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Italy: Staff Report for the 2000 Article IV Consultation

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ITALY

Staff Report for the 2000 Article IV Consultation

Prepared by the Staff Representatives for the 2000 Article IV Consultation with Italy

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May 15, 2000

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I. Summary and Key Issues

1. At the conclusion of the 1999 Article IV consultation on June 3, 1999, Directors welcomed Italy's persistent pursuit of stability-oriented policies, but also emphasized that further steps, including pension reform measures, were needed to achieve a sustainable fiscal position; and that reigniting more dynamic growth would require creating room to lower the high tax burden through primary expenditure reductions, and moving ahead to reduce structural rigidities in labor and product markets.[1] With recent economic developments broadly as anticipated, these considerations guided the 2000 consultation discussions in Rome during March 17–27, 2000.[2]

2. Against this background, and with an economic recovery that remains weaker than elsewhere in the euro area, the discussions focused on four key issues:

- **Fiscal policy**: There was broad agreement on the appropriateness of the 2000 budget deficit target, and for full play of the automatic fiscal stabilizers; however, the authorities were skeptical that, as advocated by the staff, the structural primary surplus needed to be maintained at current levels, resulting in significant fiscal surpluses over the medium term.

- **Public expenditure control**: The authorities aimed to strengthen expenditure control and efficiency, at the national and at subnational levels, to achieve a reduction in the tax burden while cutting the fiscal deficit. Staff encouraged deeper primary expenditure cuts, mainly to accelerate fiscal consolidation—notably in politically difficult areas such as pensions, health care, and public sector employment.

- **Policies to strengthen employment growth, especially in the South and for job-market entrants**: The staff suggested complementing new initiatives, which aim to strengthen growth prospects in the South, with strong labor market measures—centering on a "partnership for skills," which would involve renewed efforts by all social partners (increased training, substantially larger wage differentiation, and targeted tax incentives).

- **Competitiveness**: The weakness of the euro is supporting the Italian economy's upswing. Continued wage moderation, a reduction in the tax burden, and further product

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[1] See http://www.imf.org/external/np/sec/pn/1999/pn9952.htm.

[2] The mission—comprising Messrs. Watson, Krueger, Annunziata, Decressin, Halikias (all European I), and Szekely (FAD)—met with the Deputy Prime Minister, the Governor of the Bank of Italy, the Minister of the Treasury, Budget, and Economic Planning, the Minister of Finance, other government officials, representatives of regulatory agencies, research institutions, and labor and business leaders. Messrs. Faini or De Blasio, Office of the Executive Director, participated in the meetings. On Italy's relations with the Fund, see Appendix I.

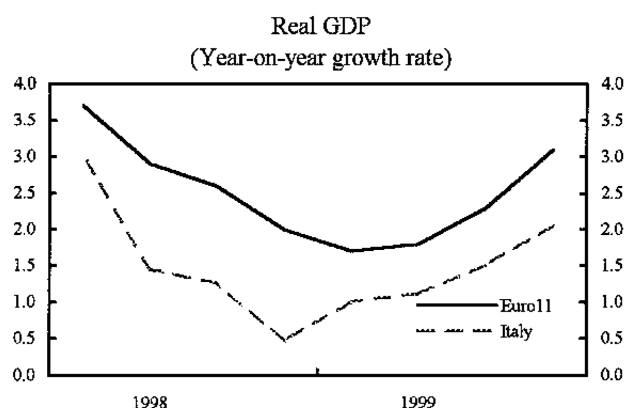
market reform and privatization will be needed to secure an adequate level of competitiveness, in particular if the euro were to realize its appreciation potential.

3. A new government assumed office in late April. With former Treasury Minister Amato as Prime Minister, it is expected to broadly follow the policies of its predecessor.

II. Economic Developments and Prospects

A. Economic Developments

4. **Accelerating world demand and accommodative monetary conditions have contributed to a cyclical upswing, but—following a decade of slow growth—the recovery remains weaker than elsewhere in the euro area** (Figure 1 and Table 1):



- **exports**, which had been strongly affected by direct and third-market effects of the Asian crisis (Box 1 and Figure 2), recovered markedly after mid-1999, helped by the depreciation of the euro;

- **investment** in machinery and equipment (Figure 3) was buoyed by the EMU-related decline in interest rates, and a decrease in the tax burden on capital income; and housing investment recovered during 1999, helped by special tax incentives;

- **consumption** has remained relatively subdued, reflecting in part a rise in the effective tax burden, weak consumer confidence, and substitution effects toward housing investment;

- against the background of sluggish GDP growth, the increase in **employment** since 1998 has been fairly robust. Temporary and part-time work contracts, spurred by the 1997 liberalization, accounted for about two-thirds of total job creation. Higher participation left the unemployment rate above 11 percent—the second highest rate in the euro area; and

Selected Economic Indicators, 1999-2000
(Real growth rates, in percent, unless otherwise noted)

	Italy	Euro-area	Italy	Euro-area
	1999		2000	
Real GDP	1.4	2.3	2.7	3.2
Output gap 1/	-3.1	-1.8	-2.5	-1.1
Household consumption	1.7	2.7	1.8	2.9
Disposable income	1.5	2.3	2.4	2.4
Gross fixed capital formation	4.4	5.0	6.4	5.4
Domestic demand	2.5	2.9	2.5	3.1
Foreign balance 2/	-1.0	-0.5	0.3	0.2
Employment	1.3	1.7	1.1	1.3
Labor costs (manufacturing)	2.4	2.7	2.5	3.1
Fiscal impulse 3/	-1.1	-0.8	-0.1	0.1

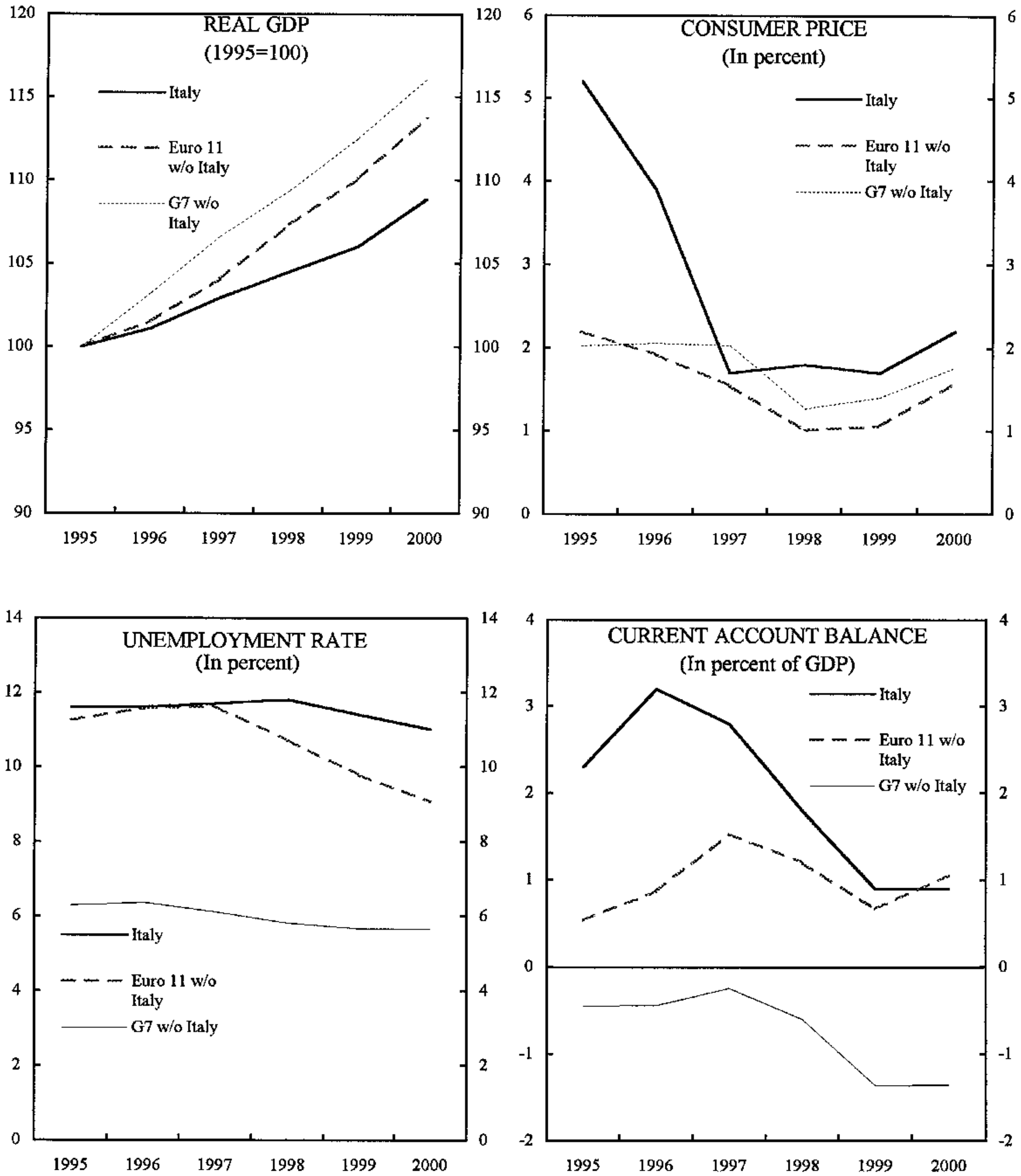
Sources: ISTAT; OECD, Economic Outlook database; and IMF staff estimates.

1/ In percent of potential GDP.

2/ Contribution in percent of GDP.

3/ Change in cyclically adjusted fiscal balance in percent of GDP.

Figure 1. Italy: International Comparisons of Macroeconomic Performance, 1995-2000



Source: IMF, *World Economic Outlook*.

Box 1. Inflation Differential vis-à-vis the Euro Area and Weak Export Growth: Grounds for Concern?

Since 1998, the inflation rate for Italy's harmonized index of consumer prices (HICP) has consistently exceeded euro-area inflation by ½–1 percentage point (Figure A). At the same time, Italy's exports have experienced a considerable loss of market share and the trade balance has deteriorated (Figure B). While a loss of market share can be expected over time, given Italy's lower potential output growth rate, and is partly compensated by improving terms of trade, there is nevertheless a question whether the developments in prices and the external sector are interrelated and provide grounds for concern.

Turning first to **inflation**, the differential vis-à-vis the euro-area countries reflected two main factors. First, economy-wide unit labor costs have increased faster than in the euro area, resulting in a cost-push differential. As nominal wage growth has declined to under 2½ percent since 1998, below the euro average, the differential was entirely due to relatively weak growth in labor productivity, notably outside the manufacturing sector. Given that slow productivity growth was partly cyclical and that no acceleration in labor costs is expected for the near future, the differential should narrow as the cyclical upswing in Italy catches up with the rest of the euro area. A second factor contributing to the inflation differential was a slower increase of competition in the services sector, with smaller price declines (or, respectively, higher price increases) in telecommunications, banking, and insurance prices in 1999 than, for example, in France or Germany. As discussed in Section III.C, some steps in these areas are underway that are likely to narrow the Italian inflation differential; rising competition due to a fast expansion of e-commerce should also lower prospective inflation.

Notwithstanding the inflation differential vis-à-vis the euro area, indicators of multilateral competitiveness strengthened during 1998–99—helped also by the weakness of the euro—indicating that the weak **trade performance** may not have had its roots in a deterioration of Italy's competitive position. Instead, the trade performance reflected in part the unwinding of an exceptional and temporary position of the trade balance in 1992–96, following the lira's ERM exit (see SM/98/57, 2/27/98). The eventual adjustment was facilitated by the strengthening of the lira in 1995/96. A second factor affecting the trade performance was the emerging market crisis in 1998/99. Italy's product mix, including relatively large export shares for textiles and footwear, made its exports vulnerable not only via direct trade linkages, but also via third-market competition. Concerning the direct trade linkages, Italy's exports to key emerging markets (and Japan) were more affected in 1998/99 than for the EU average (table). Conversely, Italy is now beginning to benefit from the recovery in much of this region, with year-on-year nominal export growth of some 30 percent in late 1999 and early 2000.

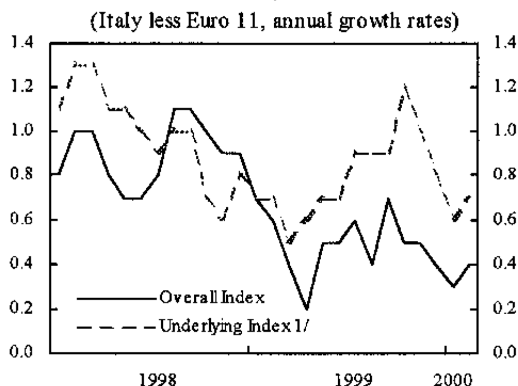
Change in Trade with "Crisis" Countries 1/
(In percent of GDP)

		Italy	EU
Exports,	1998	-0.6	-0.4
	1999	-0.3	-0.2
Imports,	1998	0.2	0.2
	1999	0.1	0.1

Source: IMF, Direction of Trade Statistics; and Fund staff calculations.
1/ Includes ASEAN-4 plus Argentina, Brazil, China, Hong Kong SAR, Japan, Korea, Russia, Singapore, and Turkey.

Overall, the level of competitiveness in the first quarter of 2000 is supportive of an economic upswing with strong export growth. Concerns relate mainly to future prospects, where the euro may realize its potential for appreciation. In such a setting, not only does wage moderation need to prevail through the upswing, but the social partners also need to take into account wage growth in partner countries, differential trends in productivity, and movements of the euro. Looking further ahead, increased competitive pressure, including in some of Italy's relatively labor-intensive exports, can also be expected from EU enlargement. Some of the competitiveness concerns could be alleviated by addressing those weaknesses in product markets that have prevented more effective price competition (see Section III.C).

Figure A. Italy: HICP Inflation Differential, 1998-2000
(Italy less Euro 11, annual growth rates)



1/ Excluding energy, food, alcohol, and tobacco.

Figure B. Italy: External Trade, 1980-99

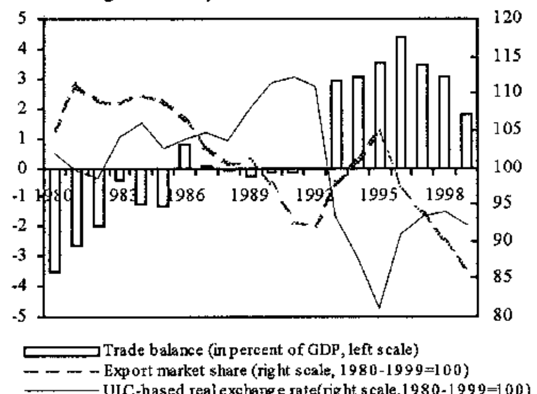
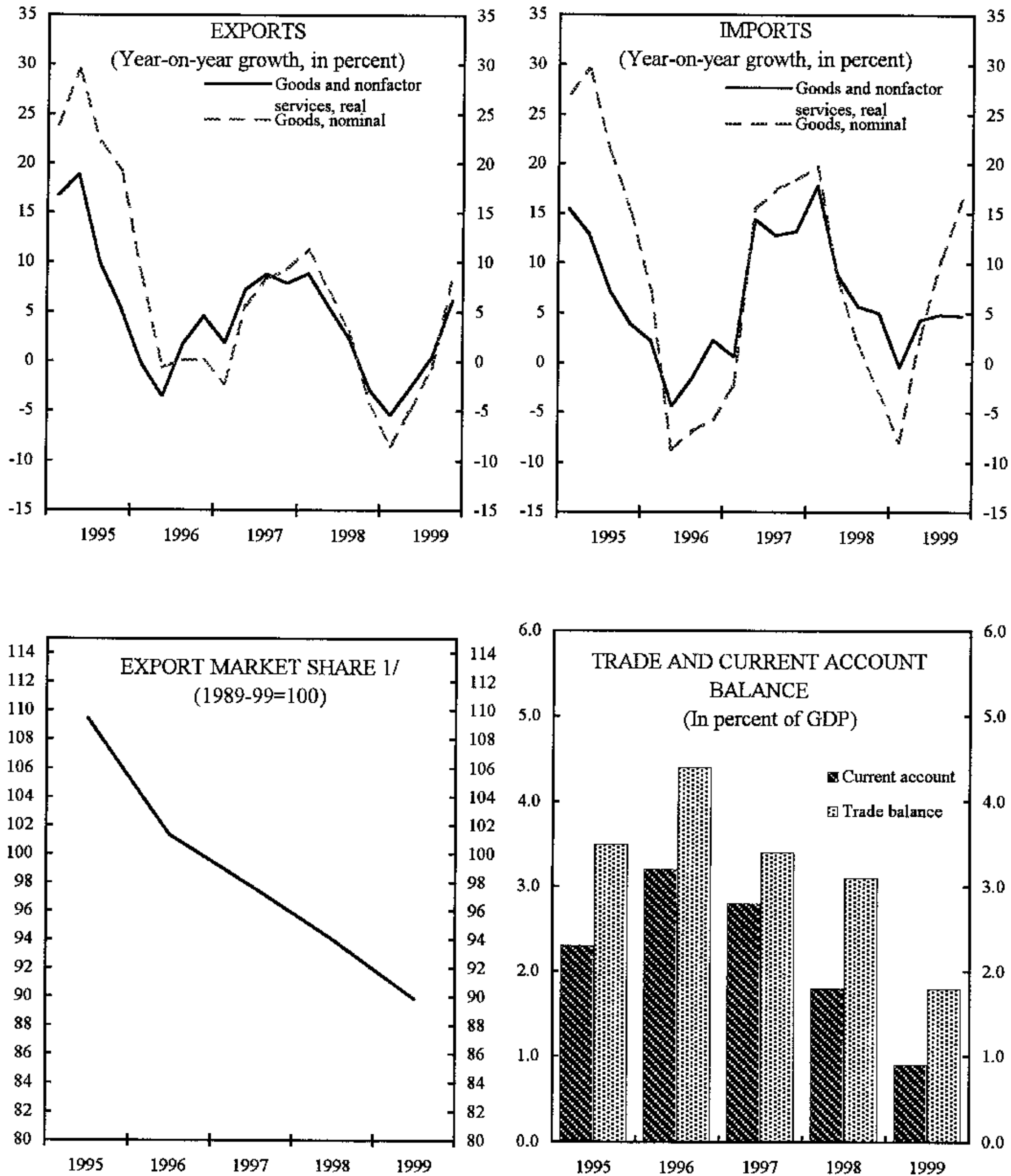


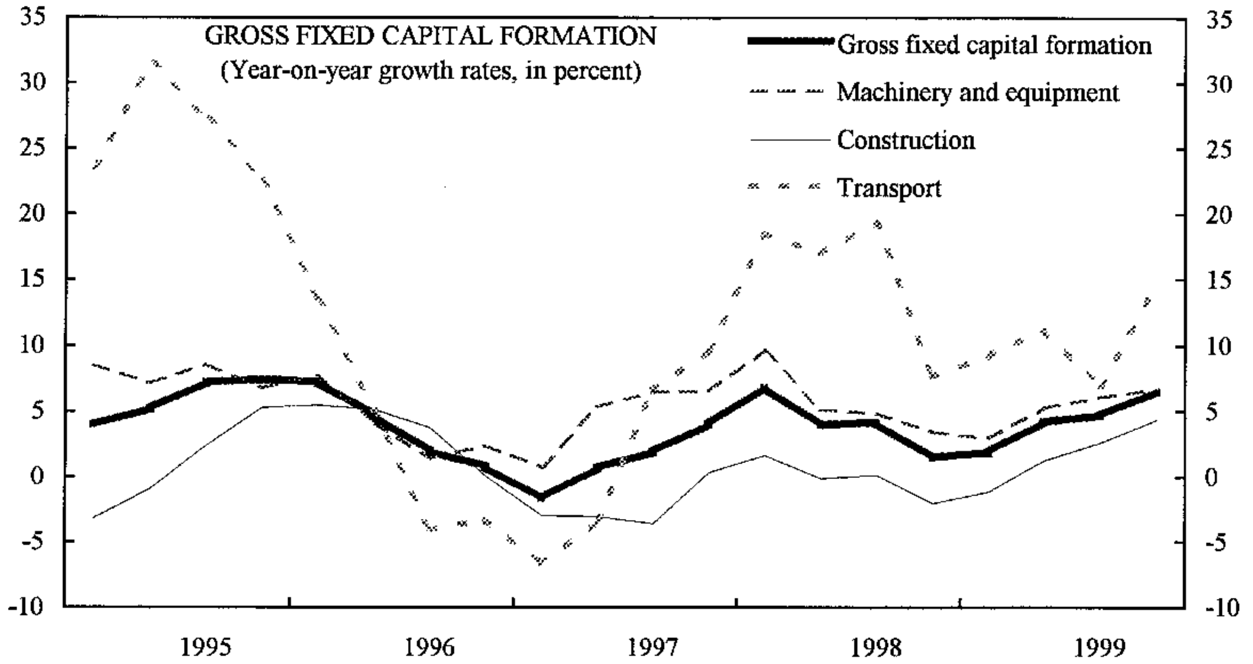
Figure 2. Italy: External Performance, 1995-99

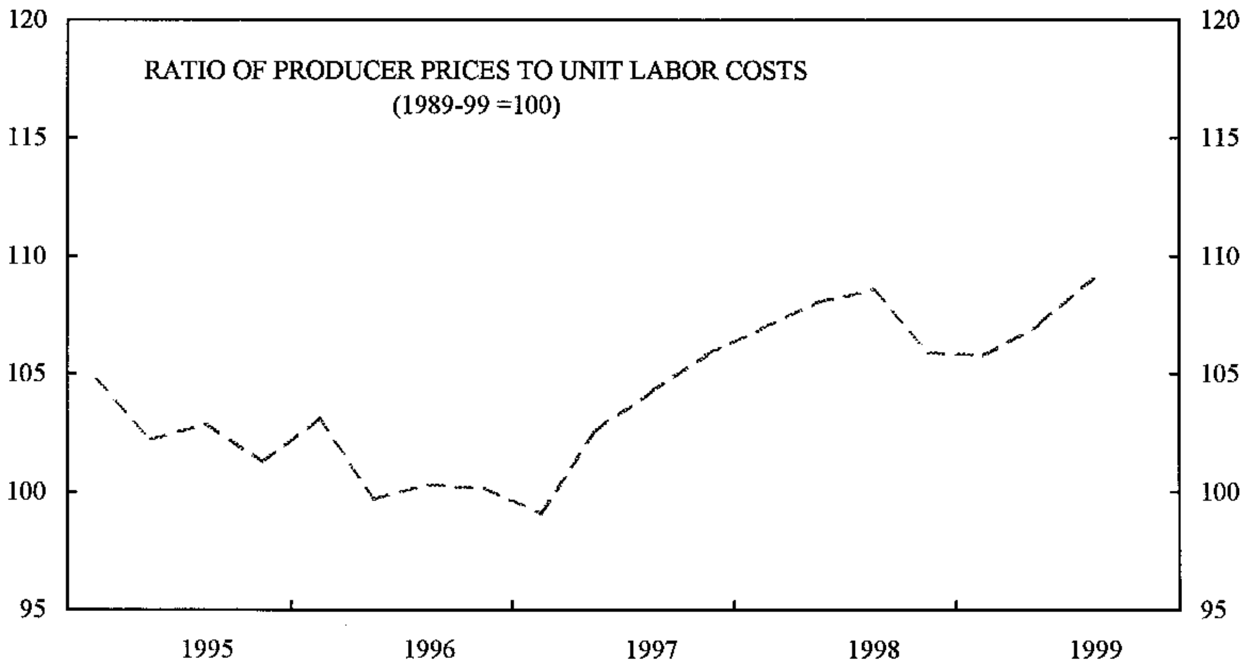


Sources: Bank of Italy; ISTAT; and IMF, *World Economic Outlook*.

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

Figure 3. Italy: Investment, 1995-99

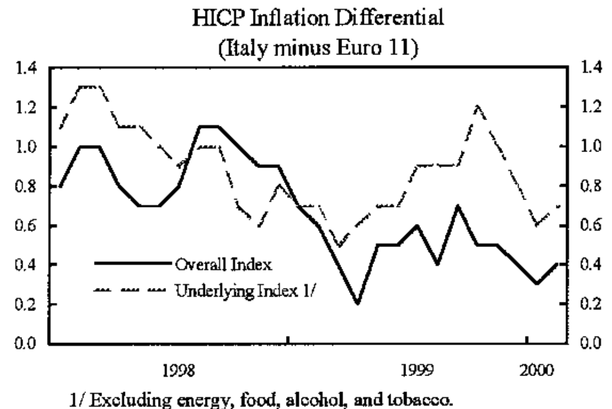




Sources: ISTAT; and Fund staff calculations.

- a stark **regional dichotomy** continues: in the South, estimated GDP growth in 1999 again fell short of other regions, and employment stagnated. Despite higher interregional migration, the unemployment rate remained at 22 percent in the South and exercised no discernible impact on productivity-adjusted labor cost differentials (Figures 4 and 5).

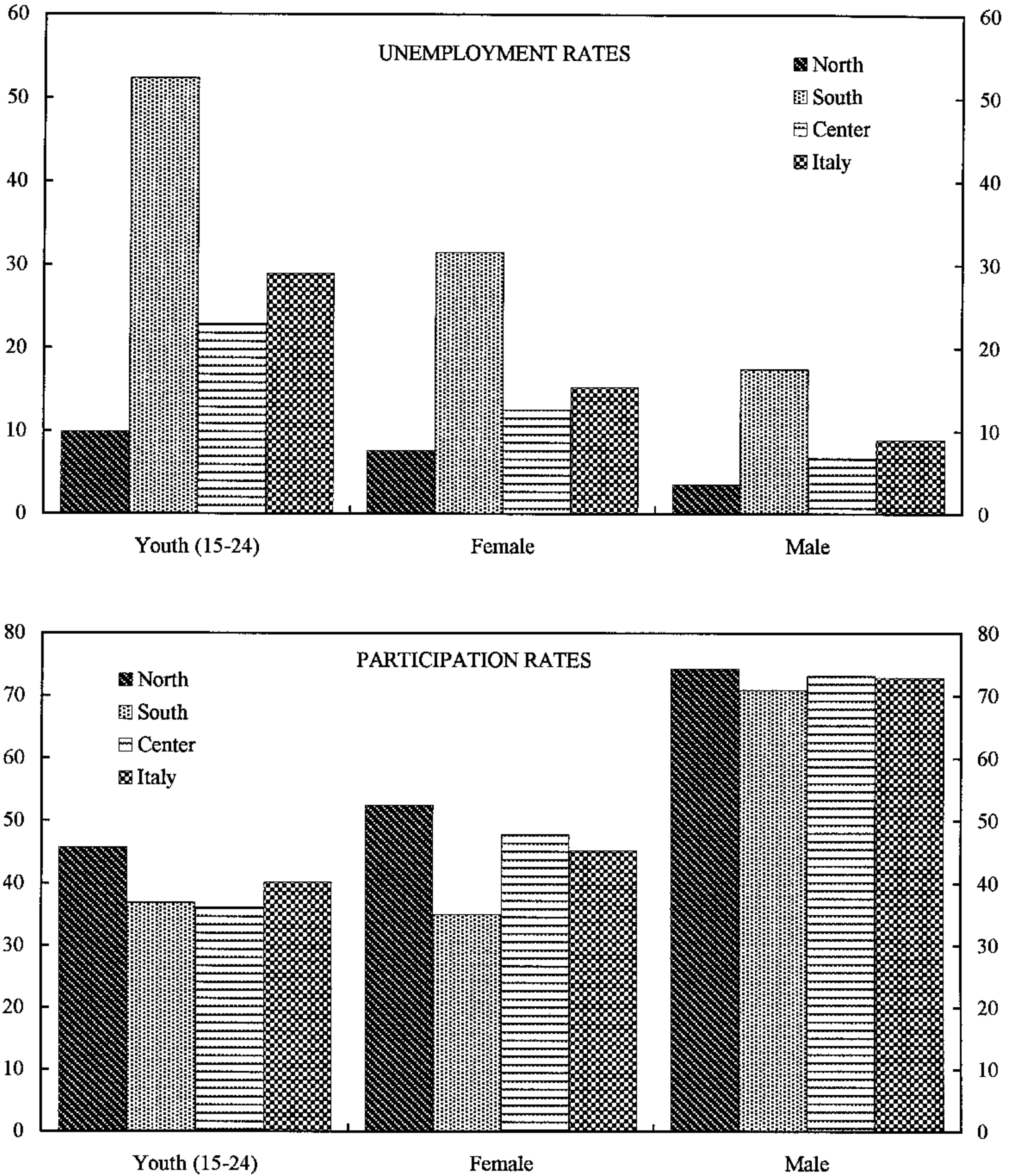
5. **Consumer price inflation accelerated to 2.6 percent by March 2000, as oil prices rose and the euro depreciated** (Figure 6). The differential vis-à-vis the euro area for underlying inflation (excluding food and energy) has stayed at around ¾–1 percentage point since mid-1998. It is likely to have been influenced by a slower liberalization and restructuring of product markets in Italy; moreover, with smaller productivity gains but similar wage growth, aggregate unit labor costs have risen somewhat faster than the euro-area average. This has implied a moderate loss in competitiveness relative to the euro area (Box 1); however, helped by the euro's weakness, indicators of overall price and cost competitiveness are at present more favorable than at any time since the lira's undershooting of the mid-1990s (Figure 7).



1/ Excluding energy, food, alcohol, and tobacco.

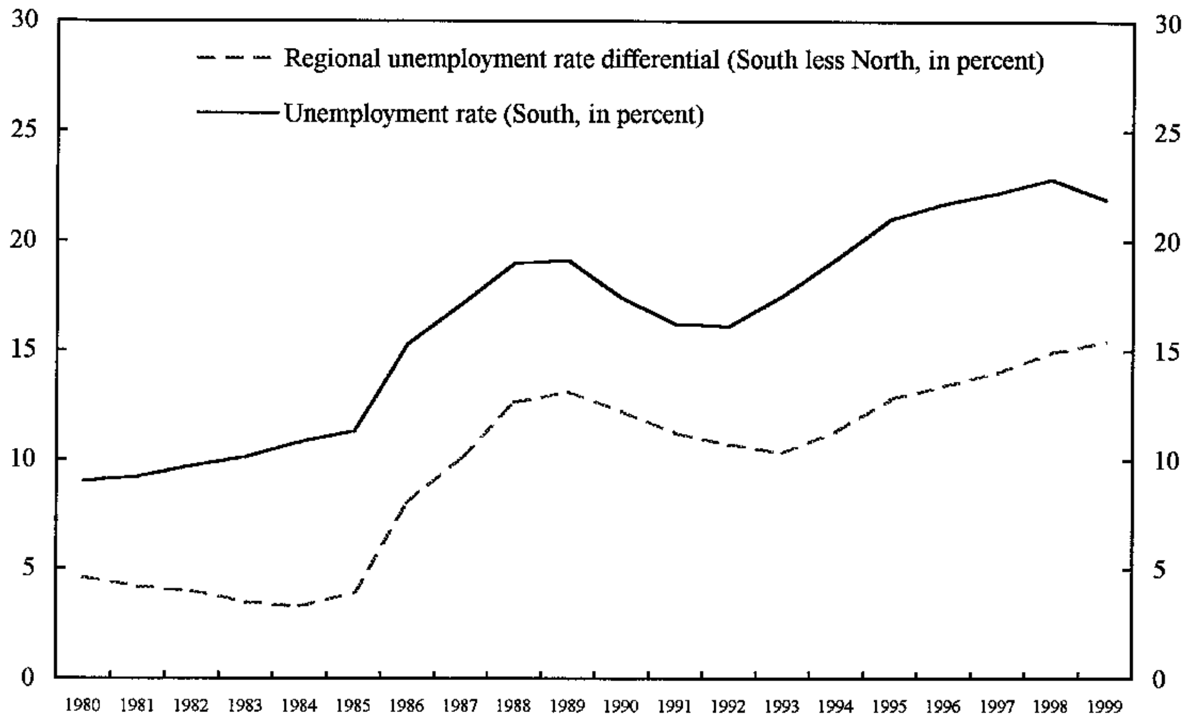
6. **Fiscal consolidation advanced substantially in 1999, and further steps—as well as some reduction in the tax burden—are envisaged for 2000.** Despite considerably weaker-than-expected growth, the general government deficit was limited to 1.9 percent of GDP in 1999 (versus a budget ceiling set at 2.4 percent in March 1999, and a 1998 outturn of 2.8 percent; Figure 8). Improvements in tax administration, as well as robust growth in labor income and lottery sales, raised revenues by almost ½ percent of GDP above budget; and interest outlays were ¼ percentage point lower than budgeted. These factors more than compensated for primary expenditure slippages, including overruns on health care, where the original budget limits had been widely considered as unrealistically tight. The public debt-to-GDP ratio declined to 114.9 percent, helped by privatization proceeds (primarily in the energy and banking sectors) equivalent to some 2 percent of GDP. The 2000 budget targets a further reduction in the general government deficit to 1.5 percent of GDP, in line with the *Stability Program's* goal of achieving approximate balance by 2003 (Table 2). The 2000 deficit target implies a broadly neutral fiscal impulse, as measured by the change in the structural overall balance; the structural primary surplus would decline slightly, to 6¼ percent of GDP. The budget includes various measures to limit expenditure; and tax cuts equivalent to the 1999 structural revenue overperformance (as estimated at the time of the budget—close to ½ percent of GDP; Table 3).

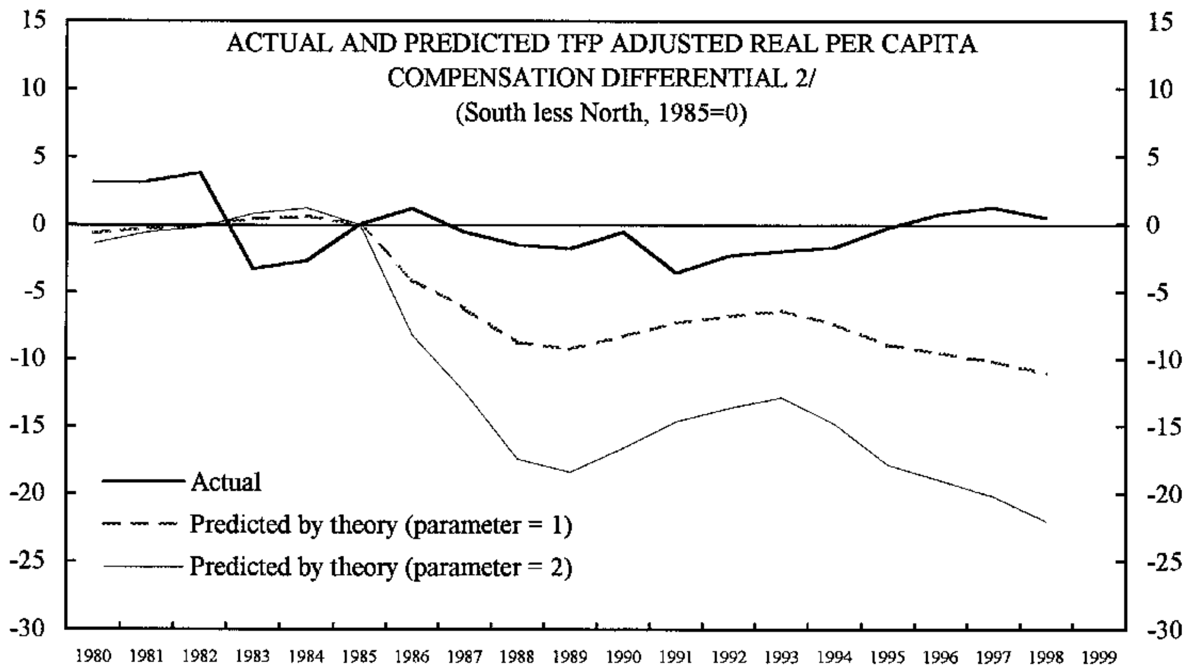
Figure 4. Italy: Unemployment and Labor Force Participation Rates, January 2000
(In percent)



Source: ISTAT.

Figure 5. Italy: Regional Unemployment Rates and Wage Differentials, 1980-99 1/



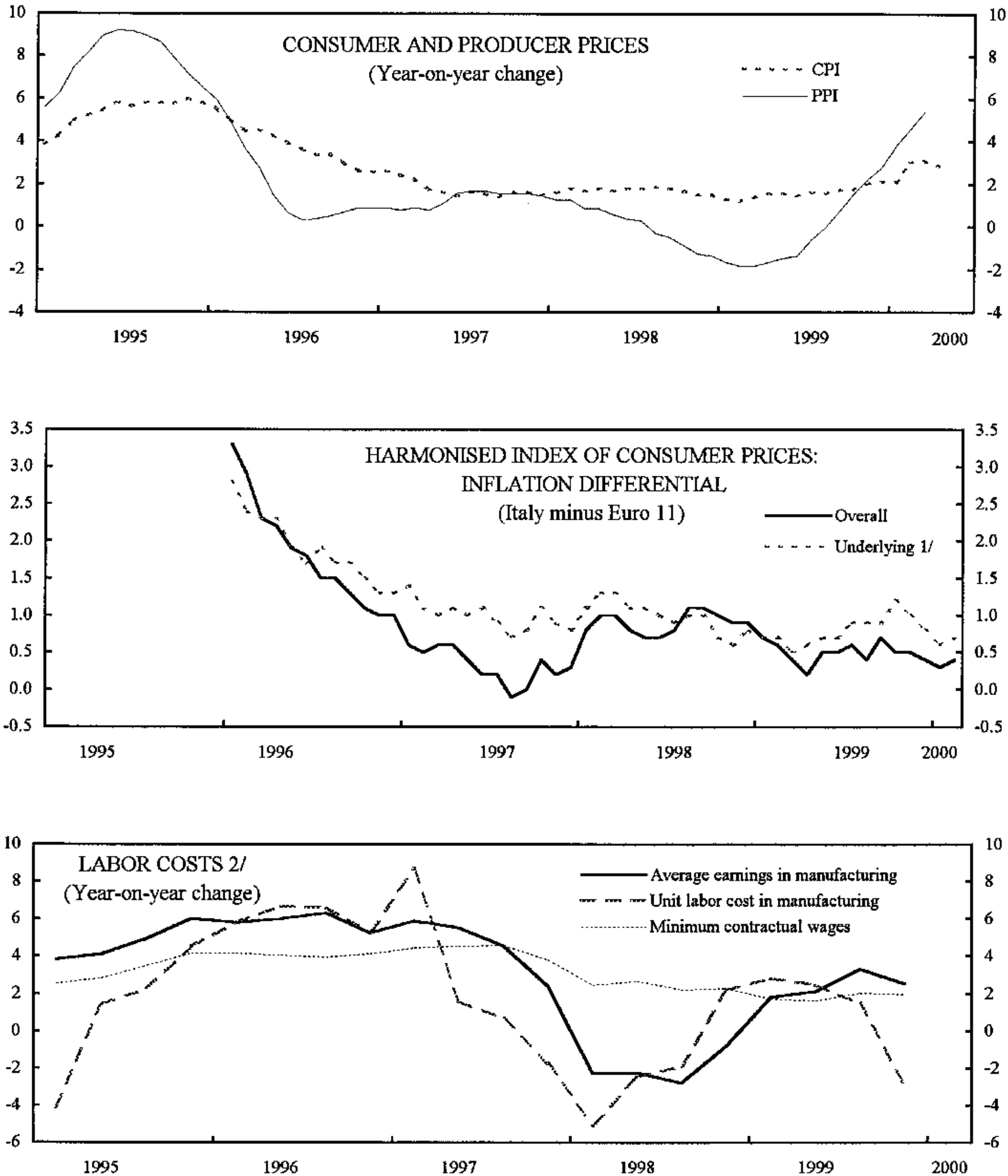


Sources: ISTAT; and Fund staff estimates.

1/ North includes all regions other than the South of Italy.

2/ For details, see Chapter I of the forthcoming Selected Issues paper.

Figure 6. Italy: Indicators of Inflation, 1995:1-2000:4
(In percent)



Sources: Bank of Italy; ISTAT; EUROSTAT; and WEFA.

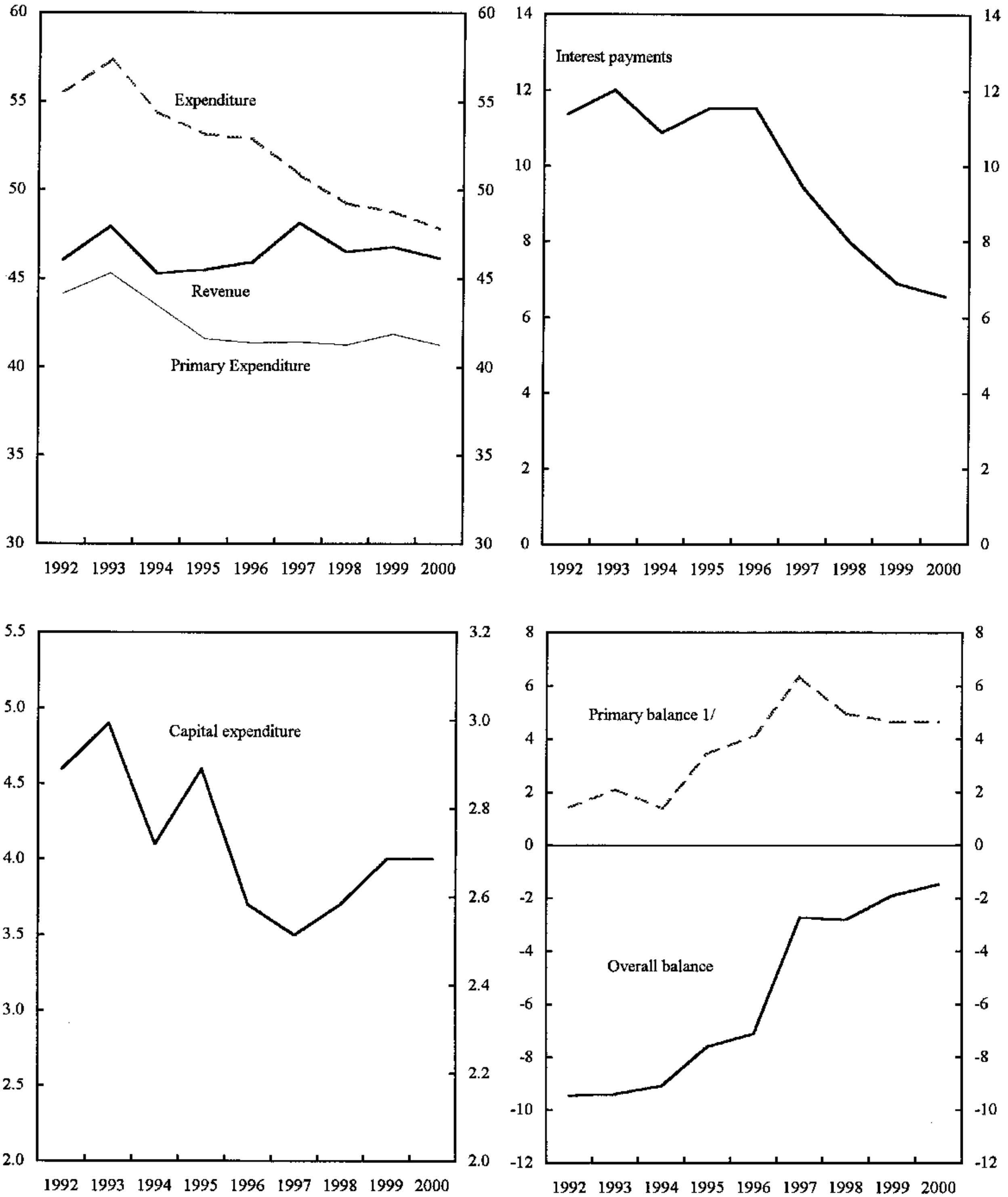
1/ Excluding energy, food, tobacco, and alcohol.
2/ Data for 1998, which suggest a decline of 1.5 percent, reflect the removal of various contributions in the context of the introduction of IRAP. If the portion of IRAP revenues attributable to labor is added to wages, labor costs effectively borne by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

Figure 7. Italy: Exchange Rates, 1990:1-2000:2

Source: IMF, *International Financial Statistics*.

1/ Lira per 1 ECU before 1999.

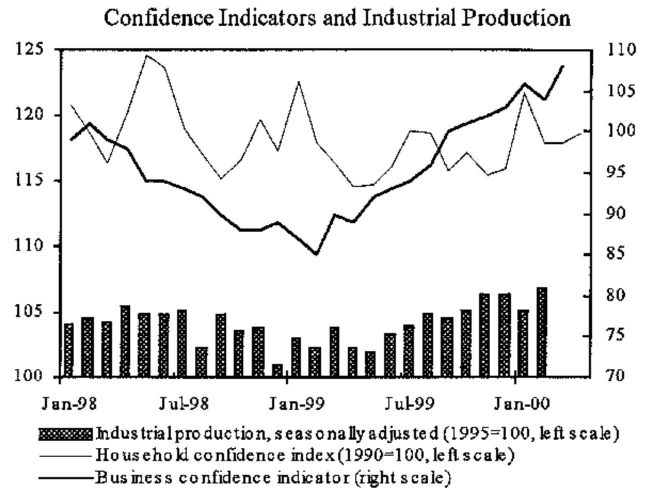
Figure 8. Italy: General Government Aggregates, 1992-2000
(In percent of GDP)



Sources: Data provided by the authorities; and Fund staff estimates for 2000.

1/ Overall balance minus gross interest expenditure.

B. Outlook



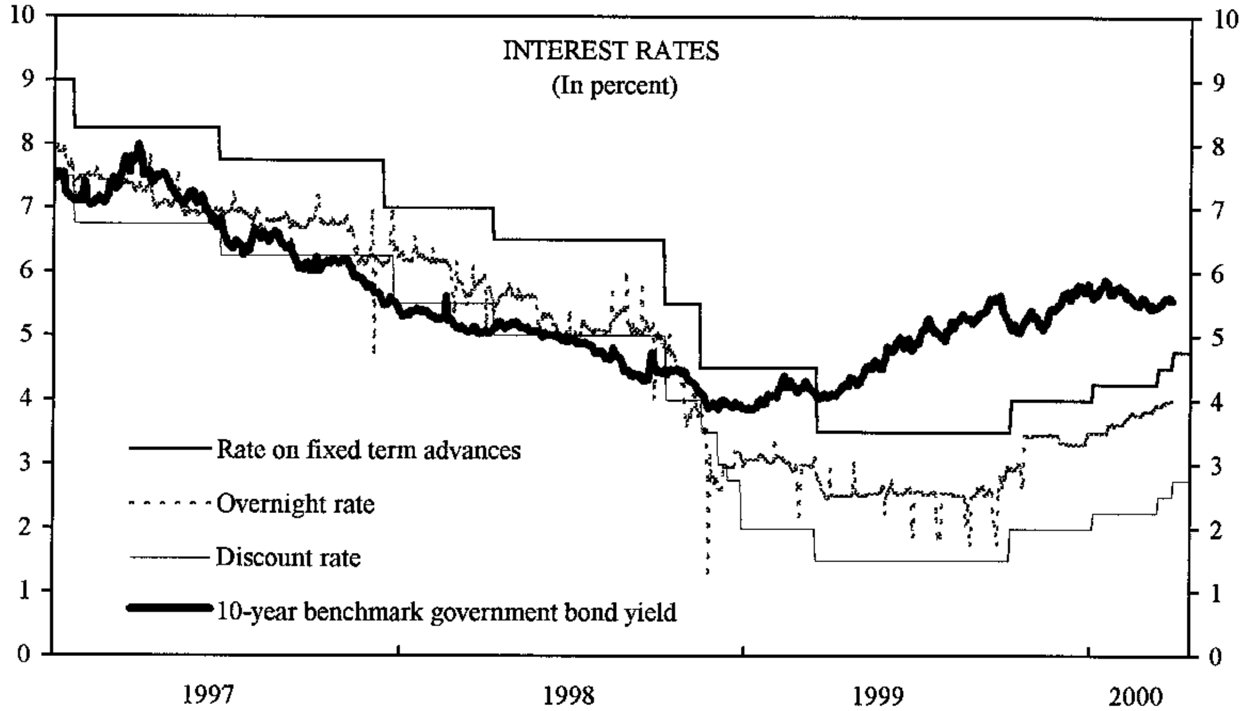
7. **The cyclical upswing is likely to continue over the next two years, as a strong export recovery results in a positive foreign sector contribution and supports GDP growth of 2¾ percent in 2000/01** (this is in line with Consensus Forecasts, but above the authorities' projection of 2½ percent). The acceleration in exports has contributed to a rebound in industrial production and business confidence. In turn, this has further improved the prospects for investment, with construction also benefiting from continued tax incentives for housing renovations and from the *Jubilee*. Additionally, monetary conditions (Figure 9) are likely to remain broadly supportive of the recovery, even when allowing for the prospective tightening embedded in market expectations (for a further discussion, see Section III.A). Under this scenario, and assuming a dissipation of effects from the earlier oil price increase, HICP inflation is projected to decline to some 1¾ percent by end-2000, close to the expected euro-area average. With most wage contracts not up for renewal in 2000 (and the social pact orienting wage increases toward inflation adjusted for terms of trade changes), second-round effects of the oil-related increases in inflation should be limited, and the rise in unit labor costs is likely to slow to below the euro-area average.

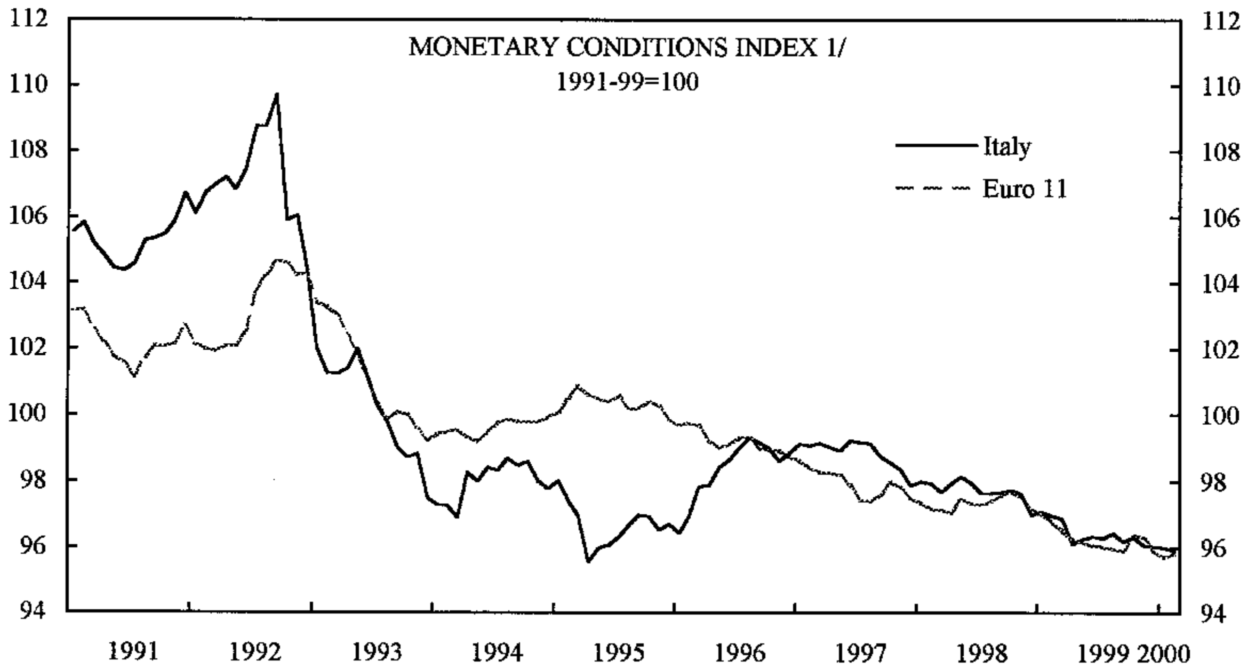
8. **The risks for growth in 2000/01 seem broadly balanced**. Upside risks relate mainly to stronger growth in partner countries, and in employment—with positive repercussions for household income. On the downside, domestic demand and exports could suffer from stronger-than-anticipated effects of the oil price increase as well as a disorderly adjustment in the euro exchange rate or in equity prices (though valuation indicators of the latter have risen broadly in line with markets elsewhere in Europe over the past five years, and other "vulnerability" indicators suggest no specific concerns for Italy; Table 4). For 2001, added uncertainty relates to the end of the *Jubilee* and of some investment incentives. Over the medium term, more dynamic growth will require further steps to address the deep-seated structural shortcomings that contributed to lackluster performance in the 1990s.

III. Policy Discussions

9. Italy's success in economic stabilization, and the relatively benign near-term outlook, allowed the discussions to look beyond short-run exigencies. Key issues included (i) structural reforms to achieve economic growth that would be stronger, richer in job creation, and more geographically balanced; and (ii) the design of a fiscal framework, prudently anchored on medium- and long-run requirements. In each of these areas, the policy challenges were striking.

Figure 9. Italy: Selected Interest Rates and Monetary Conditions Index





Sources: Bank of Italy; Bloomberg; and Fund staff calculations.

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

On growth, it would be critical to strengthen the labor market—especially in the South—which has been the Achilles heel of Italy's growth performance (Box 2). On the fiscal framework, severe policy constraints were evident in a particularly adverse demographic outlook, coupled with Italy's still high public debt—as much as by the clear need to support growth through a lowering of the tax burden. Against this background, the staff favored more ambitious expenditure reforms to avoid an untimely decline in the structural primary fiscal surplus, while also cutting taxes—if possible by more than currently envisaged.

A. The Framework for Fiscal Policy: Short-Term Stance and Long-Term Objectives

10. Discussions on fiscal policy focused first on the near-term policy mix, taking account of monetary conditions in the euro area as they apply to Italy; and then moved to medium- and long-term options for the public finances.

The near-term policy mix

11. **The authorities viewed current monetary conditions as appropriately supportive of economic activity in Italy, notwithstanding the recent increases in the European Central Bank's (ECB's) policy rates—an assessment broadly shared by the staff.** They noted in particular that the depreciation of the euro since the launch of monetary union had brought monetary conditions close to their lowest level over the past two decades. Moreover—on the basis of estimated transmission lags—the impact of the EMU-related convergence in short-term interest rates, which had taken place relatively late in Italy, should continue to exert an expansionary effect in 2000 and possibly 2001. A steady acceleration in credit to the private sector, historically an important monetary transmission channel, has been underway since mid-1999.

12. **The authorities nonetheless expressed some concern about the outlook for external competitiveness.** They pointed to the substantial increase in the tax burden over the past decade, which had been central to fiscal consolidation. Moreover, less rapid liberalization of some nontraded services and higher unit labor cost increases in recent years had resulted in a persistent differential in core inflation and some loss of price and cost competitiveness vis-à-vis the euro area. There was agreement, however, that relatively slow productivity growth in the overall economy partly reflected cyclical factors and could be expected to wane as the cyclical rebound became more aligned with the rest of the area. With respect to labor costs, the authorities also emphasized that increases in energy prices, related to higher import costs, should not be allowed to pass through to wages, in the spirit of the 1993 labor agreement. The staff concurred with the authorities that the main risk would emanate from a sharp reversal of the euro—whose depreciation had so far cushioned the economy—to levels above those observed in the late 1990s.

13. **In this cyclical setting, and given the need for further fiscal consolidation, the authorities saw the 2000 budget as leading to an appropriate policy mix—a view shared by the staff.** The staff regretted, however, the use of sizable one-off measures in the budget

Box 2. Italy: A Growth Puzzle?

During the 1990s, Italy's annual GDP growth averaged only 1½ percent, the weakest growth performance of any country in the euro area and lower than in other major industrial countries except Japan. A background paper reviews this lackluster growth performance from a cross-country perspective. Attempting to draw policy conclusions, the comparative focus is on France, the Netherlands, and the United Kingdom—countries that have pursued relatively diverse policies. The preliminary results suggest that both tighter macroeconomic policies and structural factors explain Italy's lower growth.

With respect to the **role of macroeconomic policies**, Italy tightened its policy stance even more than the comparator countries in the run-up to monetary union. Simulation results (using the Oxford Economic Forecasting model) indicate, however, that a sizable growth differential—some 1 percentage point vis-à-vis the Netherlands and the United Kingdom—cannot be explained by the relative stance of macroeconomic policies and is likely to reflect structural factors. Moreover, the simulation results probably present an upper bound on the impact of policy tightening; absent such steps, Italy's euro participation would not have been feasible and macroeconomic policies not sustainable—with implications for risk premia and growth that are not well captured in the simulation exercise.

Explaining the **structural growth differential** shifts the focus to supply-side developments, where political instability has sometimes hampered more decisive steps in the past. Growth accounting for the 1990s suggests that Italy has lagged the comparator countries mainly with respect to employment (see table). In this regard, Italy's lower population growth is one, but not the key, factor;[1] rather, low employment growth primarily reflected factor price distortions, as Italy experienced neither a decline in unemployment nor a rise in labor force participation. The staff's analysis suggests that technology-driven labor demand developments were one factor, as both Italy and France suffered large adverse shocks: possibly reflecting insufficient wage differentiation, this led to a substitution of capital for low skilled labor.

To a larger extent, however, differences in the employment performance appear to have emanated from differences in **effective wage demand**, probably owing to a considerable extent to differences in the evolution of the **tax burden on labor**. One gauge of wage demand is the change in real effective (productivity-adjusted) employee compensation for a given unemployment rate, with a decrease indicating a negative wage demand shock (or, equivalently, a positive labor supply shock).[2] In the Netherlands, for example, this compensation was some 15 percent lower in the late 1990s than in the mid-1980s (see figure). In Italy, on the other hand, there was little change until recently, reflecting also a 10 percentage point increase in effective labor taxes. By contrast, labor taxes declined substantially in the Netherlands.

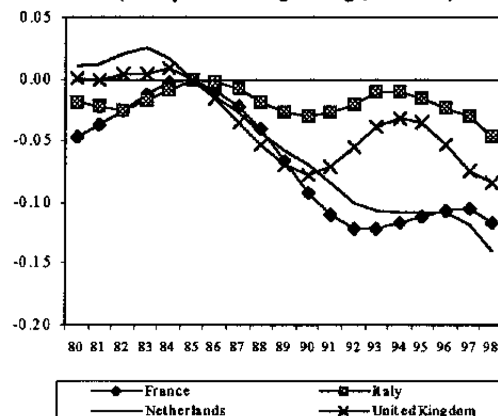
With converging macroeconomic policies, the cyclical recovery could raise Italy's GDP growth to rates near those recorded elsewhere in the euro area. However, the results of the background paper suggest that a sustainable increase in the growth trajectory would require fiscal reforms as well as further wage moderation and differentiation, as a means to increase employment rates. Supporting labor and product market reforms are discussed in the main text; these could also facilitate a rebound in total factor productivity growth.

Growth Accounting, 1980–98 1/

	GDP	TFP	L	K
1990-98				
FRANCE	1.7	0.8	0.0	0.9
ITALY	1.5	0.7	-0.2	1.0
NETHERLANDS	3.0	1.0	1.1	0.9
UNITED KINGDOM	2.6	1.0	0.7	0.9
1980-89				
FRANCE	2.3	1.7	-0.1	0.8
ITALY	2.5	1.2	0.4	0.9
NETHERLANDS	1.9	1.0	0.2	0.6
UNITED KINGDOM	2.9	1.9	0.4	0.5

Data source: OECD.
1/ GDP refers to real GDP, TFP to total factor productivity, L to employment, and K to capital, all in the business sector.

Effective Real Wages, 1980-98
(Five-year moving average, 1985=0)



[1] The growth differential for the working age population vis-à-vis the comparator countries amounted to about 0.3 percent annually over the 1990s.

[2] See Blanchard (1998) and the background paper for the underlying labor demand and supply model. Except for the United Kingdom, the relative results reflect foremost differences in real wage rather than productivity developments.

(some 0.4 percent of GDP; Table 3). On revenues, the structural overperformance in 1999—reflecting improvements in tax administration and a widening of the tax base (including through the application of sectoral peer-group studies)—was applied to tax cuts in the 2000 budget. The tax reductions, discussed below, included steps to lower labor taxes (notably a reduction in the rate for the second income tax bracket), and tax cuts aimed at strengthening sluggish demand in specific areas (for example, temporary incentives for housing renovations).

14. **There was a consensus that the budget deficit target of 1.5 percent of GDP for 2000 was well within reach, although the staff underscored the risks of renewed overruns on primary expenditure.** The strong revenue performance of 1999 had carried over into 2000, and revenues should also benefit from growth above the budget assumption of 2.2 percent. On the other hand, primary expenditure overruns were likely to reach ¼ percentage point of GDP. Further slippages at subnational levels posed, in the view of the staff, the main risks to the achievement of the budget target. Near-term budgetary risks from rising interest rates have declined in recent years with the considerable expansion of public debt into fixed-rate longer-term maturities: the average maturity—while still shorter than in major partner countries—now exceeds five years, and the estimated first-year impact of a 1 percentage point increase in interest rates is below ¼ percent of GDP.

15. **The staff argued that the near-term risks to growth could, in all likelihood, be adequately addressed by the full play of automatic fiscal stabilizers, a view to which the authorities were sympathetic.** On the implications of higher ECB interest rates, the usual adjustment lags were seen as limiting the near-term growth effects; and even if the ECB were to increase interest rates in line with market expectations—which pointed to an expected increase in short-term market rates by some 30 basis points during March-December 2000—monetary conditions would remain more accommodative than those observed prior to monetary union during similar stages of the cycle. While the ECB has raised interest rates somewhat faster than had been embedded in market expectations at the time of the discussions in March, the further depreciation of the euro has made the downside risks related to a tightening of monetary conditions more remote. Should the euro eventually appreciate sharply, the authorities argued that it would principally fall on the social partners to ensure adequate cost competitiveness. Several other steps discussed below, including reductions in the tax burden and product market reform, would have the added benefit of addressing some of the downside risks.

Long-term fiscal balances and public debt

16. **It was widely recognized that the combination of a high public debt ratio and the prospect of rapid population aging were of prime importance in setting medium- and long-term budgetary objectives.** The discussions explored to what degree these factors call for fiscal balance objectives more ambitious than those required to allow room for the automatic stabilizers under the Stability and Growth Pact. There was uncertainty, however, on the potential fiscal impact of population aging: on unchanged policies, the staff's estimate for pension outlays, combined with OECD estimates for health care, suggested expenditure

increases of up to 6½ percent of GDP (see Box 3 and Chapter II of the Selected Issues paper). While this was considerably above the authorities' estimate—who would reappraise their pension projections in the context of the 2001 review of the system—they agreed that population aging called for pressing forward with further reforms to limit the impact on pension and health care expenditures, and for safeguarding an adequate net asset position of the public sector. In addition, staff noted that the large public debt stock left the medium-term fiscal position vulnerable to sustained interest rate increases.

17. **Taking into account these considerations, the staff encouraged the authorities to maintain the structural primary surplus expected for 2000—6¼ percent of GDP—well into the medium term, which would, over time, lead to significant fiscal surpluses** (Table 5). To strengthen growth, the staff's normative scenario incorporates a cut in the tax burden along the line of the authorities' *Stability Program*, with some further decline in later years; and it envisages additional steps to limit the effects of population aging on health and pension outlays (Box 3). Even under these assumptions and with a moderate increase in participation rates, government debt would fall below 60 percent of GDP only after 2010, just ahead of an acceleration in the old-age dependency ratio. Staff underscored that this left no room for relaxing fiscal effort during the current cyclical upswing.

18. **While the authorities concurred with the basic rationale for a strong primary position, they questioned the weighing of economic trade-offs in the staff's normative scenario, and whether it could garner sufficient political support**. Their *Stability Program* implied a primary surplus about ¾ percentage point below the staff's by 2003, while projected interest payments were ¼ percentage point lower. The authorities argued that budget balance over the cycle—to be achieved under the *Stability Program* by 2003—would be broadly adequate thereafter: it would secure a steady decline in the public debt ratio and observe the requirements of the Stability and Growth Pact. Rather than building up a fiscal surplus, it would be preferable to alleviate the otherwise very stringent public expenditure limits, or possibly to implement further reductions in the tax burden. This assessment reflected also the authorities' projection, compared with the staff, of a smaller impact of population aging on public expenditure ratios—in part due to different assumptions about labor productivity growth (SM/99/115, 5/20/99). They agreed, however, with extending public expenditure reform, but saw this as mitigating the need for a sizable fiscal surpluses. The staff was sympathetic to the view that expenditure reform might lessen the fiscal surplus requirements and tilt the trade-off toward some additional tax reduction—but lowering the fiscal effort now, ahead of such expenditure reforms, could weaken hard-earned fiscal credibility.

B. Growth-Enhancing Policies I: Structural Reform of the Public Finances

19. The discussions revealed a broad-based consensus, including the social partners, that reforms of taxes and public expenditure would be essential for strengthening potential growth—assigning to fiscal policy a role that thus went well beyond budget consolidation. The staff's background work suggested that the needed fiscal consolidation had contributed to slower growth in the run-up to monetary union; however, other aspects of public finances had

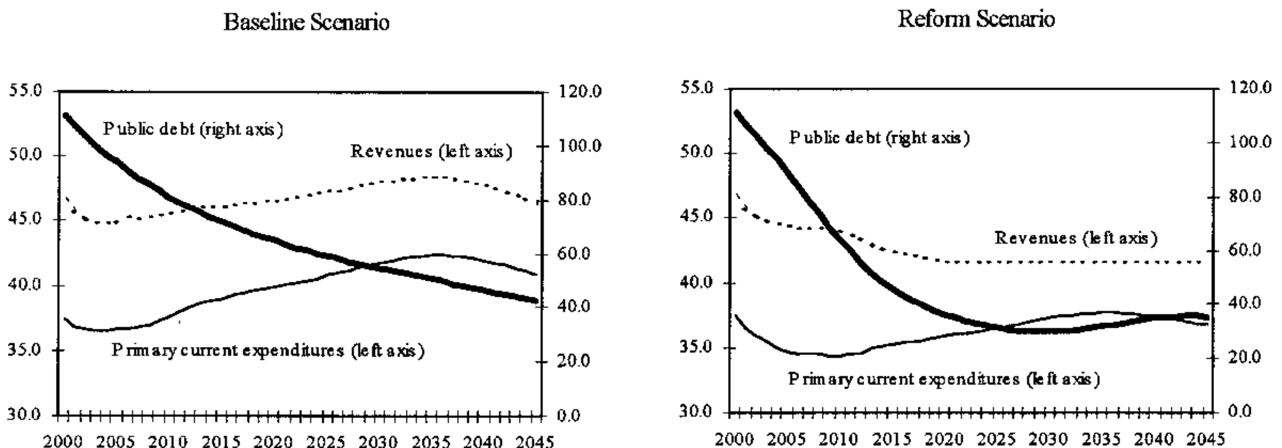
Box 3. Long-Run Fiscal Trade-Offs and Implications for Medium-Run Adjustment

Italy achieved an impressive fiscal adjustment to secure early membership in monetary union, reducing sharply the overall deficit and reversing an upward trend in the public debt-to-GDP ratio. This has set the stage for focusing on a medium- and long-term fiscal strategy. As Italy enters the new decade burdened by still high debt (over 110 percent of GDP) and taxation, and facing one of the most adverse population aging trends among OECD economies, the trade-offs involved are nontrivial, as discussed in more detail in Chapter II of the Selected Issues paper.

What is the appropriate fiscal position over the medium term? To reduce the degree of fiscal vulnerability, it would seem desirable to bring the debt stock to a sufficiently low level before the most adverse impact of population aging starts to be felt. Barring further tax increases, this would require a marked reduction in primary current expenditures—admittedly a difficult task. Rapid consolidation would be easier to achieve in a high growth setting, which could be fostered by a determined effort to reduce tax pressure—in part through a reduction in tax rates combined with a widening of the effective tax base. The speed at which the revenue ratio can be reduced would be constrained—for a given overall balance objective—by the feasibility of the expenditure reduction. To highlight these trade-offs, two illustrative scenarios are considered.

The baseline assumes that, after the current cyclical upturn has run its course, annual labor productivity growth remains at 1.2 percent during 2006–45; but population aging causes a decline in employment, and real GDP growth would slow to an average of 0.5 percent per annum. As a result of population aging, pension and health expenditures increase by 4 percent and 2½ percent of GDP, respectively, between 2000 and 2035 (in line with staff's baseline scenario for pensions (SM/99/115, 5/20/99) and an OECD estimate for health care); education expenditures decline by 1 percent of GDP. The primary surplus is kept at about 5 percent of GDP until overall balance is reached (much along the lines of Italy's *Stability Program*), and the budget is kept in balance thereafter. The debt-to-GDP ratio would still be above 80 percent in 2010, and fall below 60 percent only by 2025, leaving Italy highly exposed to sustained increases in interest rates. Moreover, with the rise in pension and health care expenditures, maintaining budget balance requires an increase in revenues of 3½ percent of GDP between 2005 and 2035, when the fiscal pressure from population aging reaches its peak.

The reform scenario assumes that the structural primary surplus is maintained at the 2000 level (6¼ percent of GDP) throughout the present decade, leading to an overall surplus of 2½ percent of GDP by 2010. This allows a more rapid reduction in the debt ratio, which drops below 60 percent around 2010—shrinking substantially the period of large fiscal vulnerability to interest rate stocks. The revenue ratio is brought down gradually, at the pace envisioned by the *Stability Program* through 2003 (as in the baseline scenario), with a further decline through 2020, when it is 5 percentage points of GDP lower than in 1999—stimulating an acceleration in economic activity (as discussed in the background study, a 1 percent decline in the tax-to-GDP ratio is assumed to increase the GDP level by a cumulative 0.2 percent over a five-year period). Reducing the revenue ratio while maintaining the structural primary surplus at 6¼ percent of GDP requires a strong adjustment in expenditures. The reform scenario assumes that measures are implemented early to contain expenditures in key sectors such as health, education, and pensions—in the case of pensions, measures to increase the age at retirement are assumed to be effective in 2001. These reforms notwithstanding, the strategy requires an up-front compression of primary current expenditures (other than on health and pensions), which would need to decline slightly in real terms (by ½ percent a year on average) over 2001–05. In future years, this leaves room for accommodating the remaining budgetary demands of aging through a temporary deterioration in the overall balance, which would bottom out at minus 1 percent of GDP in 2035.



also been critical: the rising tax burden—required in part to finance sizable primary expenditure—had impacted on labor costs (Box 2), and economic performance was adversely affected by inefficiencies in the public sector. This section focuses on a quantitative framework for reducing revenues and expenditures, on primary expenditure reform, and on fiscal devolution—with other features of tax and public sector reform being addressed later.

Revenue and expenditure reduction: A quantitative framework

20. **The authorities viewed the planned tax reform—involving a cut in the tax burden of 2 percent of GDP during 1999–2003—as critical to strengthening competitiveness and growth.** This would keep the tax burden slightly below the average level targeted by euro-area countries, even if the effort fell somewhat short of plans in Italy's main trading partner (Germany). The critical task was to identify areas for primary expenditure reductions—2¼ percent of GDP by 2003 under the government's plan, and 3 percent for the staff's more ambitious deficit path—that would ensure consistency between these tax cuts and the fiscal consolidation targets. The staff suggested that cuts somewhat beyond the authorities' target would be helpful for spurring growth—provided that additional expenditure savings could be identified.

Fiscal Adjustment 1999–2003: Cross-Country Comparisons

(In percent of GDP)

	1999	2003	Change
Overall balance			
Italy	-1.9	-0.1	1.8
Euro area	-1.2	-0.1	1.1
Germany	-1.1	-0.5	0.6
Revenues			
Italy	46.9	44.9	-2.0
Euro area	47.3	45.2	-2.1
Germany	47.3	44.5	-2.8
Primary expenditures			
Italy	42.0	39.7	-2.3
Euro area	44.1	41.9	-2.2
Germany	44.9	41.8	-3.1

Sources: National authorities' Stability Programs.

Reducing current primary expenditure

21. **The discussions revealed a general consensus on the need for curtailing primary expenditure—even if not on the precise magnitude and timing of reform.** The staff acknowledged the benefits of seeking a political consensus—and that achieving it would be a challenging task since, in view of the large size of entitlement spending, there was no avoiding expenditure cuts affecting entrenched interests. However, there was also an overriding need to address the longer-run fiscal challenges; where measures would take time to yield their intended impact, as with some entitlement reforms, this argued for early action, avoiding more drastic (and economically disruptive) steps later. This could reduce uncertainty about the future fiscal burden, thereby possibly lowering precautionary saving and strengthening demand. Several areas for curtailing primary expenditure were discussed:

- On **public sector employment**, the authorities noted that some reductions had already been achieved in recent years. Nevertheless, at some 17 percent of total employment, it remained high by international standards, and full use was to be made of the *Bassanini laws*, which allowed greater employment flexibility and mobility within the public sector. Implementation would also need to focus on the subnational level. Moreover, the staff pointed

to the ongoing reduction in the number of students: attrition should facilitate some reduction of personnel without compromising quality, while leaving also room for additional outlays to adapt the education system to the demands of new information technologies.

- On **subsidies**, several steps were underway to limit future outlays, notably through restructuring the postal service and the railways—where annual budgetary support had averaged some ½ percent of GDP. For the railways, a new business plan was being finalized: it included reductions in the wage bill, but the authorities expected the need for infrastructure upgrading and for phasing-in reductions in overstaffing to limit near-term progress.

- On **pensions and health care**, earlier reforms had fundamentally improved the expenditure dynamics, even though further steps would be needed to limit aging-related demand pressures.[3] With respect to pensions, the authorities pointed to a review of the system, involving the social partners, which is scheduled for next year. On social expenditure more broadly, they recognized a need to rebalance these expenditures from pensions toward other social objectives—including adequate support for the unemployed (discussed further below)—a view shared by the staff.

Fiscal devolution

22. **Agreement has been reached to further expand fiscal devolution, starting in 2001; while the plans would improve transparency, the authorities acknowledged that success would depend critically on strengthening the administrative capacity at the subnational level, on steps to limit the impact of population aging on health care (the principal expenditure responsibility of regions), and on stronger commitments to fiscal goals by the different levels of government**. Under the envisaged reform (detailed in Chapter III of the Selected Issues paper), the regions' own resources would be raised, and they would be granted added scope to levy selected tax surcharges; in addition, a transparent equalization mechanism is to address differences in their relative tax bases. For fiscal devolution to succeed, it was critical that it be accompanied by a reduction in public sector employment. Moreover, the staff argued that the envisaged reforms made steps to strengthen the Internal Stability Pact, and to improve fiscal transparency, even more urgent. The authorities pointed to preliminary plans that would provide some incentives (such as reducing the interest rate on subnational debt owed to *Cassa Depositi e Prestiti*, conditional on compliance with the Pact). On fiscal transparency, they explained that Italy's preparation of a ROSC fiscal transparency module would be coordinated with its EU partner countries.

[3] See also Box 3; on pensions, see last year's Selected Issues, Chapter I (SM/99/115, 5/20/99).

C. Growth-Enhancing Policies II: Labor Market, Regional, and Other Policies

23. Lackluster growth over the past decade has, to an important extent, reflected weak labor market performance with stagnating employment (Box 2). In discussing policies to strengthen potential growth, including its employment content, the staff emphasized not only the need to reduce unemployment, especially in the South and among the young, but also steps to increase labor force participation. This would alleviate long-run pressures from a declining working age population and address the risk of eventual labor market tightness in the North, where unemployment rates were relatively low by European standards. The authorities underscored their strong commitment to the press ahead with steps to foster a "new economy," as outlined at the Lisbon EU summit in March.

Employment-friendly tax reform

24. **In recent years, the successful broadening of the tax base had been used in part to lower tax rates, and further steps—including a lowering of the burden on labor income—were currently under consideration**. Following earlier reforms, in particular of corporate taxation, the government had recently approved a restructuring of tax credits, including an increase of the child tax credit, that would facilitate labor force participation of second income earners. Tax reforms aimed at improving employment prospects in the South were also being developed: these would take into account the likely need to phase out region-specific tax incentives for employers (for example, social security exemptions for certain regions), in view of EU objections to such subsidies. The staff regretted, however, that the 2000 budget included continuing recourse to temporary and ad hoc tax incentives. The authorities considered temporary tax cuts a potentially useful instrument, but acknowledged that they complicated tax administration and had a distortionary impact on different demand components; and staff noted that, in the past, they had at times contributed to erratic fluctuations in demand and, ex post, were not always well attuned to cyclical developments.

25. **The staff argued that future steps should be targeted at lowering the tax burden on labor income, with a particular view to easing job-market entry**. It welcomed the already scheduled restructuring of the personal income tax credit—and it explored a rise in the tax credit for dependent labor income; a one-time (e.g., limited to two years per person) reduction in social security contributions for the young as part of a "partnership for skills" (see below); and, in later years, using gains from further base-broadening for a general reduction in income tax rates. The authorities expressed interest in these suggestions and indicated that they would review their budgetary impact. With respect to raising the tax credit on dependent labor income, however, they pointed out that it would discriminate between dependent and self-employed labor income—though they acknowledged that the latter group was effectively taxed less. The authorities also questioned whether the focus should be exclusively on labor taxes: other measures, for example, the recent reform of the corporate income tax, could also be expected to strengthen labor market performance by stimulating labor demand. The staff agreed on the general point but noted that corporate tax rates were by now competitive in an international context, while cutting the tax wedge on labor income—which remained relatively

high (Figure 10)—could improve labor market performance and provide a favorable signal to consumers. It also raised the broader point that a detailed and well-publicized government expenditure and tax reduction program would not only allow more efficient public sector planning but, if credible, provide some early benefits as consumers and investors adjust to the prospective fall in the tax burden.

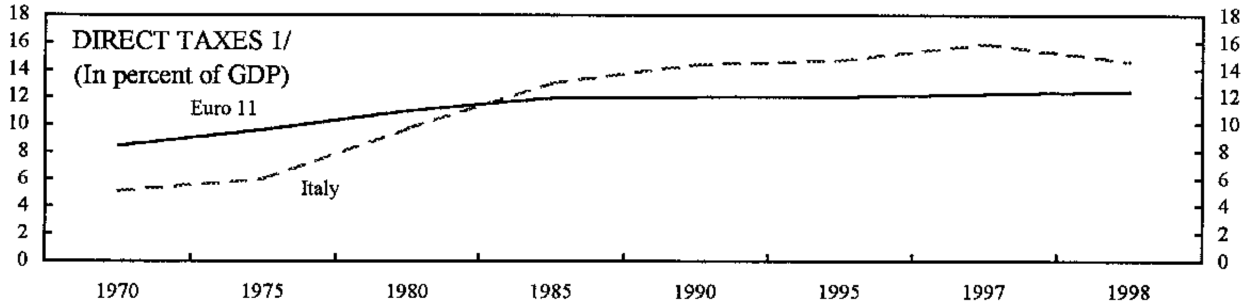
Development initiatives for the South and upgrading skills of the young

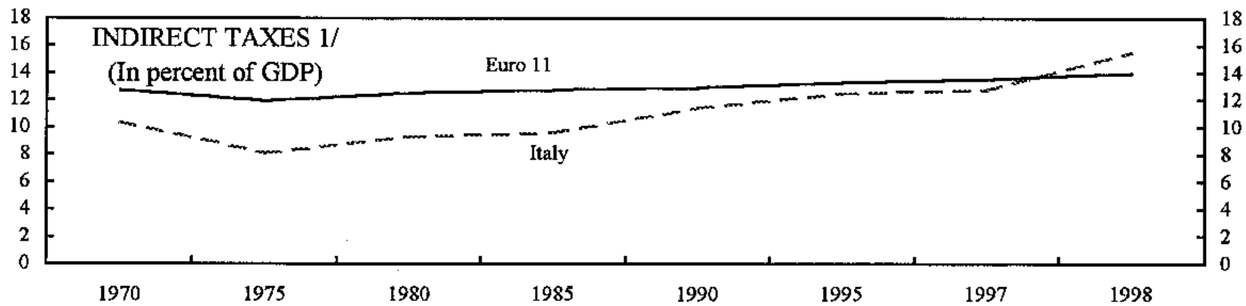
26. **The centerpiece of the government's regional initiatives is a new development program for the South, covering 2000–06 and to be aided under the EU support framework.** To jump-start growth, with 4 percent targeted by 2003, the program includes a doubling of development expenditures during 1999–2001, placing renewed emphasis on improving public services and infrastructure. It also builds on steps discussed in last year's report (SM/99/100, 5/14/99) to strengthen competition for funds, make their distribution more transparent via a new scoring system, increase local involvement in program design and local accountability, and improve monitoring. As signs of success, the authorities pointed to a higher take-up of EU funds and a rising number of enterprise start-ups in the South since mid-1999.

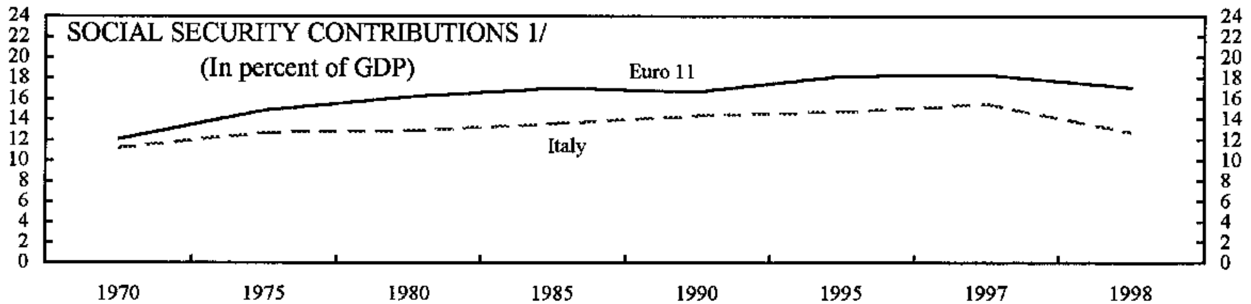
27. **The staff welcomed the strengthening of transparency and accountability in the new initiatives; but it was essential that these be complemented by substantially larger wage differentiation, targeting specifically higher open employment among the young and the most disadvantaged segments of the potential labor force.** The need for a comprehensive strategy was underscored by a growth of output and employment in the South that continued to be well below rates elsewhere in the country. On wage differentiation, labor representatives noted that this had, to some extent, already been achieved, including through differentiation in plant-level negotiations. Whether a further substantial increase in wage differentiation was needed was a matter of debate among the main labor unions. The staff's analysis (detailed in Chapter I of the Selected Issues paper) suggested that this would need to be an integral part of an employment strategy for the South, particularly at the job-entry level: it could make an important contribution to reducing unemployment rates to the single digits recorded until the early 1980s; and it would have the added benefit of extending social protection, by encouraging employment in the open economy at the expense of the underground economy, where no social protection applied. Among the authorities and labor unions, however, some expressed concerns that a sizable increase in wage differentials could create a segmented labor market with a class of the working poor. While it would be possible to address some of these concerns, as in other countries, through adjustments in the tax system, major steps were not presently under consideration, and region-specific measures were, in any case, likely to be ruled out by the EU.

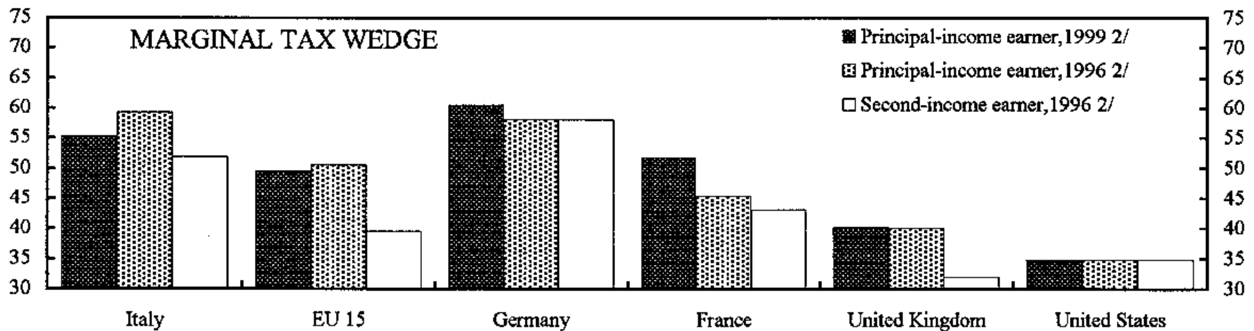
28. **Against this background, the staff suggested a "partnership for skills," involving a joint effort of the social partners and the state to strengthen open employment prospects for the young** (notably in the South, where recorded youth unemployment is around 50 percent). The scheme would entail a commitment to improve job matching and job training; a one-time reduction of social security contributions; and wage differentials going well beyond

Figure 10. Italy: International Tax Comparisons, 1970-98









Sources: European Commission; and OECD for marginal tax wedge.
1/ Break in series for Italy in 1997/98, as IRAP replaced health contributions and other direct taxes.
2/ Principal-income earner refers to head of household with income equal to production worker average, two children, and a spouse earning 33 percent of the principal's income; second-income earner refers to spouse of this principal-income earner.

those envisaged under current apprenticeship programs. Some labor unions welcomed in particular the call for improved training and suggested that this also draw on the education sector. The authorities pointed out that current apprenticeship programs already provided room for wage differentiation, though admittedly to a considerably smaller extent than, for example, in Germany, where these programs were used extensively. Overall, it remained to be seen if such an integrated partnership could garner sufficient support among the social partners. There was little support for measures to encourage interregional migration, which had picked up significantly since 1998, with declining unemployment in the North; the authorities' prime development goal was to strengthen economic conditions in the South.

29. **There was a consensus that measures to strengthen the flexibility of the labor market should be accompanied by adequate social safeguards, and that the planned broad-based unemployment insurance presented an important step**. Within a universal, contribution-based system, it would raise and extend the coverage of benefits—which, outside industry, were exceptionally limited by industrial country standards. The authorities agreed that it would be important to set time limits and other conditions in a way that would ensure adequate training and employment incentives. These considerations would also be taken into account in the upcoming review of the pilot project for minimum income support.

Other structural policies

30. **Major product market reforms in recent years—and one of the largest privatization programs among the advanced economies—have changed the competitive landscape of the economy; but additional steps are urgently needed in an increasingly integrated European and global market**. The authorities planned to dissolve the state holding IRI by midyear, with its remaining assets to be sold off or, in a few cases, to be transferred to the Treasury, with a view to privatization at a later stage. For the national postal and railway companies, any sell-off is to await improved performance under their respective restructuring programs. The authorities noted progress in liberalizing retail trade, but conceded that administrative bottlenecks at the local level had prevented a more dynamic expansion of large retail outlets. Further progress in this and other areas was expected from the full implementation of simplified administrative procedures under the *Bassanini laws*; some of these measures—for example, the one-stop shop for investment approvals—had started to eliminate red tape, but many market participants remained skeptical about a forceful implementation at the local level. Turning to nonlisted companies, which dominate the corporate landscape, legal changes are under preparation that would strengthen corporate governance. Some of these firms would benefit from the new small-equity capital market (*nuovo mercato*); and their growth could also be facilitated by relaxing relatively severe firing costs, applying to enterprises with at least 15 employees.

31. **The authorities noted that, in some areas, a relatively slower pace of deregulation and price liberalization had contributed to Italy's positive inflation differential vis-à-vis the euro area**. Some steps had been taken to address the rapid rise in insurance rates, attributed to a lack of competition in the sector. Energy prices remained relatively high,

especially for industrial customers: to accelerate competition, it was planned that the former electricity monopoly would complete the targeted divestments of generation in 2001, some 1½ years ahead of earlier plans. Ambitious reforms for the gas sector had been submitted to parliament. However, vertically integrated companies are retaining ownership of the national energy grids, and the regulatory authorities raised concerns about the implications for competition and quality improvements. On telecommunications, the authorities underscored that prices were declining rapidly toward levels in partner countries, following entry of a number of players; steps envisaged for the summer included the unbundling of the local loop and the auctioning of licenses for the Universal Mobile Telecommunications System. Moreover, strong competition among Internet service providers was facilitating a rapid expansion of e-commerce.

32. **With respect to the financial sector, the authorities pointed to the considerable progress that had been achieved in recent years in transforming a highly segmented, public sector-dominated system, with deep-seated balance sheet problems in some regions, into one that is much more competitive and dynamic.**[4] For the banking system, interest rate convergence had put strong pressure on spreads, but overall profitability had held up as banks switched to other activities, including mutual fund management. There was uncertainty, however, whether high revenues from these activities were sustainable—increased competitive pressure could be expected to reduce fees, which were in some areas still higher than in the euro area. Against this background—and in order to respond to growing competitive pressures from the single EU market as well as a possible increase in direct capital market financing at the expense of bank intermediation—the authorities viewed a significant reduction in the banking system's operating costs as an important priority; in this regard, they expressed disappointment that the large-scale consolidation of the sector had failed to achieve cost savings. With respect to financial markets, liquidity was expected to increase in 2001 with the reform of the severance payments scheme; at least part of these funds were to be placed with private pension funds, although the precise allocation remained to be decided. Regarding supervision, the authorities confirmed that their influence had been instrumental in strengthening bank balance sheets since the mid-1990s, and in the ensuing consolidation of banking in the South. And while the share of nonperforming loans remained relatively high in comparison to other industrial countries, it had been on a clear declining trend in recent years. The authorities viewed the structure of supervision in Italy as broadly adequate, especially since there were no large financial conglomerates. Looking ahead, however, they expected some further blurring of the boundaries between banking and insurance institutions that would call for continued adequate coordination between different supervisors. They agreed on the importance of monitoring adequate disclosure of the return and risk characteristics embedded in new retail financial products.

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[4] A forthcoming study prepared by EU1 staff will present a cross-country review of the financial sector in major euro-area economies, including Italy.

IV. Staff Appraisal

33. **Impressive success in macroeconomic stabilization and far-reaching structural reforms are beginning to bear fruit, and the economy is now experiencing a firm recovery**. Inflation remains close to historically low levels, while fiscal consolidation, privatization, and product market reforms have progressed remarkably.

34. **After a decade of disappointing growth, the current upswing is weaker, however, than elsewhere in the euro area, and major reform challenges remain**. Priorities include mitigating the fiscal and economic impact of population aging; reducing the tax burden; and strengthening labor markets, especially in the South and for the young. In some cases, it is the vigorous implementation of earlier steps that is most needed for sustained, strong economic growth, shared widely across different regions and segments of the population.

35. **The near-term growth outlook is benefiting from relatively accommodative monetary conditions, but risks to competitiveness may lie ahead—notably if the euro were to appreciate sharply**. Continued wage moderation will be critical: the social pact—with its explicit understanding that externally induced price increases, such as those stemming from higher oil prices, should generally not lead to higher wages—provides a useful framework to close the residual inflation differential vis-à-vis the euro area. In addition, competitiveness needs to be strengthened by lowering the tax burden and further product market liberalization.

36. **The role of fiscal policy remains circumscribed by long-run constraints and remaining fiscal vulnerabilities, related to the fiscal burden of population aging and the still high public debt**. Against this background and the projected upswing, it would be prudent to maintain the primary surplus on average over the cycle at no less than the level expected for 2000—that is, a structural primary surplus of somewhat more than 6 percent of GDP. For future years, this implies a tighter stance than indicated in Italy's *Stability Program*, which allocates only part of the prospective savings on interest payments and from the cyclical improvement of the budget to deficit reduction. Further expenditure and labor market reforms—implemented early and forcefully—could mitigate the fiscal demands from population aging; but until such reforms are fully secured, a prudent level of the primary surplus, as described above, would seem appropriate to safeguard hard-won fiscal credibility.

37. **Assessed against long-term requirements, as well as present cyclical conditions, the fiscal deficit target for 2000 is appropriate: it will, however, be important to ensure that primary expenditures are held to budgetary allocations, while allowing the full play of the automatic stabilizers on the revenue side**. On present estimates, the deficit target of 1.5 percent of GDP is well within reach—though care needs to be taken that subnational levels of government do not deviate substantially from targets laid out in the Internal Stability Pact.

38. **Securing further reductions in the fiscal deficit and tax burden over the medium term will require firmly limiting the growth of public expenditure at all levels of government**. Undeniably, this will entail difficult political choices, but perseverance in this area

is indispensable for a more dynamic economic environment. Further reductions in public sector employment will have a central role to play—taking advantage of labor savings from new technologies, and shifting employment within the public sector toward areas of most productive use. It is crucial that fiscal devolution contribute to greater efficiency in this regard, not to a swelling of public employment; this would be facilitated by outlining a well-specified medium-term expenditure strategy. The latter would also contribute to improving fiscal transparency, where preparation of a ROSC module would be most helpful.

39. **On social spending, Italy's reform agenda remains incomplete: further steps will be needed to limit the fiscal impact of population aging, and also to rebalance spending from pensions toward programs that support labor market integration and the most disadvantaged segments of the population**. As detailed in last year's staff papers, an early consensus should be sought to further curtail the pending fiscal pressure from the pension system (stemming in part from benefits unrelated to old age). On health care, the new initiative toward decentralization should improve the transparency of the regional financing system. This needs to be complemented by a strengthening of administrative capacity at the subnational level and of the incentives for compliance with the Internal Stability Pact—as well as by steps to contain the future rise in health care costs for an aging population. In rebalancing welfare expenditure, the planned introduction of a universal and adequate insurance scheme for the unemployed is welcome. It should ensure appropriate incentives to seek training and employment, a challenge that also applies to the minimum income support scheme, as it becomes a pillar of general welfare support for the very poor.

40. **Structural fiscal reforms—by lowering the overall tax burden, reducing tax distortions, and improving the quality and efficiency of public services—have an integral part to play in a growth-oriented strategy**. A decisive reduction in public expenditure should create sufficient room to lower the tax burden (in terms of GDP), at a minimum, as envisaged in the *Stability Program*, while safeguarding the fiscal consolidation objective outlined above. Additional room for lowering tax rates could become available by broadening the tax base and improving tax administration. Tax cuts should focus on reducing the high tax wedge on recorded labor income, aiming at lowering unemployment among the young and in the South, as well as increasing labor force participation. Recourse to temporary ad hoc tax incentives—with doubtful economic benefits and an adverse impact on tax administration—should be ended.

41. **Redressing the poor economic performance of the South will be indispensable for a substantial increase of Italy's long-run growth: this will require complementing existing steps with labor market initiatives that go well beyond those envisaged in the program of the authorities—and could be based on a "partnership for skills" targeted at improving open employment prospects, especially for the young; and, applying to the labor force more generally, on productivity-based wage differentiation**. While the authorities' program includes a welcome strengthening of transparency and local accountability—and improvements in infrastructure and public services are also needed—the partnership would entail a commitment to improved job training, one-time reductions in social

security contributions, and sizable wage differentials. It would provide a basis for open employment with social protection for a segment that currently is employed, if at all, foremost in the gray economy where no social protection applies. More generally, productivity-based wage differentiation would improve labor market prospects, especially as some area-specific subsidies are phased out.

42. **Building on an impressive privatization program, as well as far-reaching product and financial market liberalization, additional measures in these areas could strengthen competition and efficiency**. Particularly helpful steps would include improving the performance of the remaining public enterprises, further liberalizing the energy sector, reforming the legal framework governing nonlisted companies, and vigorously implementing the legislated simplifications in public administration and licensing procedures. With respect to the financial sector—where banks need to reduce operating costs—continuing well-coordinated supervision remains an evolving task in an increasingly integrated and competitive market.

43. **Italy provides adequate data for surveillance to the Fund** (Appendix II). Still, fiscal data compare unfavorably to most advanced countries; gaps in some economic statistics, notably related to the adoption of EUROSTAT standards, need to be overcome swiftly.

44. **Italy's role in strengthening the HIPC initiative and the increase in its official development assistance are welcome; raising ODA from its still low level (0.2 percent of GNP in 1998) to the UN target is encouraged**. The staff supports the authorities' policy objective of abolishing all EU barriers for exports from the poorest countries.

45. It is proposed that Italy remain on the standard 12-month consultation cycle.

Table 1. Italy: Selected Economic Indicators, 1995–2001

(Percentage changes, except as otherwise indicated)

	1995	1996	1997	1998	1999	2000 1/	2001 1/
Domestic economy							
GDP	2.9	1.1	1.8	1.5	1.4	2.7	2.8
Domestic demand	2.0	0.9	2.5	2.9	2.5	2.5	2.7
Consumption (households)	1.7	1.2	3.0	2.3	1.7	1.8	2.5
Public consumption	-2.1	1.1	0.9	0.7	0.8	0.2	2.7
Gross fixed investment	6.0	3.6	1.2	4.1	4.4	6.4	4.2
Machinery and equipment	10.6	3.7	4.2	7.4	6.2	7.5	6.0
Construction	0.9	3.6	-2.3	-0.1	1.8	4.7	1.5
Inventories (contribution)	0.2	-0.7	0.3	0.6	0.4	0.1	-0.1
Foreign sector (contribution)	1.0	0.2	-0.6	-1.3	-1.0	0.3	0.2
Exports	12.6	0.6	6.5	3.3	-0.4	8.0	6.4
Imports	9.7	-0.3	10.2	9.1	3.4	7.4	6.1
Employment	-0.6	0.5	0.4	1.1	1.3	1.1	0.8
Unemployment	11.6	11.6	11.7	11.8	11.4	11.0	10.4
Manufacturing value added	4.7	-1.3	2.3	1.9	1.2	3.5	2.6
Labor costs	4.7	5.8	4.6	-2.0	2.4	2.5	2.5
Unit labor costs in manufacturing	1.1	6.1	2.2	-1.8	0.9	0.4	0.3
Consumer prices (period average)	5.2	3.9	1.7	1.8	1.7	2.2	1.6
GDP deflator	5.0	5.3	2.4	2.7	1.5	1.9	1.6
Output gap	-1.1	-2.0	-2.3	-2.7	-3.1	-2.5	-1.7
External accounts 2/							
Export volume	13.2	-2.2	5.6	3.9	-1.2	8.0	6.4
Import volume	9.7	-4.3	11.2	11.1	0.4	7.4	6.1
Export unit value	9.3	4.3	-0.3	0.3	-0.4	5.0	1.2
Import unit value	12.3	0.0	0.1	-4.7	3.7	7.1	0.6
Trade balance (in percent of GDP)	3.5	4.4	3.4	3.1	1.8	1.6	1.9
Current account (in percent of GDP)	2.3	3.2	2.8	1.8	0.9	0.8	1.2
Nominal effective exchange rate 3/	-9.8	9.3	0.7	-0.4	-1.8	-3.4	...
Real effective exchange rate 3/	-7.5	11.9	2.8	0.5	-2.0	-3.7	...
Public finances (in percent of GDP)							
General government							
Revenues	45.6	45.8	48.2	46.6	46.9	46.6	46.5
Expenditures	53.2	52.9	50.9	49.4	48.8	48.1	47.6
Balance	-7.6	-7.1	-2.7	-2.8	-1.9	-1.5	-1.0
Primary balance	3.9	4.4	6.7	5.3	4.9	5.1	5.1
Structural primary balance	4.5	5.3	7.9	6.6	6.5	6.3	6.0
Debt	123.2	122.2	119.8	116.3	114.9	110.7	107.2
State sector							
Balance	-7.1	-6.8	-2.6	-2.8	-1.5	-1.0	-0.7
Financial variables							
M3 4/	...	...	...	1.6	3.4	4.3	...
Total domestic credit 5/ 6/	4.3	5.2	3.5	4.4	7.8	6.8	...
Of which: To nonstate sector 5/ 6/	2.4	3.2	5.2	9.2	13.4	12.9	...
Six-month rate on Treasury bills 3/ 7/	10.9	8.6	6.4	5.0	3.0	3.8	...
Prime lending rate 4/ 7/	11.0	11.0	9.2	7.7	5.9	6.3	...

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

1/ Staff estimates and projections, unless otherwise indicated.

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

3/ Data for 2000 refer to first quarter.

4/ Data for 2000 refer to January.

5/ End-of-period; data break in 1998.

6/ Data for 2000 refer to February.

7/ Period average.

Table 2. Italy: The Government's Medium-Term Economic Plan

	1999	2000	2001	2002	2003
	(Percent change, unless otherwise indicated)				
Macroeconomic indicators					
Real GDP	1.4	2.2	2.6	2.8	2.9
Domestic demand	2.5	2.4	2.7	2.9	2.9
Private consumption	1.7	2.2	2.4	2.5	2.5
Public consumption	0.8	0.2	0.2	0.2	0.2
Investment	4.4	5.2	6.0	6.4	6.3
Imports	3.4	5.2	6.0	6.8	6.4
Exports	-0.4	3.8	5.0	6.2	6.2
CPI	1.7	1.2	1.1	1.0	1.0
Interest rates (12-month BOT, end-of-period)	3.0	3.7	4.2	4.7	5.0
Employment	1.3	0.6	0.8	0.8	0.9
Nominal GDP	2.9	3.8	4.2	4.5	4.5
GDP deflator	1.5	1.6	1.5	1.6	1.5
Real interest rate (percent)	1.7	2.5	3.1	3.7	4.0
	(In percent of GDP)				
General government accounts					
Total revenues	46.9	46.2	45.8	45.3	44.9
Total expenditures	48.8	47.7	46.8	45.8	45.0
Primary expenditures	42.0	41.2	40.7	40.1	39.7
Current	38.0	37.2	36.9	36.5	36.2
Capital	3.9	4.0	3.9	3.6	3.6
Interest payments	6.8	6.5	6.1	5.7	5.3
Overall balance	-1.9	-1.5	-1.0	-0.6	-0.1
Primary balance	4.9	5.0	5.1	5.1	5.2
Gross debt	114.7	111.7	108.5	104.3	100.0

Sources: *Documento di Programmazione Economica e Finanziaria*, September 1999 update; Italian Stability Program, December 1999 update; and *ISTAT*.

Table 3. Italy: Adjustment Measures in the 2000 Budget

	In billions of lire	In percent of GDP
Net revenue	**-6,300**	**-0.29**
Sale of real estate assets	4,000	0.18
Tax reductions	-10,300	-0.47
Investment incentives	-1,000	-0.05
Other	-9,300	-0.42
Expenditures	**-8,500**	**-0.39**
Increase in capital expenditures	1,500	0.07
Increase in current expenditures (wage contracts)	1,000	0.05
Cuts in current expenditures	-11,000	-0.50
Public employment	-700	-0.03
Hiring limits	-350	-0.02
Limits to benefits increases	-200	-0.01
Employment cuts in education	-150	-0.01
Internal Stability Pact	-3,300	-0.15
Pensions	-1,700	-0.08
Contributions from electricity company	-1,350	-0.06
Contributions from telephone company	-300	-0.01
Other	-50	0.00
Goods and services	-2,400	-0.11
Postponement of purchases	-1,100	-0.05
Other	-1,300	-0.06
Debt management	-2,500	-0.11
Investment of available liquidity on Treasury account 1/	-1,000	-0.05
Repayment/renegotiation of outstanding loans	-700	-0.03
Early reimbursement of postal deposits	-600	-0.03
Other	-200	-0.01
Other current expenditures	-400	-0.02
Primary balance	**-300**	**-0.01**
Overall balance	**2,200**	**0.10**

Sources: Ministry of the Treasury; Bank of Italy; and Fund staff estimates.

1/ Refers to more efficient management of government's funds currently held in the Treasury account above the legally mandated minimum balance.

Table 4. Italy: Indicators of External and Financial Vulnerability 1/
(In percent of GDP, unless otherwise indicated)

	1995	1996	1997	1998	1999	2000	
						Latest estimate	Date
External Indicators 1/							
Exports (annual percent change, in U.S. dollars)	22.2	7.7	4.6	0.8	-5.4	4.4	
Imports (annual percent change, in U.S. dollars)	20.3	2.1	1.7	4.1	1.0	5.0	
Terms of trade (annual percent change)	-2.7	4.3	-0.4	5.2	-3.9	-2.0	
Current account balance (settlements basis)	2.3	3.2	2.8	1.8	0.9	0.8	
Capital and financial account balance	-0.1	-0.6	-0.3	-1.3	-1.9	...	
Of which: Inward portfolio investment (debt securities etc.)	4.3	6.2	6.4	9.5	9.2	...	
Inward foreign direct investment	0.4	0.3	0.3	0.2	0.4	...	
Other investment liabilities (net)	-1.2	1.3	1.2	0.8	1.2	...	
Official reserves (in U.S. dollars, billions, end-of-period) 2/	38.4	49.3	58.8	34.0	26.2	26.5	Feb.
Broad money to reserves	13.3	11.3	13.3	23.0	29.5	29.1	Feb.
Central Bank foreign liabilities (in U.S. dollars, billions) 2/	2.6	1.2	1.1	1.0	6.3	20.3	Jan.
Foreign assets of the financial sector (in U.S. dollars, billions)	99.0	140.4	133.2	115.0	96.7	...	
Foreign liabilities of the financial sector (in U.S. dollars, billions)	131.3	155.7	150.2	141.6	144.7	...	
Official reserves in months of imports 2/	1.8	2.3	2.7	1.5	1.2	...	
Total external debt	26.6	29.4	34.8	41.0	...	...	
Of which: General government debt	18.6	22.7	27.9	33.9	...	...	
Total external debt to exports (ratio)	1.0	1.1	1.3	1.5	...	...	
External interest payments to exports (in percent)	16.4	16.8	17.9	19.7	17.3	...	
Exchange rate (per U.S. dollars, period average)	1,628.9	1,542.9	1,703.1	1,736.2	1,815.0	...	
Financial Market Indicators							
Public sector debt (Maastricht definition)	123.2	122.2	119.8	116.3	114.9	110.7	
3-month T-bill yield	10.9	8.6	6.4	5.0	3.0	3.6	Mar.
3-month T-bill yield (real)	5.6	4.7	4.7	3.2	1.3	1.1	Mar.
Stock market index	92.1	105.2	161.3	224.0	271.3	337.0	Mar.
Share prices of financial institutions	92.3	92.6	176.4	291.7	298.8	311.1	Apr.
Spread of 3-month T-bills with Germany (percentage points, end-of-period	6.6	3.7	1.4	0.1	0.2	0.1	Mar.
Financial Sector Risk Indicators							
Foreign exchange loans (in billions of U.S. dollars)	74.0	69.9	66.1	66.5	45.0	...	
Share of foreign exchange loans in total lending (percent)	11.1	9.7	9.5	9.2	5.9	...	
Deposits in foreign exchange (in billions of U.S. dollars)	20.3	22.4	24.1	23.5	22.4	...	
Share of foreign deposits in total deposits (percent)	3.5	3.6	4.6	4.6	4.5	...	
Share of real estate sector in private credit	6.9	7.2	7.6	8.4	9.8	...	
Share of nonperforming loans in total loans	9.0	10.0	9.4	9.1	8.5	...	
Share of nonperforming loans in total assets	5.1	4.0	4.0	4.3	3.6	...	
Risk-based capital asset ratio	12.7	13.0	12.7	13.5	13.3	...	

Sources: Bank of Italy, *Economic Bulletin* and *Statistical Bulletin*; data provided by the authorities; and IMF, *International Financial Statistics*.

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

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

Table 5. Italy: Comparison of Medium-Term Fiscal Scenarios 1/

(In percent of GDP, except where otherwise indicated)

	1999	2000		2001	2002	2003	2010
	Est.	Original Proj.	Latest Proj.				
Staff (normative scenario for Italy)							
Revenue	46.9	n.a.	46.6	45.8	45.3	44.9	...
Expenditure							
Primary	42.0	n.a.	41.5	40.4	39.5	39.0	...
Total	48.8	n.a.	48.1	46.6	45.4	44.6	...
General government balance	-1.9	n.a.	-1.5	-0.8	-0.2	0.4	2.5
Primary balance	4.9	n.a.	5.1	5.4	5.7	5.9	6.3
Structural primary balance	6.5	n.a.	6.3	6.3	6.3	6.3	6.3
Gross debt	114.9	n.a.	110.7	106.8	102.6	98.2	63.8
12-month T-bill (end-of-period)	3.2	n.a.	4.3	5.1	5.5	5.8	...
Real GDP (annual growth rate)	1.4	n.a.	2.7	2.8	2.6	2.4	...
Output gap (percent of potential GDP)	3.1	n.a.	2.5	1.7	1.1	0.7	...
Government program							
Revenue	46.9	46.2	46.6	45.8	45.3	44.9	...
Expenditure							
Primary	42.0	41.2	41.5	40.7	40.1	39.7	...
Total	48.8	47.7	48.1	46.8	45.8	45.0	...
General government balance	-1.9	-1.5	-1.5	-1.0	-0.6	-0.1	...
Primary balance	4.9	5.0	5.1	5.1	5.1	5.2	...
Structural primary balance 2/	6.5	6.5	6.4	6.2	5.9	5.6	...
Gross debt	114.9	111.7	111.7	108.5	104.3	100.0	...
12-month T-bill (end-of-period)	3.2	4.5	3.7	4.2	4.7	5.0	...
Real GDP	1.4	2.2	2.5	2.6	2.8	2.9	...
Output gap (percent of potential GDP) 3/	3.1	2.9	2.6	2.3	1.6	0.7	...
Other euro area countries							
Revenue	47.2	n.a.	46.7	45.9	45.7	45.3	...
Expenditure							
Primary	44.6	n.a.	44.0	43.3	42.8	42.2	...
Total	48.4	n.a.	47.7	46.9	46.2	45.5	...
General government balance	-1.3	n.a.	-1.0	-1.0	-0.6	-0.2	...
Primary balance	2.6	n.a.	2.7	2.6	2.9	3.1	...
Structural primary balance	3.4	n.a.	3.0	2.5	2.7	2.9	...
Gross debt	63.1	n.a.	62.7	61.5	60.0	58.8	...

Sources: National authorities' most recent Stability Programs; and Fund staff projections.

1/ Macroeconomic assumptions differ across scenarios.

2/ Fund staff estimate. Based on staff's assumptions for potential output and cyclical sensitivity and authorities' assumptions for real GDP growth.

3/ Based on staff's assumptions for potential output and authorities' assumptions for real GDP growth.

ITALY: FUND RELATIONS

(As of March 31, 2000)

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

II **General Resources Account**:	SDR Million	Percent Quota
Quota	7,055.50	100.0
Fund holdings of currency	4,558.11	64.6
Reserve position in Fund	2,497.39	35.4
Operational budget transfers (net)	-92.00	

III. **SDR Department**:	SDR Million	Percent Allocation
Net cumulative allocation	702.40	100.0
Holdings	155.60	22.2
Designation Plan	19.00	

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

V. **Financial Arrangements**: None

VI. **Projected Obligations to Fund** (SDR Million; based on existing use of resources and present holdings of SDRs): None

VII. **Exchange Rate Arrangement**:

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

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

VIII. **Article IV Consultations**:

Italy is on the standard 12-month consultation cycle. The previous consultation discussions took place during March 1999, and the staff report (SM/99/110, 5/14/99) was discussed on June 3, 1999 (EBM/99/58).

ITALY: STATISTICAL INFORMATION

Italy's economic database is comprehensive and of generally high quality. Italy is subject to the statistical requirements and timeliness and reporting standards of the Eurostat and the European Central Bank (ECB). Economic data are provided to the Fund in a comprehensive manner (see attached table) and Italy has cooperated fully with the Fund in providing monetary, international reserves, and selected other financial statistics related to its membership in the European Economic and Monetary Union (EMU). These data are considered comprehensive, reliable, timely, and well documented.

Italy has subscribed to the Special Data Dissemination Standard (SDDS) and has posted the metadata for the Bulletin Board. In April 2000, Italy became the seventeenth country to be in full observance of the SDDS and has begun enhanced disclosure of international reserves data based on the format of the SDDS International Reserves Template approved by the IMF's Executive Board on March 23, 1999.

Despite some improvements, transparency of fiscal data still compares unfavorably to most advanced economies and more timely data on general government operations would help surveillance.

Italy: Core Statistical Indicators

(As of end-April 2000)

	Exchange Rates	International Reserves	Central Bank Balance Sheet	Reserve/ Base Money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Government Balance 1/	GDP/ GNP
Date of Latest Observation	4/28/00	3/00	2/00	2/00	2/00	4/28/00	3/00	2/00	2/00	2/00	1999 Q4
Date Received	4/28/00	mid-April	mid-April	mid-April	mid-April	4/28/00	4/18/00	4/21/00	end-April	begin-April	3/1/00
Frequency of Data	Daily	Monthly	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Monthly	Monthly	Quarterly
Frequency of Reporting	Daily	Monthly	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Monthly	Monthly	Quarterly
Source of Update	Reuters, Bloomberg	BoI, IFS	BoI	BoI, IFS	BoI	Reuters, Bloomberg	ISTAT Press Release	ISTAT Press Release	BoI	UIC	ISTAT Press Release
Mode of Reporting	Electronic	Cable	Internet, Publication	Internet, Publication	Internet, Publication	Electronic	Electronic	Electronic	Publication	Internet, Publication	Electronic
Confiden-tiality	None	Until data off. released	None	None	None	None	None	None	None	None	None
Frequency of Publication	Daily	Monthly	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Monthly	Monthly	Quarterly

1/ Central government on a cash basis. Overall government accounts are published once a year in February/March; the latest figure is for 1999 and was published March 1, 2000.

2/ Non-EU trade data were available through March 2000.

INTERNATIONAL MONETARY FUND

Public Information Notice

EXTERNAL RELATIONS DEPARTMENT

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

IMF Concludes Article IV Consultation with Italy

On June 5, 2000, the Executive Board concluded the Article IV consultation with Italy.[1]

Background

Following a decade of slow growth, the Italian economy entered a phase of cyclical upswing since mid-1999, which, however, remains weaker than elsewhere in the euro area. Exports, which had been strongly affected by direct and third-market effects of the Asian crisis, rebounded markedly after mid-1999, helped by a recovery of world demand and the depreciation of the euro; investment has accelerated, including in construction; but household consumption remains relatively subdued. Employment growth held up relatively well for the second year in a row in 1999, mainly reflecting the impact of the 1997 liberalization of temporary and part-time work contracts. On the other hand, higher participation left the unemployment rate above 11 percent, the second highest in the euro area, and large regional disparities continued, with the unemployment rate in the South well above 20 percent. Inflation accelerated to 2.5 percent in the spring of 2000, as oil prices rose and the euro depreciated. The differential vis-à-vis the euro area for underlying inflation has stayed at around ¾–1 percentage point, in part due to higher aggregate unit labor cost growth and relatively slower liberalization of some product markets. This has implied a moderate loss of competitiveness relative to the euro area, but on a multilateral basis the euro's depreciation has maintained price and cost competitiveness at a very favorable level.

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

Substantial progress was made in consolidating the public finances in 1999. Notwithstanding lower-than-expected GDP growth, the general government deficit was limited to 1.9 percent of GDP, well below the 2.4 percent ceiling set in March 1999. This favorable trend reflected a lower interest bill, as well as improvements in tax administration and robust growth in labor income—resulting in higher tax and nontax revenues, which more than compensated for primary expenditure slippages, including on health care. Gross government debt declined to 114.9 percent of GDP from 116.3 percent in 1998, helped also by privatization proceeds. The 2000 budget targets a further reduction of the general government deficit to 1.5 percent of GDP, in line with the *Stability Program's* goal of achieving approximate balance by 2003. The budget includes various measures to limit expenditure, and tax cuts equivalent to the estimated 1999 structural revenue overperformance (close to ½ percent of GDP).

With monetary conditions expected to remain supportive of activity and a broadly neutral fiscal stance, the cyclical upswing is likely to continue over the next two years: strong growth in exports and investment and a gradual recovery in consumption would support GDP growth of around 2¾ percent, versus 1.4 percent in 1999. The risks to this short-term projection seem broadly balanced: upside risks relate mainly to stronger growth in partner countries and in employment; on the downside, domestic demand and exports could suffer from stronger-than-anticipated effects of the oil price increase or a disorderly adjustment in the euro exchange rate and in equity prices. The outlook for the medium term is more uncertain: the economy's growth potential will depend crucially on the direction and pace of structural reforms, discussed below.

Executive Board Assessment

Executive Directors commended the authorities for pursuing stability-oriented policies that had achieved a remarkable reduction of the fiscal deficit and a sharp decline in inflation, and for initiating far-reaching structural reforms, including privatization. At the same time, Directors indicated that there was no room for complacency. With the exigencies of short-term stabilization largely behind it, Italy could now focus on longer-term structural issues: mitigating the fiscal impact of population aging; reducing the tax burden; and improving labor and product market performance. Progress in these areas was seen as essential for achieving sustained and regionally balanced growth and, more generally, was considered beneficial for the euro region as a whole.

Directors considered the near-term economic outlook to be favorable. They viewed monetary conditions as remaining supportive, and external competitiveness as broadly satisfactory; in this context, real growth should be above potential in the near term (although it would remain weaker than elsewhere in the euro area), while inflation was expected to abate as the effects of higher oil prices diminished. However, Directors saw risks to competitiveness if the euro were to appreciate sharply. Noting that the growth rebound in the recent period owed much to a good export performance, they considered that broader-based growth would depend crucially on continued wage moderation together with a firm pursuit of structural reforms, in particular far-reaching liberalization of labor and product markets and carrying through of the planned privatization programs.

With respect to fiscal policy, Directors welcomed that, despite weaker-than-expected real growth, the 1999 budget deficit was kept well below its limit. They noted, however, that this had been partly the result of revenue overperformance. For 2000, Directors viewed the deficit target of 1.5 percent of GDP as well within reach and broadly appropriate, from both a cyclical and longer-term perspective. Several Directors stressed that, in 2000, any windfall revenues should be dedicated to deficit reduction. Beyond 2000, Directors urged the adoption of a fiscal strategy that would decisively reduce Italy's still-high debt ratio, and also avoid the need for an increase in tax rates around the demographic peak. They thought that such a strategy would call for somewhat more ambitious targets than indicated in Italy's Stability Program, notably by allocating the benefits from above-potential growth and interest savings to deficit reduction, thus maintaining the primary surplus on average over the cycle at about the level expected for 2000 (a structural primary surplus somewhat above 6 percent of GDP). This would achieve a significant overall budget surplus by the end of the decade. A few Directors, however, thought that keeping the overall budget in balance over the cycle would be sufficiently ambitious for ensuring debt sustainability, while creating room for deeper, earlier tax cuts and for additional well-targeted social expenditure.

Directors emphasized that the twin objectives of reducing both the deficit and the tax burden require firmly limiting the growth of public expenditure. In this regard, scope was seen for further cuts in public employment, taking advantage of new technologies and of the room for increased mobility within the public sector offered by recent civil service reforms, and for trimming subsidies, notably those related to the postal service and railways. On social spending, Directors noted the major progress achieved in recent years, but stressed the need for further steps to limit the budgetary impact of population aging and to rebalance spending from pensions towards programs that support labor market integration and the poor. Further pension reform could include a faster increase in the effective retirement age and an acceleration of the transition to a contribution-based system. On health care, Directors expected decentralization to improve transparency, but its success in controlling costs depended on further steps: strengthening the regions' administrative capacity and incentives to comply with the Internal Stability Pact, and introducing mechanisms to rationalize health expenditure. Noting that the main risks to the achievement of the fiscal target lie at sub-national levels, Directors welcomed the authorities' intention to prevent excessive regional budget deficits arising from decentralization. Directors welcomed the planned introduction of a comprehensive unemployment insurance system, but cautioned that attention should be paid to ensuring strong incentives to seek training and employment—a challenge that also applied to the welfare program targeted at the poor.

On tax policy, Directors urged the authorities to focus as a key priority on reducing the tax wedge on labor, thereby lowering unemployment and raising participation. They took the view that further gains from improved tax administration and a broader tax base should be allocated to reducing tax rates. Several Directors expressed reservations about the frequent recourse to ad-hoc tax incentives.

Directors noted the disappointing persistence of very large regional imbalances. In this connection, they discussed the interlinkages between labor mobility, wage differentials, and

job training—elements that must be considered in the reform of labor markets. Directors welcomed the improved transparency and local accountability embedded in the authorities' new development initiatives, but stressed that success will depend on injecting broad, productivity-based wage differentiation. They urged the adoption of a comprehensive strategy, especially for the young, entailing improved job training, one-time reductions in social security contributions, and derogations from national minimum wages well beyond those under the existing apprenticeship schemes. More generally, Directors underscored the importance of improving economic performance in all regions as crucial for achieving a substantial increase in Italy's long-run growth.

Directors welcomed the progress in strengthening bank balance sheets, which had resulted in a decline in the share of nonperforming loans. They underlined the importance of reducing operating costs. In addition, as the distinction between bank and nonbank financial activities was becoming increasingly blurred, Directors stressed the continuing importance of well-coordinated supervision.

Directors welcomed Italy's role in strengthening the Initiative for Heavily Indebted Poor Countries (HIPC). They encouraged raising official development assistance toward the UN target.

Italy provides adequate data for surveillance purposes. However, fiscal data in particular compare unfavorably to most advanced economies. Directors encouraged the authorities to take the necessary corrective steps.

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

Italy: Selected Economic Indicators

	1997	1998	1999	2000 1/
Real economy (change in percent)				
GDP	1.8	1.5	1.4	2.7
Domestic demand	2.5	2.9	2.5	2.5
Harmonized CPI	1.7	1.8	1.7	2.2
Unemployment rate (in percent) 2/	11.7	11.8	11.4	11.0
Gross national saving (in percent of GDP)	21.2	20.8	21.2	22.0
Gross domestic investment (in percent of GDP)				
Public finances (general government; in percent of GDP)				
Overall balance	-2.7	-2.8	-1.9	-1.5
Primary balance	6.7	5.3	4.9	5.1
Gross debt	119.8	116.3	114.9	110.7
Money and credit (end of year, percent change)				
Money (M2)	7.8	2.9	4.8	...
Harmonized M3		1.6	2.2	...
Total domestic credit	3.5	4.4	6.5	...
Interest rates (year average)				
Three-month rate on treasury bills	6.6	4.8	3.0	...
Government bond rate, ten-year	6.9	4.9	4.7	...
Balance of payments (in percent of GDP)				
Trade balance	3.4	3.1	1.8	1.6
Current account	2.8	1.8	0.9	0.8
Fund position (as of March 2000)				
Holdings of currency (in percent of quota)		64.6		
Holdings of SDRs (in percent of allocation)		21.5		
Quota (in millions of SDRs)		7,055.5		
Exchange rate				
Exchange rate regime		EMU member		
Present rate (April 24, 2000)		US$0.928 per euro		
Nominal effective exchange rate 3/	0.7	-0.4	-1.8	-3.4
Real effective exchange rate based on unit labor cost 3/	2.8	0.5	-2.0	-3.7

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

1/ Fund staff estimates and projections.

2/ Excluding workers in the Wage Supplementation Fund.

3/ For 2000, year-on-year change for first quarter.

Statement by Riccardo Faini, Executive Director
for Italy
June 5, 2000

1. I am very grateful to the staff for the work done on this consultation. Their analysis is insightful, their opinions are well balanced, and their recommendations are very constructive. There are no major areas of disagreement between the staff and my authorities and I think that the report gives fair credit to the Italian authorities' continuing efforts to maintain prudent macroeconomic policies and carry through with the structural transformation of the economy. Italy's major challenges lie in the domain of structural reform, especially in the reduction of the rigidities in product and factor markets. Yet, it is worth emphasizing once more that these challenges are not unique to the Italian economy, but common, albeit to different degrees, to most EU countries.

The business cycle and fiscal policy in the short and medium- term

2. In 1999 Italy's economic growth was below expectations. More than other EU countries, our economy sustained the negative effects of the crises in Asia and Eastern Europe, two regions where it is a major exporter. As the recovery is now fully in place, real GDP growth is generally projected at 2.7-2.8 percent in 2000-2001 (the latest OECD projections are more optimistic, placing growth at 2.9-3.1 percent). It is noteworthy that last year we were puzzled by the observation that the interest rate reduction due to EMU convergence had not yet exerted its positive effect on economic activity. This does not seem to be the case any longer, considering the surge in fixed investment (4.4 percent in 1999), which is expected to remain the most dynamic component of domestic demand.

3. Inflation has more or less followed the general pattern of inflation in the euro area. While this is true irrespective of the specific price index that is considered, one can look at underlying inflation to see that the differential vis-à-vis the euro area has remained fairly stable around 1 percent. We agree with staff that the inflation differential reflects both lower productivity growth and a faster rise of non-traded goods prices. Concerning the first factor, the ongoing economic upswing is likely to be accompanied by a rise in productivity and a fall in unit labor cost. Moreover, the increases in wage earnings over the period 2000-2001 are expected to be in line with, or somewhat lower than, those in other major EU economies. Regarding the second factor, we would highlight that in recent years, albeit perhaps somewhat later than in other EU countries, major reforms have been undertaken to strengthen competition in product markets, especially in the service sector and, most notably, in telecommunications and energy. We are confident that these reforms should contribute to increased convergence of the price of services to that in the rest of the euro area.

4. The fiscal consolidation process has advanced significantly in 1999, with the general government deficit declining to 1.9 percent of GDP (2.8 percent in 1998). This much-better-than-expected outcome, achieved notwithstanding the considerable economic slowdown, reflects a reduction in interest expenditure and higher revenues. Primary expenditures have been only marginally higher than budgeted (by 0.1 percent of GDP). The debt-to-GDP ratio

has declined further, thanks to much-larger-than-budgeted revenues from privatization. The present government is fully committed to continue the fiscal consolidation process in line with the Stability Program. While we will have to wait until the end of June to have the *Documento di programmazione economico-finanziaria* (DPEF), the document that lays down the government's fiscal strategy for the period 2001-2004, the objective remains to gradually achieve broad balance by 2003. This involves a slight increase of the primary surplus, which will rise above 5 percent of GDP. For the year 2000, the structural primary deficit would be broadly unchanged at 6.25 percent. The budgetary outcome could be even stronger if growth turns out to be better than expected. As for last year, improvements in tax administration will be used to further reduce the tax burden, a goal whose crucial role is highlighted in a background paper by the staff themselves. We expect this strategy to help reduce the debt-to-GDP ratio through its positive effect on economic growth. Finally, for 2001, the Italian government is committed to reducing the budget deficit below the level that should provide a fully adequate cushion to meet the Maastricht ceiling even in the event of a major cyclical downturn.

Long run fiscal sustainability

5. Italy's unfavorable demographics and the still high burden of public debt pose important challenges for policymaking. The Italian government is fully aware of such challenges and is already committed to a number of structural expenditure reforms. In the health field, in particular, Italian authorities have launched a reform program based on the fiscal devolution process (see below, par. 11-12). The reform aims at building a more decentralized and accountable system, at increasing effectiveness through lower costs, and at ensuring a high level of health services throughout the country. Concerning the pension system, social parties are expected to undertake a comprehensive review of the Dini reform as early as next year. Past reforms since the early nineties have already had a major impact on social spending. An additional area where Italian authorities have taken a headstart is the reform of the public administration. Ongoing reforms have already succeeded in achieving a significant contraction of both public employment, which has declined by 4.9 percent since 1992, and the public wage bill. Additional reforms aim at improving the effectiveness of the public administration sector. The payoff of many of these reforms is already visible. Public employment has decreased by more than 4 percent since 1992 and health spending is now significantly lower in Italy than in the rest of Europe. Similarly, as noticed by staff, without the Amato and the Dini reforms, pension outlays would have increased by more than four percentage points of Italy's GDP. Staff advocates further spending restraint. Their simulations (Box 3 of the Staff Report) show that, in the absence of further reforms, pensions and other age-related spending will start again to rise markedly as a share of GDP. This issue was treated at length in the previous consultation. At this stage, I would only observe that the staff baseline scenario simulation does not differ in any significant way from that of the Italian Treasury until at least 2010. Moreover, longer-run simulations are subject to considerable margins of uncertainty as they crucially depend on assumptions about labor market conditions (staff simulations are based on the assumption that unemployment would not fall below 9 percent even in 2045) and productivity and demographic variables, none of which can be predicted with any confidence. Still, it cannot be excluded that further spending reforms could be necessary to cope with the rise of age-related expenditures. The Italian

government is determined to take additional measures, if necessary, while pressing ahead with ongoing reforms.

Privatization and regulatory reforms

6. The amount raised for privatization in 1999 (€ 19 billion) is the second largest since the program started in the early '90s. OECD data show that the Italian privatization program has been one of the largest among the industrial countries. A by-product of this program was the increase in the market capitalization of the Italian stock exchange, which reached 73 percent of GDP in March 2000. International investors are increasingly accessing the Italian equity market: in the offer of the electricity company ENEL in October 1999, foreign investors accounted for almost 60 percent of the placement. The government is now working on broadening the scope of privatization by including sales of real estate assets and promoting the participation of private investors to the realization of infrastructure projects. Finally, with the recent divestment of "Mediocredito centrale" the privatization process in the banking sector can be said to be virtually completed.

7. The privatization process is being accompanied by the definition of a set of regulatory measures in the electricity, gas, transportation and telecommunications sectors designed to foster competition. It is probably too early to assess their effectiveness. Access to the electricity market will be liberalized and ENEL will be forced to divest a large share of its production capacity. The process should lead to lower electricity prices, which have already fallen by 5 percent over the last year and are expected to drop an additional 20 percent in the period 2000-2003. In the telecommunications sector, the fixed communications market is open to competition as of January 1, 2000, joining the previously liberalized mobile market. The ongoing process has resulted in a broader range of services and lower tariffs. The latter dropped by 14 percent during the period 1996-1999. Further regulatory and restructuring efforts are being implemented in the postal service, in the railway sector, and the system of air transportation. Last, but not least, the reform of the gas sector became effective on May 17, 2000.

Growth in the long run and the regional dimension

8. Staff analysis on the growth slowdown in Italy is competently and professionally done. It provides a valuable contribution to a burgeoning literature both in policy-making and academic circles. The issue was already dealt with, though in a somewhat more cursory way, in the previous consultation report. Staff shows that Italy has grown at a significantly slower rate than a number of comparator countries (France, Netherlands, and the UK). According to staff, high taxes on labor are mostly to blame for this poor growth performance. This emphasis is probably well placed and is consistent with the authorities view that a reduction in tax rates should be a paramount objective of fiscal policy (par. 4). Indeed, a high tax burden especially on labor is likely to partly account both for the unsatisfactory employment performance of the Italian economy and for the slowdown in growth. However, we should not overlook the role of other key factors. First, allowing for the substantive differences in (working-age) population growth reduces the 1996-99 growth differential between Italy and two of the comparators - France and Netherlands - from 0.8 and 2.0 percent respectively to

0.3 and 1.5 percent. Adding the impact of more restrictive macroeconomic policies further reduces the growth gap to –0.5 and 0.5 percent. Clearly, none of these factors taken individually provides a compelling explanation. Taken together, however, they go a long way in explaining the so-called growth puzzle of Italy. Finally, the growth differential all but disappears when we focus on Northern Italy, and allow for the fact that growth in that region was significantly higher than in Southern Italy. All in all, as I said in my BUFF last year – but I will not reiterate the arguments here – we remain skeptical on the existence of a long-run growth puzzle for Italy. This is not to say that growth performance has been satisfactory. The staff view that high taxes and the labor market, particularly in the South, are key factors, if not the only ones, in explaining such performance (Box. 2) is nonetheless consistent with our interpretation and with the policy agenda of Italian authorities. In fact an unpalatable feature of the Italian wage-setting mechanism is that trade unions tend to set a uniform minimum wage across all regions, independently of labor productivity differentials and more generally of local labor market conditions. There is compelling evidence that the Southern unemployment rate does not have any effect on the behavior of wages either at the national or at the local level. Existing wage setting mechanisms have provided some wage differentiation across regions, but they still fall short of what is required to make a dent in unemployment differentials. Therefore I cannot but agree with the staff that further wage differentiation would be an essential element to improve the growth dynamics and the labor market conditions. That is why the regional development policy pursued by the Italian authorities in recent years has put at the forefront the need to create more flexible labor market conditions in the South (through the *contratti d'area* and the *patti territoriali*).

9. Though necessary, an increased flexibility in the labor market would not be sufficient to eliminate the huge unemployment differential because other differences, mainly in human capital and public infrastructures, remain. Recognizing this, a comprehensive approach, based on improving public involvement on the one hand, while assuring non-distorted competitive conditions on the other, has been envisaged: the new medium-term development program for the South (under the EU support framework) is pivotal for the entire government reform program. In this field, the "partnership for skills" staff suggestion is stimulating and could contribute to cementing consensus among social partners, which would be a key ingredient for a renewed pact for development.

10. Reforms in the labor market play a paramount role in the policy agenda of Italian authorities. The benefits of some of these reforms are already manifest. Between 1997 and 1999 employment has been increasing at an average annual rate of 1.2 percent. Most of the employment growth is in turn accounted for by part-time and temporary workers, whose contracts were liberalized in 1997. The policy emphasis will now be on the reform of the unemployment benefit system, which is saddled by several distortions (for instance, collective dismissals receive far greater benefits than individual dismissals) and until now has covered only a limited segment of the workforce (according to Eurostat, only 20 percent of Italian job leavers rely on some form of unemployment benefits). Without such measures, the consensus for changing the employment protection legislation with a view to reducing both firing and hiring costs would not materialize. Workers must be protected against the hazard of unemployment: the thrust of the reform is to shift this protection from the workplace to the market.

Fiscal devolution

11. Since 1992, Italy has embarked on an ambitious process of fiscal devolution, under the influence both of reasons of economic efficiency and of the political thrust in favor of regionalism, common to many European countries. Fiscal devolution aims at improving the correspondence between the preferences of local users and the provision of local services. Under the plan envisaged by the authorities, Italian regions will enjoy significant fiscal autonomy even in the medium term. In the context of this process the authorities have recently taken important steps to substitute regional transfers from the central administration with the regional tax on productive activities (IRAP), the sharing of the VAT and gasoline tax revenues, and the income tax surcharge. On the expenditure side, further spending items are being transferred from the central to the local administrations. Lastly, the authorities have committed to eliminate, as of 2004, the constraint on the earmarking of regional financial resources, which are currently mainly destined to health services. Health expenditures make up by far the largest part of regional budgets.

12. Fiscal devolution of this scale poses serious challenges. First, the authorities have established the Internal Stability Pact to prevent excessive regional budget deficits arising from the decentralisation of expenditure decisions and to ensure compatibility with the national limits set at the European level by the Stability and Growth Pact. It might be necessary to reinforce its system of penalties for excessive regional deficits to eliminate incentives to free-riding at the sub-national level, which would have unacceptable consequences for the central budget. Second, the national equalization fund has been designed to ensure the correction of financial imbalances among regions arising from largely different tax bases. The complex and innovative equalization mechanism represented by the fund has been the result of an intense theoretical debate, drawing also on the historical experience of other countries with a federal organization. Third, the envisaged full decisional autonomy of regions in this field will have to be consistent with the national health objectives, such as the provision of essential health services. Fourth, as staff notes, the reform requires strong institutional capability at the regional level, which the Italian authorities are committed to improve. The streamlining and modernization of the public administration in general is one of the key objectives of the Bassanini reform.

Conclusions.

13. The pursuit of sound macroeconomic policies and of an ambitious structural reform are beginning to bear fruit. The Italian economy is now poised for a recovery. Pressing ahead with the unfinished reform agenda while maintaining a stable macroeconomic environment are essential steps to ensure that the ongoing recovery will be sustained over the medium and the long run.