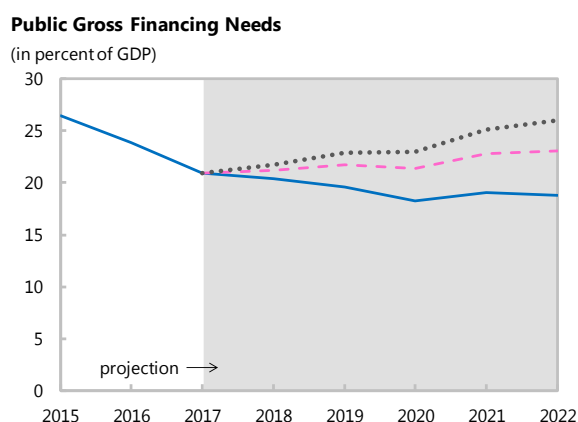
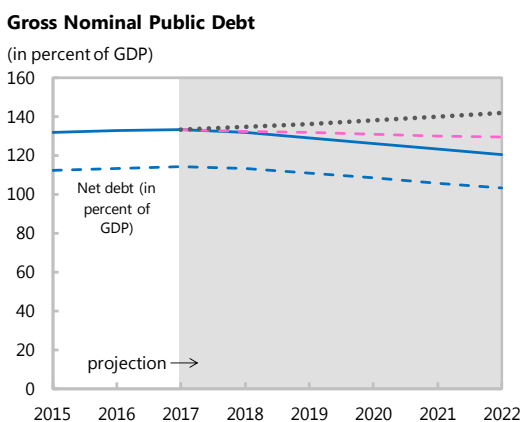
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

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



### Alternative Scenarios

— Baseline     
 ⋯ Historical     
 - - - Constant Primary Balance



### Underlying Assumptions (in percent)

Baseline Scenario	2017	2018	2019	2020	2021	2022	Historical Scenario	2017	2018	2019	2020	2021	2022
Real GDP growth	1.3	1.0	0.9	1.0	0.9	0.8	Real GDP growth	1.3	-0.6	-0.6	-0.6	-0.6	-0.6
Inflation	0.6	1.2	1.4	1.4	1.4	1.4	Inflation	0.6	1.2	1.4	1.4	1.4	1.4
Primary Balance	1.6	2.4	3.4	3.7	3.8	3.8	Primary Balance	1.6	1.4	1.4	1.4	1.4	1.4
Effective interest rate	2.9	2.9	2.9	3.0	3.1	3.2	Effective interest rate	2.9	2.9	3.0	3.2	3.3	3.5
<b>Constant Primary Balance Scenario</b>													
Real GDP growth	1.3	1.0	0.9	1.0	0.9	0.8							
Inflation	0.6	1.2	1.4	1.4	1.4	1.4							
Primary Balance	1.6	1.6	1.6	1.6	1.6	1.6							
Effective interest rate	2.9	2.9	2.9	3.0	3.1	3.2							

Source: IMF staff.

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



## Annex III. Progress Against IMF Recommendations

<b>Italy: Progress Against IMF Recommendations</b>	
<b>2016 Article IV Policy Advice</b>	<b>Actions since 2016 Article IV</b>
<b>Product markets</b>	<p>Adopt the Annual Competition Law (ACL), while strengthening its provisions per the recommendations of the Competition Authority. Implement the relevant legislations to eliminate regulatory barriers in sectors outside the ACL (e.g., transport, retail, permits). Fully implement already legislated reforms by all levels of government.</p>
<b>Public Services</b>	<p>Reform local public services and rationalize local public enterprises to improve efficiency. Rationalize the legal framework related to local public services with a view of improving competition in services.</p> <p>Implement fully the public administration reform. Advance reforms to improve the skill-mix in the public sector, match positions with skills, align wages with productivity, simplify functions and procedures, rationalize procurement, and tackle privileges and employment in public enterprises, including through privatization. Strengthen anti-corruption efforts, in particular by implementing AML/CFT measures on domestic politically exposed persons.</p>
<b>Labor market</b>	<p>Promote the use of firm-level wage bargaining.</p> <p>Improve active labor market policies (ALMPs) through better coordination and information sharing via the new National Agency for Active Labor Policies (ANPAL). Enhance placement capacity and institute regular and coordinated monitoring of service delivery.</p>
	<b>Structural reforms to boost growth</b>
	<p>The draft ACL has been discussed by both chambers of parliament but is yet to be adopted. Some provisions have been weakened or delayed following discussions in parliament.</p> <p>Most implementing decrees for the Enabling Law on reforming the Public Administration (L. 124/2015), approved in August 2015, have been approved. However, decrees on accountability and career of public sector managers and rationalization of local public services (except transport) have stalled, whereas the decree on rationalizing state owned enterprises has been weakened and implementation delayed. Uncertainties in the implementation of the procurement reform have resulted in slower processes and higher costs.</p> <p>Further reliance on tax exemption on productivity wage bonuses.</p> <p>Creation of a national register of employment services in charge of facilitating job matching.</p>
	<b>Next steps</b>
	<p>Strengthen several provisions of the draft law in line with the recommendations of the Competition Authority, and ensure an annual process of adopting pro-competition laws. Give consideration to enhancing competition in areas such as local public service provision, transport, and closed professions. Fully implement existing legislation (e.g., retail sector) and enhance the authority to sanction anti-competitive practices.</p> <p>Implement fully existing measures and broaden public sector reform to include all local public services and reorganize careers and accountability of public sector managers, improve the skill-mix in the public sector, enhance mobility, match positions with skills, and align wages with productivity.</p> <p>Implement fully the new procurement reform, broaden its coverage, and remove remaining impediments to competition. Monitor reform outcomes.</p> <p>Modernize the wage bargaining system by giving primacy to firm-level contracts to align wages with productivity at the firm level, clarifying rules on representativeness, and establishing a minimum wage that could be differentiated across regions.</p> <p>Scale up spending on ALMPs. Enhance coordination with local authorities, and improve centralized data collection and job matching. Monitor effectiveness of ANPAL, or consider providing ALMPs alongside passive labor market policies.</p>

<b>Italy: Progress Against IMF Recommendations</b>	
<b>2016 Article IV Policy Advice</b>	<b>Actions since 2016 Article IV</b>
<b>Labor market (cont.)</b>	<p><b>Structural reforms to boost growth</b></p> <p>Extended 100 percent exemption from social contributions for 3 years up to €3,250 annually, targeted to graduated apprentices. New 50 percent capped exemption for employees who hire young workers not in education, employment or training. Voucher scheme for irregular work is being phased out or reformed, following the Constitutional Court ruling that allowed the possibility of a referendum.</p> <p>More flexible parental leave extended to all types of workers. The 2017 Budget Law introduces compulsory parental leave for male workers.</p> <p>Boost female labor participation; ensure refugees are integrated into the workforce.</p>
<b>Fiscal adjustment</b>	<p><b>Growth-friendly fiscal adjustment and reducing public debt</b></p> <p>Following the fiscal relaxation of recent years, including in 2017, the authorities announced in April 2017 their intention to reach a balanced budget by 2019. However, at end-May, the authorities changed course and announced their intention to consolidate only marginally in 2018.</p> <p>The April 2017 medium-term fiscal plan envisages approaching a structural balance by 2019 and sustaining it thereafter.</p> <p>Steps are being taken to streamline procurement processes, including by cutting the number of expenditure centers and introducing e-procurement, and making spending reviews an integral part of the budget process.</p> <p>Steps are being taken to tackle tax evasion, including through the VAT split payment and reverse charge mechanisms. A legal approach to reviewing tax expenditures has been adopted.</p> <p>The 2017 budget reduced the tax burden on labor and firms further, including by reducing the CIT rate.</p>
<b>Growth-friendly policy mix</b>	<p>Monitor take-up of new open-ended contract, recourse to legal action, and judges' interpretation of new legislation. Implement legislative decree on streamlining of contracts and monitor use of enhanced flexibility in allocation of labor within the firm.</p> <p>Monitor take-up of new open-ended contract. As the economy strengthens, give consideration to extending the new open-ended contract to all existing work arrangements in the private sector and reduce the compensation for dismissals, which is high in OECD comparison: two monthly wages per year of service with a minimum of 4 and a maximum of 24 (at 12 years of service), compared with the OECD average of 14 monthly wages at 20 years of service.</p> <p>Continue monitoring effectiveness of measures taken to raise female labor force participation. Remove fiscal disincentives for female employment, reduce tax wedge of secondary earners, and enhance provision of childcare.</p> <p>Given limited fiscal space and debt vulnerabilities, implement plans as announced in April, aiming for overall deficit of 1.2 percent of GDP in 2018 and broad budget balance by 2019. Underpin this adjustment with growth-friendly and inclusive measures—by cutting current primary spending, lowering tax rates on productive factors, and broadening the tax base.</p> <p>Target a small structural surplus of about ½ percent of GDP in the medium term to ensure debt is on a firmly declining trajectory, while providing valuable insurance against shocks.</p> <p>Raise capital spending and improve targeting of support to the low income, including by rationalizing social protection schemes. Cut current primary spending, giving consideration to lowering 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 that need to be rationalized. Pension parameters could be reviewed and adjusted, consistent with current policy settings.</p> <p>Reduce VAT compliance and policy gaps. Comprehensively review and rationalize tax expenditures based on economic impact. Accelerate the reform of cadastral values and introduce a modern real estate tax.</p> <p>Further reduce the labor tax wedge which remains high by international standards, and shift the tax base toward consumption and property.</p>
<b>Next steps</b>	<p>Monitor take-up of new open-ended contract. As the economy strengthens, give consideration to extending the new open-ended contract to all existing work arrangements in the private sector and reduce the compensation for dismissals, which is high in OECD comparison: two monthly wages per year of service with a minimum of 4 and a maximum of 24 (at 12 years of service), compared with the OECD average of 14 monthly wages at 20 years of service.</p> <p>Continue monitoring effectiveness of measures taken to raise female labor force participation. Remove fiscal disincentives for female employment, reduce tax wedge of secondary earners, and enhance provision of childcare.</p> <p>Given limited fiscal space and debt vulnerabilities, implement plans as announced in April, aiming for overall deficit of 1.2 percent of GDP in 2018 and broad budget balance by 2019. Underpin this adjustment with growth-friendly and inclusive measures—by cutting current primary spending, lowering tax rates on productive factors, and broadening the tax base.</p> <p>Target a small structural surplus of about ½ percent of GDP in the medium term to ensure debt is on a firmly declining trajectory, while providing valuable insurance against shocks.</p> <p>Raise capital spending and improve targeting of support to the low income, including by rationalizing social protection schemes. Cut current primary spending, giving consideration to lowering 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 that need to be rationalized. Pension parameters could be reviewed and adjusted, consistent with current policy settings.</p> <p>Reduce VAT compliance and policy gaps. Comprehensively review and rationalize tax expenditures based on economic impact. Accelerate the reform of cadastral values and introduce a modern real estate tax.</p> <p>Further reduce the labor tax wedge which remains high by international standards, and shift the tax base toward consumption and property.</p>

**Italy: Progress Against IMF Recommendations**

	2016 Article IV Policy Advice	Actions since 2016 Article IV	Next steps
<b>Accelerate NPL resolution</b>	Banks should be required to present comprehensive NPL strategies with ambitious targets to significantly reduce NPLs over the medium term. Guidance should be provided on banks' approaches to provisioning and loan restructuring practices.	<p><b>Banking sector—Accelerating balance sheet repair</b></p> <p>The SSM issued guidance to significant institutions for strategies to tackle high NPLs. Banks need to agree with the SSM on NPL reduction targets in the coming months, although sanctions are not envisaged for missing the targets. The Bank of Italy issued a template requiring banks to report detailed data on their bad loans, collateral, and ongoing recovery procedures.</p>	The supervisor should ensure NPL reduction strategies and targets are ambitious and credible through an assessment of banks' capacity to resolve NPLs using internal tools and resources. Supervisors should review internal workout capacity, and provide feedback on banks' approaches to provisioning and loan restructuring practices.
<b>Advance insolvency reforms</b>	Distressed enterprises need a streamlined and flexible system of out-of-court and in-court restructuring options, with fast-track solutions for the existing stock of NPLs. Debt restructuring principles for multilateral workouts and adoption of a triage approach for indebted firms would be important additions to the restructuring toolkit.	Following recent reforms, some of which affected new NPLs rather than the existing stock, progress has largely stalled. The authorities are aiming for a unified and comprehensive reform that rationalizes the complex insolvency framework, increases options for restructuring, addresses shortcomings such as procedural inefficiencies and excessive creditor priorities, and adopts new rules for the insolvency of enterprise groups and consumers.	The authorities' proposed reforms for an insolvency overhaul should be adopted promptly, while maintaining ambitious goals for the rationalization of corporate debt restructuring and special procedures for large enterprises. Implementation requires considerable efforts to improve court functioning, the qualification of insolvency administrators, the development of registries and platforms for the sale of collateral.
<b>Enhance efficiency and supervisory oversight of consolidation</b>	The emerging banking groups need to be assessed ex ante as sound from capital, assets, management, earnings and liquidity perspectives. In that regard, subjecting banks that are not under the supervision of the SSM to a process of capital assessment following an asset quality review would clarify uncertainty, with follow-up actions in line with regulatory requirements.	Three new banking groups are expected to emerge from the consolidation of more than 300 cooperative banks by end 2018, two of which are expected to fall under direct ECB/SSM supervision and will be subject to an asset quality review.	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. In regard to consolidation, supervisors should undertake a rigorous analysis to ensure the three emerging banking groups start with a clean bill of health and are profitable over the long term. This includes undertaking an asset quality review of all emerging groups, ensuring robust governance and risk management structures, and following up on issues found in the remaining smaller banks.
<b>Effective use of resolution framework</b>	Effective use of the framework for the timely and orderly resolution of failing banks would prevent the costs of the weaker banks from being borne by the rest of the system and eventually raising stability concerns. To address concerns about bailing in retail investors, consideration could be given to identifying and dealing firmly with cases of mis-selling to retail investors and safeguarding poor households through a means-tested social safety net.	One significant bank received precautionary recapitalization from the state, while two were liquidated with state aid. The authorities created a backstop of €20 billion to finance the banks' rescue or liquidation and guarantee up to €150 billion of bank liquidity.	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.



# ITALY

July 6, 2017

## STAFF REPORT FOR THE 2017 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

Prepared By

European Department  
(In consultation with other departments)

### CONTENTS

FUND RELATIONS	2
STATISTICAL ISSUES	4

## FUND RELATIONS

(As of June 12, 2017)

**Mission:** Rome, Milan, and Frankfurt, May 29–June 12, 2017. The concluding statement of the mission is available at <http://www.imf.org/external/np/ms/2016/052316.htm>.

**Staff team:** Messrs. Rishi Goyal (head), Alvar Kangur, Mehdi Raissi, and Ms. Anke Weber (all EUR), Messrs. José Garrido (LEG), and Dermot Monaghan (MCM). Mr. Poul Thomsen (EUR) attended the concluding meetings. Mr. Carlo Cottarelli and Ms. Cristina Collura (OED) also participated.

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

**Fund relations:** The previous consultation discussions took place during May 9–23, 2016. The associated Executive Board’s assessment is available at: <http://www.imf.org/external/np/sec/pr/2016/pr16329.htm> and the staff report and other mission documents at: <http://www.imf.org/external/pubs/cat/longres.aspx?sk=44071.0>. Italy accepted the obligations under Article VIII and, apart from certain security restrictions, maintains an exchange rate system free of restrictions.

**Data:** Italy subscribes to the Fund’s Special Data Dissemination Standard, and comprehensive economic data are available on a timely basis (Table 1).

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

<b>General Resources Account:</b>	SDR Million	Percent Quota
Quota	15,070.00	100.00
Fund holdings of currency	14,070.28	93.37
Reserve Tranche Position	999.85	6.63
Lending to the Fund		
New arrangements to borrow	977.75	

<b>SDR Department:</b>	SDR Million	Percent Allocation
Net cumulative allocation	6,576.11	100.00
Holdings	5,148.99	78.30

**Outstanding Purchases and Loans:** None

**Financial Arrangements:** None

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

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

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

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

**Article IV Consultations:** Italy is on the standard 12-month consultation cycle. The previous consultation discussions took place during May 9–23, 2016, and the staff report (IMF Country Report No. 16/222, 06/20/16) was discussed on July 6, 2016.

**ROSCs/FSAP:**

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

**Technical Assistance:**

<b>Year</b>	<b>Department/Purpose</b>
2007	FAD: Public Expenditure Management
2012	FAD: Tax Policy
2015	FAD: Tax Administration

## STATISTICAL ISSUES

<b>ITALY—STATISTICAL ISSUES APPENDIX</b>	
(As of June 19, 2017)	
<b>I. Assessment of Data Adequacy for Surveillance</b>	
<b>General:</b> Data provision is adequate for surveillance. Italy's economic and financial statistics are comprehensive and of generally high quality. Data are provided to the Fund in a comprehensive manner (Table 1). The authorities regularly publish a full range of economic and financial data, as well as a calendar of dates for the main statistical releases. Italy is also subject to the statistical requirements of Eurostat and the European Central Bank (ECB), including the timeliness and reporting standards, and it has adopted the <i>European System of Accounts 2010 (ESA2010)</i> .	
<b>National Accounts:</b> Further improvements should be considered regarding changes in inventories in the quarterly national accounts, which are currently derived as a residual and lumped together with the statistical discrepancy.	
<b>Price Statistics:</b>	
<b>Government Finance Statistics:</b> Data on Grants and Other revenues are not reported as part of the 2015 GFS submission while this information was provided in previous years.	
<b>Monetary and Financial Statistics:</b>	
<b>Financial Sector Surveillance:</b> Participates in the IMF's Coordinated Direct Investment Survey (CDIS), Coordinated Portfolio Investment Survey (CPIS), and financial soundness indicators (FSIs) databases.	
<b>External Sector Statistics:</b> The Bank of Italy adopted the standards for reporting Balance of Payments (BOP) and International Investment Position (IIP) data on the basis of the <i>Balance of Payments and International Investment Position Manual, 6<sup>th</sup> edition (BPM6)</i> in the second half of 2014.	
<b>II. Data Standards and Quality</b>	
Italy has subscribed to the Special Data Dissemination Standard (SDDS) since 1996 and posts its metadata on the Dissemination Standards Bulletin Board (DSBB). In 2015 Italy subscribed to SDDS Plus, together with the first group of adherents.	A data ROSC was disseminated in 2002.
<b>Implementing G-20 DGI recommendations:</b> The authorities have implemented all of the recommendations. Further progress in the near future is likely to be made on the reporting frequency of Financial Soundness Indicators.	

**Table 1. Italy: Common Indicators Required for Surveillance**  
(As of June 19, 2017)

	Date of latest observation	Date received	Frequency of Data <sup>7</sup>	Frequency of Reporting <sup>7</sup>	Frequency of Publication <sup>7</sup>	Memo Items:	
						Data Quality – Methodological soundness <sup>8</sup>	Data Quality – Accuracy and reliability <sup>9</sup>
Exchange Rates	June 2017	June 2017	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities <sup>1</sup>	April 2017	June 2017	M	M	M		
Reserve/Base Money	April 2017	June 2017	M	M	M	O,O,LO,LO	O,O,O,O,LO
Broad Money	April 2017	June 2017	M	M	M		
Central Bank Balance Sheet	April 2017	June 2017	M	M	M		
Consolidated Balance Sheet of the Banking System	April 2017	June 2017	M	M	M		
Interest Rates <sup>2</sup>	June 2017	June 2017	D	D	D		
Consumer Price Index	May 2017	June 2017	M	M	M	O,O,O,O	LO,O,LO,O,O
Revenue, Expenditure, Balance and Composition of Financing <sup>3</sup> – General Government <sup>4</sup>	Q4 2016	April 2017	Q	Q	Q	LO,O,LO,O	LO,O,O,O,LO
Revenue, Expenditure, Balance and Composition of Financing <sup>3</sup> – Central Government	March 2017	May 2017	M	M	M		
Stocks of Central Government and Central Government-Guaranteed Debt <sup>5</sup>	March 2017	May 2017	M	M	M		
External Current Account Balance	March 2017	May 2017	M	M	M	O,LO,LO,O	LO,O,LO,O
Exports and Imports of Goods and Services	April 2017	May 2017	M	M	M		
GDP/GNP	Q1 2017	June 2017	Q	Q	Q	O,O,O,O	LO,LO,O,O,O
Gross External Debt	Q4 2016	March 2017	Q	Q	Q		
International Investment position <sup>6</sup>	Q4 2016	March 2017	Q	Q	Q		

<sup>1</sup>Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.

<sup>2</sup>Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.

<sup>3</sup>Foreign, domestic bank, and domestic nonbank financing.

<sup>4</sup>The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.

<sup>5</sup>Including currency and maturity composition.

<sup>6</sup>Includes external gross financial asset and liability positions vis a vis nonresidents.

<sup>7</sup>Daily (D); weekly (W); monthly (M); quarterly (Q); annually (A); irregular (I); and not available (NA).

<sup>8</sup>Reflects the assessment provided in the data ROSC or the Substantive Update for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O); largely observed (LO); largely not observed (LNO); not observed (NO); and not available (NA).

<sup>9</sup>Same as footnote 7, except referring to international standards concerning source data, statistical techniques, assessment and validation of source data, assessment, and revisions.

**Statement by Mr. Carlo Cottarelli, Executive Director for Italy  
July 21, 2017**

We thank the IMF staff for a set of well-written papers. The Italian authorities broadly concur with the staff's current short-term macroeconomic projections and with their assessment of the medium-term challenges faced by the Italian economy. However, in several cases, they believe the staff report could have better recognized the progress made so far in reforming the Italian economy, as well as the difficult circumstances under which policy-making had been managed during the last few years as Italy was hit by both the global economic and financial crisis and the euro-area confidence crisis. They also believe staff could have better recognized some important elements of strengths of the Italian economy and be more balanced in evaluating Italy's performance *vis-à-vis* its peers.

The pace of economic growth is now firming up since the nascent signs of recovery in 2014. Non-financial firms are overcoming the deep and prolonged crisis while reaping the benefits of the policy measures introduced to spur innovation and investment. Public finance has undergone a significant adjustment, in compliance with the European fiscal framework, which has been effective in reining in public expenditure, improving its composition while also stabilizing the public debt ratio. The identified vulnerabilities in the banking sector have also been addressed, in line with the EU framework. This said, my authorities agree on the importance of making further progress on the road of reforms.

**Macroeconomic outlook, the real sector and the external sector**

There is broad agreement on several aspects in this area. Staff projects GDP growth at 1.3 percent this year, broadly in line with the current projection of the Italian authorities. This is higher than the prudent assumption underlying the budget (1.0 percent), and almost twice as large as projected by staff in the January WEO update (indeed ½ percentage points of GDP higher than projected even in the more recent April WEO). Growth remains below the euro area average, but the growth differential projected by staff for 2017 is the lowest since 2010. Over the medium-term, under the assumption of a continuation of the reform effort, Italy's growth rate is likely to surpass the projections of the IMF staff. This said, we agree that estimates of potential output and the output gap are subject to a high degree of uncertainty, as reported in footnote 2 on page 7 of the report (see more on this below).

Regarding external developments, my authorities share with staff the view that competitiveness could be improved, but believe that the staff's assessment of the competitiveness gap and of the external position are much gloomier than warranted, and are mainly based on a backward-looking analysis which does not acknowledge recent improvements. In 2016 the Italian current account (CA) surplus – the fourth in a row – almost doubled compared to 2015 (to 2.6 percent of GDP). The NIIP notably improved reaching -15 percent of GDP at end-2016, down from -23.5 at end-2015, with a further significant improvement to -13.5 percent in the first quarter of this year. This

notwithstanding, staff worsened their assessment of the Italian external position compared to last year, moving from ‘broadly in line’ to ‘moderately weaker’ than suggested by fundamentals and desirable policies.

The worsening envisaged by staff is due to an increase of the CA norm, which the EBA-model now estimates at 4 percent of GDP (albeit corrected to 3.5 by staff judgment), i.e. 2 percentage points higher than in 2014 and 4 compared to 2013. Such large revisions are puzzling and cast doubts on the reliability and robustness of the model. Altogether, my authorities believe that the staff’s current estimate of the norm is too high. The possible overestimation of the Italian CA gap on the side of staff is also confirmed by the indication of a slight undervaluation of Italy’s REER stemming from the EBA REER models. Furthermore, my authorities are under the impression that staff did not fully account for the impact on the CA norm coming from the implemented labor market reform and from the recent legislation on the increased retirement age of workers (67 years as of 2019, with subsequent upward revisions based on increases in life expectancy). All in all, my authorities believe that the external position is in line with fundamentals.

Relatedly, my authorities do not agree on the extent of the cost competitiveness gap. ULC indicators tend to overestimate the cost of utilizing manpower in Italy, because they do not take into account wage developments of many workers formally classified as self-employed but that are, *de facto*, employees. These workers include a high number of less qualified or younger workers whose wages have responded very flexibly to the business cycle and structural changes, rising much less than the wages of other workers included in the ULC calculation. They also note that, in any case, based on alternative competitiveness indicators, for example PPI-based, the competitiveness outlook appears less gloomy. This is confirmed by Italy’s export trends, whose share in world trade has remained broadly stable.

### **Structural policies**

My authorities are in broad agreement on the need to further advance on the reform agenda in product and service markets, the labor market, the public administration and the judicial system, while also strengthening the banking sector. To this end, it is worth mentioning the efforts in enhancing firm competitiveness by the Industry 4.0 Initiative, which should support a technological upgrade of the productive system; the stepping up of the fight against tax evasion; the improvement in the efficiency of the judicial system (pending cases in civil courts have declined by 25 percent between 2010 and 2015, while further progress is needed), including through refinements to the insolvency framework. It is also worth reminding that other several reforms have been completed such as the budget reform, which is aimed at improving the efficiency and effectiveness in the use of public resources, and the tax administration reform, which is already delivering substantial improvements in the relations with taxpayers. Additionally, as regards social policy, authorities recently introduced the first universal anti-poverty instrument to improve living conditions of vulnerable households.

However, my authorities disagree with staff on various aspects regarding ongoing structural reforms. The draft competition law does already include important measures in many sectors, such as insurance, banking, pension funds, communications, utilities and regulated professions. While my authorities agree on the need for a more decentralized wage bargaining system, they point at the important tax incentives introduced in the 2017 budget to enhance decentralization at the plant level, and underscore that, ultimately, it is the responsibility of social partners to decide on the preferred wage bargaining system. Finally, regarding public sector reforms, my authorities believe that the description of the process of public administration reforms is not fully accurate: the objectives of the public-sector reform approved in 2015 are indeed far reaching, encompassing activities relevant for citizens, firms and public sector workers. Most of the implementing acts deriving from the reform have been adopted. Regarding the decree on the rationalization of publicly-owned enterprises, my authorities concur that its implementation has been delayed as a result of a ruling from the Constitutional Court. However, they disagree that such provisions have been weakened with respect to its contents.

### **Fiscal policy**

My authorities agree on the need for further fiscal consolidation, in compliance with the EU fiscal rules and striking the appropriate balance between stability and sustainability needs. Italy's high public debt must be put on a firmly declining path to reduce the economy's vulnerabilities. Despite very modest growth rates, the Italian public debt ratio has already stabilized, due to a continued fiscal effort implemented by the government, notably primary surpluses which are among the highest in the EU. In line with the approach put forward by the European Commission in the 2017 EU Semester Package, published on May 22, my authorities' strategy aims at maintaining a gradual fiscal adjustment, which would ensure debt reduction while not negatively hinging on the incipient recovery. Against this background, at the end of May, the Italian authorities welcomed the intention of the European Commission to consider, in evaluating the appropriate country-specific fiscal stance, the uncertainties related to cyclical conditions, with an unusual recovery still affected by the legacy of the crisis. Consistently, they informed the European Commission of their intention to implement a structural fiscal adjustment in 2018 equal to 0.3 percentage point of GDP. The Authorities underscore that their fiscal approach strikes the right balance between the need to continue the process of fiscal consolidation and the need not to jeopardize the continuation of the ongoing economic recovery from Italy's deepest recession since the 1930s. The adjustment path put forward by the Italian Authorities would allow to continue reducing the headline deficit at the same pace observed in recent years and will ensure a decline in the debt-to-GDP ratio. A recent reply by the European Commission to the Italian Authorities confirms the appropriateness of the proposed strategy.

My authorities do not agree with the staff qualification of the Italian fiscal stance as being 'markedly expansionary' in 2014-17. Staff's assessment is based on the change in the structural primary balance. We already noted on several occasions that measuring the fiscal

stance based on changes in structural balances can be quite tricky in countries that have experience a prolonged period of weakness in aggregate demand. In such circumstances, the usual techniques to measure potential growth yield estimates that are quite cyclical, and reflect more aggregate demand developments than the underlying growth potential of the economy under normal demand circumstances (by the way, the same critique applies also to the approach followed by other institutions, not just by the IMF). In particular, with an estimated potential GDP growth at a barely positive level – 0.2 percent in 2016 – any moderate actual GDP growth – such as the 0.9 percent rate recorded last year – is mistaken for an economic boom. This in turn leads to a presumed rapid closing of the output gap which would imply, for a given reduction in the headline fiscal deficit, a much smaller decline of the calculated structural deficit or even a fiscal expansion.

My authorities underscore that such assessment is clearly inconsistent with a broader view of fiscal data: the Italian headline deficit has been on a steadily declining path since 2010, reaching -2.4 percent of GDP in 2016 (down from -2.7 in 2015), with a projection of a further reduction to -2.1 for this year; the primary balance has been broadly stable in the last few years at about 1½ percent of GDP (and will exceed that level this year); the debt ratio has stabilized and is projected to decline steadily in the coming years. Overall my authorities believe that these numbers describe a path of gradual and growth-friendly fiscal consolidation, rather than one of marked fiscal expansion. Staff acknowledges that measuring potential output growth is subject to much uncertainty in Italy (as mentioned above), but it does not seem to draw the necessary conclusions.

The Italian authorities believe that the appropriate medium-term fiscal objective is a balanced budget, in line with Italy's commitments under the SGP. They therefore disagree with staff that a surplus of ½ percentage points of GDP would be needed to ensure fiscal sustainability.

As to the long run my authorities believe that the assessment of pension spending trends included in Box 3 of the staff report is too pessimistic. Staff, for example, fails to note that, while immigration is projected to increase, Italy's fertility rate is projected to remain rather low. Moreover, the more pessimistic view taken in the staff report is not consistent with the projections included in the Fiscal Monitor (according to which Italy's pension spending is projected to remain stable over the next 15 years, and to decrease by 1.8 percent of GDP by 2050), nor with the 2017 euro area staff report, which shows (Figure 5) that the Italian long- term adjustment needs stemming from aging related spending are among the lowest in Europe. Finally, staff projections are also at odds with those of the European Commission included in the Aging Report, which are close to my authorities' projections. We also find that Box 3 misses important details, which are only included in the Selected Issues Paper: for example, the Box says that the old defined benefit scheme will be phased out fully only by 2050; it does not say that already by 2030 all new retirees will be fully under the new NDC scheme. But even the selected issues paper is incomplete: for example, it fails to show that the gross replacement rate at retirement is projected to decline, according to the 2015 European Commission Ageing Report, by over 8 percentage points,

from 60 per cent of 2013 to 51.8 per cent of 2060. Moreover, the cross-country comparison of replacement ratios is based on gross pension benefits (in Italy pensions are fully taxed, while this is not always the case for other countries); finally, the paper fails to say that, while benefits may be higher, social security contribution rates are also higher than in many other euro area countries. Going back to the staff report, the reference to a partial reversal of the recent pension reform is not justified: the adjustments introduced involved costs to the budget amounting on average to just 0.1 percentage points of GDP over the period 2017-2060, a small fraction of the savings from the Fornero reform.

My authorities also disagree with the characterization of spending trends. The comparison between Italy and other countries is entirely based on the primary spending-to-potential GDP ratios, even if staff acknowledges the uncertainty regarding potential output estimates in Italy (see above). The reality is that between 2010 and 2016 Italy had one of the lowest primary spending increases in the euro area (3.8 percent, compared, for example, to 21.6 percent of Germany, and 15.3 percent of France); indeed, in real terms, primary spending declined by over 4 percent in real terms. This could have been appropriately highlighted in the staff report.

### **Financial sector policies**

The Italian authorities believe that, given the severe shock suffered by the Italian economy during 2008-13 (with a cumulative GDP loss of almost 9 percent), the Italian financial sector proved to be quite resilient: only a handful of banks had to be intervened and we estimate that the taxpayer money used since the global financial crisis is less than 1 percent of GDP including the effect of the most recent decisions (see below), far below the amounts injected by many other advanced economies in their banking systems. It is thus difficult to understand why staff is insisting so much on the burden that the current strategy has involved for the taxpayer. Much higher private and public costs would have been suffered through alternative strategies, including in the area of bank resolution.

More generally, many important recent decisions have addressed tail risks. As described in the staff report, in the last months two important steps have been taken regarding the Italian banking system: (i) the precautionary public recapitalization of Banca Monte dei Paschi di Siena (MPS); (ii) the liquidation of Banca Popolare di Vicenza and Veneto Banca. Moreover, the transfer of the last of the four banks resolved at the end of 2015 (Nuova Carife) has been finalized. These decisions have *de facto* eliminated the tail risks looming over the Italian banking sector and, together with the substantial impact which is coming from the reforms adopted by my authorities in recent years, set the system on a stronger footing.

My authorities believe that some additional information is important to complement that provided in the staff report:

- All the above decisions have been taken in strict coordination with the European institutions and are fully compliant with the European rules, including the BRRD and state-aid rules as also acknowledged in the summing up of the most recent Eurogroup meeting of July 10. In the case of the two banks in Veneto, the Single Resolution Board considered that a resolution was not justified by the existence of a public interest; this implied that their liquidation had to be implemented under Italian solvency legislation.
- Both for MPS and for the two banks in Veneto a substantial share of the needed financial resources has come from burden sharing. Specifically, €4.3 bn in MPS subordinated debt will be converted in shares and MPS' shareholders will be heavily diluted; €5.2 bn in shares and subordinated bonds of the two banks in Veneto were *de facto* obliterated.
- There are reasonable expectations that in both cases most – if not all – tax-payer money will be recovered. As for MPS, the stake owned by the Government will be sold once the implementation of the restructuring plan agreed upon with the Italian and European authorities is completed, no later than 2021. In the case of the two banks in Veneto, should the recovery rate of the NPLs transferred to the state-owned specialized vehicle be in line with the average recovery rate recorded by the Italian banking system in the years 2006-2015, public resources would be fully recovered.

The solution adopted for the two banks in Veneto, which includes the sale of the good assets and some liabilities to Intesa San Paolo, allows to preserve client relationships with around 100,000 SMEs and 200,000 households. This shows the deep rooting of the two banks in the economy of the Veneto region, whose GDP size is just a little smaller than that of countries such as Portugal or Greece, and is thus of critical importance for the recovery of the broader Italian economy.

The ongoing reduction of the stock of NPLs is expected to accelerate sharply in the coming months. The operations with MPS and the two banks in Veneto will have a notable impact also on the stock of NPLs. As a consequence, and considering other NPL market disposals that are being finalized, the ratio of net NPLs to total loans – which at the end of Q1-2017 stood at 9.2 percent for significant institutions – could decline below 8 percent in the next twelve months.

Furthermore, the strengthening of the economic recovery will continue to play a critical role. The flow of new NPLs is gradually declining from the peak reached in 2013 (5.9 percent per year); in the first quarter of 2017 it was 2.4 percent, a value that is close to the one observed before the crisis.

Following this improvement, my authorities will continue tackling the NPL issue with firm determination and accelerate its solution in line with the “Council Conclusions” in developing a European Action Plan to tackle NPLs approved by the Ecofin Council on July 11. To this aim, they agree on the importance of enhancing the banks' internal management of NPLs, pursuing prudent provisioning, and achieving further efficiency

gains in the judicial system. My authorities remain also mindful of the need to avoid generalized fire sales of NPLs, which would likely result in an unwelcome transfer of resources from Italian banks to a few specialized investors which are operating – *de facto* – in an oligopolistic regime, thereby leading to an erosion of banks' capital at a time when raising it remains important.

Besides the operations mentioned above, the broader restructuring of the Italian banking system is advancing steadily, also as a reflection of the reforms adopted by my authorities in recent years. As recalled by staff, since end-2015 eight of the ten largest cooperative banks ('banche popolari') have been transformed into joint-stock companies with the aim of improving – *inter alia* – their corporate management and capacity to tap the capital markets. Furthermore, the reform of the mutual banks ('banche di credito cooperativo') is being implemented and is expected to lead – by May 2018 at the latest – to the formation of three larger groups which will consolidate around 300 mutual banks currently operating on the territory; for the two largest groups – whose supervision will be carried out directly by the SSM – a comprehensive assessment (like that held in 2014) will be conducted in 2018 by the ECB together with the Bank of Italy.

Looking ahead, the elimination of the tail risks that were looming over the banking sector and the progress with the ongoing restructuring – which my authorities consider as substantial advancements, rather than 'very slow repair' as qualified in the staff report – will now allow banks to step-up efforts on the critical objective of upgrading their business model and shoring up profitability. In my authorities' views, while there is no such thing as a 'one-size-fits-all' banking business model, there are ample margins across the banking system to streamline operating costs, enhance efficiency and productivity, better leverage technology and human capital. Banks have already been taking measures to reduce costs and rationalize branch networks, but more needs to be done, particularly in small and medium-size banks. My authorities assign high priority to achieving further progress along these fronts.