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Italy: 2003 Article IV Consultation—Staff Report; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Italy

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2003 Article IV consultation with Italy, the following documents have been released and are included in this package:

- the staff report for the 2003 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **July 22, 2003,** with the officials of Italy on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on October 23, 2003.** The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its November 7, 2003 discussion** of the staff report that concluded the Article IV consultation.

- a statement by the Executive Director for Italy.

The documents listed below will be separately released.

Selected Issues Paper
Report on the Observance of Standards and Codes—Fiscal Transparency Module Update

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

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ITALY

Staff Report for the 2003 Article IV Consultation

Prepared by the Staff Representatives for the 2003 Consultation with Italy

Approved by Michael Hadjimichael and Michael Deppler

October 23, 2003

- The Article IV discussions were held during July 8–23 and October 7–8, 2003. The staff—Messrs. Cottarelli (head), Krueger, Kent, Milesi-Ferretti, Vamvakidis and Ms. Zanforlin (all EU1)—met with the Ministers of Economy and Finance, Health, and Productive Activities; the Governor of the Bank of Italy; and other officials and representatives of regulatory agencies, financial markets, research institutions, and labor and business organizations. Mr. Padoan, Executive Director, attended most of the meetings.

- A coalition government is in power since June 2001 and enjoys a large parliamentary majority. Italy holds the EU Presidency during the second half of 2003.

- Italy has accepted the obligations of Article VIII, Sections 2, 3, and 4, and maintains an exchange system free of restrictions, except for exchange restrictions imposed and maintained by Italy solely for the preservation of national or international security (Appendix I).

- For Directors' considerations at the conclusion of the latest Article IV consultation on October 25, 2002, see http://www.imf.org/external/np/sec/pn/2002/pn02120.htm.

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Executive Summary

Background

Economic activity stagnated in the first half of 2003, but recent indicators point to a gradual recovery. Staff projects GDP growth of 0.4 percent in 2003 and 1.7 percent in 2004 (slightly below the authorities' projections). However, important risks persist, including a delayed recovery in investment, a slower-than-projected recovery in Europe, and a further euro appreciation. Notwithstanding the economic slowdown, the **unemployment** rate has fallen below 9 percent—reflecting key labor market reforms since the mid-1990s. **Inflation** remains above the euro-area average, and competitiveness losses contributed to declining market shares

Policy discussions

The staff and authorities broadly agreed that supply-side weaknesses were at the heart of Italy's growth malaise over the past decade, when GDP growth was among the lowest for advanced economies. Policies to address these weaknesses were closely linked to fiscal consolidation and reform, and these issues were at the center of the policy discussions. There was agreement on the general direction of reforms, but staff argued for a faster pace.

- ***Fiscal consolidation***: Ensuring fiscal solvency and downsizing the public sector require expenditure-based adjustment, including further reforms of aging-related spending. Instead, the record of recent years points to an inability to reduce the primary spending-to-GDP ratio (relying instead on large one-off measures—tax amnesties and asset sales—and on falling interest payments to satisfy the Stability and Growth Pact's strictures). Staff recommends (i) reducing the structural deficit by at least ½ percent of GDP until a small surplus is reached, while rapidly phasing out one-off measures; and (ii) introducing further reforms to slow the growth of aging-related spending (mainly by raising the effective retirement age). The authorities have opted for slower progress on the first point in 2004. Important progress is, however, underway on the second point, with the government proposing steps to raise the effective retirement age.

- ***Policies to strengthen growth***: Staff argued for additional spending cuts in 2004 to allow for growth-enhancing **durable reductions in the tax burden**, but these, while remaining on the government's agenda, were not included in the 2004 budget. Progress in liberalizing the **labor market** has continued, and staff sees room for extending these gains, especially in the South, through increased wage differentiation. On **other policies to strengthen growth,** discussions focused on steps to address insufficient competition in some sectors; weak public infrastructure; low R&D spending; and regional disparities. Progress in these areas could also help strengthen Italy's export performance, following extensive losses in market shares in recent years. The **financial sector** has proven relatively resilient during the present slowdown, but staff agreed with the Bank of Italy on the need to strengthen bank profitability further.

I. Key Issues

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

- *Securing strong, durable economic growth.* Over the past decade, GDP growth has remained one of the weakest among industrial countries, even adjusting for lower population growth. Boosting growth requires steps to raise Italy's low employment rate and stagnating productivity.

Real GDP and Real GDP Per Capita
(Annual average, in percent)

	1992-2002 Actual	2003 Estimated Potential
Real GDP		
Italy	1.5	1.7
Euro area w/o Italy	2.0	2.1
G7 w/o Italy	2.5	2.5
Real GDP per capita		
Italy	1.3	
Euro area w/o Italy	1.6	
G7 w/o Italy	1.7	

Source: IMF, *World Economic Outlook*.

- *Completing the fiscal consolidation and reform process initiated in the early 1990s.* The highest public debt-to-GDP ratio in the EU, substantial aging-related spending pressures, and a high tax burden underscore the need for adjustment.

2. **The Fund has seen these challenges as closely related.** Strong, durable growth requires, in addition to labor and product market reforms, fiscal reforms to enhance the incentives to work and invest—essentially by lowering tax rates—and to place the public finances on a sounder footing, so as to dispel the risk that tax rates will have to be raised. All this calls for cutting primary fiscal spending, while protecting investment outlays, greatly compressed in the 1990s.

3. **While progress was made in carrying forward the agenda recommended by the Fund, much remains to be done.** In recent years, a relaxation of constraints on temporary and part-time jobs, a reform of job placement services, and steps to increase competition in some sectors have improved the working of labor and product markets. But considerable distortions remain. And in the fiscal area reforms have stalled. The monetary union dividend (the sizable fall in interest rates and payments) did allow some cuts in tax rates and some decline in the cyclically-adjusted (or structural) fiscal deficit ratio. But the latter (net of substantial one-off measures) has remained above its 1999 level, and primary spending has risen as a share of GDP. Moreover, after major reforms earlier in the 1990s, steps to moderate aging-related spending stalled until recently, with new proposals about to be submitted to parliament.

II. Report on the Discussions

A. The Roots of Low Growth

4. **Economic growth—sluggish over the past decade—weakened further with the euro-area slowdown in 2002, and the economy stagnated in the first half of 2003**. GDP growth declined to ½ percent in 2002, once again below the euro-area average (text table, Table 1, and Figure 1). In contrast with the euro area, the net contribution of the external

sector was sharply negative. While weakness in export markets (especially in Germany) contributed, Italy also lost market shares, in the context of a further erosion of competitiveness (Figures 2–3).

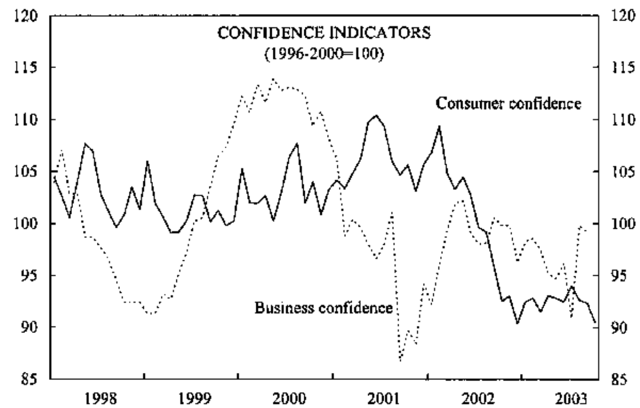
Selected Economic Indicators, 2002-04
(Real growth rates, in percent, unless otherwise noted)

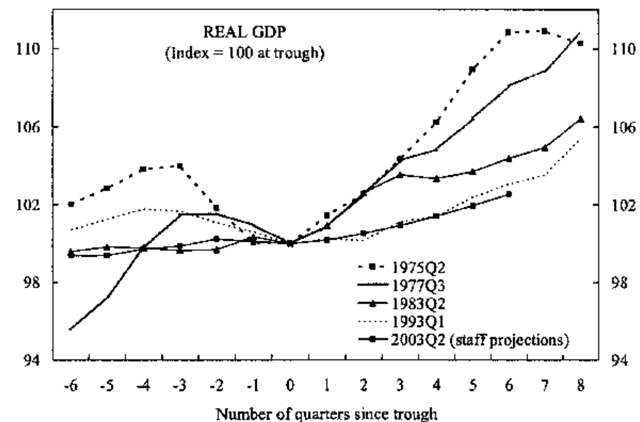
	Italy	Euro area	Italy	Euro area	Italy	Euro area
	2002		2003		2004	
GDP						
Annual average	0.4	0.8	0.4	0.5	1.7	1.9
Fourth quarter (y-o-y)	0.9	1.2	0.3	0.6	2.0	2.1
Output gap 1/	-1.0	-0.6	-2.3	-2.1	-2.3	-2.3
Total domestic demand	1.1	0.4	1.6	1.0	1.9	2.0
Employment	1.5	0.6	0.8	0.0	0.6	0.5
CPI (percentage change)	2.6	2.3	2.8	2.1	2.1	1.6

Sources: ISTAT; IMF, WEO (September 2003) for euro-area data; and Fund staff estimates and projections.
1/ In percent of potential GDP.

Domestic demand proved instead fairly resilient to adverse equity and oil price movements, partly reflecting the temporary incentives for investment and car purchases. As these incentives expired at end-2002, GDP declined by a cumulative 0.2 percent in the first half of 2003.

5. **Staff and authorities project a gradual recovery during the remainder of 2003 and for 2004, but concrete signs of an upswing are still few**. The 2004 budget projects GDP growth at 0.5 percent in 2003 and 1.9 percent in 2004, slightly above staff projections (0.4 percent and 1.7 percent, respectively). There was agreement that this pick up would be spurred by both domestic and external factors: conditions for a recovery in private consumption were in place, with employment rising and increases in disposable income driven by higher wages, declining inflation, and tax cuts for low-income families in 2003. Moreover, monetary and credit conditions remained supportive. More recently, a brighter external outlook was also encouraging. Finally, while balance sheets had been weakened by the cycle (Table 5), the deterioration was less worrisome than elsewhere, owing to structurally lower private sector debt ratios. Nevertheless, with expectations of a recovery having repeatedly failed to materialize over the last 18 months, only tentative signs of an upswing, and still weak consumer confidence, the outlook remained highly uncertain. Downside risks include a slower-than-projected recovery in Europe, a further appreciation of the euro, and a delayed recovery in private investment. Upside risks emanate





investment. Upside risks emanate from a strong rebound in business confidence late in the summer, continued employment growth that may spur somewhat stronger consumption, and the fact that the projected rebound is weaker than typically experienced during past upswings (text chart).

6. **While low growth in 2002–03 clearly reflected also cyclical factors, there was broad consensus that structural weaknesses had played a key role in Italy's growth malaise over the past decade**. Staff estimated potential output growth at a lackluster 1¾ percent; consequently, the output gap was regarded as still relatively small at end-2002 (1 percent). EU Commission estimates showed an even smaller gap. Indeed, the persistent inflation differential with the rest of the euro area and the low unemployment rate in the North (Figures 4–5) suggested that, for at least some parts of the economy, supply constraints were not trivial (Box 1). Moreover, the authorities agreed that domestic demand should have been boosted by the monetary-union-related decline in interest rates, and the lack of a strong output response—in marked contrast to other EMU countries of Southern Europe—was also seen as indicative of deep-seated supply weaknesses. Thus, discussions turned to the structural factors that were contributing to low growth. Here, views were more nuanced.

Box 1. Italy's Inflation Differential and Export Performance

Italy's inflation differential vis-à-vis the euro area averaged ½ percent during 1998–2002, and more recently hovered at close to 1 percent (Figure 4). The authorities cited studies indicating a stronger degree of inflation inertia in Italy relative to other euro-area countries, leading to a slower decline in inflation after the euro changeover and oil price shocks of 2002. However, this alone cannot explain why Italy's inflation has remained above the euro-area average for most of the past 6 years.

Staff work (see Chapter II of the Selected Issues Paper) suggests that the inflation differential is not explained by (pre-euro) backward-looking inflation expectations, nor by Balassa-Samuelson effects (Italy's productivity growth has not exceeded the euro-area average). Rather, together with slower product market liberalization, higher inflation may reflect price level convergence, after Italy entered the euro area at a relatively depreciated exchange rate.

The convergence of price levels and the associated real exchange rate appreciation have important implications for Italy's external sector. In particular, this interpretation would suggest that Italy's export market shares were (ceteris paribus) relatively high in recent years, supported by a still undervalued exchange rate. Looking ahead, as prices converge to the euro-area average, Italy's competitiveness would be eroded further, and this would likely result in additional declines in market shares.

It is important to note that there has been a trend decline in Italy's export market shares that goes beyond the effect attributable to standard competitiveness indicators (Figure 3). And in contrast to the other large countries in the euro area, the external current account has moved into deficit in recent years, which is difficult to reconcile with Italy's prospective population aging and advanced stage of development. These features suggest that structural factors have also hampered Italy's export performance.

7. **In the authorities' view, Italy's growth, particularly since 2000, has been hampered by a structural shift of export demand.** Italy's exports are primarily

concentrated in 'traditional' sectors, in which world demand is growing less rapidly and in which Italy has lost market shares to emerging economies, particularly China. Government representatives stressed the difficulty of Italian producers to compete, especially for products with high price elasticities, with countries that have much lower production costs, partly due to labor protection and environmental standards that are less demanding than those of industrial countries. Bank of Italy representatives stressed that Italy's vulnerability to competition in traditional export markets reflected the inability of the Italian enterprise system, characterized by the dominance of small and medium-sized enterprises, to innovate and shift its production toward sectors less exposed to competition from emerging markets. While acknowledging the impact of emerging market competition on certain export sectors, staff noted that Italy had been losing market shares not only to emerging markets, but also to other euro-area countries (Figure 3), suggesting the importance of losses in price competitiveness (due to higher inflation), a view shared by the Bank of Italy. Moreover, staff argued that the weak export performance—accompanied by external current account deficits in recent years—reflected also broader structural weaknesses that had hindered productivity growth of Italian firms. The authorities agreed that this called for tackling the underlying structural impediments to growth.

8. **Indeed, staff attributed lackluster growth in Italy over the past decade primarily to supply-side weaknesses.**[1] A *high tax burden* (Figure 7), and particularly a *high tax wedge on labor*, stifled incentives to work and invest, while the incomplete fiscal consolidation process raised concerns about the future tax burden.[2] The authorities and other observers also noted that fiscal adjustment during the 1990s had sharply curtailed *public investment*, and that inadequate public infrastructure was acting as a supply bottleneck. *Labor market distortions* remained important, especially in the South, partly reflecting insufficient regional wage differentiation. Moreover, as there was evidence that nationwide wage settlements reflected primarily conditions in the North,[3] this may also help explain why inflation remained high, in spite of widespread unemployment in the South. *Insufficient competition in product markets* remained significant, raising costs for firms that use inputs from these

[1] Some of these weaknesses have also impeded the growth of firms, contributing to the dominance of small and medium-sized enterprises.

[2] On the adverse impact of the tax wedge for employment, see Francesco Daveri and Guido Tabellini, "Unemployment and Taxes," Economic Policy, April 2000.

[3] See "Regional Differentiation and Wage Bargaining Systems: The Case of Italy," in IMF Country Report No. 02/232.

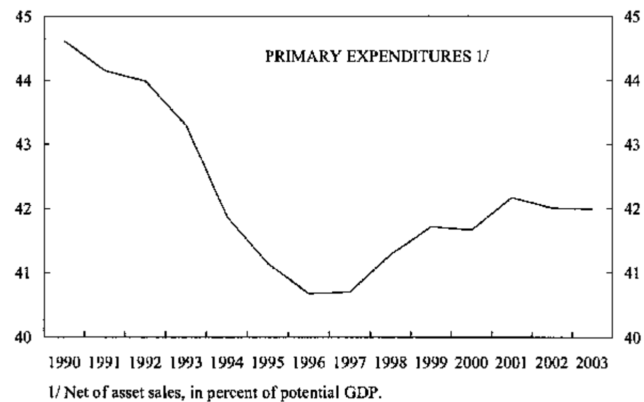
sectors (for example, energy prices are considerably higher than in most other trading partners).[4]

9. **The authorities were well aware of these weaknesses and discussions focused on how to address them**. But, they noted, tackling these problems involved important redistributional issues and had not been easy in the context of weak cyclical conditions.

B. Fiscal Policy

Recent developments

10. **Italy is the only large euro-area country that has not breached the 3 percent deficit ceiling of the *Stability and Growth Pact* (SGP). However, this has reflected large one-off measures and declining interest payments, with scant recent progress in lowering primary spending**. The authorities envisaged for 2003 a deficit of 2.5 percent of GDP, against an original budget target of 1.5 percent (text table and Table 2). While half of this deviation would be structural (including health spending), they noted that the structural deficit net of one-off measures would nevertheless decline by almost 1 percent of GDP during 2002–03, a good result in a low growth environment.



1/ Net of asset sales, in percent of potential GDP.

[4] The growth impact of these factors is discussed in Giuseppe Nicoletti and Stefano Scarpetta, "Regulation, Productivity and Growth: OECD Evidence," Economic Policy, April 2003.

Fiscal Developments and Prospects, 2001–03

(In percent of GDP)

	2001	2002		2003		
		Budget	Outturn	Budget	Auth. Rev. Est.	Staff
Overall balance	-2.6	-0.5	-2.3	-1.5	-2.5	-2.7
Structural balance 1/ 2/	-2.9	-0.9	-1.9	-1.2	-1.5	-1.7
Net of all one-off measures	-3.8	-2.1	-3.3	-2.5	-3.0	-3.1
Structural primary balance (net of one-off measures) 1/ 2/	2.7	3.7	2.4	3.4	2.3	2.1
Primary expenditure (net of one-off measures) 2/	42.2	42.1	42.0	41.4	42.0	42.0
Memorandum items:						
One-off measures	0.8	1.2	1.5	1.2	1.5	1.5
Of which: asset sales	0.2	0.7	0.9	0.6	0.1	0.1
GDP growth	1.8	2.3	0.4	2.3	0.5	0.4

Sources: Ministry of the Economy and Finance; and Fund staff calculations and estimates.

1/ Structural balances are based on the staff's estimate for potential output and reflect the authorities' and staff's growth projections in the respective columns.

2/ In percent of potential GDP.

Staff welcomed the decline in the structural deficit, but noted that:

- The decline was more than explained by falling interest payments. Indeed, the structural primary surplus net of one-off measures had weakened over the same period, reflecting a reduction in the tax burden not matched by primary spending cuts.

- Some risks remained to fiscal developments in 2003: staff projected the deficit at 2.7 percent of GDP, on account of less sanguine assumptions for health spending and indirect taxes. Thus, staff encouraged the authorities to intervene, if needed, to stem expenditure slippages.

- One-off measures (tax amnesties,[5] sales of public real estate assets) remained sizable (1.5 percentage points of GDP in 2003), underscoring the remaining need for durable progress to achieve the SGP target of balancing the budget. The authorities stressed that one-off measures had a weaker impact on domestic demand, and had allowed to respect the Maastricht criteria in a period of cyclical weakness. Staff noted, however, that some one-off measures have long-term costs: in particular, tax amnesties were likely to reduce tax compliance, especially given the regular pattern that had characterized the granting of such amnesties over the last 30 years.

[5] These primarily consisted of a generalized amnesty for underdeclaration of past tax liabilities, applying to both individuals and firms, and an extension of the 2002 amnesty on undeclared capital held abroad.

11. **Staff also noted that the cash-based deficit measure (*fabbisogno*) was again expected to substantially exceed the Maastricht-based accrual measure (*indebitamento*), slowing the decline in public debt.** The authorities projected the 2003 *fabbisogno* to exceed the *indebitamento* by some 1½ percent of GDP. Staff noted that a similarly large gap in 2001 had been associated with an ex post upward revision in the Maastricht-based deficit measure (by 0.6 percent of GDP). The authorities acknowledged the importance of the *fabbisogno*, as it affected public debt growth, but argued that the differences with *indebitamento* were in 2003 explained by financial operations and debt settlements—such as outstanding tax credits and health sector arrears toward suppliers—not included in the public debt definition.

Fiscal trends and the authorities' fiscal consolidation strategy

12. **There was broad agreement that the state of fiscal accounts and aging-related spending pressures called for further fiscal consolidation.** Aging-related spending pressures are less dramatic than in other euro-area countries (such as Germany), on account of the reforms implemented during the 1990s, and will be partially reversed after 2040.[6] Nevertheless, they would imply that the public debt ratio would start rising rapidly after 2015 (Box 2).[7] The authorities noted that the staff's projections were based on lower labor productivity growth assumptions than their own, but acknowledged the need for further action.[8]

13. **Along the lines of previous Fund advice, staff argued that fiscal consolidation required a three-pronged strategy involving:**

- **Strengthening the structural fiscal balance by at least ½ percentage point of GDP per year starting in 2004** until a small surplus is reached. This pace seemed the minimum for a high-debt country and its attainment would be facilitated by the further prospective decline in interest payments.

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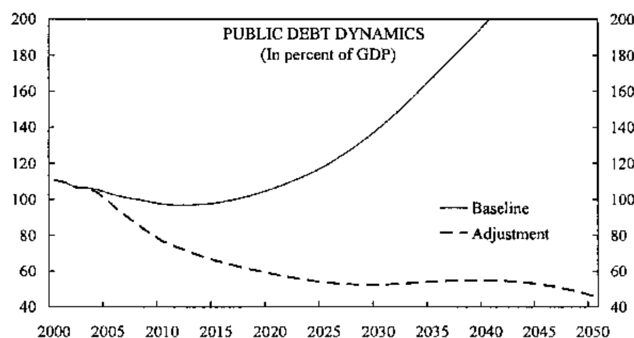
[6] These reforms included the shift to a contribution-based system and to price indexation of pensions (rather than wage indexation).

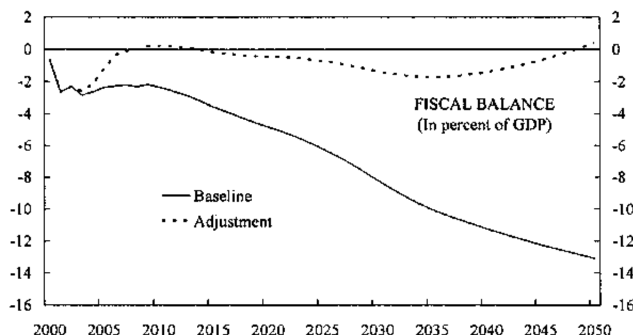
[7] Debt sustainability problems arising from population aging are not well captured by the standard debt sustainability template (see IMF Country Report No. 02/230). Box 2 accordingly examines debt sustainability in a long-run context.

[8] The authorities assume an average labor productivity growth of 1¾ percent during 2003–50. Staff's assumption is 0.5 percentage point lower, and productivity growth during 1993–2002 was only 1.1 percent. Both projections envisage a significant rise of the employment rate through 2050, which will require further structural reforms.

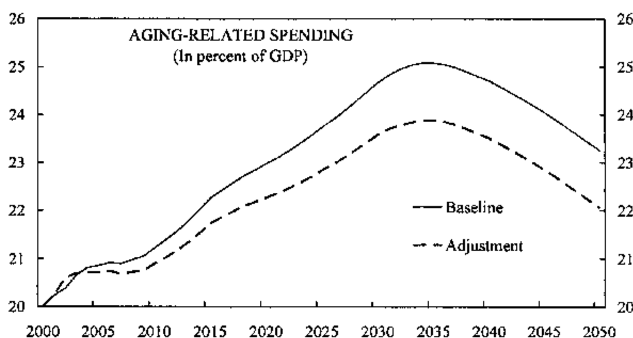
Box 2. Fiscal Scenarios



The **baseline scenario**—a "no-policy change" scenario—assumes a constant structural primary balance (net of health and pension, or aging-related, spending) at its 2003 level. Thereafter, aging-related spending rises in line with the current government projections, adjusted for staff's baseline on labor productivity growth (1¼ percent per annum). The average real interest rate on public debt is assumed to rise gradually to 3½ percent (its average level during 1998–2003). Under these assumptions, the deficit shrinks over the next five years (as the output gap closes), but rises thereafter due to increased aging-related spending and, later, also increased interest payments, with public debt rising steadily after 2014.



The staff's **adjustment scenario** features a gradual containment of aging-related spending (reaching 1¼ percentage points vis-à-vis the baseline by 2035, although somewhat smaller savings would be needed over the longer run), a structural balance adjustment of ½ percent per year, starting in 2004, through spending cuts until budget balance is reached, and accelerated privatization (7 percent of GDP within the current decade). Once budget balance is reached, nonaging-related spending is held constant as a share of GDP. This implies some modest budget surpluses during the next decade, as interest payments decline. The fiscal balance weakens thereafter, reflecting increased aging-related spending, but remains at a level sufficient to reduce the debt ratio to around 50 percent of GDP at the middle of the century.



These long-run **projections are subject to substantial uncertainty** related to underlying macroeconomic and demographic assumptions. For example, under the authorities' more optimistic productivity growth assumption (1¾ percent per annum during 2003–50), the increase in aging-related spending in the baseline from 2003 to the 2035 peak would be 3¼ percent of GDP, the same as in the staff adjustment scenario. If instead the real interest rate were to gradually rise to 4 percent, the debt-to-GDP ratio in the adjustment scenario would remain at around 70 percent of GDP.

- **Gradually replacing the one-off measures with permanent expenditure cuts**. The authorities envisaged phasing out all one-off measures by 2006. To reap early on the credibility benefits of this adjustment, staff argued for equal steps toward this target, requiring structural expenditure cuts of some 0.5 percent of GDP each year during 2004–06.

- **Reducing aging-related spending trends**. Staff's illustrative scenario (Box 2) suggested that savings in aging-related spending (with respect to the baseline) had to gradually rise to 1¼ percent of GDP to ensure fiscal sustainability.[9] These savings could be achieved through measures to raise the effective retirement age (both in the current system and in the contribution-based system, introduced in 1995, but with a long phasing-in period) and to accelerate the transition to the contribution-based system (see Chapter IV of the Selected Issues Paper).

14. **The 2004 budget moves in the direction recommended by staff, but its targets are less ambitious:**

Italy's Medium-Term Fiscal Targets, 2003–07

(In percent of GDP, except as otherwise indicated)

	2003		2004	2005	2006	2007
	Auth.	Staff Proj.	Auth.	Auth.	Auth.	Auth.
Real GDP (percentage change)	0.5	0.4	1.9	2.2	2.5	2.6
CPI (percentage change)	2.6	2.8	1.7	1.5	1.4	1.4
Overall balance	-2.5	-2.7	-2.2	-1.5	-0.7	0.0
of which: one-off measures	1.5	1.5	1.2	....	0.0	0.0
Structural balance 1/	-1.5	-1.7	-1.3	-0.8	-0.4	0.0
Net of all one-off measures	-3.0	-3.1	-2.5	...	-0.4	0.0
Primary balance	2.8	2.6	2.9	3.5	4.4	5.1
Gross debt	106.0	106.5	105.0	103.0	100.9	98.6

Sources: Ministry of Economy and Finance, Nota di Aggiornamento al *Documento di Programmazione Economica e Finanziaria* (Sept. 2003); and Fund staff projections.

1/ In percent of potential GDP, using staff estimates of potential.

[9] This level of saving would be needed through 2030–40, after which smaller saving would be required as the full effects of the reforms implemented during the 1990s would materialize. On the other hand, larger savings would be needed to lower the high social security contribution rate, assumed to be unchanged in the projections in Box 2. The latter also assume that the replacement ratio is lowered, every ten years, in line with population aging. Current legislation does require that the replacement ratio is reviewed, and if needed reduced, in light of population aging. But these reductions are not automatic, requiring discretionary decisions.

- The nominal and structural deficits would decline by 0.3 percent of GDP in 2004, mostly on account of lower interest payments, and thereafter by about 0.5 percent per year until budget balance is reached (text table). On current growth projections, the 2004 deficit target is 2.2 percent of GDP.

- The amount of one-off measures would decline only gradually—by 0.3 percentage point to 1.2 percent of GDP in 2004—and would, once again, involve an amnesty (for zoning code violations) as well as revenues from asset sales and from a presumptive assessment of tax liabilities for small enterprises.

- The improvement in the deficit net of one-off measures would thus amount to 0.6 percentage point of GDP, almost entirely through a reduction in the expenditure-to-GDP ratio. The latter would reflect: (i) lower interest payments (0.2 percentage point); (ii) the corporatization of ANAS (the agency in charge of managing the public road system) and the consequent shift below the line of state transfers to it; and (iii) lower spending in goods and services and wages (0.2 percentage point).

15. **In conjunction with the budget, the government has proposed a pension reform aimed at containing** future pension spending (Box 3). The proposals, presented in early October and to be sent to parliament soon, aim to raise significantly the effective retirement age. While further work will be needed to assess the effect of the reform proposals, preliminary projections provided by the authorities indicate that the reform would go a long way toward moderating spending trends up to 2030–35, although its effects would diminish thereafter. This reform is adamantly opposed by trade unions, who have called for a general strike.[10] The government has expressed willingness to amend the reform following discussions with social partners, provided the projected savings remained unchanged.

[10] During the discussions, some trade union representatives noted that the magnitude of the pension problem in Italy was exaggerated by the inclusion as pension spending of items that should more properly be classified as welfare subsidies and thus be financed by general taxation rather than pension contributions. Staff noted, however, that while the distinction between pension and welfare spending was often blurred, the projected rise in aging-related spending reflected largely the rise in narrowly defined pension spending.

Box 3. Pension Reform Proposals

The most important element of the pension reform proposal presented by the government in early October is the increase in the minimum contributory period: starting in 2008, workers will need 40 years of contributions (instead of the current 35) if they want to retire before the statutory retirement age (60 for women and 65 for men). This change will apply both to workers under the current "mixed" system and to workers under the contribution-based system (see Chapter IV of the Selected Issues Paper). Workers under the "mixed" system will be permitted to retire after 35 years of employment even after 2007, but in this case their pension would be lower (by up to one-third for dependent workers and even more for the self-employed).

The reform also envisages a set of incentives to postpone retirement. Workers eligible for retirement that continue to work would receive as a salary increase the full amount of their social security contributions (for a total of 33 percent of the gross wage) and this increase would be tax-exempt. The net impact of this measure on public finances is uncertain: it will entail a revenue loss for those workers that would not have retired anyway (since they will stop paying their contributions) but it can yield short-term expenditure savings insofar as workers that would have retired decide to continue working.

The reform would also facilitate the growth of a second, fully funded pension pillar (through the use of funds accumulated for severance payments, which are quite high in Italy) and reduce social security contributions for newly hired workers.

The reform, primarily as a result of the increase in the minimum contributory period, would moderate pension spending trends significantly. The authorities' preliminary calculations suggest that the savings would rise to some 0.7 percent of GDP (less than in the staff's scenario of Box 2, but with a more upfront profile), although the effect would decline gradually over the longer term. If coupled with the structural fiscal adjustment path recommended by staff (also Box 2), this would be sufficient to keep the public debt ratio on a declining trend for the next 30 years, with a trough of some 50 percent of GDP. Thereafter, the debt ratio would rise again to over 60 percent by the middle of the century.

16. **Staff welcomed these steps—in particular the proposed pension reform—but remained of the view that a faster pace of fiscal adjustment in 2004 would be preferable.** The proposed pension reform, if implemented as envisaged, would present a major structural step toward containing aging-related spending trends. On near-term fiscal consolidation, however, the authorities had, during the July discussions, stated their intention to cut the deficit by 0.5 percentage point of GDP in 2004 (rather than the 0.3 percentage point ultimately included in the draft budget), and staff saw no strong economic reasons for a smaller adjustment. Staff regretted the envisaged back-loading for the phasing out of one-off measures, but the authorities reiterated that, amid cyclical uncertainty, these measures involved lower risks, while still providing benefits for the fiscal accounts. By contrast, staff argued that, particularly in a high debt country, the stabilization role of fiscal policy should be left to the automatic stabilizers. While the authorities accepted the merits of the full (and symmetric) play of automatic fiscal stabilizers, they also stressed the importance of respecting the SGP deficit limit.

17. **In the staff's view, the attainment of the targeted reduction in the 2004 structural fiscal deficit was subject to some risks**. These related primarily to: (i) the savings from the corporatization of ANAS, as the latter might not be able to raise its own revenues to the extent needed to meet Eurostat criteria for its shift outside the general government. Moreover, even if accepted by Eurostat, the shift below the line of the transfer to ANAS was an accounting operation, rather than a genuine cut in public spending; (ii) indirect taxes, which were projected to increase faster than both GDP and consumption; and (iii) other smaller items. Altogether, risks, while possibly reduced by conservative interest payment projections, amounted to about ½ percent of GDP. The authorities were confident that the targets were achievable, but noted that their tools to contain unexpected overruns had been enhanced by a recent law that had strengthened budget control instruments.[11]

Downsizing the public sector

18. **The authorities reiterated their commitment to deficit-neutral expenditure and tax cuts, but did not see much room for progress in this area in 2004.** They acknowledged the potential growth benefits of downsizing the public sector. Indeed, tax rates for low income households and for corporate incomes had been lowered in 2003 and further cuts (matched by offsetting cuts in spending on top of what was required for reducing the deficit) remained on the agenda. But cuts were viewed as contingent on improved economic prospects—the authorities saw deficit-neutral tax reductions as contractionary in the current state of pervasive uncertainty, as higher disposable income from the tax cuts may be saved. Staff argued that the budget should have seized the opportunity to effect tax cuts and more substantial reductions of primary expenditures in 2004, given that: (i) structural expenditure cuts would strengthen the perception that tax cuts would be permanent, reducing the risk that the latter would be saved; (ii) the genuine primary expenditure cuts envisaged by the 2004 budget were modest (0.2 percent of GDP in goods and services and wages); and (iii) some investment spending was being shifted outside the budget (Box 4).

[11] This law (approved in late 2002) allows the economy minister to seek a reduction in budgetary allocations for discretionary outlays, if fiscal trends indicate that budget objectives are at risk. It also requires a new spending authorization for outlays in excess of previously authorized ceilings, limits to one year the carryover of committed funds, and eliminates the possibility of carrying-forward uncommitted funds. The law was successfully used in late 2002 to limit expenditure overruns.

Box 4. Public Investment Outside the SGP Definition

The authorities intend to rely on off-budget financing of some infrastructure projects, including through public-private sector partnerships (PPP) and the *European Action Plan for Growth*. The vehicle for promoting PPPs is *Infrastrutture SpA*, a public financial institution (outside the SGP general government definition) established with the purpose of cofinancing PPP infrastructure projects. Its activities are still at an early stage, and, currently, its main endeavor is to prepare a bond issuance to co-finance the development of a high-speed rail network. Moreover, the proposal for a European Action Plan for Growth, put forward at the beginning of the Italian EU Presidency, involves spending on infrastructure projects, particularly Trans-European Networks. While the original plans were scaled back to some extent during subsequent discussions, work remains underway to identify spending priorities and financing modalities. Staff agreed that PPPs could usefully support needed improvements in infrastructure. However, the viability of each project had to be closely and transparently assessed, ensuring, for those projects that are not fully self-financing, that future government liabilities (including contingent ones) are clearly spelled out in budgetary documents and limited. Furthermore, staff stressed the need to ensure timely and transparent reporting of the activities of *Infrastrutture SpA*.

19. **Staff noted that structural expenditure cuts needed to be pursued in several areas, in line with earlier government plans**: (i) reducing *public employment* had proved, so far, an elusive goal, and *public sector wages* had risen faster than those in the private sector in recent years; (ii) room remained for cutting *enterprise subsidies*, especially for railways and postal services, and for extending the use of *means-tested user fees* in the provision of public services; (iii) recent reforms in *procurement* were promising, but competition in this area needed to be promoted further, including at the local level; and (iv) in *health spending*, regions should be given sufficient tools and incentives to meet spending and financing targets, in line with national objectives. In particular, increased recourse to co-payments could be encouraged—only half of the regions had co-payments for pharmaceuticals. The authorities broadly agreed with the areas identified by staff, but highlighted the difficulty of ensuring reductions in some spending areas (such as public employment and health) in a context of increasing fiscal devolution.

20. **Reconciling fiscal devolution and discipline remained a challenging task, and one that would become increasingly important in the future.** The constitutional reform approved in late 2001 widened the areas of responsibility of regions and local governments (to include health, education, public safety, and welfare). However, the accompanying legislation establishing rules for revenue and expenditure sharing in areas of joint state-regional competence, the amount of redistribution across regions, and the boundaries for regional legislation in several areas has yet to be determined. Further constitutional reform proposals in these areas are under discussion, and a high commission is expected to issue a report in 2004 proposing a financing model for fiscal devolution. Staff noted that the persistent overruns in health spending of recent years, the repeated need for the central government to settle debt accumulated by subnational governments, the difficulties in lowering public employment at the local level, and the limited success in privatizing local public enterprises underscored the need for decisive progress in this area. Moreover, assessing developments was hampered by nonuniform accounting standards across different

levels of government (see forthcoming fiscal ROSC update). The authorities agreed with the need to strengthen financial discipline in all territorial entities, but also noted that action had been taken to improve fiscal coordination (including by strengthening the flow of information).

C. The Labor Market and the South

21. **Employment has continued to grow, despite the cyclical downturn.** There was broad consensus that the rise in employment—and the fall in the unemployment rate, to a seasonally adjusted 8.7 percent in the third quarter—reflected:

- Wage moderation: real wages in the business sector had increased by an annual average of 0.4 percent during 1993–2002.
- Increased labor market flexibility: reforms in the late 1990s liberalized part-time and fixed-term contracts.
- Tax incentives: a generous tax credit, in place since October 2000, contributed to a significant boost in permanent contracts—the authorities estimated that the credit covered 250,000 jobs, half of them in the South. This incentive was suspended in July 2002, given the higher-than-expected utilization and budgetary costs, but reinstated in January 2003 in a less generous form.
- Earlier pension reforms: these encouraged continued employment by older workers. Indeed, employment increased strongly in 2003 among workers aged over 50.

The authorities concurred that some of the increase in employment may reflect emergence from the underground economy—but stressed that there was no evidence that this was the primary cause behind the employment increase. Indeed, official employment and output statistics included an estimate of underground workers (Box 5), and did not suggest that the increase in open employment had been matched by a decline in underground employment. In any case, even the emergence of underground employment was an important result both in terms of broadening the fiscal revenue base and extending labor protection to additional workers.

Box 5. The Size of the Underground Economy

GDP data prepared by ISTAT include an estimate of the underground economy. This is constructed starting from an employment survey, designed to measure the actual number of employed workers, including undeclared ones, complemented by analyses covering illegal immigrants and other labor activities.[1] The difference between the employment data resulting from these sources and those resulting from firm- and institutional-level data provides an estimate of underground employment. Data on output is corrected by attributing to unrecorded workers the average productivity in their sector. Additional adjustments are made to reflect the undeclared output of small enterprises, obtaining a GDP estimate based on the supply side, and a lower bound on the size of the underground economy (15.2 percent in 2000). An upper bound (16.9 percent in 2000 which includes statistical discrepancies due to incomplete coverage of supply-side data) is obtained after reconciling demand-and supply-side GDP estimates. A recent paper (Roberta Zizza, "Metodologie di Stima dell'economia sommersa: un'applicazione al caso italiano", Bank of Italy Discussion Paper no. 463, 2002) shows that estimates of the size of the underground economy based on alternative methodologies fall in a range that is consistent with ISTAT estimates.

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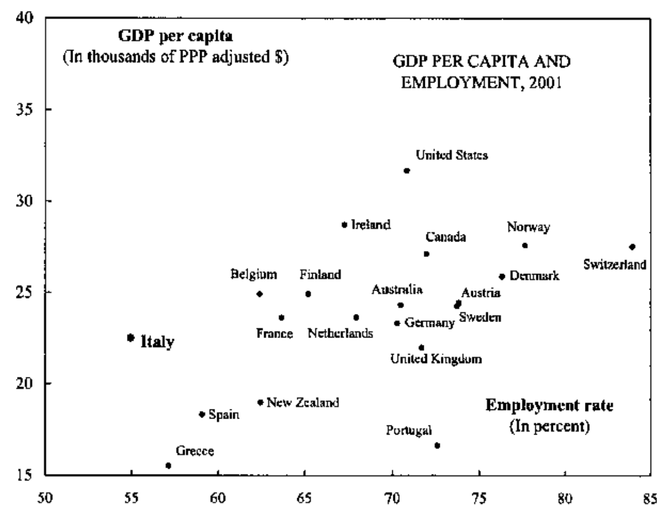
[1] A law that regularized illegal immigrants led to the emergence of some 700,000 workers. However, this will not substantially affect official employment and output statistics because the estimate of illegal immigrant workers by ISTAT was close to the number of emerged workers.

22. **Notwithstanding the success in lowering unemployment, the employment rate remains the lowest in the EU, reflecting low labor force participation**. The authorities' strategy to raise employment rates, in line with the EU Lisbon objectives, is based on a gradual reduction of tax rates and on the implementation of the *Pact for Italy*, the labor market accord reached in 2002 between employers and two of the three main trade unions. The first part of the accord, enacted in mid-2003, introduced new forms of employment contracts, eased restrictions on job outsourcing and staff leasing, and allowed private employment service agencies to operate in all areas of the labor market. The authorities expected that these agencies would offer the whole range of job-matching services within a year. The draft law implementing the second part of the accord is expected to be legislated by end-2003, and includes: training; a reorganization of employment incentives, particularly for part-time employees; a modest weakening of employment protection legislation (EPL); and a strengthening of the (currently very low) unemployment benefits. Staff encouraged a quick approval of this law, which was supported by employers and two of the main trade unions (the largest union, which did not sign the *Pact for Italy*, maintained its opposition to



weakening EPL). Unions and employers also stressed the need for improved job training and education, and staff noted that there was room for expanding Italy's relatively underdeveloped active labor market policies, provided these were well targeted.

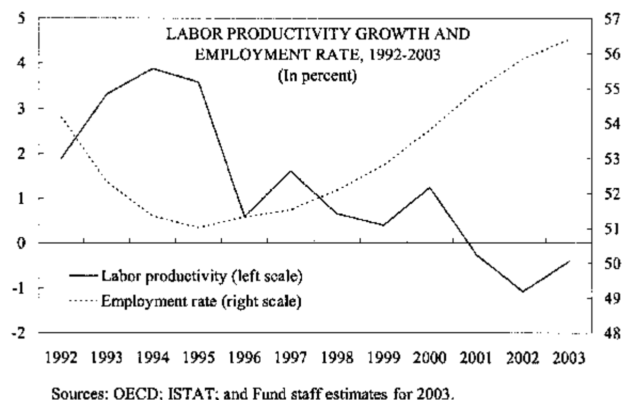
23. **With labor force participation particularly low in the South, labor market issues intersect with those relating to regional development**. Per capita output in the South is only slightly above half of that in the Center-North, reflecting lower productivity and, more importantly, substantially lower employment rates (Table 3). There are some positive signs in this area. Regional output and unemployment disparities have declined since 1999. The authorities were hopeful that their new policy framework for the South—focusing on infrastructure investment, project transparency and accountability, law enforcement, strengthening the capacity of local administrations, and financial incentives and disincentives to encourage rapid adoption of necessary reforms—would accelerate economic convergence (see Chapter III of the Selected Issues Paper). There was, indeed, evidence that the growth contribution from infrastructure investment in the South has increased substantially in recent years. However, the convergence pace was still slow and implementation of the new policy framework was delayed in some regions by vested interests.

24. **Staff supported the authorities' approach, but argued that more regional wage differentiation would help narrow the regional employment gap.**[12] The public sector could play a leading role in encouraging wage differentiation by introducing regionally differentiated cost-of-living allowances for public employees, once ISTAT completes the publication of regional price level data. While the authorities saw wage differentiation within the public sector as difficult, they agreed that private sector wages should better reflect productivity differentials. However, progress on this front depended on social partners. While broadly agreeing with the staff analysis, employers considered that the current wage bargaining system—conducted at the national level, with additional firm-level negotiations—provided some room for wage differentiation, and expressed concern that a push toward more formal wage differentiation across regions would result in higher wages in the North. Unions did not oppose linking wage *increases* to productivity, but reiterated their objection to revising wage *levels* to reflect productivity differences.

[12] Last year's Country Report (02/230) discussed the case for wage differentiation in more detail, noting inter alia that, while Italy had the highest variation of regional unemployment rates in the EU, its variation of wages was the second lowest.

D. Boosting Productivity[13]

25. **The authorities indicated that redressing the impediments to productivity growth remained a key objective of their agenda.** Italy's productivity *levels* are high, but as the employment ratio picked up in recent years, productivity *growth* has slowed sharply (text chart). Important structural weaknesses were seen as contributing to the lack of dynamism in productivity growth (see also Table 6):



Sources: OECD; ISTAT; and Fund staff estimates for 2003.

- *Research and development expenditures* (R&D) are, in relation to GDP, only about half the euro-area average;
- *Inflows of foreign direct investment* are low;
- *Product market regulations* remain restrictive relative to other industrial countries;
- *Bankruptcy regulations and judicial proceedings* are frequently noted as hindering entrepreneurial activity.

26. **The authorities attributed low spending on R&D in part to Italy's industrial structure, characterized by a preponderance of small firms.** They noted that this structure had coped well with the pattern of development until the late 1980s, but had hampered the adoption of new technologies, as firm spending on R&D was correlated in Italy with firm size. In addition to historical and cultural factors that characterized the country's development during the post-war years, the authorities also noted other obstacles to firms' expansion, including labor market restrictions, a high tax burden, insufficient provision of public infrastructure, and bureaucratic hurdles. Removing these obstacles was a key objective of the government. Staff underscored the urgency of progress in these areas, noting that these obstacles were also reflected in the low level of FDI in Italy, which hampered access to new technologies and production techniques.

27. **On product markets, there was agreement that progress had been secured over recent years, but also that Italy continued to suffer from insufficient competition in a number of protected sectors.** These included: electricity and gas markets—where prices, even before taxes, were among the highest in Europe; communications—where prices had

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[13] The 2003 "Economic Survey of Italy" of the OECD addresses in greater detail many issues discussed in this section.

not declined as much as in the EU in recent years; wholesale and retail distribution—characterized by low productivity and high markups, with competition often undermined by entry barriers at the local level; and professional services—which suffered from above average regulation and limited enforcement powers of the Anti-trust Authority. Discussions covered recent efforts to push ahead with reforms in a number of areas, including: plans to restart the privatization process at the central level, despite difficult market conditions;[14] and constitutional reform (under parliamentary consideration) that would facilitate overcoming local impediments to building more efficient electric generation capacity—critical in light of potential capacity constraints and high prices. Staff and some market participants raised concerns regarding government interference in the pricing rules for the electricity market late last year, and the authorities agreed with the importance of strong, independent regulatory authorities.

28. **The length of court proceedings in general, and of bankruptcy proceedings in particular, raises firms' costs and discourages entrepreneurial activity and risk-taking.** The completion of bankruptcy proceedings can take over 7 years, hindering efficient debt workouts for firms in distress, and implying higher costs for the recovery of collateral.[15] The authorities highlighted that a new bankruptcy law, soon to be submitted to parliament, would introduce procedures to favor out-of-court settlements, eliminate penalties on debtors in case of nonfraudulent behavior, and allow the creation of new public institutions to coordinate agreements between debtors and creditors, giving creditors a say in the management of the firm for a period of time. Furthermore, a reform streamlining company laws governing limited liability and joint-stock companies and cooperatives was approved, and will be implemented in January 2004. Staff welcomed these steps and urged the expeditious approval of the new bankruptcy law.

E. Financial Sector

29. **Consolidation, privatization, and improvements in risk management in recent years have helped the banking system weather the current economic slowdown.** These structural developments have generally facilitated a strengthening of banks' financial position and, together with falling interest rates, fostered the growth of the bank loan market, with the bank loan-to-GDP ratio, stagnant for several decades, rising rapidly over the past few years

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[14] ETI (the state tobacco company) and some other smaller companies were sold in 2003.

[15] These problems are more severe in the South. Tullio Jappelli, Marco Pagano, and Magda Bianco ("Courts and Banks: Effects of Judicial Enforcement on Credit Markets", CEPR Discussion paper No. 3347, 2002) show that judicial inefficiency is higher in the South and increases credit rationing. International comparisons suggest that Italy and Spain have the most protracted judicial process (in terms of length of civil trials and trials pending per capita) among a large sample of industrial countries.

(Table 5). The market for loans to households, particularly in the mortgage segment, has been especially buoyant, albeit from a low base. The economic slowdown was, however, accompanied by a decline in credit quality and profitability (the latter owing primarily to a decline in non-interest income). Nevertheless, the Bank of Italy estimated that the declines in credit quality (in terms of probability of default) and profitability were small compared with similar cyclical phases. The Bank also noted that large exposures fell in 2002, but it continued to monitor closely significant exposures to some of the largest Italian companies. In the insurance sector, the authorities noted that profitability had held up quite well by international comparison and that return on equity, stable for life insurance, had increased in other areas in 2002.

30. **Against this background, discussions focused on additional steps to strengthen the resilience and efficiency of the financial sector**:[16]

- *Bank profitability and capital*: Prior to the cyclical downturn, bank profitability had generally followed a rising trend, but staff noted that profitability indicators remained low by international standards. This was inter alia due to relatively high operating costs and a significant stock of nonperforming loans—the latter reflecting importantly the above-noted shortcomings of bankruptcy proceedings. The authorities concurred with the need to strengthen bank profitability. They also noted that evolving financial sector risks had warranted a rise in the target ratios for banks' risk-weighted capital, and were satisfied with the continued rise in capital ratios.

- *Transparency and consumer protection*: The mission encountered a widespread view that consumer protection for complex financial products needed to be improved, as highlighted by recent controversies related to retail sales of Cirio bonds by financial intermediaries.[17] The authorities were considering new steps to strengthen controls over sellers of securities so as to ensure that customers had a better understanding of the risks involved, while the bankers' association was working on strengthening self-regulation, including the provision of a list of low-risk instruments.

[16] The IMF's Monetary and Financial Department (MFD) is currently assessing Italy's observance of the Basel Core Principles for Effective Banking Supervision and the Core Principles for Systemically Important Payment Systems. While the assessment has not yet been finalized, the MFD mission found high overall observance of both principles.

[17] High-risk bonds issued by Cirio, a company in serious financial difficulties, had been placed in Luxembourg. They were subsequently resold by domestic financial institutions to Italian retail investors, reportedly without adequate indication of the bonds' riskiness.

F. Other Issues

31. **Possibly reflecting Italy's loss of market shares, trade policy issues have recently attracted considerable attention**. Indeed, some members of the coalition have publicly argued that trade barriers may have been removed too rapidly over the last few years without paying sufficient attention to the short-term adjustment costs of increased trade. Nevertheless, further liberalization of trade with developing countries is on the agenda of the Italian EU presidency, and staff argued for determined leadership in this regard during the ongoing round of trade negotiations within the framework of the WTO. The Italian authorities welcomed the reform of the EU's Common Agricultural Policy agreed in June 2003, and expected that their trading partners also advance toward reforming their agricultural policy. Regarding fairness in international trade, they were concerned about counterfeiting of manufactured goods and were strongly supporting measures to enforce the certification of country origin.

32. **Official development assistance** (ODA) is low. It is estimated at 0.20 percent of GDP in 2003 and budgeted to remain broadly unchanged in 2004.

33. A law to incorporate the new EU directive for **anti-money laundering** (AML) and countering the **financing of terrorism** (CFT) is awaiting parliamentary approval. Italy assesses itself as fully compliant with seven of the eight new special recommendations for AML/CFT (for the eighth, covering nonprofit organizations, the authorities are awaiting clarifications from the Financial Action Task Force). Italy continues to provide other countries with technical assistance on AML/CFT, and is a signatory to the OECD **anti-bribery** convention.

34. The authorities reported the introduction of **collective action clauses** in the documentation of all New York law governed sovereign bonds issued by Italy, starting with a 5-year global bond for $2 billion in June 2003.

35. The authorities highlighted progress in the provision of **statistics** in a number of areas, notwithstanding cuts in ISTAT staffing. Quarterly accrual-based fiscal data were released for the first time on October 21, 2003, covering the period from 2001 to the second quarter of 2003. In addition, a more detailed employment survey was being implemented. They also emphasized ongoing efforts by ISTAT, the Ministry of Economy, and the Bank of Italy to improve quality and timeliness of fiscal data and explain discrepancies in data originating from different sources.

III. Staff Appraisal

36. **Economic performance has been disappointing, and securing strong growth requires a more proactive role of the authorities in advancing their economic agenda—as seems finally to be the case in the area of pension reform**. Some deep-rooted structural weaknesses, particularly in the labor market, have been effectively addressed, and, reflecting

a fall in interest payments, the structural fiscal deficit has declined somewhat during the last two years, even after adjusting for one-off measures. But the deficit reduction has been relatively modest, and no progress has been made in lowering primary spending ratios and—pending adoption of the recent pension reform proposals—in moderating long-term spending pressures arising from population aging. All this has prevented more decisive progress in lowering the burden of taxation, which remains high and reduces incentives to work and invest. More is also needed to complete the labor market reforms and improve competition and the efficient use of all factors of production. Further reforms are likely to produce effects only gradually, but they will lay the foundation for raising the economy's longer-term growth potential, and facilitate a strengthening of external competitiveness, eroded over the last few years.

37. **In this context, the recent pension reform proposals would, if adopted, present a significant step toward securing fiscal solvency and fuller utilization of labor resources.** The proposals rightly focus on increasing the effective retirement age. Coupled with the attainment of a structural balance budget position over the next few years, the proposed reform would go a long way in checking public debt dynamics over the coming decades. At this stage, it will thus be critical to resist political pressure to dilute the reform during the process of parliamentary approval.

38. **The government's general fiscal strategy for 2004–07 also moves in the right direction but faster progress is needed.** The further decline in the structural fiscal deficit targeted for 2004–07 and the reduced reliance on one-off measures—and their complete phase out by 2006—are steps in the right direction. However, Italy's high public debt level and lack of progress in lowering primary public spending in recent years would justify a faster adjustment in 2004, including a swifter replacement of one-off measures with structural measures. Moreover, even the relatively unambitious fiscal deficit targets for 2004 are at risk, and interventions should be taken swiftly if structural slippages emerge. Deviations from target related to cyclical developments should be accommodated, however, allowing automatic stabilizers to operate fully and symmetrically. It will also be important to ensure that the cash-based deficit (in addition to the Maastricht-based accrual measure) is kept under control.

39. **Raising potential growth requires not only ensuring fiscal solvency, but also downsizing the public sector through deficit-neutral spending and tax cuts.** It is regrettable that the 2004 budget did not proceed on this account, reflecting persistent difficulties in implementing matching spending cuts. Yet, there is scope for expenditure reductions in several areas, such as public employment, health care costs, subsidies to enterprises, and public procurement (especially at the local level). Reliance on public-private partnerships for infrastructure investment can potentially yield efficiency gains and budgetary expenditure savings, but needs to be accompanied by careful monitoring and full transparency.

40. **Reconciling decentralization with overall fiscal discipline remains a key challenge**. As decentralization proceeds, it will be critical to clearly delineate expenditure and revenue assignments, while introducing stronger incentives and constraints to ensure financial discipline for all territorial entities. Building on recent steps that have strengthened centralized expenditure monitoring, it will be essential to ensure that the central government has sufficient information to monitor fiscal developments at sub-national levels. This would be helped considerably by the introduction of a uniform accounting methodology and timely reporting standards for all general government components.

41. **Wage moderation and substantial liberalization since the mid-1990s have led to strong employment gains—and ongoing labor market reforms, together with increased regional wage differentiation, could spur a further rise in employment**. The fact that some of the increase in employment may be due to the emergence of workers already employed does not detract from the importance of these achievements. In this context, the rapid implementation of the first part of the reforms agreed with the social partners in 2002 is welcome. The second part should also proceed expeditiously. The government and social partners need to work together to ensure that wages more adequately reflect productivity differences across regions and groups of workers. Importantly, this would secure open employment and thus social protection for some that are currently employed in the underground economy. The public sector should lead by example with regional cost of living allowances, which could be assessed once ISTAT completes its welcome initiative on the publication of regional price level data.

42. **Other ongoing initiatives hold out the promise of more durable convergence in living standards for the South**. Employment, export, and private investment growth, as well as the creation of new firms and some administrative improvements, are all positive signs. But further attention needs to be paid to strengthening local administrations and law enforcement. Complementing these steps, there is a role for well-planned and executed public infrastructure, an area where needs are sizable not only in the South.

43. **Competition and deregulation in product markets should be strengthened**. Lack of competition in key service sectors reduces efficiency and raises the costs for firms that use these services as inputs, thereby reducing their competitiveness. State interference in the operation of the regulatory authorities (newly created only a few years ago) should be resisted. The prospects of overcoming local veto power over the location of new electricity plants is welcome. Local impediments blocking new large retail outlets should also be overcome. In the case of professional services, there is a case for reducing regulations and strengthening the role of the Anti-trust Authority. Recent corporate law reforms are welcome and afford the potential for an enhanced role of minority shareholders. The reform of the bankruptcy law should not be delayed further. Finally, proceeding with privatization as rapidly as allowed by market conditions remains a priority, including at the local level.

44. **While the banking system has become stronger and more resilient in recent years, bank profitability needs to improve further, particularly through efforts to**

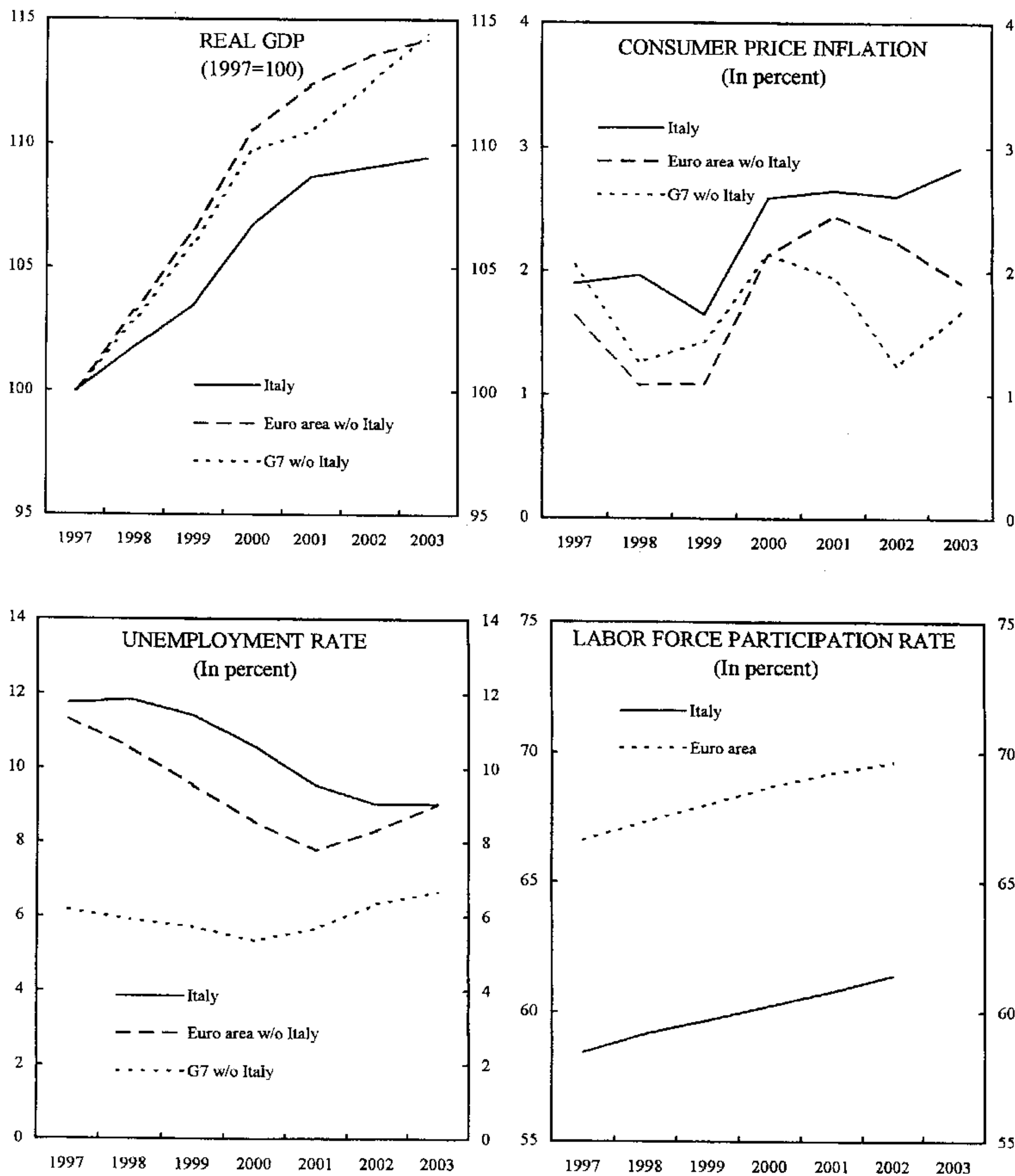
control costs. Securing additional efficiency gains while maintaining competitive pressures is likely to require further consolidation and eventually greater cross-border penetration by financial institutions (in Italy, as elsewhere in Europe). Efforts to maintain consumer confidence in financial markets following losses by retail customers who bought high-risk corporate bonds should focus on strengthening and enforcing clear and comprehensive disclosure requirements concerning the risks and prices of all financial products.

45. Regarding **trade policy**, the government should take full advantage of its current EU presidency and play a leadership role in advancing trade liberalization in the context of negotiations under the Doha round. The authorities' concerns regarding unfair trade practices should be addressed through the existing multilateral institutions. Italy is encourage to raise its relatively low ODA toward the UN target.

46. **Economic statistics are broadly adequate for surveillance**. The update of the fiscal ROSC notes, however, continued shortcomings in several areas, and large revisions to historical data raise doubts about the reliability of fiscal estimates for policy making. The recent provision of quarterly accrual-based fiscal data is most welcome.

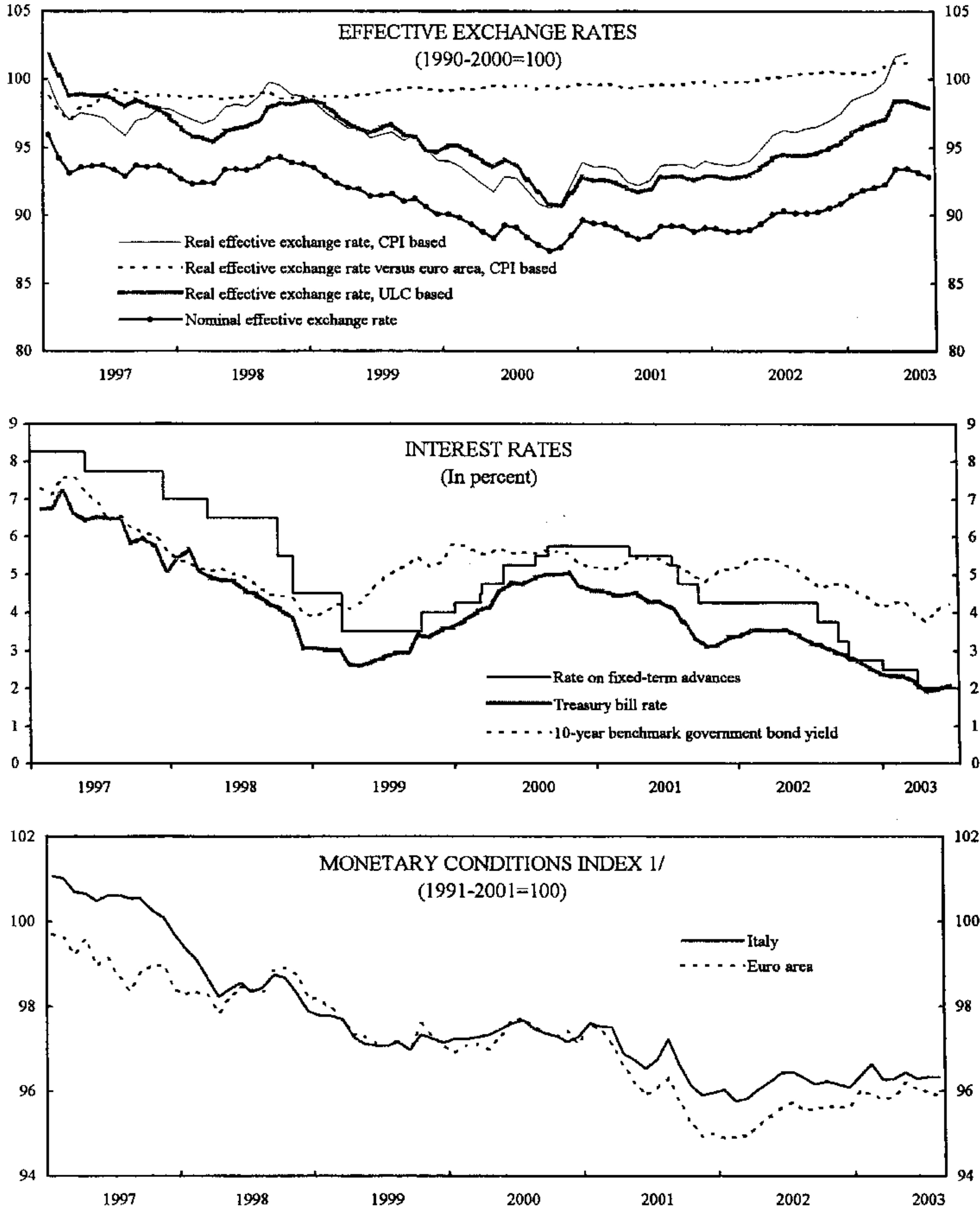
47. It is proposed that the **next Article IV consultation** take place on the standard 12-month cycle.

Figure 1. Italy: International Comparisons of Macroeconomic Performance, 1997–2003



Sources: IMF, *World Economic Outlook*; OECD, *Labor Market Statistics*; and Fund staff estimates.

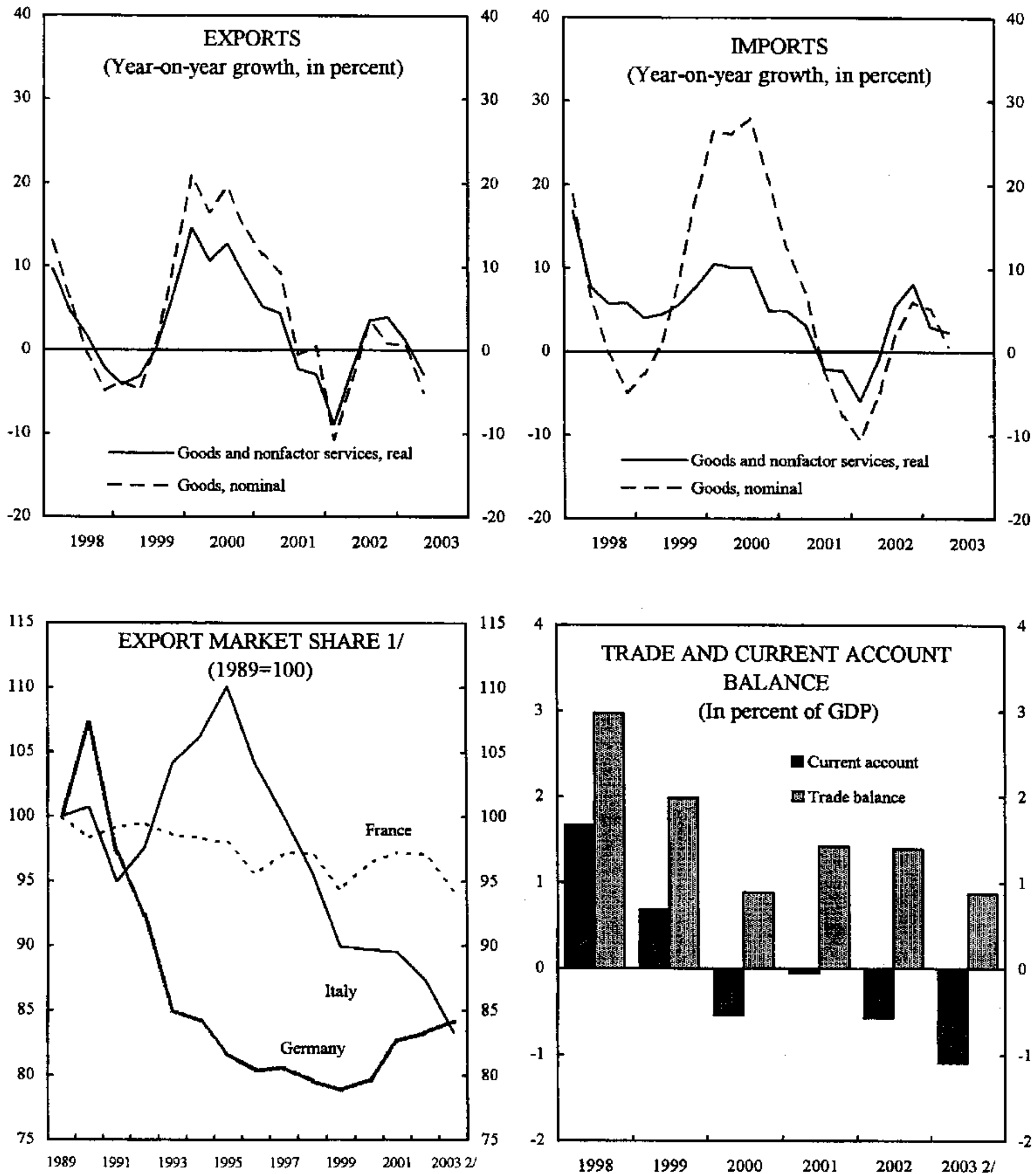
Figure 2. Italy: Effective Exchange Rates, Selected Interest Rates, and Monetary Conditions Index, 1997:1-2003:8



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

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

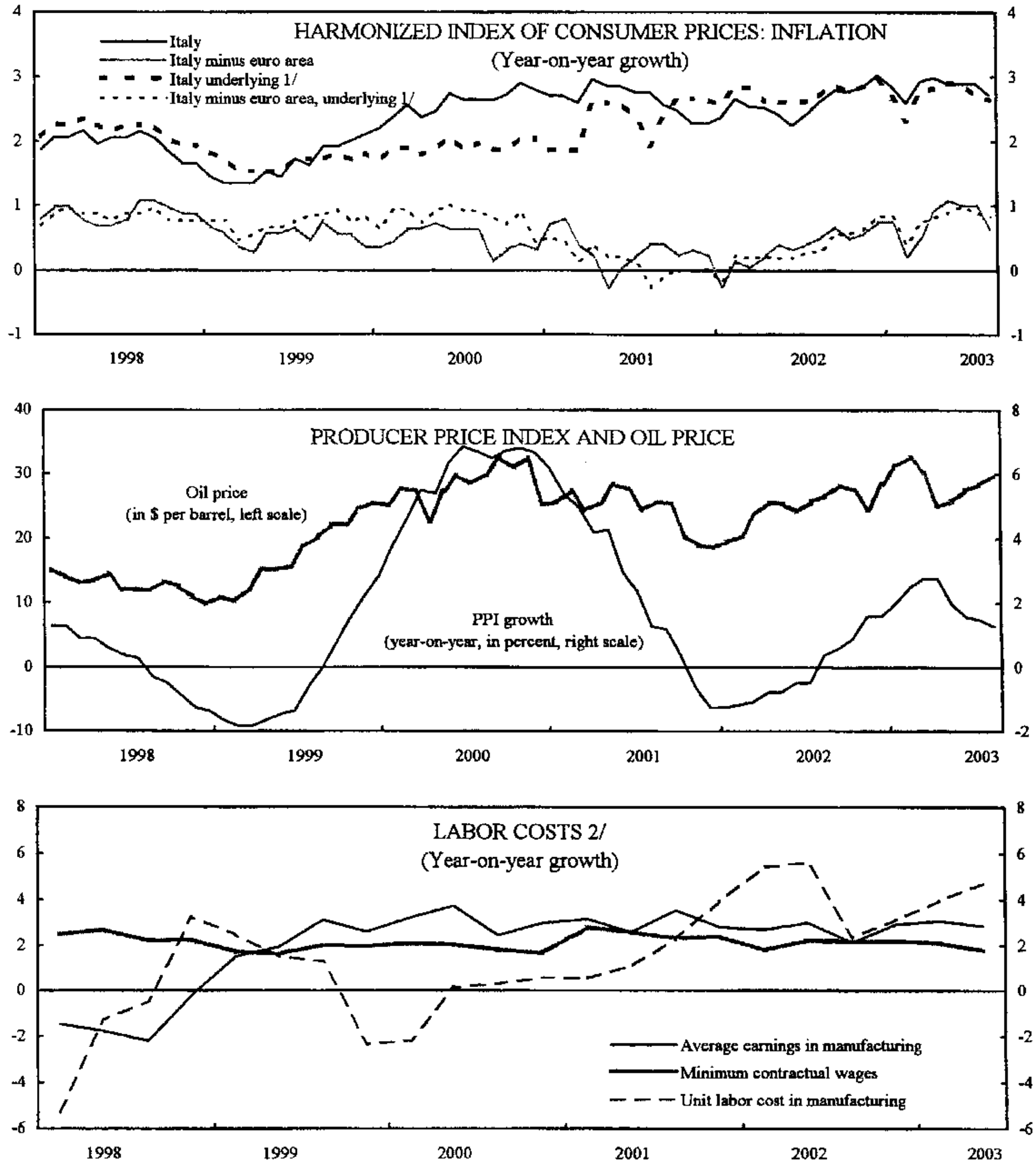
Figure 3. Italy: External Performance, 1998–2003



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

1/ As measured by real growth of exports of goods and nonfactor services less growth of import demand in partner countries.
2/ Fund staff estimates for 2003.

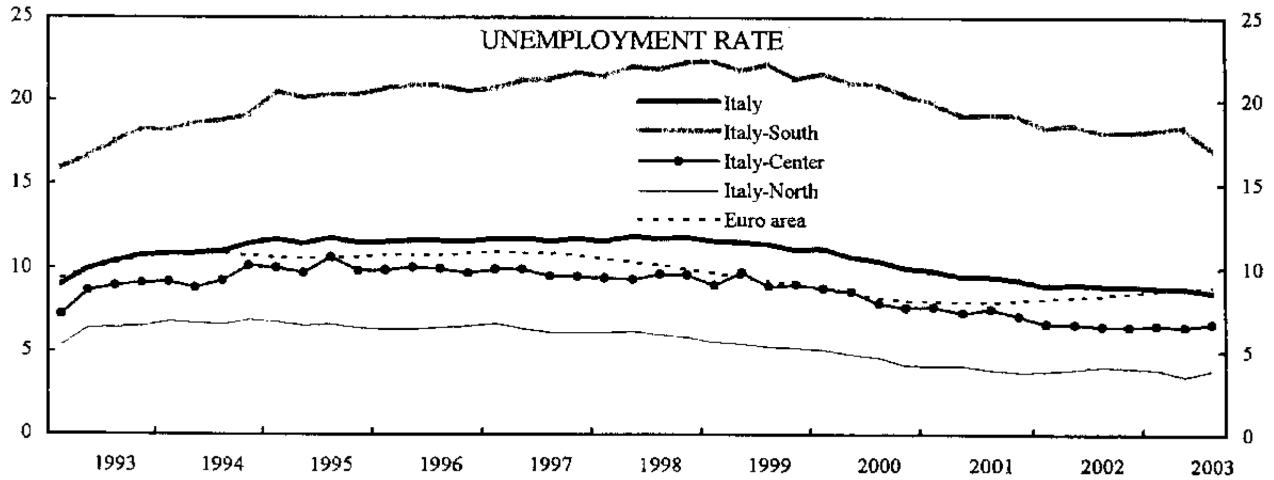
Figure 4. Italy: Indicators of Inflation, 1998:1-2003:08
(In percent)

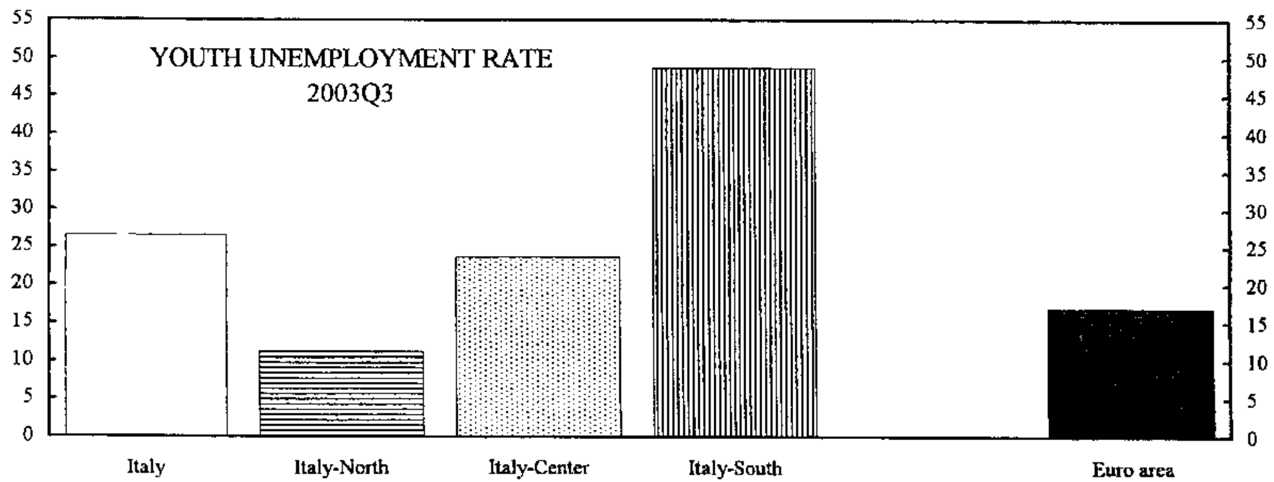


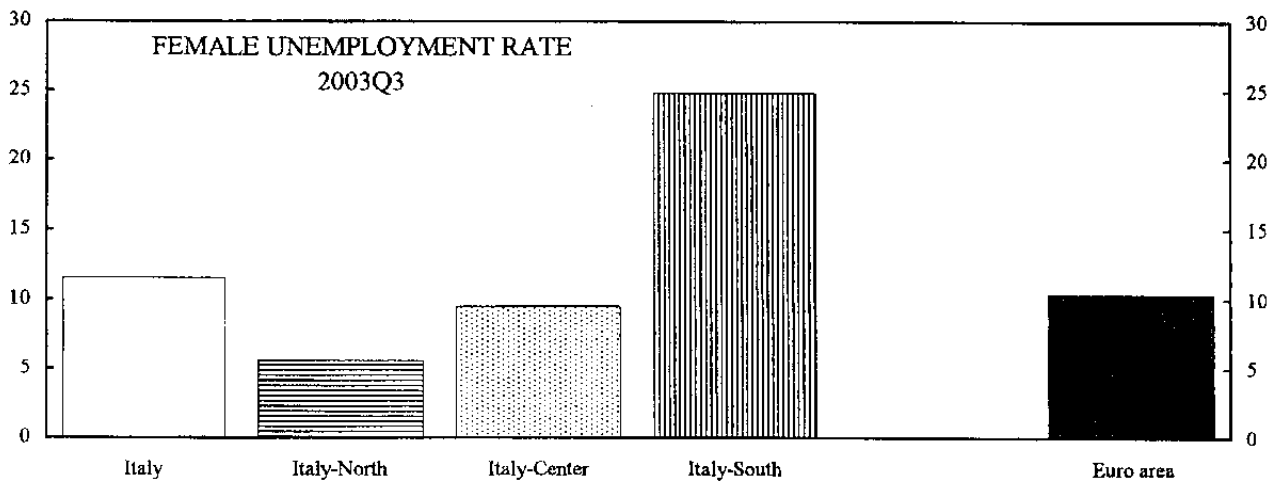
Sources: Bank of Italy; ISTAT; and EUROSTAT.

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

Figure 5. Italy: Unemployment in Italy and the Euro Area, 1993–2003
(In percent, seasonally adjusted)

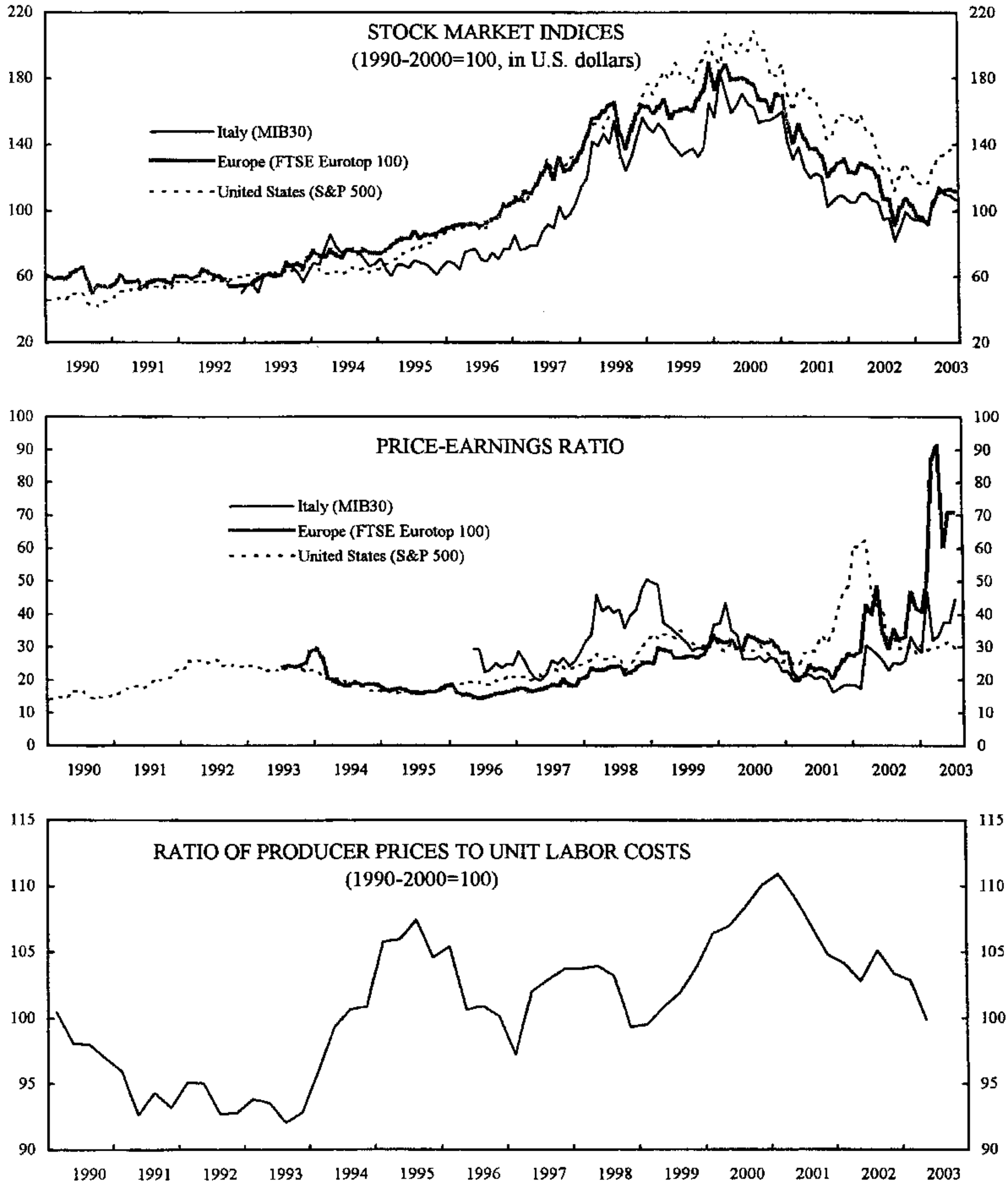






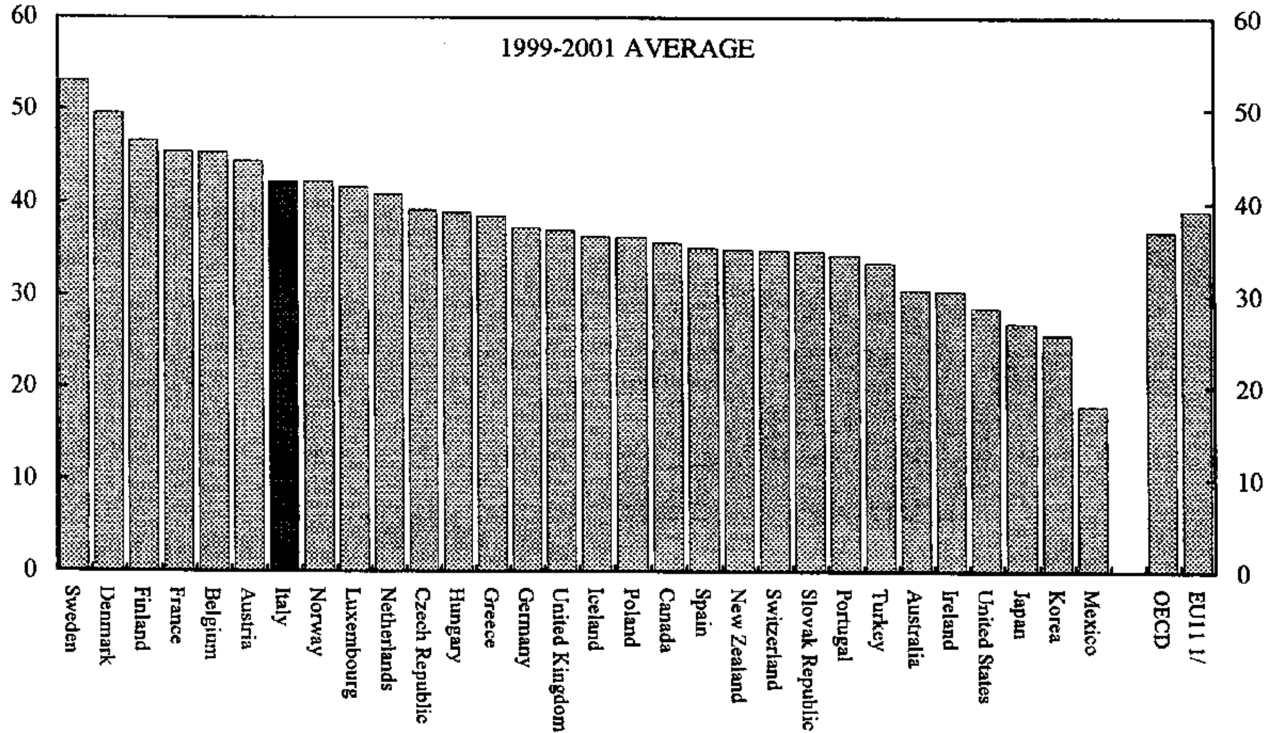
Sources: ISTAT and EUROSTAT.

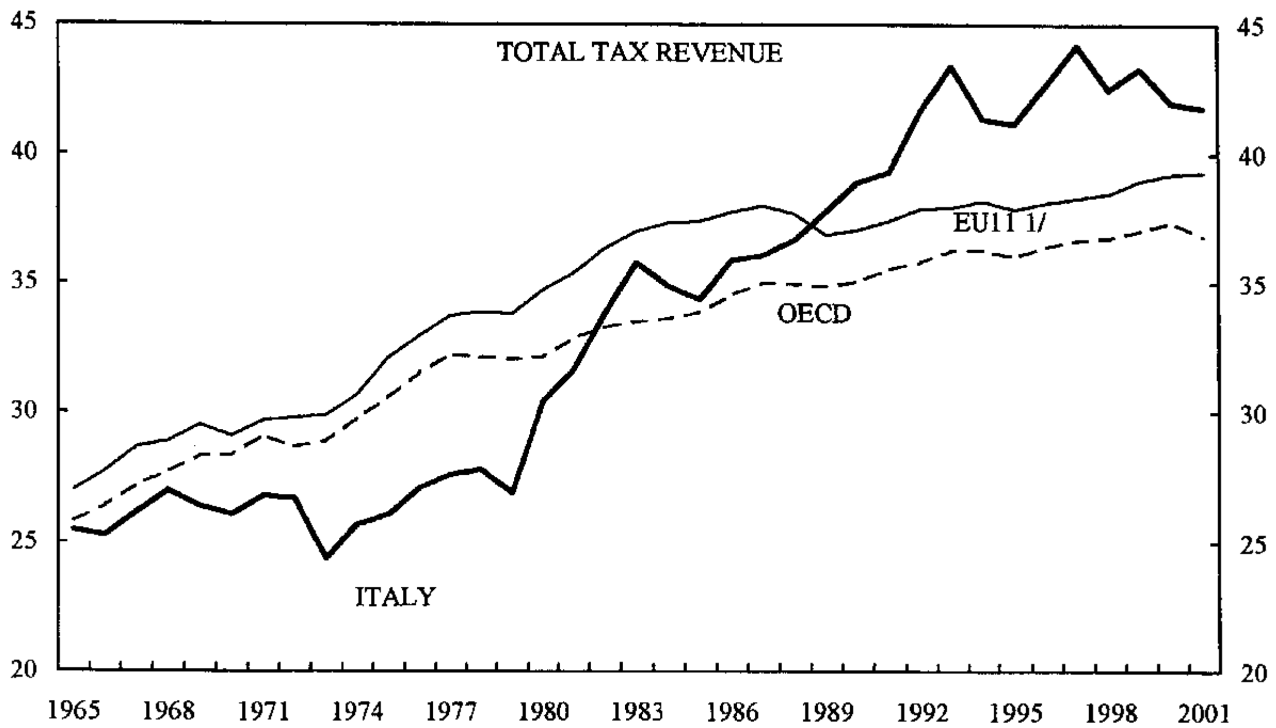
Figure 6. Italy: Stock Market and Profitability Indicators, 1990-2003



Sources: Bloomberg; ISTAT; and Fund staff calculations.

Figure 7. Italy: Tax Revenue, International Comparisons
(In percent of GDP)





Source: OECD Revenue Statistics.

1/ EU, excluding Italy and the Nordic countries (Denmark, Finland, and Sweden).

Table 1. Italy: Selected Economic Indicators, 2000-04

(Percentage changes, except as otherwise indicated)

	2000	2001	2002	2003 1/	2004 1/
Domestic economy					
GDP	3.1	1.8	0.4	0.4	1.7
Domestic demand	2.3	1.8	1.1	1.6	1.9
Consumption (households)	2.7	1.0	0.4	1.9	1.9
Public consumption	1.7	3.5	1.7	1.7	1.1
Gross fixed investment	7.1	2.6	0.5	-1.5	3.2
Machinery and equipment	8.0	2.2	0.6	-4.5	3.5
Construction	5.9	3.2	0.3	3.0	2.8
Inventories (contribution)	-1.1	0.0	0.4	0.4	-0.1
Foreign sector (contribution)	0.9	0.1	-0.7	-1.2	-0.2
Exports	11.7	1.1	-1.0	-2.4	5.1
Imports	8.9	1.0	1.5	1.8	5.9
Employment	1.9	2.1	1.5	0.8	0.8
Unemployment rate	10.6	9.5	9.0	8.7	8.5
Manufacturing value added	3.4	0.5	-0.8	0.6	1.7
Labor costs	3.1	3.0	2.7	2.1	3.3
Unit labor costs in manufacturing	-0.3	2.0	4.1	1.2	2.0
Consumer prices (period average)	2.6	2.7	2.6	2.8	2.1
GDP deflator	2.1	2.7	2.7	2.9	2.2
Output gap	1.0	0.6	-1.0	-2.3	-2.3
External accounts 2/					
Export volume	11.7	1.1	-1.0	-2.4	5.1
Import volume	8.9	1.0	1.5	1.8	5.9
Export unit value	5.1	3.8	-2.0	-1.3	1.1
Import unit value	14.0	1.6	-2.4	-2.1	0.8
Trade balance (in percent of GDP)	0.9	1.4	1.4	0.7	0.6
Current account (in percent of GDP)	-0.5	-0.1	-0.6	-1.3	-1.3
Nominal effective exchange rate 3/	-3.2	0.4	0.8	3.4	...
Real effective exchange rate (based on unit labor costs) 3	-3.4	-0.7	1.6	4.1	...
Public finances (in percent of GDP) 4/					
General government					
Revenues	45.8	45.5	44.9	45.6	44.8
Expenditures	46.5	48.1	47.2	48.2	47.1
Balance	-0.6	-2.6	-2.3	-2.7	-2.2
Structural balance (in percent of potential GDP)					
Net of asset sales	-2.4	-3.1	-2.7	-1.7	-1.9
Net of all one-off measures	-3.0	-3.8	-3.3	-3.1	-2.5
Primary balance	5.8	3.8	3.4	2.6	2.9
Structural primary balance (in percent of potential GDP)					
Net of asset sales	4.1	3.3	2.9	3.5	3.1
Debt	110.4	109.5	106.7	106.5	105.0
Financial variables					
Contribution to euro area M3 5/	4.1	7.1	11.2	13.1	...
Private sector credit 6/	19.2	10.3	8.1	10.1	...
Bank lending to private sector 7/	12.3	6.7	6.4	8.3	...
Six-month rate on treasury bills 8/	4.5	4.1	3.2	2.1	...
Prime lending rate 8/	7.3	7.7	7.3	7.1	...

Sources: Data provided by the Italian authorities; Ministry of Economy and Finance estimates for public finance data in 2004; 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/ For 2003, data refer to September.

4/ For 2000, including UMTS receipts of 1.2 percent of GDP, for 2001, 2002, 2003, and 2004 including asset sales of 0.2, 0.8, 0.1, and 0.6 percent of GDP, respectively, as a negative entry under capital expenditure; however, these receipts are removed for the purpose of calculating the structural balance. The fiscal balance projections for 2004 are the government's budget projections.

5/ End-of-period data; data for 2003 refer to August; data break in 2002.

6/ End-of-period data; data for 2003 refer to April.

7/ End-of-period data; data for 2003 refer to August.

8/ Period average; data for 2003 are available up to August.

Table 2. Italy: General Government Accounts, 1999–2004
(In percent of GDP)

	1999	2000	2001	2002	2003		2004
					Auth.	Staff Est.	Auth.
Total revenues	46.6	45.8	45.5	44.9	45.6	45.6	44.8
Direct taxation	15.0	14.6	15.0	14.1	13.4	13.4	13.3
Indirect taxation	15.1	15.0	14.5	14.6	14.5	14.5	14.7
Social contributions	12.7	12.7	12.6	12.7	12.8	12.8	12.9
Other current revenues	3.3	3.0	3.2	3.1	3.1	3.1	3.0
Capital revenues	0.5	0.4	0.3	0.4	1.8	1.8	0.8
Total expenditures	48.4	46.5	48.1	47.2	48.1	48.2	47.1
Current expenditures	44.5	43.9	44.2	43.8	43.9	44.0	43.5
Wages and salaries	10.7	10.6	10.7	10.7	10.8	10.8	10.6
Purchases of goods and services	7.1	7.3	7.7	7.6	7.6	7.7	7.5
Social transfers	17.2	16.8	16.6	17.1	17.3	17.3	17.3
Interest payments	6.7	6.5	6.4	5.7	5.3	5.3	5.1
Capital expenditures	3.9	3.8	3.9	3.4	4.2	4.2	3.6
Of which : asset sales	0.0	-1.3	-0.2	-0.9	-0.1	-0.1	-0.6
Overall balance	-1.8	-0.6	-2.6	-2.3	-2.5	-2.7	-2.2
Primary balance	5.0	5.8	3.8	3.4	2.8	2.6	2.9
Memorandum items:							
Structural overall balance	-1.7	-1.1	-2.9	-1.9	-1.5	-1.7	-1.3
Net of asset sales	-1.8	-2.4	-3.1	-2.7	-1.6	-1.7	-1.9
Net of all one-off measures	....	-3.0	-3.8	-3.3	-3.0	-3.1	-2.5
Structural primary balance	5.0	5.4	3.5	3.8	3.7	3.6	3.7
Net of asset sales	4.9	4.1	3.3	2.9	3.6	3.5	3.1
Primary expenditure 1/	41.7	41.7	42.2	42.0	41.9	42.0	41.6
Public debt	114.9	110.6	109.5	106.7	106.0	106.5	105.0
Real GDP growth (in percent)	1.7	3.1	1.8	0.4	0.5	0.4	1.9

Sources: ISTAT; Ministry of Economy and Finance, *Relazione Previsionale e Programmatica* (October 2003) and Fund staff calculations and estimates.

1/ Net of asset sales, in percent of potential GDP.

Table 3. Italy: Regional Selected Economic Indicators, 1997-2002
(In percent)

	1997	1998	1999	2000	2001	2002
Real GDP per capita in South relative to Center-North	55.4	55.4	55.6	55.6	55.9	56.5
Real GDP per employee in South relative to Center-North	80.2	78.7	80.1	79.6	79.5	79.5
Real GDP per capita growth, annual average						
Center-North	1.5	1.6	1.5	2.7	1.5	-0.2
South	2.6	1.5	1.9	2.8	2.0	0.9
Real GDP per employee growth, annual average						
Center-North	1.4	1.1	0.0	1.6	-0.1	-0.7
South	0.9	-0.8	1.8	1.0	-0.2	-0.7
Agriculture value added (in percent of GDP)						
Center-North	2.8	2.7	2.6	2.5	2.5	...
South	5.9	5.7	5.6	5.1	5.0	...
Industry value added (in percent of GDP)						
Center-North	31.5	31.3	30.6	30.4	30.3	...
South	20.5	20.0	19.9	19.8	19.7	...
Services value added (in percent of GDP)						
Center-North	50.2	49.9	50.2	50.5	51.1	...
South	49.4	49.4	49.2	49.7	50.1	...
Employment growth						
Center-North	0.4	0.8	1.7	1.4	1.8	1.3
South	1.9	2.4	-0.1	1.6	2.2	1.9
Unemployment rate						
Center-North	7.4	7.0	6.7	5.9	5.2	4.9
South	21.0	21.7	21.4	20.5	18.9	18.3
Long-term unemployment rate						
Center-North	58.5	43.9	47.0	41.1	38.3	...
South	80.0	71.2	69.4	70.5	61.5	...
Labor force participation rate						
Center-North	61.5	62.0	62.9	63.6	64.3	64.8
South	51.5	52.8	53.0	53.3	53.6	54.0
Employment rate						
Center-North	57.0	57.6	58.7	60.0	61.0	61.8
South	40.4	41.1	41.2	42.0	43.1	44.0
Investment (in percent of GDP)						
Center-North	17.8	18.0	18.8	19.5	19.5	...
South	19.6	20.0	19.6	20.6	20.5	...
Public consumption (in percent of GDP)						
Center-North	15.2	15.0	15.2	15.3	15.8	...
South	23.4	23.0	23.0	23.3	24.0	...
R&D spending, business (in percent of GDP)						
Center-North	0.6	0.6	0.6	...	...	...
South	0.2	0.2	0.2	...	...	...
R&D spending, public (in percent of GDP)						
Center-North	0.2	0.2	0.2	...	...	...
South	0.1	0.1	0.1	...	...	...

Sources: Eurostat; ISTAT; and Bank of Italy.

Table 4. Italy: Selected Indicators of Vulnerability, 1997-2003 1/

(In percent of GDP, unless otherwise indicated)

	1997	1998	1999	2000	2001	2002	2003	
							Latest Est.	Date
External indicators 1/								
Exports (annual percentage change, in U.S. dollars)	-3.2	0.9	-5.0	0.8	1.9	3.7	16.2	
Imports (annual percentage change, in U.S. dollars)	1.7	4.1	-0.1	6.1	0.2	4.7	19.2	
Terms of trade (annual percentage change)	-1.1	2.3	-0.1	-7.2	1.6	1.4	0.8	
Current account balance (settlement basis)	2.8	1.7	0.7	-0.5	-0.1	-0.6	-1.3	
Capital and financial account balance	-1.5	0.5	-0.6	0.8	-0.2	0.9	...	
Of which: Inward portfolio investment (debt securities, etc.)	6.3	9.3	8.8	5.3	2.7	2.8	...	
Inward foreign direct investment	0.3	0.2	0.6	1.2	1.4	1.2	...	
Other investment liabilities (net)	1.2	0.8	3.3	2.5	0.8	-0.5	...	
Official reserves (in U.S. dollars, billions, end-of-period) 2/	55.7	29.9	22.4	25.6	24.4	28.6	33.7	Jul.
Contribution to euro area M3 (in percent of reserves) 3/	13.6	27.5	29.5	24.9	27.1	30.5	29.5	Jul.
Central Bank foreign liabilities (in U.S. dollars, billions) 2/	1.1	1.0	6.3	0.2	2.2	3.1	3.5	Jul.
Foreign assets of the financial sector (in U.S. dollars, billions)	198.5	225.1	175.4	175.5	152.7	224.6	...	
Foreign liabilities of the financial sector (in U.S. dollars, billions)	239.2	268.9	248.7	278.1	275.6	315.3	...	
Official reserves (ratio to average monthly imports) 2/	2.6	1.3	1.0	1.1	1.0	1.1	...	
Total external debt	59.0	71.1	72.0	82.5	81.4	92.5	...	
Of which: General government debt	25.4	31.1	29.7	35.2	35.0	40.4	...	
Total external debt to exports (ratio)	2.2	2.7	2.9	3.0	2.9	3.5	...	
External investment income payments to exports (in percent)	18.0	19.9	18.8	16.4	15.5	17.6	...	
Exchange rate (per U.S. dollars, period average)	0.88	0.90	0.94	1.09	1.12	1.06	0.90	Aug.
Financial market indicators								
Public sector debt (Maastricht definition)	6.7	5.2	5.0	5.8	3.8	3.4	...	
3-month T-bill yield	6.3	4.6	3.0	4.5	4.1	3.3	2.1	Aug.
3-month T-bill yield (real)	4.4	2.6	1.3	1.9	1.4	0.6	-0.6	Aug.
Stock market index (year end; year 2000 = 100)	55.4	78.1	95.6	100.0	75.4	57.7	60.8	Sep.
Share prices of financial institutions (year end; year 2000 = 100)	50.6	78.6	81.6	100.0	71.1	49.8	57.1	Sep.
Spread of 3-month T-bills with Germany (percentage points, period average)	3.0	1.2	0.1	0.2	0.4	0.3	0.0	Aug.
Financial sector risk indicators 4/								
Foreign exchange loans (in billions of U.S. dollars)	67.1	73.7	45.4	50.0	45.7	43.9	...	
Share of foreign exchange loans in total lending (percent)	9.4	9.1	5.9	6.1	5.5	4.2	...	
Deposits in foreign exchange (in billions of U.S. dollars)	24.1	25.8	21.8	22.3	22.1	29.2	...	
Share of foreign deposits in total deposits (percent)	3.9	4.0	3.9	4.2	4.1	4.6	...	

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

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

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

3/ Definition of M3 from 1999 onwards excludes currency held by the public.

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

Table 5. Italy: Financial Soundness Indicators, 1996-2002 1/

(In percent, unless otherwise noted)

	1996	1997	1998	1999	2000	2001	2002
Core Set							
Deposit-taking institutions							
Capital adequacy 2/							
Regulatory capital to risk-weighted assets 2/	12.2	11.4	11.3	10.6	10.1	10.4	11.2
Regulatory tier I capital to risk-weighted assets 2/	10.5	9.7	9.4	8.6	7.8	7.8	8.2
Asset quality							
Nonperforming loans (bad and subst.)							
Share of total gross loans	13.9	12.6	11.8	9.8	7.8	6.7	6.5
Percentage change	9.2	-3.6	-0.8	-8.8	-10.7	-8.6	2.8
Net of provisions, percent of capital	64.4	58.4	51.1	38.9	30.1	26.8	25.0
Sectoral distribution of loans to total loans							
General government	9.0	8.8	8.0	7.6	6.4	5.8	5.3
Financial corporations	11.4	12.7	12.5	13.0	14.5	14.7	14.6
Nonfinancial corporations and sole proprietorships	63.3	61.7	61.3	59.4	59.2	59.3	59.1
Building and construction	9.5	8.6	8.3	7.6	7.0	6.8	6.9
Consumer households	16.3	16.8	18.2	20.0	19.9	20.2	21.0
Large exposures to capital 2/	63.7	66.5	44.7	66.1	66.9	66.8	60.2
Earnings and profitability							
Return on assets	0.2	0.1	0.5	0.6	0.8	0.6	0.5
Return on equity 3/	0.3	1.5	7.4	9.6	11.5	8.8	6.2
Interest margin to gross income	75.7	71.6	60.6	55.0	52.2	52.3	56.7
Noninterest expenses to gross income	66.8	68.8	60.8	60.6	55.9	55.3	59.8
Liquidity							
Liquid assets to total assets (liquid asset ratio)	13.3	11.8	12.9	11.3	8.9	8.7	7.8
Liquid assets to short-term liabilities	43.4	36.9	37.2	34.0	27.1	26.0	23.4
Sensitivity to market risk							
Duration of assets	7M-11D	6M-1D	8M-13D	7M-28D	7M-18D	7M-21D	8M-18D
Duration of liabilities	4M-9D	4M-19D	7M-7D	6M-26D	6M-20D	7M-1D	8M-4D
Net open position in foreign exchange to capital 2/	...	5.9	5.2	4.4	5.6	4.9	3.9
Encouraged Set							
Deposit-taking institutions							
Supervisory capital to assets 2/	6.6	6.5	6.8	6.7	6.8	7.1	7.4
Average risk weight (ratio of risk-weighted assets to assets)	0.54	0.57	0.60	0.63	0.67	0.68	0.67
Geographical distribution of loans							
North	54.5	56.0	57.1	59.3	61.9	62.2	62.2
Center	28.5	27.5	26.9	25.2	23.9	24.1	24.1
South	17.0	16.5	16.0	15.6	14.2	13.7	13.6
Geographical distribution of nonperforming loans							
North	33.2	34.0	33.7	34.8	37.0	37.9	40.4
Center	27.5	29.7	29.7	26.5	28.0	27.1	27.4
South	39.3	36.4	36.8	38.7	35.0	34.9	32.2
Gross asset position in financial derivatives to capital	21.6	31.3	31.3	25.6	36.8	50.8	46.8
Gross liability position in financial derivatives to capital	21.5	31.9	32.7	25.1	25.2	37.0	44.9
Trading income to total income	10.5	8.8	9.1	5.1	3.9	3.5	2.1
Personnel expenses to noninterest income	64.0	62.1	60.4	58.4	56.3	54.5	54.6

Table 5. Italy: Financial Soundness Indicators (continued)

(In percent, unless otherwise noted)

	1996	1997	1998	1999	2000	2001	2002
Spread between reference lending and deposit rates (CDs up to 6 months)							
Household lending (average for new loans)	5.0	4.4	3.1	3.1	3.0	3.3	3.0
Corporate lending (average for new loans)	2.9	2.0	1.4	2.2	2.3	2.2	2.1
Customer deposits and bonds to total (noninterbank) loans 4/	127.1	120.0	116.4	107.8	100.3	100.5	103.7
Foreign currency-denominated loans to total loans 4/	8.3	9.4	9.1	5.9	6.1	5.5	4.2
Foreign currency-denominated deposits to total deposits	3.3	4.3	4.3	4.1	4.5	4.5	4.7
Net open position in equities to capital	...	2.8	3.7	5.2	5.7	11.4	2.6
Market liquidity							
Average bid-ask spread in the securities market	0.07	0.05	0.02	0.04	0.05	0.04	0.03
Average daily turnover ratio in the securities market	...	...	...	0.96	0.89	0.90	0.81
Nonbank financial institutions							
Assets to total financial system assets	21.3	26.2	34.4	37.4	36.9	36.6	34.6
Assets to GDP	39.8	53.2	76.7	92.3	92.5	89.8	85.5
Corporate sector							
Debt to GDP - Italy	51.8	51.0	50.6	54.3	57.7	59.2	60.7
Debt to GDP - euro area	55.4	55.9	57.5	60.9	67.4	...	...
Total debt to equity	103.4	86.9	73.4	57.2	56.2	65.9	68.9
Return on equity	6.4	8.0	8.7	9.3	7.3	4.8	...
Earnings to interest expenses	152	175	276	341	265	214	233
Corporate net foreign exchange exposure to equity	...	...	-6.7	-3.1	-3.5	-2.6	-2.6
Number of applications for protection from creditors 5/	...	...	1,255	1,164	571	605	883
Household sector							
Household debt to GDP - Italy	18.6	19.0	19.8	22.0	22.8	22.9	24.1
Household debt to GDP - euro area	43.4	44.5	46.8	49.1	50.4	51.0	...
Household debt service and principal payments to income	1.8	1.7	1.6	1.3	1.8	1.9	1.7
Real estate markets							
Real estate prices (1990=100, deflated by CPI)							
Residential	97.9	98.5	94.6	92.3	93.6	98.3	106.9
Commercial	39.2	37.1	45.9	50.8	62.9	...	...
Residential real estate loans to total loans	...	7.5	8.3	9.6	10.3	10.3	12.0

Sources: Bank of Italy; and Eurostat.

1/ Some data were provided directly by the Bank of Italy and have not been sourced to a published document.

2/ Consolidated data.

3/ Net earnings include the net change in the fund for general banking risks; capital and reserves are calculated as centered 13-month average.

4/ Including loans to nonresidents and excluding bad loans.

5/ Special administration and private preemptive agreements.

Table 6. Italy: Selected Structural Determinants of Growth in Italy and in the Euro Area (2002 unless indicated otherwise)

	Italy	Euro area
Convergence		
GDP per capita relative to the euro area (in percent)	94.2	100.0
Investment		
Gross fixed capital formation (in percent of GDP)	19.7	20.2
Private gross fixed capital formation (in percent of GDP)	15.4	17.3
Public gross fixed capital formation (in percent of GDP)	4.3	2.8
Foreign direct investment inflows (in percent of GDP)	1.2	3.6
Human Capital		
Primary school enrollment ratio (in percent) 1/	100.9	104.2
Secondary enrollment ratio (in percent) 1/	95.9	107.2
Tertiary school enrollment ratio (in percent) 1/	49.9	51.7
Public spending on education (in percent of GDP) 1/	4.5	4.8
Structural		
OECD regulation indices (increasing to the strictness of regulation)		
Product market regulation 2/	2.3	1.7
Barriers to entrepreneurship 2/	2.7	1.9
Regulation of competition 2/	2.0	1.1
Administrative regulation 2/	3.0	2.2
Administrative burdens of startups 2/	4.6	2.5
Legal barriers 2/	3.0	1.7
Employment protection legislation index 2/	3.3	2.7
Spending on active labor market policies (in percent of GDP) 2/	1.3	3.1
Economic freedom index (increasing from 1 to 10) 1/	7.0	7.3
of which:		
Legal system and property rights 1/	7.4	7.8
Business regulation 1/	5.0	5.7
of which:		
Starting a new business 1/	4.4	5.1
Technology		
R&D spending (in percent of GDP) 1/	1.0	2.1
Information and communication technology expenditure (in percent of GDP) 1/	5.7	7.2
Personal computers (per 1,000 people) 1/	194.8	286.2

Sources: IMF, WEO; World Bank , WDI; OECD; and Economic Freedom Network.

1/ 2001.
2/ 1998.

ITALY: FUND RELATIONS

(As of September 30, 2003)

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	3,915.83	55.50
Reserve position in Fund	3,139.68	44.50

III. **SDR Department**:	SDR Million	Percent Allocation
Net cumulative allocation	702.40	100.00
Holdings	89.09	12.68

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)**:

	Forthcoming				
	2003	2004	2005	2006	2007
Principal					
Charges/Interest	2.40	9.58	9.56	9.56	9.56
Total	2.40	9.58	9.56	9.56	9.56

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 maintains an exchange system free of restrictions on the making of payments and transfers for current international transactions, except for restrictions vis-à-vis Myanmar and Zimbabwe (imposed by Council Regulations (EC) No. 1081/2000 and Council Regulations (EC) No. 310/2002, respectively). Additional restrictions concern measures freezing the accounts of and banning payments in favor of listed terrorists and the Taliban, and these restrictions were notified to the Fund (EBD/02/51, 3/29/02) in accordance with Executive Board Decision No. 144-(52/51).

VIII. **Article IV Consultations**:

Italy is on the standard 12-month consultation cycle. The previous consultation discussions took place during May 28–June 11, 2002 and the staff report (SM/02/304, 9/28/02) was discussed on October 21, 2002 (EBM/02/107).

IX. ROSCs

Standard Code Assessment	Date of Issuance	Document Number
Fiscal Transparency	October 9, 2002	SM/02/319
Data	October 18, 2002	SM/02/328

ITALY: STATISTICAL INFORMATION

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

Recent steps to improve economic data include: work on the way by ISTAT to calculate regional price levels—expected to be available by mid-2004; the publication of quarterly data for the general government balance, expenditure, and revenue on an accruals basis (that is, in line with ESA95) starting in October 2003; and a new, more detailed labor survey, conducted by professional staff, which is expected to lead to the publication of hours worked by 2005. The shift to chain-weighted indices for national accounts is expected in March 2005, with initial estimates within 2004.

Notwithstanding these improvements, weaknesses remain in some areas. In the national accounts, inventory accumulation is derived as a residual and lumped together with the statistical discrepancy: this hampers an analysis of the business cycle. Furthermore, as highlighted by a recent fiscal transparency Report on Observance of Standards and Codes (ROSC) mission, the quality and timeliness of some fiscal data, particularly on expenditure by local governments, falls short of the SDDS requirements, notwithstanding some improvements of late.

A ROSC Data Module Report (SM/02/328, 10/18/02) found Italy's macroeconomic statistics to be of generally high quality, but also identified some shortcomings that hindered an accurate and timely analysis of economic and financial developments: (i) no statistical agency had the responsibility to compile and disseminate an integrated, comprehensive statement of government finances, and a troubling difference had emerged between the several distinct measures of government deficit/financing; (ii) source data and/or statistical techniques could be strengthened in several areas, most importantly, by raising response rates on the enterprise surveys used in the national accounts and producer price index (PPI), by making price collection for the CPI more efficient, and by improving the coverage of cross-border financial transactions that did not go through domestic banks; (iii) monetary, balance of payments, and the existing portions of government finance statistics could come closer to the internationally accepted methodological guidelines on concepts and definitions, scope, classification and sectorization, and/or valuation; and (iv) resources were under pressure in some parts of the National Institute of Statistics in the face of the statistical requirements of the European Union and the euro area. The authorities reactions to these concerns were published along with the Report, and they are in the process of addressing most of these problems.

Italy: Core Statistical Indicators
(As of September 11, 2003)

	Exchange Rates	International Reserves	Central Bank Balance Sheet	Reserve/ Base Money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Government Balance 1/	GDP/ GNP
Date of Latest Observation	9/11/03	7/03	7/03	7/03	7/03	9/11/03	8/03 2/	6/03	6/03	8/03	2003 Q2
Date Received	9/11/03	mid-August	9/01/03	9/01/03	9/01/03	9/11/03	8/29/03	9/03/03	8/12/03	9/01/03	8/08/03
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	Ministry of Economy and Finance	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 2002 and was published March 1, 2003.

2/ Provisional estimate.

INTERNATIONAL MONETARY FUND

Public Information Notice

EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 03/134
FOR IMMEDIATE RELEASE
November 13, 2003

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

IMF Concludes 2003 Article IV Consultation with Italy

On November 7, 2003, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Italy.[1]

Background

Output growth weakened in 2002 and, as elsewhere in the euro area, the economy stagnated in the first half of 2003. The recent weakness in activity followed a decade of relatively slow growth, with GDP expanding at one of the lowest rates among industrial countries. In 2002, GDP growth declined to 0.4 percent, as weakness in export markets and further losses in market shares resulted in a sizable negative contribution from the external sector. Domestic demand remained relatively resilient, partly reflecting the effect of temporary incentives for investment and car purchases. However, as these incentives expired at end-2002, and despite supportive monetary conditions, GDP declined by a cumulative 0.2 percent in the first half of 2003. Notwithstanding the cyclical downturn, employment has continued to grow, supported by the recent labor market reforms, wage moderation, and some employment incentives; and the unemployment rate fell to 8.7 percent in the third quarter of 2003. However, Italy's employment rate remains the lowest in the European Union, reflecting low labor force participation, particularly in the South. Inflation has continued to exceed the euro-area average.

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[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.

Italy has been the only large euro-area country that has not breached the 3 percent deficit ceiling of the Stability and Growth Pact. However, this has been secured with large revenues from one-off measures and declining interest payments. At the same time, primary spending remains (in relation to GDP) above its level at the beginning of monetary union. In 2003, further expenditure overruns (primarily on health care) and lower revenues on account of the weakening economy are expected to raise the fiscal deficit, with staff expecting the deficit to reach about 2.7 percent of GDP in 2003; the authorities expect a deficit of 2.5 percent of GDP. The decline in the cyclically-adjusted deficit (net of one-off measures) would be smaller than the fall in interest payments and, as a result, the cyclically-adjusted primary balance is expected to worsen further in 2003. The cash-based borrowing requirement is expected to exceed 4 percent of GDP, and its high level has prevented a significant decline in the debt-to-GDP ratio, which remains the highest among euro-area countries.

Near-term growth prospects have strengthened somewhat over the summer with the rebound in business confidence and firmer signs of an external recovery. In all, staff expects GDP growth of 0.4 percent in 2003 and 1.7 percent in 2004. However, concrete signs of an upswing are still few and the outlook is subject to sizable downside risks, including a slower-than-projected recovery in Europe, a further appreciation of the euro, and a delayed recovery in private investment.

Executive Board Assessment

Executive Directors noted that, while the prospects for a gradual recovery in economic activity in the near term have improved, Italy's GDP growth over the past decade has been disappointingly low, whereas inflation has remained above the euro-area average. Accordingly, Directors saw as the key challenge facing the authorities to continue to address the supply-side weaknesses that are at the heart of Italy's slow growth. Deep-rooted structural weaknesses in the labor market have been effectively reduced, but a more determined fiscal consolidation and structural reform strategy will be needed to raise the economy's employment and productivity growth, and strengthen its external competitiveness. This will require continued strong efforts to mobilize public support for the implementation of reforms in a wide range of areas.

Against this backdrop, Directors welcomed the recent pension reform proposals. If adopted, the proposed reform will constitute an important step toward increasing labor force participation by raising the effective retirement age. Together with the attainment of a structural balanced budget position over the next few years, the savings envisaged by the current reform proposal will also help lower and then stabilize the public debt over the coming decades. Directors urged the authorities to work toward expeditious and full implementation of the reform.

Directors underscored the need for a more determined fiscal consolidation effort. Many Directors commended the authorities for being the only large euro-area country that has kept the fiscal deficit below the Stability and Growth Pact's 3 percent of GDP ceiling. However, Directors generally expressed concern about the steady worsening of the primary balance and lack of progress in lowering primary spending ratios, with extensive recourse to one-off measures, including various tax amnesties which put future tax compliance at risk. Directors

considered that the government's medium-term targets for reducing the structural deficit and plans for phasing out the reliance on one-off measures are moves in the right direction. However, in light of Italy's high public debt, they felt that a faster adjustment in 2004 than envisaged in the budget, including a swifter replacement of one-off measures with structural expenditure measures, would be desirable.

Directors regretted that persistent difficulties in reining in public spending have precluded faster progress in reducing Italy's high tax burden. To help raise Italy's growth potential, they encouraged the authorities to aim for more ambitious progress through expenditure savings in areas such as public wages and employment, enterprise subsidies, health spending, and public procurement, that would create room for tax cuts. Directors considered that public-private partnerships for infrastructure investment could yield efficiency gains and budgetary expenditure savings, provided they are accompanied by a careful assessment of risks, close monitoring, and full transparency. Regarding fiscal decentralization plans, they underscored the need to clearly delineate tax and spending responsibilities, introduce adequate incentives and constraints for all territorial entities, and ensure the availability of accurate data on sub-national finances.

Directors commended the substantial liberalization of the labor market since the mid-1990s, which, together with wage moderation, has led to strong employment gains also during a period of cyclical weakness. Notwithstanding these successes, Italy's employment rate remains the lowest in the EU, and Directors looked forward to ongoing labor market reforms, as well as increased regional wage differentiation, that will spur a further rise in employment, including through incorporation of the underground economy. They welcomed the implementation of the first part of the reforms agreed with the social partners in 2002, and called for proceeding expeditiously on the second part of the accord. They also encouraged the government and social partners to work together to ensure that wages better reflect productivity differences and labor market conditions across regions, and looked forward to the public sector leading by example with regional cost of living allowances, once regional price level data are published.

Directors welcomed ongoing policy initiatives to help achieve more durable convergence in living standards for the South. While there has been a welcome pick-up in employment, export, and private investment growth, and the creation of new firms, they saw scope for further strengthening local administrations and law enforcement, and for well-planned and executed public infrastructure initiatives.

Directors called for steps to boost productivity, whose growth rate has slowed sharply in recent years. They stressed the importance of raising expenditure on Research and Development, removing impediments to entrepreneurial activity by eliminating bureaucratic hurdles, and rapidly implementing a long overdue reform of the bankruptcy law. To strengthen competition and deregulation in product markets, Directors encouraged the authorities to address the lack of competition in key service sectors where high prices raise the costs for firms, to resist state interference in the operation of the regulatory bodies, and to proceed with privatization, including at the local level, as rapidly as allowed by market conditions. They welcomed recent corporate law reforms affording the potential for an enhanced role of minority shareholders.

Directors welcomed the strengthening of the Italian banking system in recent years. To raise profitability levels, they saw scope for further efficiency gains, including through cost reduction and further consolidation. They also emphasized the importance of maintaining consumer confidence in financial markets by enforcing clear and comprehensive information disclosure requirements for all financial products.

Directors welcomed the turnaround in Italy's Official Development Assistance and the definition of a road map for further increase in ODA from 2002 to 2006; they urged the authorities to continue working toward this goal. They also encouraged them to take advantage of Italy's EU presidency to help advance trade liberalization under the Doha round, with a number of Directors underscoring the importance of further reforms of the Common Agricultural Policy. Directors commended the authorities for their efforts to counter money laundering and the financing of terrorism, and for providing other countries with technical assistance in this area. They welcomed the authorities' decision to include collective action clauses in foreign bond issues.

Directors noted that Italy's statistics are adequate for surveillance, and welcomed the recent publication of quarterly accrual-based general government accounts. They encouraged the authorities to address in a timely fashion the remaining areas of weakness identified by last year's statistical and fiscal Reports on the Observance of Standards and Codes—particularly regarding general government data.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board. The Staff Report for the 2003 Article IV Consultation with Italy is also available.

Italy: Selected Economic Indicators

	2000	2001	2002	2003 1/
Real economy (change in percent)				
GDP	3.1	1.8	0.4	0.4
Domestic demand	2.3	1.8	1.1	1.6
CPI	2.6	2.7	2.6	2.8
Unemployment rate (in percent)	10.6	9.5	9.0	8.7
Public finances (general government; in percent of GDP)				
Overall balance 2/	-0.6	-2.6	-2.3	-2.7
Primary balance 2/	5.8	3.8	3.4	2.6
Gross debt	110.4	109.5	106.7	106.5
Money and credit (end of year, percent change)				
Contribution to euro-area M3 3/	4.1	7.1	11.2	13.1
Private sector credit 4/	19.2	10.3	8.1	10.1
Interest rates (year average)				
Six-month rate on treasury bills 5/	4.5	4.1	3.2	2.1
Government bond rate, ten-year 5/	5.6	5.2	5.3	4.2
Balance of payments (in percent of GDP)				
Trade balance	0.9	1.4	1.4	0.7
Current account	-0.5	-0.1	-0.6	-1.3
Fund position (as of September 30, 2003)				
Holdings of currency (in percent of quota)		55.5		
Holdings of SDRs (in percent of allocation)		12.68		
Quota (in millions of SDRs)		7,055.5		
Exchange rate				
Exchange rate regime		Euro-area member		
Present rate (October 7, 2003)		US$1.18		
Exchange rate (change in percent)				
Nominal effective 6/	-3.2	0.4	0.8	3.4
Real effective (based on unit labor cost) 6/	-3.4	-0.7	1.6	4.1

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

1/ IMF staff estimates and projections.

2/ For 2000, including UMTS receipts of 1.2 percent of GDP. For 2001, 2002, and 2003 including estimated receipts from asset sales of 0.2, 0.8, and 0.1 percent of GDP, respectively.

3/ For 2003, year-on-year change for August. Data break in 2002.

4/ For 2003, year-on-year change for April.

5/ For 2003, average up to August.

6/ For 2003, based on monthly average to September.

Statement by Pier Carlo Padoan, Executive Director for Italy
November 7, 2003

As for other EU countries Italy's growth over the recent past has been constrained by an unfavorable international environment. Prospects for the next year are more encouraging as the global recovery hopefully gains momentum. Notwithstanding short-term improvements in growth perspectives, we concur with staff that medium-term growth performance has been disappointing, reflecting structural weaknesses.

Structural reforms are beginning to bear fruit and additional structural measures are being introduced

On a more positive side, as also described in the staff report, measures adopted in the second half of the nineties to reform the labor market, as well as the new policy approach to tackle the long standing issue of lagging growth in the Mezzogiorno, are beginning to bear fruit. Such developments confirm that structural reforms are needed to revamp the economy but also that it takes time for these reforms to produce tangible results, especially in a low growth environment.

The authorities are encouraged by these results and significant actions have been taken to reinforce them. Additional labor market reform measures have been introduced early in 2003 and they are being complemented with measures to curb spending in aging related items as a new pension reform bill has been submitted to Parliament and is about to be introduced. These structural measures, in addition to sustaining long-term growth, will strengthen fiscal consolidation in the framework of the EU integration process.

The short-term outlook remains favorable

My authorities share with staff the view that a pick-up is expected in 2004. Private consumption, supported by the favorable employment performance, has so far underpinned domestic demand. However, this has not been enough to compensate for the negative contribution of external demand to growth. My authorities expect, for 2004, a significant rebound in private investment, supported by a stronger business confidence, the level of which in October was well above the average of the previous nine months. In addition, the external component of demand, while still negative, should improve with respect to 2003.

Long-term growth is disappointing, and it partly reflects weakening international competitiveness

In spite of improvements in the short term, longer-term growth prospects continue to be less than satisfactory. Over the past decade Italy's growth rate has remained below the EU average. It is not reassuring to note that the trend of decelerating growth can be traced back to the previous decade and that it follows a pattern that is partly shared by other EU countries. Over the recent past, and especially since the last Art. IV consultation, the debate over the causes of such performance in my country has been very lively. Views differ on the causes of such performance. But there is hardly any disagreement that no single factor can be

held accountable for the overall slowdown and that these causes lie mostly with supply side impediments.

Lower long-term growth is partially related to weakening external competitiveness, itself the result of a number of factors that, in many cases, overlap. The erosion of competitiveness, which has become more visible recently, reflects the still insufficient adjustment of the economic system to the changes in the distribution of comparative advantages that have taken place, and continue to take place, in the international economy.

Real appreciation is putting pressures on firms. But past experience shows that firms have the capacity to react

There is broad agreement in my country that, notwithstanding the strong performance of highly competitive industry segments, Italy's production mix should be strengthened in high value-added and high growth-of-demand sectors. Over the past decade, and before that, real depreciations have periodically provided some breathing space to exporting firms. The strengthening of the euro and the perspective of further real appreciation due to price level convergence, as suggested in the staff report, have now changed the picture. While these developments add to short-term pressures they should also stimulate the capacity of firms to react. Indeed during previous episodes of sustained real appreciation, firms have responded to pressures by increasing productivity in a number of ways, including through higher capital investment, and similar reactions should be expected in the current phase, especially once the growth environment improves. My authorities believe that, in the current circumstances, the way forward is to increase the pace of innovation activities and, to this purpose, they have included measures in the budget law for 2004 to support innovation efforts.

The inflation differential should decline as reforms produce their effects

Weakening competitiveness is also the result of a persistence of an inflation differential. The causes of this divergence have to do, in part, with the structural determinants indicated in the staff report, including low productivity growth, price level convergence, lagging benefits of energy sector liberalization and a much tighter output gap effect once regional segmentation effects are taken into account. The relevance of several of these factors should diminish substantially once measures to address structural impediments in the energy sectors and in the Mezzogiorno fully produce their effects.

There are also some additional explanatory factors whose effects on inflation should be temporary: a) the increase in housing prices over the last several years, accelerated after the stock market crisis of 2000, has been more substantial than in other EU countries, especially in large cities. Such increase has progressively slipped into increases in rents and in higher costs for the retail system and has been carried on to consumer prices. The long-term increase in house prices has now largely subsided and there are indications that it is coming to an end. Nonetheless, substantial lags due to the duration of rental contracts could sustain such effect for some time; b) because of the heat wave and the drought very substantial price increases have affected the food

industry, particularly fruits and vegetables. Tensions have been easing after the summer and food prices are now coming down. Preliminary October data for consumer prices (Istat, non harmonised) point to a reduction of the inflation rate to 2.6% from 2.8%. Furthermore, the industrial price core inflation rate remains under control (0.9%).

Service sector liberalization

We concur with staff that progress in liberalization will further support a decline in inflation differentials and improve competitiveness. The government moved in this direction in a number of sectors, including railways and postal services where further liberalization has been scheduled through the implementation of EU Directives in 2003.

In the telecommunication sector, prices have decreased in 2002 by 5.4%. The Authority for Telecommunications has recently revised downward the price cap in the retail market. Furthermore, recently introduced measures will result in further reductions in prices, likely to be in the order of 15%.

With reference to the electricity sector, some competition enhancing measures have recently been implemented and others are being developed. By July 2004 final users—except households—will be able to choose their own provider, while households will be able to do so by July 2007. The establishment of the Electric Exchange, which will start its operations early in 2004, is expected to increase the transparency of prices in this sector.

It should be noted, however, that the level of energy prices mainly reflects the lack of low-cost energy sources in Italy, differently from other European countries. A number of initiatives recently undertaken by the authorities address this issue by providing incentives to develop renewable energy sources. With the aim of increasing the productive capacity, a recently-introduced law considerably streamlines the procedures for building new electric plants and for connecting the domestic electric system with those of other countries. However, while these measures have a favorable impact on prices in the long-run, they may induce temporary upward pressures in the short-run, given the need for financing extensive investment plans.

Labor market. Encouraging results and new measures

Higher growth will require higher employment. For the first time since the release of new Istat data on employment (end 1992), the Italian unemployment rate is as low as 8.7%, slightly below the EU12 average. The employment level has surpassed 22 million people in 2003 (marking an increase of 231,000 units with respect to the previous year). The employment rate and the activity rate are also rising. As emphasized also in the staff report these results are encouraging, the more so given the low growth environment, and they are largely the result of reform measures introduced during the second half of the nineties. Such results are likely to be reinforced once the new labor market reform, approved by parliament in February 2003, produces its full effects.

The 'Biagi'[1] reform, represents a major step in the implementation of the *Pact for Italy,* signed in July 2002 between the government and the majority of social partners, aiming at raising employment rates in line with the EU Lisbon strategy. It includes a number of major institutional innovations in line with the approach of increasing 'flexibility at the margin'. The implementing measures have entered into force in October 2003. They focus on improving job matching services and introducing/redefining different types of contracts. The intervention of a plurality of agents in an integrated network (private-public) should improve transparency and efficiency of job matching services, facilitating employment. A complete monitoring system will be instrumental in improving statistical information and especially in the evaluation of policies.

The second pillar of the reform includes measures to improve the legislative framework to better interpret the needs of a modern economy. It envisages flexible schemes to increase the opportunities for regular employment, according to workers and employers' preferences: the introduction of job sharing, temporary jobs, a redefinition of part-time, incentives for training young people entering the job market, workers over 50 and women in areas with high unemployment.

Wage differentiation

Given the large regional disparities staff suggests that more pronounced wage differentiation would improve employment opportunities. As we reiterated in last year's discussion such initiatives are for the social partners to decide. With respect to staff's advice that the public sector should play a leading role in introducing wage differentiation through differentiated cost of living allowances for public employees, my authorities believe that public salary differentiation should reflect different productivity levels, as already is the case for the private sector. A first step in this direction has already been taken for the salary of top management in the Public Administration, which is partially related to performance.

The Mezzogiorno. Breaking with a long tradition of ineffective policies

As we had already noted during the 2002 Art. IV consultation there is no doubt that Italy's long-term growth would be significantly increased if the Mezzogiorno could complete its catching-up process. The chapter on the Mezzogiorno included in the selected issues offers a quick, yet comprehensive, description of the evolution of the policy approach to this deep rooted problem. It also highlights how the new approach adopted by authorities since the mid nineties is now beginning to bear fruits.

The new approach is based on a shift away from sectoral interventions towards integrated regional policies that are based on concentrating funds on selected targets to increase competitiveness rather than on broad redistribution measures, provision of public goods (especially, physical and immaterial infrastructure) rather than state aids. Moreover, it introduces a reform of the implementation practices, including stronger monitoring and

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[1] The law takes its name after its original proponent Marco Biagi, a Professor of Law and consultant to the Minister of Welfare, assassinated by the Red Brigades in March, 2002

evaluation, increased transparency and accountability. Special emphasis is put on coordination in the provision of public goods and incentives for institution building and empowerment of regional administrations.

In this context, the *performance reserve system* introduces incentives for local administrators to accelerate the implementation of administrative reforms and pursue high quality projects. In Southern Italy, the modernization of regional administrations takes on special relevance, given that they are responsible for selecting projects for nearly two thirds of all capital resources available. The national performance reserve system of the Community Support Framework 2000-2006 allocates nearly five billion euro (10 per cent of total funds, the highest percentage among all EU Member States) to high performing administrations. The reward system is based on clearly identified indicators, approved by central and regional administrations. The system has led to significant results, although with variations across regions, including: the implementation of administrative reforms (for example delegation of managerial responsibilities to public officials; setting up of public investment evaluation and verification units, etc), administrative innovations (promotion of the information society in public administration; setting up of one-stop shop for enterprises, etc.) and the implementation of structural reforms in key sectors (integrated water resource systems and urban waste collection etc.).

This approach will take time to show its results. However, it is encouraging to observe that regional output and unemployment disparities have declined since 1999. The latest available information show that the southern regions are performing above national average. Improved confidence in the private sector goes hand in hand with the positive results in the labor market, where unemployment has further been reduced to 16.8% (in July 2003). The contribution to growth of infrastructure investment since the second half of the nineties is also a positive sign, indicating a stronger effectiveness of public investment.

The Italian EU Presidency, considers cohesion policy a fundamental pillar in the process of EU integration and has recently promoted an initiative to evaluate the reform prospects in the context of EU enlargement. The guiding principle is that cohesion policy, by reducing social and economic disparities, can strongly contribute to the Lisbon and Gothenburg agendas, to boost competitiveness in employment and growth.

Fiscal consolidation. Increased emphasis on structural measures to reduce spending and support growth

The low growth environment and the high stock of debt continue to put severe pressure on the budget. The financial law for 2004, now under discussion in Parliament, amounting to approximately 16 billion euros is based on the following principles: continued consolidation of public finances, gradual elimination of one-off measures and their replacement with structural measures aimed at reducing spending, additional measures to support growth and competitiveness.

Eight billion euros will be targeted to the South to increase physical and immaterial infrastructure. In this area, projects have already come a long way: from July 2001 through

June 2002 infrastructural projects have been launched for a total of 32 billion euros; between July 2002 and June 2003 projects for an additional 19 billion euros have been allocated.

A significant amount of resources will be committed to support innovation activities. Measures include the tax abatement of profits reinvested in innovation and research activities and fiscal incentives to Italian researchers working abroad to return home. A new Institute for Technological Innovation will be established, aiming at creating a more effective interaction between R&D activities carried out in universities and applied R&D performed by the private sector, also through reinforcing monitoring and dissemination of results.

On privatization, a few days ago, the authorities have divested shares from ENEL for an amount equivalent to 6.6% of its capital, with a view to further reduce their holding in the future.

The 2003 deficit will be close to 2.5% of GDP, 0.2 percentage point higher than in 2002. The cyclical adjusted deficit, however, amounts to 1.9% of GDP, 0.3 percentage points lower than in 2002. The output gap[2] will be significantly higher in 2003 than in 2002, given the prolonged slowdown. This has resulted in an increase in the cyclical component of the deficit amounting to 0.7% of GDP.

Looking ahead, the cyclically-adjusted budget deficit in 2004 should fall to 1.6% of GDP, thus decreasing by a further 0.3% with respect to 2003 and the trend should continue in the following years, with a 0.5% reduction each year, implying to significant fiscal consolidation effort in 2005-07.

Pension reform

The proposed pension reform, which is currently being discussed, builds on the 1995 reform ("Dini"). The overall aim is to prolong working life, rising the retirement age to 60 for women and to 65 for men, - a measure staff has advocated several times in the past– and extend the contributions period needed to access the pension benefits to 40 years (from 35). This strategy, which requires a significant investment of political capital by authorities, alleviates pressure on financing requirements over the coming years due to the rise of aging population and contributes to rising the employment rate and will ultimately support long term growth. These last results will be enhanced by some provisions of the Biagi law which encourage firms to hire workers over 50 through fiscal bonuses similar to those previously granted for the exclusive hiring of young people. In the same fashion, actions will be taken to encourage continuous learning during the workers life cycle so as to facilitate job transition for senior workers.

Staff has produced a remarkable job in carefully reviewing the Italian pension system and exploring its future evolution under different assumptions and policy options. Staff and authorities however (RGS, Ministry of Finance) adopt different assumptions on both the macroeconomic outlook (GDP and labour productivity) and on the size of the deficit for their

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[2] Computed according to EU methodology

long-run projections. In particular, authorities' assumptions foresee an average annual growth rate of Gdp of 1.4 – 1.5%, in line with both the European Union and the OECD long-term scenarios for Italy. Staff assume a growth rate slightly below 1%, with a difference of about 0.5 percentage point per year. Similarly different assumptions are made with respect to labour productivity which my authorities place at 1.7-1.8% on average for the overall simulation period, with a peak of 2.0% from 2026 to 2050, while staff numbers are respectively 1.2-1.3% and 1.5%.

The combined effect of different macroeconomic assumptions and different hypotheses on the deficit level leads to quite different results. Staff project an explosive growth of the debt/GDP ratio to over 200% in 2050 while the EU projections, which my authorities take as reference, indicate a final debt ratio ranging from approximately 90% to zero according to the assumptions on net borrowing requirements

The Banking System

The position of the banking system is sound. Capital adequacy ratios have increased during 2002, the ratio of nonperforming loans to total gross loans has decreased in the course of 2002 to 6.5 percent, and large exposures in relation to capital have fallen.

With regard to the cost structure and the profitability of the banking system, structural improvements in cost ratios have been achieved as a result of the reorganization of the banking system that began in the mid-1990s. The increase in operating costs in the most recent period is mainly due to investments in the field of information technology and to early severance incentives. As a result, between 1995 and 2002 the stock of IT capital rose roughly fourfold, and the number of employees decreased by 4.5 per cent. In the years 2000 and 2001, the profit performance of the Italian banking system was heavily affected by the financial difficulties in some Latin America countries and a few large foreign corporations. In fact, the operating profits of Italian banks turned out higher than the EU average.

Looking ahead, the authorities welcome any further action aimed at strengthening the profitability of the system. It should be, however, noted that policies directed to enhance the efficiency of individual institutions are up to bank managers, who can choose among a wide range of options. M&As made it possible to improve the efficiency in the production and distribution of banking services in Italy starting from a situation in which the banking system was highly fragmented, with a large number of small and medium-sized banks engaging mainly in deposit-taking and lending in local markets.

Official Development Assistance

Italy has subscribed to the EU commitment to pursue the 0.39 percent objective (as a collective average) as an intermediate objective in view of the attainment of the UN target of 0.7 percent.

Within this framework, Italy is committed to make every effort to reach the 0.33 percent target by 2006 and the Italian government has defined a roadmap for a gradual increase in ODA from 2002 to 2006.

Some progress is already visible. In 2002 and 2003 the Italian percentage of ODA in relation to the Gni went up to 0.20 and 0.21 percent respectively after a sharp decline in the Nineties (from 0.41 percent of Gdp in 1989 to 0.15 in 2001). ODA increased also very substantially in real terms (by 31.5% in 2002) reflecting a major increase in bilateral aid, including debt relief operations in the context of the HIPC initiative, as well as contributions to the EC and Global Funds.

In addition, the Italian Government is in the process of devising alternative mechanisms of development financing, such as the de-tax, which was approved by the Parliament in March 2003, and is expected to become operational within one year. This mechanism is based on the involvement of private sector in the financing of development and would free additional resources with respect to ODA.