

Italy: Staff Concluding Statement of the 2021 Article IV Mission

March 30, 2021

Washington, DC: *Italy's policy response to the pandemic has been generally effective at cushioning the impact of the health crisis on the population and the economy;*

The pace of vaccinations should be accelerated and support measures should be gradually wound down as the health crisis recedes and the economic recovery takes hold;

Stimulus will be needed even after the health crisis is over to limit scarring of the labor market and capital stock and to build a greener, smarter and fairer economy.

Economic Situation and Outlook

The pandemic has dealt a harsh blow to the Italian people and their economy . The large number of infections and fatalities as well as repeated waves of social distancing have caused considerable personal suffering. The economic impact has also been severe, interrupting the slow recovery from the previous double-dip recession and causing an unprecedented—but highly uneven—fall in output. Despite the very strong rebound in the third quarter of last year and manufacturing returning close to pre-COVID levels, GDP dropped by almost 9 percent in 2020, with hospitality, tourism, and transport most affected. At end year, output remained about 6½ percent below the level at end 2019.

Prompt and decisive policy responses helped to shield the pandemic's impact . Large fiscal resources were allocated to fight the health crisis and cushion its social and economic effects. Income lifelines were provided to workers, businesses and the self employed through short-time work (STW) programs and grants. To conserve liquidity and provide bridge financing, temporary moratoria on taxes and the servicing of bank loans were declared. A credit crunch was averted by making government-guaranteed loans available to both small and large firms, European and national supervisors granted banks temporary flexibility on capital and liquidity requirements, and low cost ECB funding was provided conditioned on banks maintaining lending. As a result, aggregate household disposable income decreased only modestly and many firms reported having adequate liquidity. Nonetheless, the unprecedented uncertainty and concerns about the future felt by households and firms is evident from their continued high saving and low investment.

The outlook for the Italian economy is contingent on the path of the pandemic and support policies . The growing number of authorized vaccines and the ongoing immunization program will provide an exit from the pandemic, although emerging mutations could cause setbacks. The timing and shape of the economic recovery therefore remain uncertain. Assuming the vaccination program is well advanced by late summer, that social distancing persists in the interim and economic support to the most affected is maintained for the duration of the health crisis, GDP could grow by around 4¼ percent in 2021, with a weak start followed by an acceleration in the latter part of the year. Thereafter, return to pre-

COVID conditions in much of the economy, reinforced by substantial spending under the National Recovery and Resilience Plan (NRRP), would boost growth well-above the previous trend over the medium term. However, many businesses could still face excessive debt and large equity gaps, leading them to scale back or shut down, causing layoffs and higher unemployment if reallocation and new business formation are slow.

Considerable uncertainty surrounds this baseline forecast . In the near term, faster defeat of COVID through accelerated vaccinations, both in Italy and internationally, would bring forward herd immunity and could release pent-up demand, with output surpassing its pre-COVID level already this year. The large U.S. fiscal package is a further upside support. Efficient utilization of Next Generation EU (NGEU) resources accompanied by successful implementation of growth-enhancing structural reforms could generate a larger and more persistent boost to medium-term output. On the other hand, slower resolution of the pandemic would delay the recovery, increase firms' leverage and worker layoffs and preserve elevated saving rates. Were loan quality to deteriorate markedly, banks' capacity to lend to support the recovery could be constrained and contingent fiscal liabilities could materialize. A jump in U.S. long-term interest rates could lift European and Italian real interest rates more quickly than warranted by the low underlying inflation and persistent excess capacity.

Fiscal Policy as Income Backstop

The public sector has appropriately absorbed much of the income loss brought by the pandemic, but policies should be refined as the recovery proceeds . Phase out of relief measures should proceed in tandem with the recovery but remain available until the recovery is firmly established. However, fiscal space should be used prudently. Ensuring the health system and vaccination program are adequately funded is a top priority. More targeted fiscal support to individuals and viable firms that continue to be most affected by lost income and with faster distribution of benefits would strengthen the effectiveness of relief spending. A comprehensive review of eligibility and benefit levels of the various above- and below-the-line support programs could ensure that compensation to individual recipients is better targeted and aligned with their lost income. If demand in hard-hit sectors remains subdued even after the health crisis has passed, a targeted-but-temporary demand stimulus could help kickstart activity by unlocking high accumulated savings, encouraging businesses to reopen, getting employees back to work, generating additional tax revenue and thereby reducing future scarring. This would also increase the fiscal multiplier associated with previous lifeline support payments.

Spending as needed to address the pandemic shock and secure the recovery should be accompanied by a credible plan to anchor significant—albeit gradual—debt reduction once the recovery is entrenched . The pandemic-induced widening of the fiscal deficit occurred alongside a decrease in government borrowing costs. Even if interest rates remain low, the public debt ratio is expected to decline only slowly, and sustaining the decline into the next decade would require additional fiscal effort to offset the effects of population aging until the full impact of prior pension reforms has been realized. Calls on guaranteed credits and equity support to the corporate sector as well as tightening financial conditions are significant risks for debt dynamics. A credible strategy for reducing the public debt ratio requires well-identified reforms to raise economic growth and to increase the efficiency and equity of government spending and tax systems. Part of the tax windfall from the exceptional lift to growth brought by the NRRP should be saved. Further lengthening the maturity of debt would lock in current exceptionally-low rates and sequester COVID-related

and maturing debt, alleviating future rollover needs and—provided lower interest costs are saved rather than spent—reducing the debt ratio more quickly.

Reviving the Business Sector and Maintaining Financial Stability

Quickly restoring to financial health those highly-leveraged firms that are likely to be profitable in the future and enabling the smooth exit of firms with little chance of survival would provide a solid footing for the recovery . A rapid and vigorous rebound in activity is the best cure for the business sector. However, even with a strong recovery, many firms could emerge from the crisis with too-high debt, impeding their capacity to invest and raise productivity. Smaller firms and those in contact-intensive and affiliated sectors are likely to have been most affected by the crisis. Part of the private savings stockpile could be mobilized to strengthen firms' capital or provide long-term participatory financing. Some firms may require debt restructuring. Private sector-led decisions on targeting and size of financing, with co-financing or insurance by the state, would limit moral hazard and diversify risk. Support should address weaknesses due to COVID rather than pre-existing conditions, with eligibility limited to firms likely to be profitable on a forward-looking basis, although identification could be difficult while the pandemic is ongoing. Business startups, with their high propensity for job creation and for investing in newer-vintage capital, should be encouraged by lowering legal and administrative hurdles. The expected increase in nonviable firms will raise demands on the debt restructuring and insolvency regimes, which are among the least efficient in the EU. This will reinforce the need to increase the capacity and efficiency of the courts and streamline debt restructuring procedures.

Banks' loan quality is expected to weaken once temporary policy supports expire, but keeping credit flowing to firms with good prospects is essential to underpin the recovery . Supported by loan moratoria and guarantees, banks increased the flow of credit, enabling borrowers to cushion forgone revenue and build liquidity buffers. A gradual phasing out of moratoria, linked to normalization of firms' activity levels, would help to avoid renewed liquidity pressures. Increasing banks' risk retention on guarantees by lowering the coverage rate would help ensure guarantees are directed mainly to viable firms. Consideration could be given to incentivizing banks to actively manage fully guaranteed loans. Increasing government oversight of the guaranteed portfolio is also necessary, and SACE's planned acquisition by the Treasury is therefore welcome. Banks and the authorities should intensify their efforts to improve their understanding of underlying loan quality, which will require assessments that take account of current conditions, borrowers' strong liquidity buffers, and expected post-pandemic performance once temporary support measures have been lifted. A flexible timetable for rebuilding capital in line with international and European peers, conditioned on a realistic assessment of loan quality, would also help avert an undue tightening of credit conditions for viable borrowers. Maintaining an active secondary market in NPLs, building on the success of the GACS scheme, is encouraged, while the authorities should plan to take prompt, targeted action to deal with any individual distressed banks. Following the expiration of the current European restrictions, case-by-case supervisory decisions on permitting dividend payments would avoid penalizing banks with stronger capital and profit generation while preserving capital in weaker banks.

Cushioning the labor market

Once the pandemic is over, labor market support should decouple from existing employment contracts, buffered by social safety nets and enhanced training programs. The STW schemes and firing ban have preserved job attachments, removing the need for workers and firms to undertake costly job searches once activity resumes.

However, as the health crisis recedes, subsidizing frozen employment relationships and hours-not-worked should be replaced with rewards for getting employees back to work and for new hiring. This would encourage viable businesses to reopen sooner (possibly supported by targeted demand stimulus)—limiting the risk of unwarranted large-scale layoffs—and resize their staffing levels to meet new demand conditions. Combining a gradual winding down of exceptional labor market measures with a strictly temporary wage subsidy for heavily-affected businesses that restart operations would incentivize firms to decide whether to reopen (or permanently shut down) while also restoring labor market turnover. Existing unemployment benefits and the Citizenship Income program would provide a social safety net to those transitioning to a new job or remaining unemployed. Because at-risk employment could exceed the near-term capacity of growth sectors to absorb workers, effective retraining and skills upgrading programs (including through online platforms) will be crucial to increase within-sector productivity and facilitate across-sector mobility. However, permanent wage subsidies to specific groups and regions would not address the persistent weak productivity that underpins the historically poor labor market outcomes of some groups, and consideration should be given to a faster phasing out of these measures.

Investing for the recovery

An investment boost—if spent efficiently and accompanied by growth-enhancing reforms—could help recoup lost ground on productivity and accelerate the transition to a greener, smarter and fairer economy. The NRRP will set out a comprehensive medium-term investment and reform agenda, financed by sizable EU resources, to facilitate green and digital transitions, increase the economy's growth potential and secure more balanced gender, regional and intergenerational outcomes. Implementation will also raise demand, helping to compensate part of the output lost due to the pandemic and mitigate the risk of post-pandemic economic scarring. Some backloading of public investment spending as foreseen in the Plan would afford additional time to prepare projects and raise spending efficiency. Envisaged tax incentives could be an effective tool for supporting smaller-scale investments by the private sector. Well-defined reforms to modernize public administration and streamline civil procedures and the judicial system would help reverse Italy's track record of slow project implementation while also improving the overall business environment. Lowering regulatory barriers to competition and enhancing transparency and accountability of public procurement will also be crucial to reap the full economic and social dividends from public investment. Beyond the NRRP, a comprehensive base-broadening tax reform would promote growth and inclusion while tackling tax evasion.

We are grateful to the Italian authorities and our private sector counterparts for generously giving their time to the mission and for the informative discussions.