IMF Country Report No. 13/298

ITALY

2013 ARTICLE IV CONSULTATION

September 2013

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 2013 Article IV consultation with Italy, the following documents have been released and are included in this package:

- The **Staff Report** for the 2013 Article IV consultation, prepared by a staff team of the IMF for Executive Board's consideration on September 23, 2013, following discussions that ended on July 5, 2013, 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 September 6, 2013.
- An **Informational Annex** prepared bt the IMF.
- A **Press Release** summarizing the views of the Executive Board as expressed during its September 23, 2013 discussion of the staff report that concluded the Article IV Consultation with Italy.
- A **Statement by the Executive Director** for Italy.

The document listed below has been or will be separately released.

Selected Issues Paper

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 2013 ARTICLE IV CONSULTATION

September 6, 2013

KEY ISSUES

Beyond Austerity: Priorities for Reviving Growth

A difficult recovery. After two years of recession, the economy is showing signs of stabilizing, but continues to face strong headwinds from tight credit conditions. A modest recovery is expected to take hold later this year, led by exports.

Declining trend growth. The euro area crisis hit Italy hard, but the origins of Italy's low growth pre-date the crisis and stem from its stagnant productivity, difficult business environment, and an over-leveraged public sector. In the absence of deeper structural reforms, medium-term growth is projected to remain low.

Risks and spillovers. Italy is vulnerable to a renewal of euro area tension and risks from domestic policy slippages, stalling of structural reforms, and banking distress that could undermine confidence. In view of its central role in the global trade and financial system, steps by Italy to reduce fiscal vulnerabilities and boost growth would carry important spillover benefits for the currency union and for global financial stability.

Policies to revive growth and tackle structural problems. A comprehensive policy response is needed to reduce vulnerabilities and sustain a robust recovery:

- **Improving the business environment and creating jobs**. The government has taken steps to liberalize services, open the energy sector, and improve the labor market, but more is needed to boost productivity and raise Italy's low employment rate.

- **Reducing public debt and rebalancing adjustment**. Italy is set to reach its target of a structural balance this year. To support growth, a rebalancing of fiscal adjustment towards spending cuts and lower taxes is needed. Once the recovery is underway, building a buffer under the structural balance rule would bring down debt more quickly and reduce vulnerabilities.

- **Strengthening banks' balance sheets and lending**. Banks have improved their capital positions, but continue to suffer from weak asset quality and profitability. To strengthen lending, banks should build adequate capital and liquidity buffers and accelerate the repair of their balance sheet. Measures to address financial fragmentation at the European level would ease credit conditions and funding concerns.

Approved By
Aasim M. Husain and Hugh Bredenkamp

Discussions took place in Rome and Milan from June 21 to July 5, 2013. The staff team comprised K. Kang (head), S. Lanau, J. Tyson (all EUR), L. Eyraud (FAD), N. Jassaud (MCM), A. Tiffin (SPR); and B. Barkbu (EUR) at headquarters. A. Husain (EUR), D. Demekas (FSAP head, MCM), N. Schwarz (LEG), S. Nardin (COM) and S. Pompe (external expert) joined for part of the mission. A. Montanino and C. Quaglierini (OED) also participated in the discussions. The mission met with Finance Minister Saccomanni, Bank of Italy Governor Visco, Minister of Justice Cancellieri, other senior officials, and finance, industry, academic, and trade union representatives.

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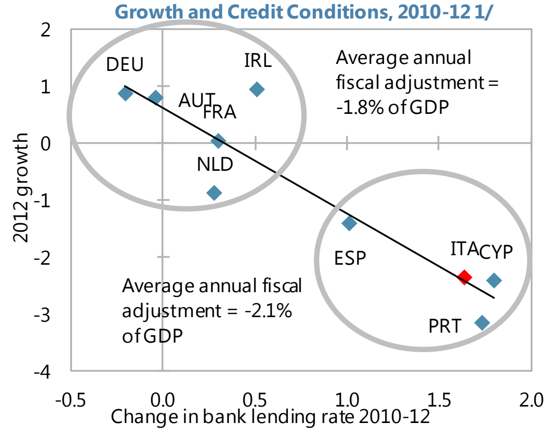
BACKGROUND: A DIFFICULT RECOVERY

1. **After nearly two years of recession, the economy is showing signs of stabilizing**. GDP contracted by 2.4 percent in 2012, and at a similar annualized rate in the first half of 2013. The contraction was led by sharp falls in domestic demand, reflecting tight credit conditions, the sizeable fiscal adjustment, and depressed confidence. Recent data show some signs of stabilization: business and household confidence is improving and export orders have picked up, but spending and employment remain weak. The unemployment rate is at post-war highs of 12 percent, with youth unemployment nearing 40 percent.

2. **Sovereign financing pressures have eased significantly.** Following significant fiscal adjustment and the announcement of the Outright Monetary Transactions (OMT) framework in August 2012, sovereign yields have fallen considerably. Volatility and yields picked up earlier this year following the elections in Italy and global reaction to Federal Reserve policy, but proved temporary, and have returned roughly to levels seen at the end of last year.

3. **Credit conditions, however, remain tight and have depressed private spending**. Since 2010, financial fragmentation has driven Italian lending rates up by nearly 150 bps, far exceeding those in the core countries and elsewhere. Compared to the sharp declines in sovereign yields since the OMT announcement, Italian lending rates have fallen only slightly. Staff analysis indicates that higher lending rates have tightened monetary conditions, negating the impact of ECB rate cuts and the euro's depreciation, and were a major factor behind the deep recession (Box 1).

Growth and Credit Conditions, 2010-12 1/



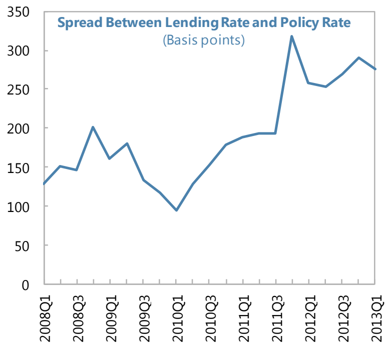
1/ Fiscal adjustment is defined as the average annual change in the cyclically-adjusted primary balance, 2010-12.

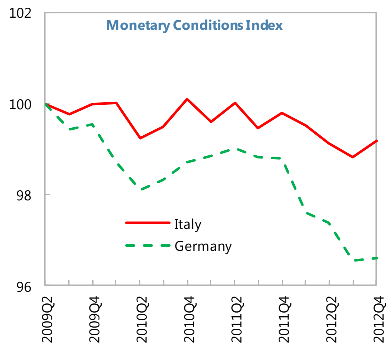
4. **The lengthy recession and financial fragmentation have taken a heavy toll on Italian banks**. The ratio of nonperforming loans has almost tripled since 2007, while the outflows of nonresident deposits and limited access to wholesale financing have raised the cost of funding. Italian banks have responded by keeping lending rates high and reducing loans to the corporate sector (by 4 percent in June, y/y). While weak demand was the main factor driving deleveraging last year, lending survey data suggest that supply constraints are becoming more important.

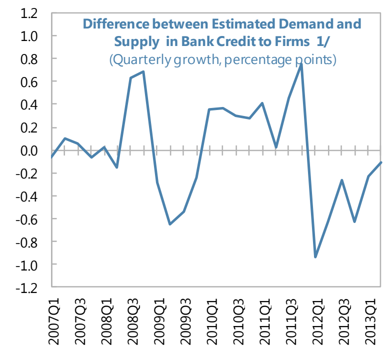
5. **Weak demand has also contributed to the narrowing of external imbalances**. The current account deficit has declined from 3½ percent of GDP in 2010 to near zero in the first half of 2013, reflecting mainly a collapse in imports and steady exports. Italy's net international investment position is modest at -24 percent of GDP and has been broadly stable. Private-sector capital inflows have increased over the past few quarters, as overseas investors have resumed purchases of Italian sovereign bonds.

Box 1. Italy—The Impact of Tight Credit Conditions on Growth

Despite cuts in the policy rate, monetary conditions in 2013 have eased only marginally compared to 2009.[1] Over the period, the spread between the Italian lending and the policy rate has increased by nearly 160 bps. The tightening from higher real lending rates has largely offset the 4 percent real effective depreciation, leaving monetary conditions only marginally looser. In contrast, the MCI for Germany has declined by more over the period, led by falling lending rates.







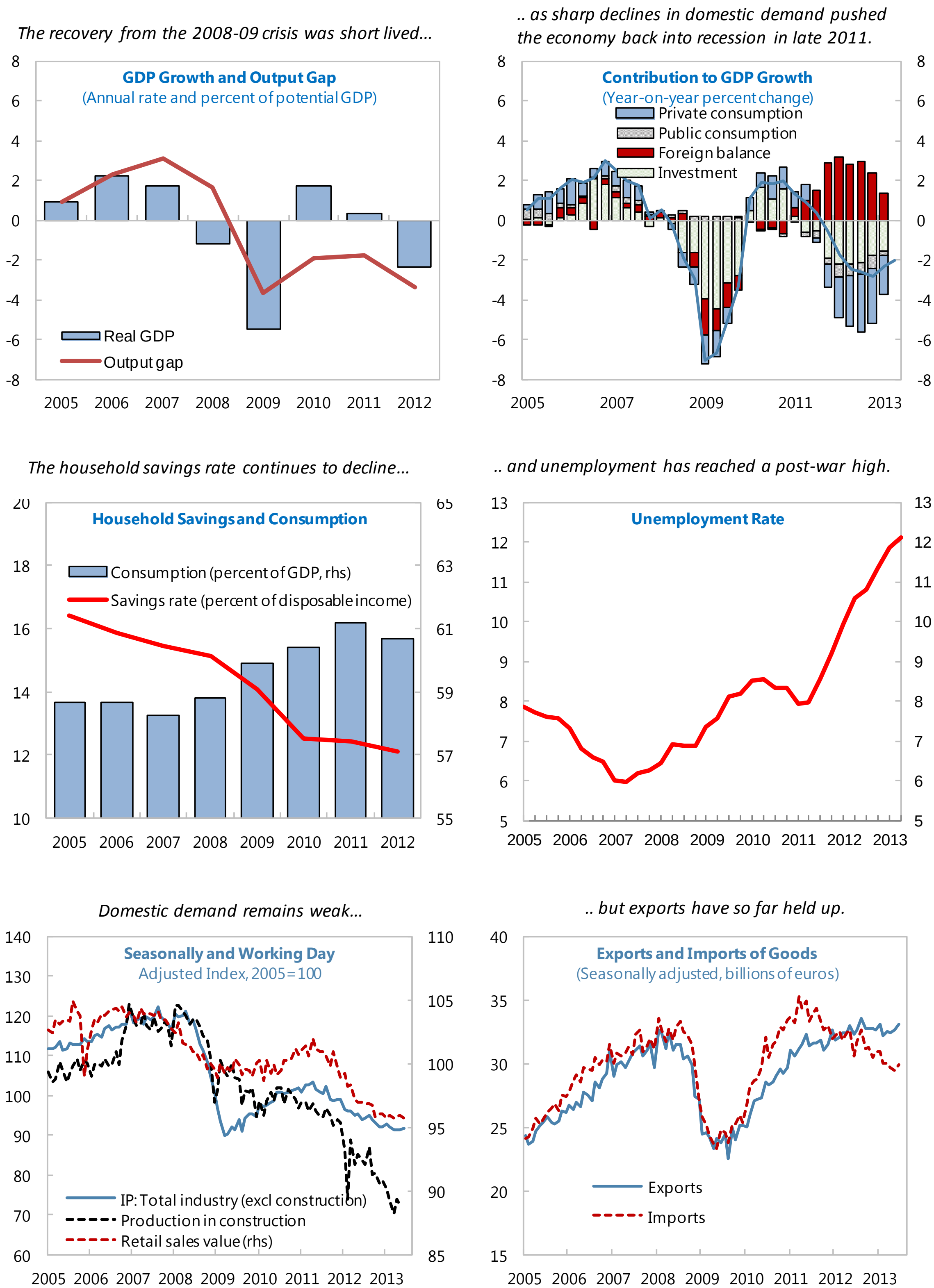
1/ Loan supply and demand are estimated as linear functions of the indicators of supply and demand conditions obtained from the bank lending survey,

An analysis based on bank lending surveys suggests that supply factors are becoming more important in driving credit developments. An approach that uses bank surveys on credit demand and lending standards as proxies for unobserved demand and supply (Zoli, 2013) finds that after the LTRO in 2012, demand for funds fell well short of supply. However since late 2012, supply factors are becoming more important and, along with weak demand, have been driving deleveraging. According to the surveys, expectations of weak growth have been an important factor constraining supply.

VAR analysis suggests that tight credit conditions are a key factor in explaining the depth of the recession. We estimate a VAR over the period 2003Q1–2012Q4 that includes four lags of GDP growth, inflation, real interest rate on new bank loans, real credit growth, and changes in credit standards to enterprises. Generalized impulse responses find the impact of credit shocks on growth in Italy to be statistically significant and sizeable. In annualized terms, a 1.2 percent contraction in credit reduces growth by 0.68 percentage points. A one standard deviation exogenous tightening in lending standards (roughly one third the tightening that took place after the sovereign shock in late 2011) lowers growth by 1.2 percentage points. Since the VAR tends to overestimate GDP contractions out-of-sample, the magnitude of the responses should be interpreted with caution and attention should be paid to the lower bound of the confidence intervals.

[1]A Monetary Conditions Index (MCI) is defined as a weighted average of the interest rate and the exchange rate: $MCI_t = 100 + a_1(r_t - r_0) + a_2(q_t - q_0)$, where *r* is the real lending rate to non-financial corporations and *q* is the log of the CPI-based REER. The reference period is 2009Q2. The a_1/a_2 ratio represents the exchange rate depreciation needed to offset the effects of 100bps increase in interest rates. Here, the ratio is set to 2.9 following Dornbusch et al. (1998) who estimated the parameters for Italy. Higher ratios as estimated by Peeters (1998) generate a smaller impact.

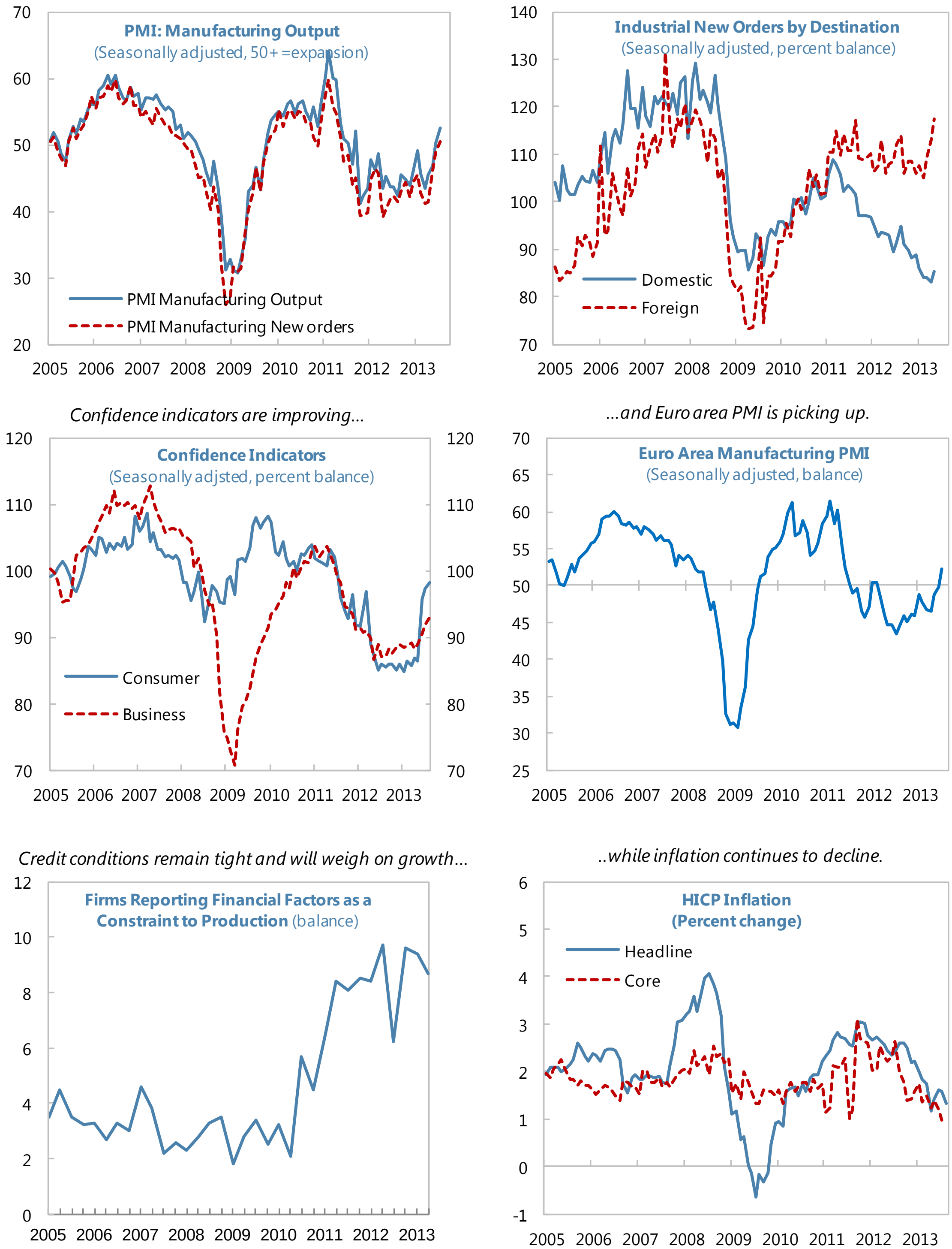
Figure 1. Italy: Real Sector Selected Economic Indicators, 2005-13



Sources: Haver; ISTAT; and IMF staff estimates.

Figure 2. Italy: Real Sector Developments, 2005-13

PMIs and industrial orders suggest the pace of contraction is slowing led by growing foreign demand.



Sources: National authorities; and Haver Analytics.

6. **The coalition government that took office in April is moving forward on the reform agenda, but faces political constraints.** The government is led by Prime Minister Letta from the Democratic Party, and includes representatives from the center-right and Mr. Monti's Civic Choice parties, as well as technocratic members. In June, the government announced further measures to boost growth and improve the labor market, in particular for the youth. While the government maintains support in the parliament, tensions between the coalition partners are apparent and represent a key risk to the economic outlook.

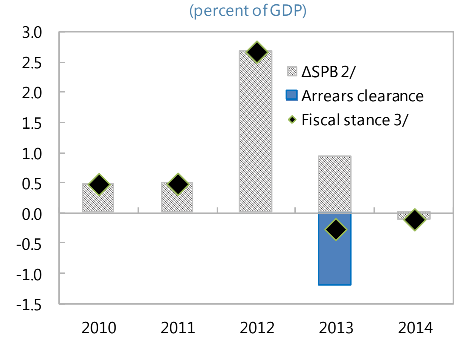
OUTLOOK AND RISKS

A. From Recession to Recovery

7. **A modest recovery is expected to start in late 2013, supported by net exports**. After sharp declines in previous years, domestic demand is expected to recover slowly in the face of stiff headwinds from tight credit conditions. On this basis, growth is projected at -1.8 percent this year, before rising to 0.7 percent next year. The main factors underlying the forecast are:

- *Easing fiscal drag*. The pace of consolidation in structural terms will slow from 2¾ percent of GDP in 2012 to 1 percent of GDP this year and close to zero in 2014. The arrears clearance program (€40 billion or 2½ percent of GDP) is estimated to contribute 0.4 percentage points to growth, mainly in 2014. After taking into account the arrears payment, the fiscal stance is projected to be broadly neutral for this year and next.[1]

Change in Fiscal Stance 1/
(percent of GDP)



1/ A positive number is an improvement in the fiscal stance. That is, contractionary fiscal policy.
2/ Change in structural primary balance.
3/ Including arrears.

- *Steady exports*. A weak recovery in the euro area and slower growth in key emerging markets are expected to keep export growth modest. Weak domestic demand and imports imply further positive contributions of net exports to growth.

- *Tight credit conditions*. However, tighter lending standards since end-2011 are expected to persist and limit the pass-through of lower sovereign yields to lending rates, holding back growth.

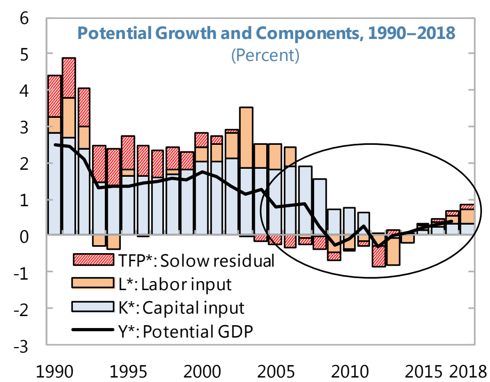
[1] The arrears payments are treated as a one-off fiscal operation and excluded from the structural balance estimates. The estimated growth impact assumes that half are cleared in 2013, and the rest in 2014. Around ¼ of the €40 billion goes to banks to redeem factored debt with a minimal impact on activity. For the remainder paid to firms, staff assumes a multiplier of 0.5. Given the lags in spending, most of the growth impact is expected to take place in 2014.

8. **Unemployment is expected to peak at around 12½ percent in 2013 and decline gradually as the recovery takes hold.** The slow recovery and hysteresis effects, however, will leave the unemployment rate above pre-crisis levels over the forecast horizon.

9. **The large output gap is projected to keep inflation below the euro area average**. HICP inflation declined to 1.1 percent in July (y/y), reflecting mainly the pass through of VAT rate and indirect tax hikes. Core inflation (excluding energy and seasonal food) was 1.0 percent (y/y) and is expected to remain low, consistent with the large output gap. High unemployment and weak aggregate demand are likely to keep wage inflation moderate.

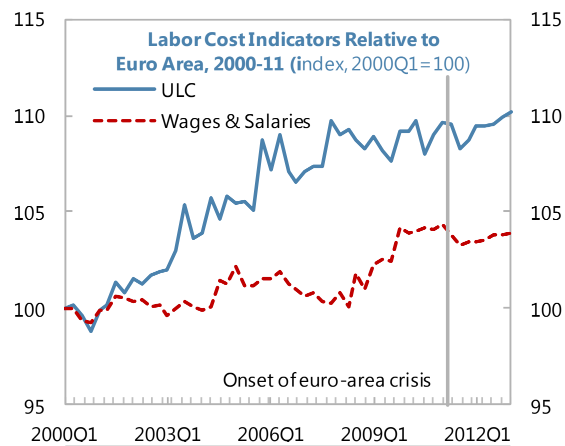
B. Weak Medium-Term Growth Prospects without Reforms

10. **In the absence of deeper structural reforms, medium-term growth is projected to remain low.** The euro area crisis hit Italy hard, but the origins of Italy's low growth pre-date the crisis and stem from its stagnant productivity, difficult business environment, and over-leveraged public sector. Without vigorous reforms to lift these impediments, growth is projected to average 0.7 percent during 2013–18, supported by a gradual recovery in domestic demand. Italy's potential growth is also projected to rise but remain low at ½ percent by 2018, reflecting weak productivity and subdued investment and employment trends compared to the pre-crisis period. On this basis, the output gap, estimated at 4¾ percent of GDP this year, would gradually close by 2018.



Sources: Eurostat; AMECO; and IMF staff calculations.

11. **Weak productivity has also contributed to Italy's gradually widening competitiveness gap.** Following a sharp turnaround in 2012–13, Italy's current account surplus is projected to fall back to a modest deficit of around ¾ percent of GDP over the medium term. External competitiveness continues to weaken, as indicated by the persistent deterioration of most price-based indicators, particularly unit labor costs. In structural terms, Italy's current account is estimated to be 1 percent of GDP weaker than justified by fundamentals and appropriate policies.[2] Italy's



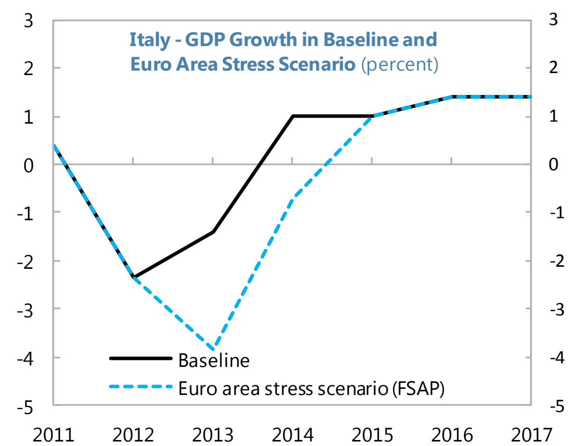
[2] The IMF's External Balance Assessment (EBA) for 2012 and other similar exchange-rate analysis suggest that the potential degree of misalignment is more modest—EBA estimates imply that the REER is broadly in line with fundamentals, whereas CGER estimates suggest that the exchange rate may be overvalued by around 8 percent.

(continued)

share of world exports has generally moved in parallel with its European peers, but weak productivity has pushed up relative unit labor costs and placed Italian exporters at a growing disadvantage, particularly vis-à-vis other countries that have adjusted sharply in recent years.[3] Taking into account a broad range of indicators, staff considers that a real effective depreciation of not more than 10 percent would be appropriate to restore competitiveness.[4]

C. Managing Risks and Global Spillovers

12. **Risks to the outlook are tilted to the downside, stemming mainly from potential policy slippages and banking distress.** As highlighted in the Risk Assessment Matrix (RAM), Italy remains vulnerable to financial contagion due to the high level of sovereign debt and financing needs (€400 billion annually). Policy slippages, including at the European level, could undermine confidence in the sovereign, pushing Italy into a negative environment of rising sovereign spreads, tighter bank funding, and a worsening economy. In a prolonged recession, analysis for the FSAP shows that rising corporate bankruptcies and falling property prices would further increase NPLs, especially for weak, leveraged SMEs, and erode banks' capital buffers (Annex II). At the global level, higher volatility from unconventional global monetary policy exit could exacerbate sovereign funding pressures, while a slowdown in emerging markets could derail the export-led recovery. A scenario of renewed stress in the euro area could lower GDP in Italy by more than 4 percentage points compared to the baseline, and with the output gap widening to historic highs, raise the risk of a debt-deflation spiral.



13. **Strong policies, both in Italy and at the euro area level, to maintain credibility and confidence will be crucial for mitigating spillover risks**. The appropriate policy response would depend on the shock and market reactions, but in general should aim to restore confidence by reaffirming the structural balance target, including over the medium-term, enhancing the commitment to structural reforms, and strengthening the resilience of the banks.

In this context, given the uncertainty surrounding these estimates, the 2013 Pilot External Sector Report notes that the exchange rate may be overvalued by 0-10 percent, consistent with a current-account gap of 0-2 percent of GDP.

[3] See Selected Issues Paper "Italy: Innovation, Productivity and Competitiveness."

[4] IMF staff estimates suggest that product and labor market reforms that bring Italy close to OECD best practices could increase the level of GDP by about 6 percent over the medium term and contribute significantly to closing Italy's competitiveness gap (see Lusinyan and Muir, "Assessing the Macroeconomic Impact of Structural Reforms: The Case of Italy", IMF WP/13, 22, January 2013). These reforms are not incorporated in staff's medium-term baseline growth projections.

Italy: Risk Assessment Matrix

Risk	Relative likelihood	Impact on Italy if realized	Policy recommendations
Italy			
1. An unstable coalition leading to policy slippages, stalling of structural and fiscal reforms, or rating downgrades.	**Medium**	**High**. Impact on debt sustainability and loss of market confidence could be significant and push Italy into a self-reinforcing bad equilibrium and protracted period of slow growth.	Maintain short-term structural fiscal targets and strengthen fiscal buffer over medium term. Accelerate structural reforms to restore confidence (¶s 20-23, 33, 37)
2. Banking stress due to rising corporate bankruptcies, falling property prices, or worsening financial fragmentation.	**Medium**	**High**. NPLs would rise and collateral values would fall, raising provisioning needs and tightening credit conditions. Growth could suffer significantly, although ECB support could mitigate the effects. Higher funding costs would raise lending rates or lead to a credit squeeze.	Ensure proper loan classification and provisioning. Targeted action to increase bank capital where needed; accelerate balance sheet repair. Use euro area backstops if stress affects sovereign. (¶s 46-50)
3. Large positive investment response to arrears clearance.	**Low**	**Medium**. Growth could rebound strongly in 2014 if firm's marginal propensity to invest is very high.	Keep up pace of structural reforms to support investment. Use savings to reduce further public debt. (¶37)
Regional / Global			
4. Distortions from unconventional monetary policy (excessive risk-taking followed by broad-based market re-pricing; delays in structural reforms; or side effects from exit modalities)	**High**	**Medium**. Higher global risk aversion and financial market volatility could push up Italian sovereign yields and worsen the debt dynamics. This could push up private lending rates and worsen the recession.	Reaffirm medium-term fiscal plan and reform agenda to signal policy continuity. ECB action to reduce volatility. (¶s 20-23, 37)
5. Deeper than expected slowdown in EMs (reflecting lower than anticipated potential growth).	**Medium**	**Medium**. Could undermine the export led recovery, given weak prospects for higher domestic demand. Impact similar to that of a protracted period of slower European growth.	Accelerate structural reforms and fiscal rebalancing to support demand. More accommodative monetary policy. (¶s 35, 50)
6. Financial stress in the euro area re-emerges (triggered by stalled or incomplete delivery of euro area policy commitments).	**Medium**	**High**. Could compound with domestic political uncertainty and trigger spiral of higher yields, bank stress, falling credit and slower growth.	Use euro area backstops to strengthen banking sector.(¶ 13)

In the event that banking stress spills over to the sovereign, a euro area backstop would be needed to break the sovereign–banking link and support the needed adjustment and reform efforts.

14. **Spillover analysis indicates that a shock from Italy could have a marked impact on Europe and beyond through trade and financial channels.** Bilateral links are particularly pronounced vis-a-vis Germany and France; but more broadly, Italy is the world's fifth largest manufacturer, represents 17 percent of euro area GDP, and has the world's third largest bond market. Given its central role in the global trading and financial system, a significant idiosyncratic shock in Italy could generate regional or global spillovers that would likely be larger than suggested by direct exposures alone (Box 2). In this context, the authorities' ongoing efforts to reduce fiscal vulnerabilities and support growth will have benefits beyond Italy—contributing to a more robust recovery in Europe, strengthening the currency union, and supporting global financial stability.

D. Authorities' Views

15. **The authorities shared staff's view on the headwinds from tight credit, but placed more emphasis on stimulus measures in helping the recovery.** They remain concerned about the tight credit conditions for firms, as banks continue to deleverage, keep rates high, or demand more collateral for loans. They saw recent policy actions to pay arrears and accelerate infrastructure spending as playing an important role in supporting the recovery. In particular, the arrears payments, which have helped avert further corporate defaults and unblock credit markets, could contribute more than 0.6 percentage points to growth in 2013-14. This is also borne out in Bank of Italy (BOI) surveys in June which still highlight the difficulties in accessing credit but point to an improvement in investment expectations in the second half of the year. On this basis, the BOI's July Economic Bulletin forecasts GDP to decline by 1.9 percent this year before recovering to 0.7 percent in 2014.

16. **Domestic risks have eased as public support for the government coalition has grown and on account of recent steps to strengthen the banking system**. Instead, the authorities saw greater external risks to the outlook, arising from weaker growth in emerging markets, renewed euro area tensions, and higher interest rates. On the inward spillovers, Italy remains vulnerable given its high level of public debt, though the introduction of the OMT framework, progress on the banking union, and an improved fiscal outlook have reduced these vulnerabilities. Foreign banks have also reduced significantly their exposures to the Italian sovereign and banks, while Italy's export mix has diversified into more non-euro area destinations. As cross-border vulnerabilities have been reduced, Italy is also less likely to be the source of disruptive shocks flowing outward. To mitigate these risks, the authorities saw achieving the fiscal objectives and fully implementing reforms as crucial for maintaining confidence.

Box 2. Assessing Italy's Inward and Outward Spillovers

Italy has sizeable links with other euro area countries, and remains vulnerable to inward spillovers from the region (Figure 6). *On trade,* about 41 percent of Italy's total exports are still directed to the euro area. *Financially*, the direct exposure of Italian banks to the euro area is also considerable (30 percent of GDP), with the largest exposure to Germany and Austria. Bank funding is similarly concentrated, with most interbank loans coming from Europe (4¼ percent of GDP) and primarily from Germany and France (3 percent combined). In addition, Italy has guaranteed funding to Greece, Ireland, and Portugal through the Greek loan facility and the EFSF, amounting to around €37 billion (2.4 percent of GDP).

Italy's central role also suggests that outward spillovers, especially to Central, Eastern, and Southeastern Europe (CESEE), could be significant. Italy is the second largest bank creditor, after Austria, to the CEE. Most of these exposures are funded locally, rather than from Italy, but distress among Italian parent banks could nonetheless have regional consequences by prompting a withdrawal of local deposits. Moreover, interconnectedness analysis suggests that Italy is also a global "gatekeeper," acting as a propagator or a dampener of trade and financial shocks, depending on the country's vulnerabilities and policy response. Given Italy's relatively central global role, a large disturbance in Italy would represent a significant regional or global shock for other countries, and might have a larger impact than suggested by direct exposures alone.

Model simulations and empirical analysis confirm the key role of financial channels in propagating potential shocks from Italy. Staff simulations using the G35-S model provide a quantitative guide to the transmission of shocks originating in Italy. The general pattern of outward spillovers can be summarized by spillover coefficients to each other country, similar to the concept of a multiplier. Spillovers from macroeconomic shocks (such as a demand or policy disturbance) are most evident in central Europe, Austria and Switzerland, but seem relatively modest. However, the potential spillovers from a *financial* shock—such as a sudden increase in Italian sovereign spreads—are markedly higher. For example, an increase in spreads (of around 500 bps) would not only reduce Italian demand, thereby depressing Italian imports, but also impact foreign debt holders. Moreover, this impact would be further amplified to the extent that the prices of other assets, both within Italy and abroad, tend to move together. The net effect could be to lower output by up to ½ percent in countries such as Austria, Russia, and Switzerland. Spillovers could be twice as high for those with limited fiscal space or those facing a zero lower bound on policy rates. In addition, the co-movement of asset prices tends to be especially elevated during periods of financial turmoil. Indeed, recent staff analysis of asset-price volatility spillovers suggest that shocks to Italy had a substantial impact on other markets during the recent euro-area crisis (albeit somewhat less than Spain) (See 2013 Spillover Report).

Outward Spillover Coefficients: Financial Shock 1/
(Percent of recipient GDP)

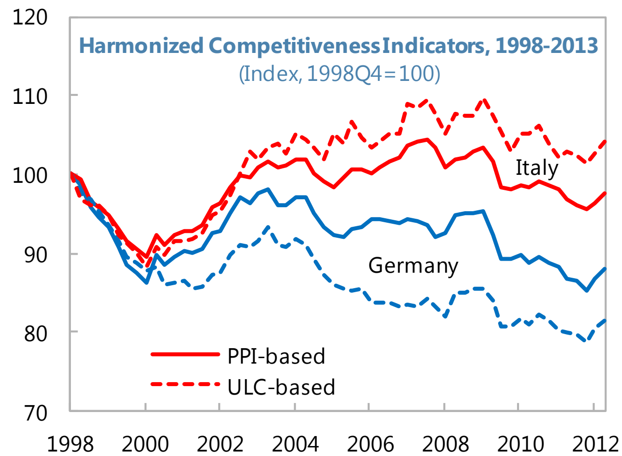
Russia	0.44
Switzerland	0.44
Austria	0.41
Poland	0.41
Turkey	0.39
Czech Republic	0.37
Netherlands	0.33

Source: IMF G35 Model; and IMF staff estimates.
1/ Impact of a 500 bps increase in Italian spreads.

[1] Models of financial spillovers will sometimes offer different results, depending on their treatment of asset-price comovements (contagion). The G-35 model assumptions are based on past experience, as informed by event studies.

Sources: *2013 Financial System Stability Assessment* for Italy; "Enhancing Surveillance—Interconnectedness and Clusters—Background paper" FO/DOS/12/38, and the *2012 and 2013 Spillover Reports.*

17. **On competitiveness, the authorities cautioned against relying too much on labor-based indicators which showed a much wider gap than other price-based measures.** Since 2000, the rise in unit labor costs relative to Italy's peers reflects more Italy's weak labor productivity, rather than excessive wage increases. More recently, the limited downward wage adjustment to productivity reflects the shift in employment towards older workers, the high labor tax wedge, and the lag in renewing collective agreements, while the wage declines in some of Italy's key competitors has been mainly due to labor tax cuts. Nevertheless, with the wage share in gross output falling in Italy and elsewhere, broader price-based indicators, such as for producer prices, may be more indicative and for Italy, show a more modest competitiveness gap. The authorities viewed the recent improvement in the current account as structural, and expect the current account to remain broadly balanced over the medium term. They agreed that Italy's declining competitiveness is consistent with a modest overvaluation of the real effective exchange rate that could be addressed through structural reform.



Source: Bank of Italy, ECB, IMF staff calculations

18. **The authorities still saw potential growth returning to around pre-crisis levels of 1 percent by the end of the decade**. They agreed, however, that further structural reforms are needed to achieve this and saw significant potential gains. For example, they estimate that the package of reforms approved last year, if implemented fully, could increase GDP 3.9 percentage points by 2020 and 6.9 percent in the long term. Should lending rates, however, remain elevated and hold back investment, potential growth could be lower.

POLICY PRIORITIES FOR REVIVING GROWTH

Reviving growth will require comprehensive reforms to improve the business environment, reduce fiscal vulnerabilities, and strengthen the banking system. *The difficult reforms taken over the past years were necessary to restore confidence and bring Italy back from the brink. But growth prospects remain weak, unemployment is high, and market sentiment is still fragile, underscoring that the task is far from complete. Accelerating the momentum for reforms will be essential to strengthen confidence and secure a robust recovery. Europe will also need to play its part with actions to reverse financial fragmentation and strengthen further the currency union.*

A. Structural Reforms to Improve the Business Environment

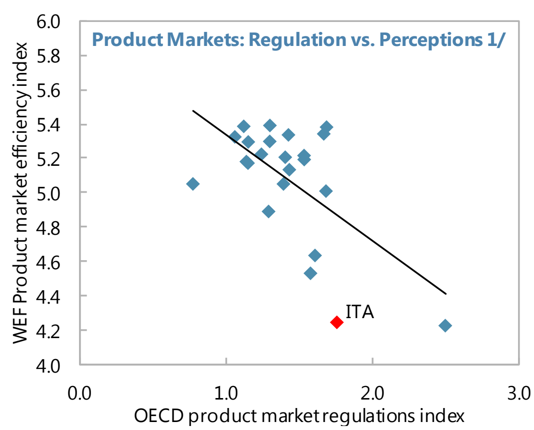
Ease of Doing Business in Italy vs. OECD Average 1/2/

The 2013 World Bank Doing Business survey ranked Italy 30 out 31 OECD countries in the ease of doing business, with Italy faring poorly particularly in the areas of contract enforcement, tax payments, and getting electricity.

Enforcing contracts #31	Getting electricity #27	Construction permits #28	Registering property #15	Resolving insolvency #20
• Takes twice longer and more procedures • And costs more	• Takes more time • And costs 3 times more	• Takes more time • And costs twice as much	• More procedures • But takes less time at about the same cost	• Takes longer to close a business • Costs twice but with lower recovery rate
Paying taxes #31	**Getting credit #28**	**Trading across borders #25**	**Starting a business #22**	**Protecting investors #13**
• Takes more time and more payments • Tax rates are much higher	• Weaker legal rights • Wider coverage in credit registries	• Takes twice longer to export/import • Costs about 10% more to export	• Takes less time • But costs 4 times more	• Close to average in most aspects

Source: World Bank Doing Business 2013.
1/ OECD high-income economies; 2/ For each topic, the ranking among 31 OECD countries is reported.

19. **The economy's weak recovery since the crisis highlights its lack of flexibility in responding to shocks and changes in global demand.** High entry barriers and regulatory hurdles, especially in services, inefficient public services, and the prohibitive cost of electricity (about 50 percent greater than the euro area average) have eroded Italy's productivity and competitiveness. The lengthy and inefficient justice system has also been linked to the high cost of doing business, low inward FDI, as well as the small size of firms and capital markets (see table for Italy's continued poor ranking in the ease of doing business). These impediments have contributed to a difficult business environment that has kept productivity low and held back needed adjustment after the crisis. Accelerating structural reforms would help address the decline in trend growth and enhance Italy's international competitiveness.



Sources: OECD; and WEF.
1/ Higher values mean more burdensome regulation in the OECD index but more efficient markets in the WEF index.

20. **Priority should be given to completing the implementation of product market reforms and improving public services.** Progress has been made in liberalizing some professional services and opening the gas sector, amid signs that greater competition is pushing down energy prices. However, implementation in other areas has lagged. Compared to other

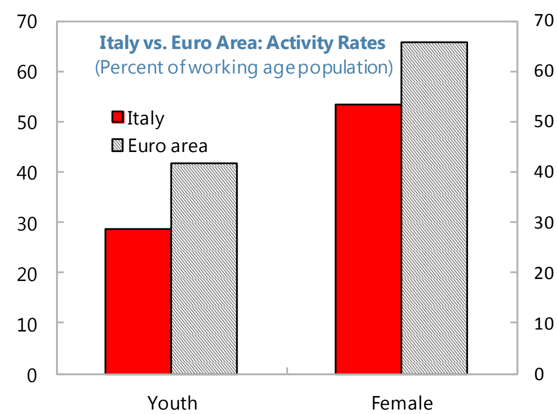
OECD countries, the gap between regulations on paper and perceptions of market efficiency in Italy is wide, highlighting the need for further concrete action.

- *Product and service markets*. Steps to appoint transport regulators, enhance competition in the electricity sector, and reform the legal profession should be completed quickly to reduce markups and boost productivity. At the euro area level, moves to strengthen the common market, such as the Services Directive, would enhance the cross-border benefits of reforms.

- *Public services*. Accelerating the privatization agenda, especially at the local level, and completing the spending reviews to enhance public administration would improve the efficiency and costs of public services.

21. **More is needed to raise Italy's low employment and better match wages to productivity.** Italy's employment rate for women and the youth is well below the euro area average and represents an underutilized source of growth. Staff estimates that reforms that close half the employment gap with the rest of Europe (some 4½ percentage points) could lift the level of GDP by as much as 2½ percent by 2018[5] and should aim to:

- *Improve active labor market policies (ALMP)*. Employment support is fragmented between the national government which administers unemployment insurance and local authorities in charge of job matching and training. Improving the coordination of ALMPs, such as by strengthening information sharing, would better help the unemployed find work and ensure that ALMP resources under the European youth guarantee program next year will be used effectively.



Source: Eurostat

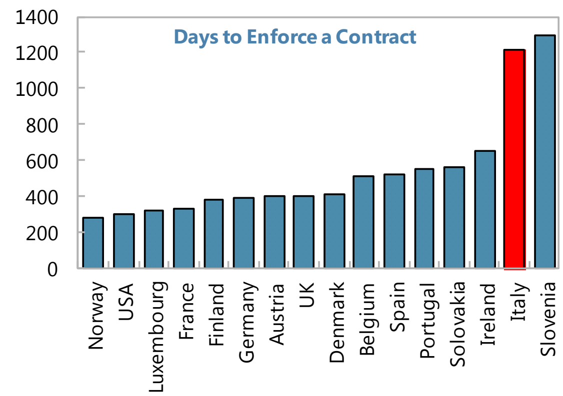
- *Simplify contracts*. Shifting to a more flexible, single contract for new workers that gradually increases job protection with seniority could lower the cost of new hires and support apprenticeships for young workers.

- *Decentralize wage setting*. Encouraging companies and workers under the June 2011 labor agreement to set more firm-level contracts independent of national ones would better match wages with productivity and encourage workers to seek jobs in new growth areas.

[5] Derived from a production-function approach to potential output where half of the labor force participation gap is closed and hours worked converge to the euro-area average.

- *Reduce labor tax wedge*. Lowering the marginal tax rate for married, second earners could also lift labor participation, especially for women, which at 50 percent, is one of the lowest in the OECD.

22. **A more efficient judicial system could also have significant cross-cutting benefits in improving productivity.** The lengthy judicial process is a major contributing factor behind Italy's low ranking in global competitiveness. It takes on average more than 1,200 days to enforce a contract (more than twice the OECD average), with repeated appeals creating a huge backlog of cases (9.7 million as of 2012). The government has taken important steps to reorganize the court system, introduce compulsory mediation, and address the significant backlog of cases, but more is likely needed. Consideration could be given to a comprehensive review of court fees to limit abuse, the development and use of performance indicators for all courts, and a further alignment of the appeal systems with international practice to reduce excessive appeals.[6]



Source: Doing Business, 2013

23. **Efforts to combat corruption should be stepped up.** Although it is difficult to measure, Italy fares poorly in global surveys on corruption perceptions, and the government has made fighting corruption a policy priority. The 2012 anti-corruption law took important steps in criminalizing corruption in the private sector and emphasizing prevention. Further strengthening of anti-money laundering (AML) tools, including by criminalizing self-laundering and reinforcing due diligence regarding persons entrusted with prominent public functions, would better equip the authorities in their fight against corruption.

Authorities' Views

24. **The authorities stressed their continued commitment to the reform agenda.** They highlighted the growth package passed in June that included public infrastructure investments and funds to promote employment, especially among the youth and have recently issued a report to Parliament on deregulation and simplification. On energy, they pointed to progress in liberalizing the gas market as having lowered wholesale prices by nearly 25 percent. However, further declines will be limited by Italy's heavy dependence on more expensive natural gas and the need for further infrastructure investment in distribution. The Cabinet's appointment of a management team to lead the transport authorities is waiting for parliamentary approval.

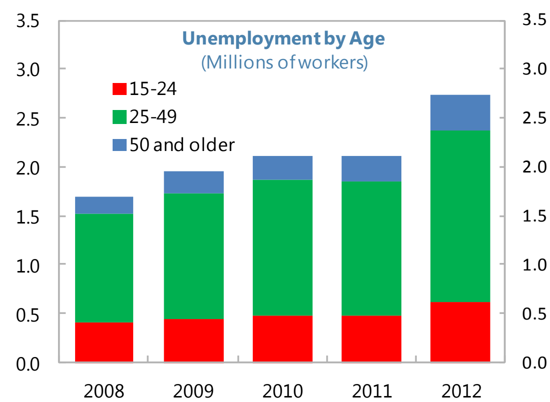
25. **The authorities plan to push forward with privatization as part of their efforts to reduce debt and improve the efficiency of public services**. The government has pledged to sell state-owned assets, mainly real estate, amounting to around 5 percent of GDP through 2017.

[6] See accompanying Selected Issues Papers on "Judicial System Reform – A Key to Growth".

While privatization at the central government level has moved forward, most recently with the separation of gas distribution and production, progress at the local level has been slow. The government aims to announce a more detailed privatization plan in the fall that will include both state-controlled companies and property.

26. **Labor reforms passed last year clarified the conditions for dismissals and expanded apprenticeships, but any impact on hiring was likely overshadowed by the collapse in demand.** Despite the incentives for apprenticeships as a bridge to regular contracts, firms still face the legal risk of reinstatement for unfair dismissals and saw the cost of conversion as too large. While a more flexible, single labor contract could help bridge this gap, it would not resolve the larger issue of existing contracts. Rather than further legal changes, the authorities placed greater emphasis on effectively implementing the new rules and improving the judicial review for disputes to reduce hiring uncertainty.

27. **In addition to tackling youth unemployment, there is a need to look more broadly at labor market and demand policies to strengthen employment**. Some observers noted that although youth unemployment is a serious issue, much of the increase in unemployment in recent years has been for the working age and elderly who now face greater difficulties in re-entering the labor force. To expand participation, the authorities agreed on the need to improve the coordination of ALMPs where unemployment benefits are paid at the national level, but active labor policies are done at the provincial level with little sharing of information. On wage decentralization, the number of cases in which firms and workers had opted out of national contracts had risen, but wages set in national contracts still dominate in the absence of a legal requirement and an official minimum wage. Encouraging greater flexibility in national contracts, including on wage indexation, could provide more scope for firms to set wages to productivity in their labor contracts.



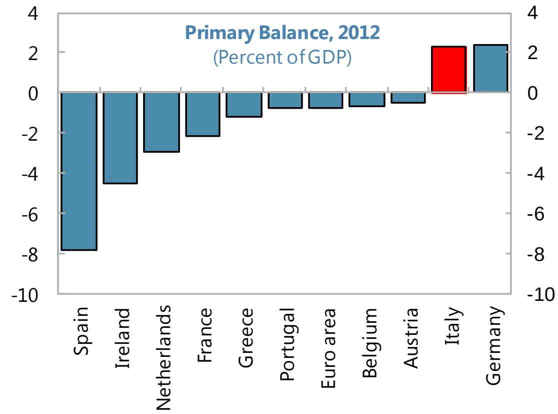
Source: Eurostat.

28. **Important judicial reforms are underway to improve the business environment**. The authorities have reintroduced compulsory mediation after a constitutional challenge, reduced the backlog of pending cases, shifted to more online court procedures, and raised some court fees which, compared to other countries in Europe, still cover only a modest portion of court costs. Nevertheless, their efforts continue to face stiff resistance from lawyer groups against limiting access to the justice system. Looking ahead, the authorities are preparing a comprehensive review of the civil procedure code to reform the appeal system and facilitate more settlement outside the courts.

29. **The authorities agreed that greater use of AML tools would increase the effectiveness of their efforts**. They saw the cost of corruption to the economy to be a significant drag on business and are taking steps to implement the anti-corruption law's preventative framework and review customer due diligence measures.

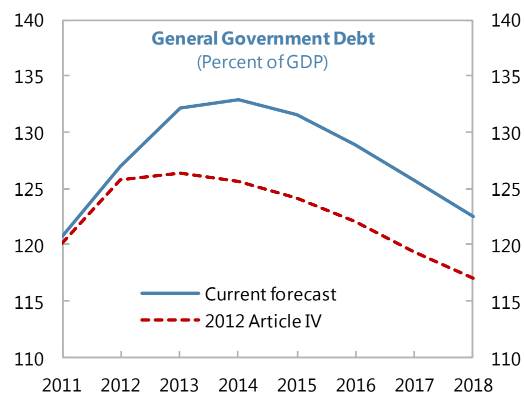
B. Fiscal Policy—Reducing Vulnerabilities and Supporting Growth

30. **Italy is set to reach its target of structural balance this year**. Following the sizeable fiscal adjustment in recent years, the nominal budget deficit fell to 3 percent of GDP in 2012, allowing the country to exit from the EU's Excessive Deficit Procedure, and is projected to be close to that level in 2013. In structural terms, the overall balance is projected to be near zero this year, and thereafter some adjustment will be needed, to maintain compliance with the new structural balance rule.[7] As the economy recovers and the output gap closes, the primary surplus is projected to rise from 2.2 percent of GDP in 2013 to 5.6 percent in 2018, and the overall deficit would shrink to close to zero.



Source: IMF, World Economic Outlook, July 2013.

31. **Despite the significant adjustment, the public debt ratio continues to rise**. The public debt-to-GDP ratio reached 127 percent in 2012 and is projected to rise another 5 percentage points this year due to the weak economy and one-off factors related to the public arrears clearance and higher ESM contributions. Although the debt ratio is projected to decline after 2014, the debt outlook and financing needs remain vulnerable to a variety of macro-economic shocks, including slower growth or market distress (see Debt Sustainability Analysis in the Annex).



Sources: ISTAT; and IMF staff estimates.

32. **Sovereign financing pressures have subsided, partly reflecting the fiscal adjustment and improved sentiment towards the euro area**. Treasury debt auctions have seen renewed interest from long-term, institutional investors, both domestic and foreign. After a sharp decline in 2011–12, the foreign ownership of Italian government bonds has held steady at around 33 percent. Demand has been particularly strong among retail investors for longer-dated bonds, helping to keep the maturity of public debt at around 7 years. Nevertheless, given the high level of public debt, sovereign funding needs will remain high, with the amount to be rolled over annually amounting to around €400 billion (25 percent of GDP) during 2014–15.

[7] This includes as yet unidentified measures to finance the revenue shortfall (to be announced in the 2014 budget), potentially around ¼ percent of GDP, from the proposed abolition of the property tax on primary residences starting in 2014.

Policy Issues and Staff Views

33. **The structural balance target for this year is appropriate.** Achieving one the highest primary surpluses in the euro area last year was a key factor in strengthening policy credibility and confidence. Targeting a structural balance this year will preserve Italy's hard-won fiscal gains, while allowing fiscal policy to remain flexible to the economic cycle.

34. **Recent fiscal policy changes have been mixed**. Effective implementation of the government's arrears payments could significantly ease firms' credit constraints, without affecting the underlying fiscal stance. The renewed efforts to legislate the *Delega Fiscale* which aims to improve the structure and efficiency of the tax system are also welcome. Staff also supported finding savings to substitute the increase in the top VAT rate, which is now postponed till October. However, the proposal at end-August to repeal the property tax on primary residences (and introduce a new local services tax) could erode an important tax base, compromise the fiscal targets, and does little to support medium-term growth. To avoid weakening the fiscal stance, it will be important to identify measures in the budget to offset the revenue shortfall. Progress in privatization, especially at the local level, has been slow, and should be accelerated.

35. **Rebalancing of fiscal adjustment is urgently needed to support growth.** With the tax burden in Italy among the highest in the OECD at 44 percent of GDP, more needs to be done to support the economy by lowering capital and labor taxation financed with cuts in unproductive current spending and tax expenditures. Additional savings could also be used to raise public investment. In staff's estimates, such a package (Box 3) could lift the level of GDP by around ½ percent over 2 years by shifting resources to higher multiplier areas and could include:

- *Spending reviews*. Starting in 2014, a bottom-up spending review covering all levels of government should focus on improving the efficiency of public spending and finding additional savings to lower taxes. This should build on past efforts to control the public sector wage bill, health costs, and local government spending.

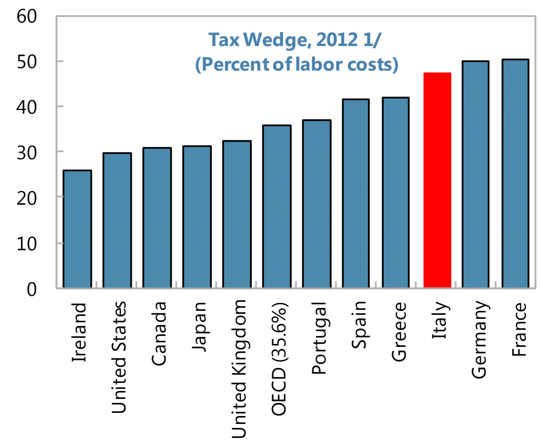
- *Broadening the tax base*. The spending reviews should be undertaken jointly with a systematic review of tax expenditures which, estimated at 8 percent of GDP, are high by international standards. The new local services tax should also cover primary residences for equity and efficiency reasons, and the review of cadastral values accelerated to ensure fairness. Consideration could also be given to raising the inheritance tax to generate savings and make the tax system more progressive.

- *Lower marginal tax rates on labor and capital*. Savings from cutting expenditures and broadening the tax base would help achieve the government's objective of reducing the high tax on labor (4 percentage points of GDP higher than the euro area average) to boost employment and raising the allowance for corporate equity returns (ACE) to spur investment.

Box 3. Rebalancing Taxes to Support Growth[1]

Evidence suggests that property and consumption taxation are more growth-friendly than direct taxes. A growth-enhancing tax reform would shift part of the revenue base from labor and capital income to consumption, immovable property and other forms of wealth whose taxation is less distortionary.

Taxation of labor and capital income remains high in Italy, weighing on employment and growth. Italy in 2011 had the 4th highest capital taxes among EU27 countries and the 7th highest labor taxes. Italy's tax wedge also stands out at 48 percent of total labor costs, compared to an OECD average of 36 percent. This is despite steps to reduce direct taxes in recent years.



Source: OECD.
1/ Single individual without children at the income level of the average worker. Includes payroll taxes where applicable.

Targeted tax cuts on labor and capital income could boost employment and investment. Compared to a general reduction in the tax wedge and the corporate income tax rate, targeted measures, especially those at the margin, may be more effective in promoting new hiring and investment and have a lower budgetary cost. These could include cuts to social security contributions benefiting low earners, women and young workers whose employment and participation are low and more sensitive to taxes. Increasing the ACE scheme by raising its notional rate of return (currently 3 percent) would support investment in profitable projects.

These tax cuts could be partly financed in two ways:

- **Reducing tax expenditures**. Tax expenditures (reduced rates and exemptions), estimated at around 8 percent of GDP, are relatively high in Italy. Although some support may be justified, tax initiatives are often a poor way of pursuing policy objectives and create distortions. Instead, tax expenditures, in particular the VAT reduced rates and exemptions and those benefiting specific sectors and regions, should be reviewed regularly as part of a broader strategy for government support. Simplifying the tax system would reduce administration and compliance costs and opportunities for avoidance.
- **Raising wealth taxation**. Bringing the cadastral values closer to market values would improve the fairness of the property tax system and substantially increase the tax base. Revenue gains could be partly used to cut property tax rates, and reduce distortionary transaction taxes on real estate. Strengthening the inheritance tax, which at 0.03 percent of GDP is very low due to generous tax rates and allowances, could also generate revenue for other more growth-friendly tax cuts on labor and capital, while allowing the tax system to become more progressive.

In light of the revenue uncertainties from broadening the tax base and introducing wealth taxes, the package should be carefully costed and sequenced to ensure budget neutrality.

1/ See accompanying Selected Issues Papers on "Tax Expenditures in Italy" and "Reforming Capital Taxation in Italy."

- *Public investment*. If space allows, a modest, well-targeted increase in public infrastructure investment could catalyze private spending.

Options for Fiscal Rebalancing by 2014 1/
(in percent of GDP)

	Fiscal Impact	Possible Packages		Staff advice
Financing Gap				
Estimated gap in baseline projections 2/	-0.4	✓	✓	✓
Growth Supportive Measures				
Reducing the labor tax wedge 3/	-0.8		✓	✓
Doubling allowance for corporate equity	-0.2	✓	✓	✓
Well targeted increase in public investment	-0.3			✓
Raising the tax deductibility of banks' loan loss provisions	-0.2			✓
Savings Measures				
Reduction in tax expenditures	1.0		✓	✓
Wealth tax measures (property and inheritance tax)	0.3			✓
Public expenditure based savings 4/	0.6	✓	✓	✓
Net Fiscal Impact		**0.0**	**0.2**	**0.0**

1/ First year of structural balance rule. Circled option is staff's advice.
2/ Measures included but not yet identified in the medium-term fiscal plans to maintain a structural balance.
3/ Equivalent to a reduction in the social security contribution rate of about 2 percentage points.
4/ Annualized savings from the Spending Review.

36. **Stepping up efforts to combat tax evasion would also raise revenue and more fairly distribute the tax burden**. The government has conducted more risk-based tax audits and lowered the thresholds for cash transactions. More can be done, including by strengthening and making greater use of AML tools mentioned earlier, broadening the scope of false accounting offenses, and providing the revenue authority with access to suspicious transaction reports related to tax crimes.

37. **Vulnerabilities from the high public debt underscore the importance of building a primary surplus buffer over the medium term to support growth**. Targeting a more ambitious surplus than prescribed by the fiscal rule would provide insurance against the risk of an economic shock to the debt profile. After the recovery is firmly underway, the authorities should consider gradually over the medium raising the structural target to a surplus of 1 percent of GDP to bring down the debt ratio more quickly. This will help ensure that the debt ratio remains on a sustainable path, even in the face of a negative shock, and more broadly contribute to global stability in sovereign bond markets.

38. **Stronger budget institutions will enhance the credibility of the fiscal anchor and improve the efficiency of expenditure**. To achieve the fiscal objectives, binding multi-year expenditure ceilings should be used to guide budget planning by ministries and sub-national

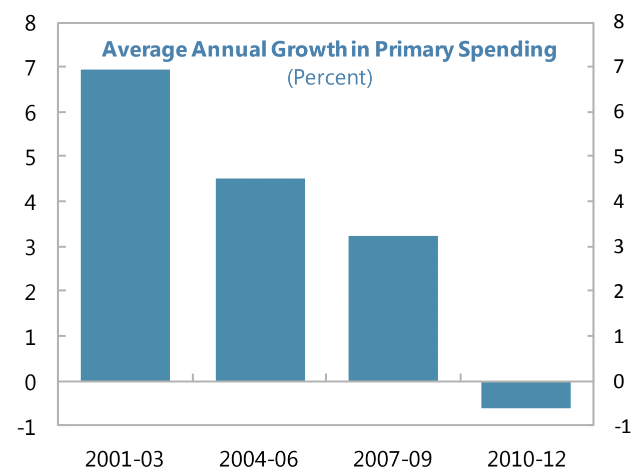
governments. The bill establishing the Parliamentary Budget Office (PBO) in January 2014 is broadly in line with international best practice. The selection of qualified board members and the integration of the PBO's role in the budget cycle will be critical to underscoring its independence and effectiveness.

Authorities' Views

39. **The authorities viewed the 3 percent of GDP nominal deficit as important for bolstering their policy credibility.** They agree in principle on targeting a structural balance—consistent with their Medium-Term Objective and the new fiscal rule—to allow for automatic flexibility to the economic cycle. However, should the outlook deteriorate, they would put priority on maintaining their fiscal commitments, both to lock in their hard-won fiscal credibility and to create space next year for more investment spending under the EU framework. They saw in the near term a greater role for clearing public arrears and accelerating infrastructure spending to support growth.

40. **Over the medium term, any savings above the structural balance target should be used to lower the tax burden.** The authorities saw that maintaining a structural balance in line with the fiscal rule would set the debt ratio on an appropriate downward path and comply with the EU debt requirements. Rather than targeting a higher surplus over the medium term, they favored using any savings to reduce the high tax burden to support growth. To bring down debt in the near term, they emphasized privatization receipts, which they estimate at up to 5 percent of GDP over the next five years, and aim to accelerate plans in this area.

41. **The authorities agree with need to rebalance the budget toward lower spending and taxes, but face near-term constraints.** Following large spending cuts in recent years, the authorities saw limited scope to do more quickly without undermining key public services—they pointed to the 2 percent drop in primary spending during 2010–12. Instead, the authorities aim to build on past spending review and conduct a careful, bottom-up analysis covering all levels of government to find savings and improve the quality of public services. The authorities noted that their efforts to combat tax evasion had yielded higher revenue than last year and are considering further action, including criminalizing self-laundering. They agreed with the economic efficiency of inheritance taxes, but noted that exemptions on public debt have narrowed the base. On the property tax, the authorities plan to replace it with a new local service tax in next year's budget and have pledged to find other sources of savings to maintain their fiscal targets.



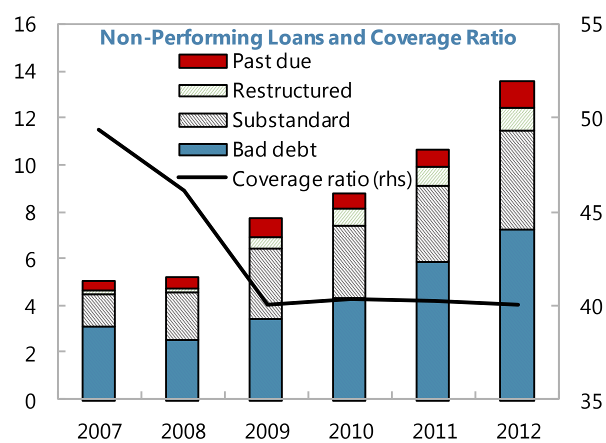
Sources: ISTAT; and IMF staff estimates.

42. **Italy has made significant progress in strengthening fiscal institutions.** Since 2010, the authorities have begun producing an indicative medium-term budget framework, enacted legislation to create a fiscal council, and initiated various reforms to unify budget legislations and reduce special funds. On the fiscal council, they plan to follow an open selection process for the board members of the PBO. They concurred that the budget process needs to be simplified further and aligned with EU requirements under the fiscal governance framework, e.g. by changing the timeline on budget decisions, and are considering further steps to strengthen the fiscal rule, including through top-down spending ceilings.

C. Banking Sector—Strengthening Balance Sheets to Revive Lending

43. **Italian banks continue to rely heavily on Eurosystem support**. Italian banks have repaid little of their Eurosystem borrowing (€255 billion as of June). Household and corporate deposits continue to increase, but access to wholesale term funding remains tight. The FSAP stress test finds that with Eurosystem support, Italian banks can easily absorb a liquidity shock with their substantial collateral (more than €300 billion), leaving deposit flight as the main liquidity risk. However, Italian banks still face a sizeable funding gap (estimated at 12 percent of total liabilities) with the expiry of the LTRO next year and the phasing out in March 2015 of government guaranteed bonds as ECB-eligible collateral.

44. **The recession has severely eroded banks' asset quality and profitability.** The ratio of nonperforming loans (bad, substandard, restructured and past-due) has nearly tripled to 14 percent since 2007, while provisioning coverage has declined from 45 percent to 39 percent. Lower sovereign yields have boosted trading gains, but core profitability remains weak as loan losses absorbed nearly all operating profits last year. Given the lag with the business cycle, NPLs are expected to rise further next year and remain a source of bank vulnerability and a drag on profits (Box 4). Indeed, firm-level analysis of corporate debt highlights about 30 percent of Italian firms (accounting for nearly 50 percent of corporate debt) as vulnerable to the weak economy and concentrated mainly in the SME and construction sectors (Annex II).[8]

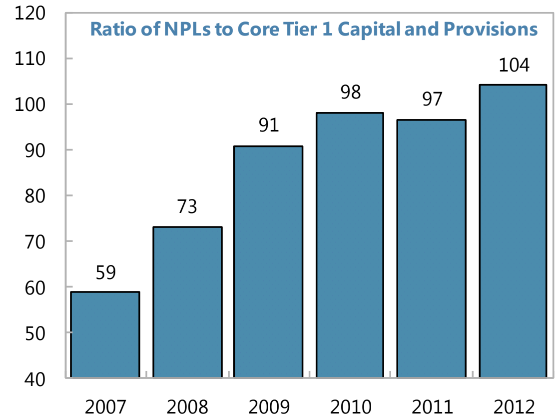


Source: Bank of Italy.

[8] A "vulnerable" firm is classified as having an interest coverage rate (gross operating income to interest payments) of less than two (see Annex II). The forthcoming GFSR, which contains further analysis of corporate debt under alternative stress scenarios, also points to significant vulnerabilities in the corporate sector and their implications for bank asset quality.

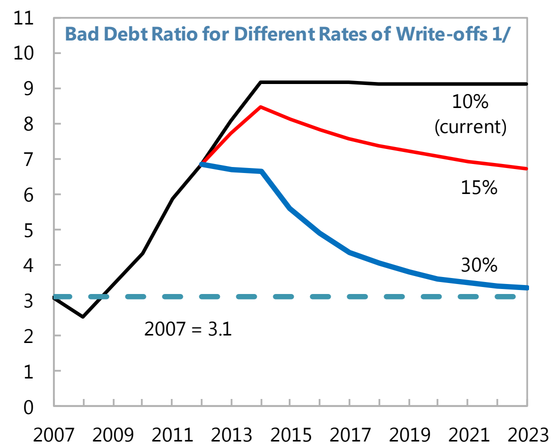
Box 4. Addressing the NPL Problem in Italy

High NPLs represent a growing risk to bank profitability and soundness. Since 2007, NPLs have outpaced the buildup of loan loss provisions and core Tier 1 capital and now exceed capital buffers and provisions. This however, does not include collateral backing (real estate and guarantees) which in Italy accounts for nearly 2/3 of all loans. In addition to absorbing bank profits, high NPLs have raised concerns about the risks to banks' balance sheets and their ability to extend new loans. Worsening asset quality may be a factor in explaining Italian banks' higher CDS spreads and lower market share valuations compared to banks in the rest of Europe and the United States (Figure 3).



Sources: IMF staff estimates; and Bank of Italy.

Addressing the buildup of NPLs will likely remain a challenge for Italian banks well after the recession. Given the slow pace of write-offs and weak outlook, NPLs could remain high for several years. Staff simulations suggest that at current write-off rates, the bad debt ratio would peak in 2015 and decline only gradually. In the absence of a stronger recovery, it would take a substantial increase in write-offs--nearly a tripling compared to the historical average--to bring the bad debt ratio back down to pre-crisis levels within ten years



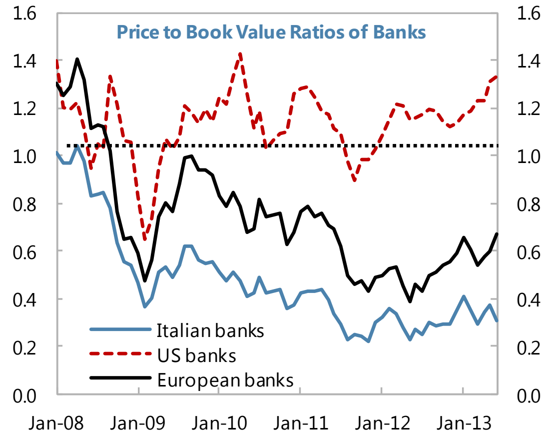
Sources: IMF staff estimates; and Bank of Italy.
1/ The simulation assumes a 2 percent default rate, reduced to 1 percent from 2015 and a 1 percent loan growth. Write-off rates are expressed as a percentage of bad debt.

Steps to strengthen provisioning practices, remove the fiscal disincentives for write-offs, and expand the market for distressed assets could accelerate NPL disposals. Strengthening provisioning coverage, including through forward-looking, comprehensive asset quality reviews and conservative valuation of real estate collateral, would ensure that banks face the proper incentives to write-off or dispose of bad loans. Aligning the tax deductibility of loan loss provisioning and write-offs to international levels could accelerate disposals. Staff estimates that allowing for full deductibility of new loan loss provisions would cost around €3 billion (0.2 percent of GDP) in tax revenue. The market for distressed assets, which in the mid-1990s was active in purchasing NPLs from banks, could be expanded to facilitate NPL disposals and restructuring. Such a market has been used effectively in other countries to not only dispose of bad assets, but also draw in outside financing and expertise, including from overseas, to help rehabilitate distressed borrowers. The large pricing gap between banks and distressed debt investors (10-25 percent depending on the loan category) remains an obstacle, but has started to narrow, reflecting in part recent actions by the BOI to strengthen provisioning.

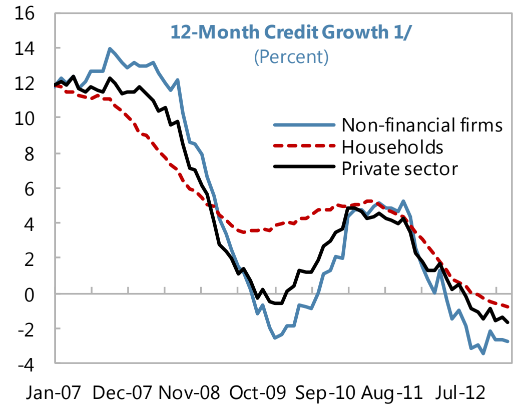
1/ Based on the accompanying Selected Issues Paper, titled, "A Strategy for Developing a Distressed Debt Market in Italy."

Figure 3. Italy: Banking Sector Indicators

Markets have discounted Italian banks more than in the rest of Europe and the U.S.

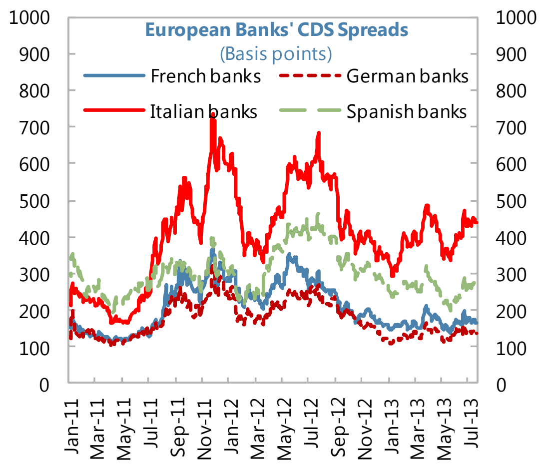


Credit is contracting, both to firms and households, reflecting weak demand and tight lending standards

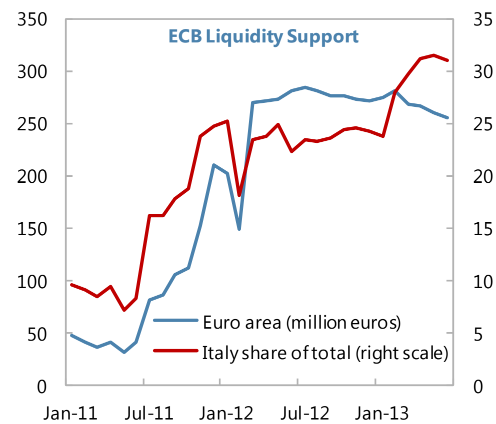


1/ Corrected for securitization.

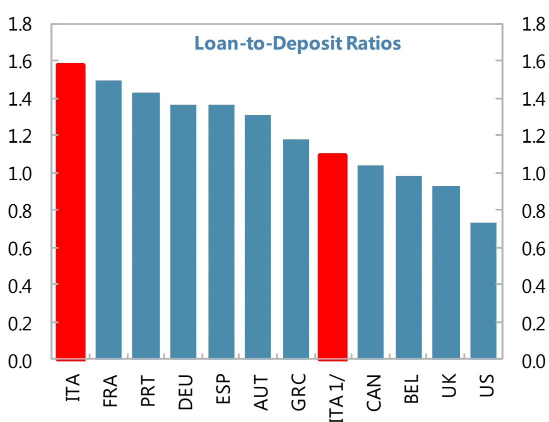
Italian banks' CDS spreads are high compared to other Euro Area countries



ECB liquidity support has not come down.

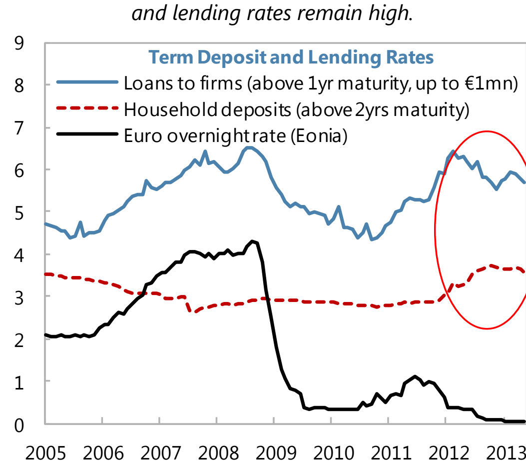


Italian banks still have a sizeable funding gap.



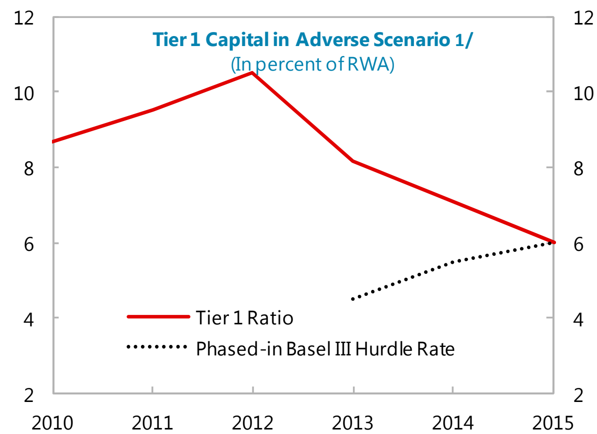
1/ Including retail bonds.

Despite lower Euribor, term deposit and lending rates remain high.



Sources: Bank of Italy; Bloomberg; Agenzia del Territorio; ISTAT; and IMF staff estimates.

45. **Banks have strengthened their capital position but remain vulnerable to the weak economy**. Banks have increased their average core Tier 1 capital ratio from about 6 percent in 2008 to 10 percent in December 2012 by raising new capital, selling noncore assets, and adjusting risk models. Looking ahead, the IMF's FSAP stress tests find the overall level of capital in the system to be above the Basel III hurdle rate in the baseline scenario. However, given the low level of profitability and weak asset quality, an adverse macroeconomic shock would deplete the extra capital buffers, leaving the system vulnerable to further distress. In such a scenario, 13–20 banks accounting for a quarter to one-third of the banking system would fall below the Basel III Common Equity Tier 1 (CET1) and Tier 1 minima, respectively as of 2015, by €6-14 billion in aggregate (0.4-0.9 percent of GDP).[9] This amount would be larger if a higher capital ratio target were used or if banks were to reclassify loans or raise provisioning rates under the BOI inspections or the forthcoming ECB/EBA asset quality review (AQR).



Source: FSAP.
1/ the "adverse" scenario simulates a double-dip, with growth rates of -3.9 percent in 2013, -0.7 percent in 2014, and 1.0 percent in 2015.

Policy Issues and Staff Views

46. **Accelerating write-offs of bad loans would strengthen confidence in Italian banks and ensure they play a supportive role in the recovery.** The high stock of NPLs is due both to an increase in flows and the slow pace of write-offs (6 years on average). Slow write-offs reflect several factors, including tax disincentives against provisioning, banks' heavy reliance on real estate collateral (which reduces the need for cash provisioning), the lengthy judicial process (3 years to foreclose on collateral estate and more than 7 years to complete a bankruptcy), and the limited market for distressed assets. Policies to assist banks in developing strategies for selling, disposing, or writing down impaired loans should look to:

- *Enhance provisioning / write-offs*. The BOI inspections of 20 banking groups last autumn have arrested the decline in provisioning coverage since the crisis. Expanding the BOI inspections to cover more impaired and performing loans as well as smaller banks would strengthen provisioning further. This will also help banks be prepared for the forthcoming ECB/EBA AQR and stress tests. Publishing the general findings of the inspections, including guidance on provisioning, would encourage banks to converge to best practices and enhance market confidence. As the FSAP notes, ensuring a minimum level of harmonization and

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[9] In terms of the breakdown, banks influenced by foundations and cooperative banks account for more than three-quarters of the total shortfall for the system as a whole in the "adverse" scenario. See accompanying Financial Sector Stability Assessment report for a fuller interpretation of the stress test results.

strengthening prudential considerations in write-off practices could also accelerate NPL disposal (see Table 5 for a summary of the FSAP's recommendations).

- *Increase tax deductibility of loan losses*. Raising the tax deductibility cap on existing loan loss provisions (currently 0.3 percent of total loans), while allowing for full deductibility of new ones, would encourage more provisioning and lift bank earnings.

- *Expedite the judicial process*. Expanding the use of specialized insolvency courts beyond Milan could reduce the time in insolvency, while greater reliance on on-line court filings and decisions could accelerate the collateral foreclosure process. Introducing best practice guidelines on workouts would encourage more out-of-court restructuring.

47. **Ensuring adequate capital and liquidity buffers would strengthen bank lending.** Targeted action to strengthen capital buffers where needed would strengthen Italian banks' resilience and lending capacity, and prepare for the forthcoming ECB/EBA AQR. At the euro area level, extending a new LTRO of sufficient tenor would help reduce uncertainty surrounding Italian banks' funding gap. At the same time, banks should be encouraged to prepare for changes in ECB collateral rules on government guaranteed bonds and a gradual exit from Eurosystem support.

48. **Public capital support for problem banks should attach stringent conditionality**. As noted by the FSAP, and in accordance with new EU State Aid rules, state recapitalization should be conditional on the attribution of losses to shareholders and junior debt-holders, and mitigation of moral hazard, such as by replacing the Board and senior managers and restricting dividends to shareholders. Restructuring plans should include targets for raising new capital and a clear and credible exit strategy for public assistance to minimize the risk to the sovereign. The authorities should monitor closely the implementation of the restructuring plan of Banca Monte dei Paschi di Siena (MPS), which has received nearly €4 billion in public capital, and be prepared to take action quickly if the bank fails to meet its targets.

49. **Corporate governance of the banking sector should be enhanced**. Foundations that are major shareholders in the banks should have in place proper governance frameworks, including a cap on leverage and strict diversification rules. Banks should be subject to stringent fit and proper tests for directors and controlling shareholders. To raise new capital, the large cooperative banks should be encouraged to convert to joint stock companies (Box 5).

50. **A more robust framework for financing SMEs would help ease credit constraints**. Initiatives, such as the launch of mini-bonds, lending support from the Cassa Depositi e Prestiti, and expansion of the Central Guarantee Fund have helped ease SME access to credit. The authorities should monitor the expansion of its public credit guarantees for SMEs and strengthen the fee system to limit moral hazard. At the euro area level, to address financial fragmentation, the ECB could consider further unconventional policies, including through a targeted LTRO (linked to new SME lending), or direct purchase of select private assets to promote SME securitization and covered bonds.

Box 5. Improving the Governance of Foundations as Shareholders in Italian Banks[1]

Nonprofit foundations (*Fondazioni*) were created in the early 1990s to take over the capital of privatized banks. Later, they were recognized as private legal entities, with full statutory and operational autonomy and obliged to gradually sell their controlling interests. Foundations have served as stable long-term shareholders, helping banks to expand and modernize. They have supported the consolidation of the banking system, and during the global crisis, provided nearly 22 percent of the capital raised by the largest Italian banks.

Despite the legal mandate to diversify their investments, foundations still control or exercise significant influence over 30 percent of the banking system. Foundations are major shareholders in four of the top 10 groups: Banca Monte dei Paschi di Siena (MPS), Banca Carige, Intesa and Unicredit, and have used cross-holdings, shareholder agreements and voting rights ceilings to expand their control beyond their actual ownership. For instance, in the case of MPS, although the foundation's shares were diluted with the public recapitalization last year to around 33 percent, the 4 percent voting cap on outside shareholders and mandated voting majority in shareholder meetings still allowed the foundation to exercise absolute control over the bank.[2]

Shareholder Structure of Major Italian Banks and Presence of Foundation

Bank name	Foundations	Percent ownership
Banca delle Marche	4	59.1
Banca Carige s.p.a.	1	49.4
Banco di Sardegna Spa	1	49.0
Banca Monte dei Paschi di Siena s.p.a.	1	34.2
Intesa Sanpaolo s.p.a.	5	24.7
Cassa di Risparmio di Parma e Piacenza	1	15.0
Credito Bergamasco Spa	1	11.6
Unicredit Banca s.p.a.	3	9.0
Mediobanca	2	4.6
Unione di Banche Italiane s.c.p.a.	2	4.5

Sources: BoI; Bloomberg; CONSOB; and company documents.

Foundations pose a special challenge for the governance of the banks. Although foundations follow some general corporate governance principles, they face weak internal accountability and are heavily influenced by the interests of their membership. Foundations do not follow uniform accounting rules and lack transparency in the appointment of their governing bodies. In 2003, the Constitutional Court curtailed the supervisory powers of the Ministry of Economy and Finance, limiting oversight over the foundations. Foundations also have very concentrated portfolios (with stakes varying from 30 to 90 percent in the original bank) and at times use risky leverage to support their banks.

Reforms to enhance the governance of the foundations would strengthen the shareholder base for Italian banks. Ensuring that foundations meet standards of transparency and audit and accounting principles and move towards more balanced portfolios and prudent investment policies would strengthen their role as stable investors in the banks. Foundations should remove restrictions on outside bank shareholders' voting to facilitate capital raising and be subject to strict related party transaction rules.

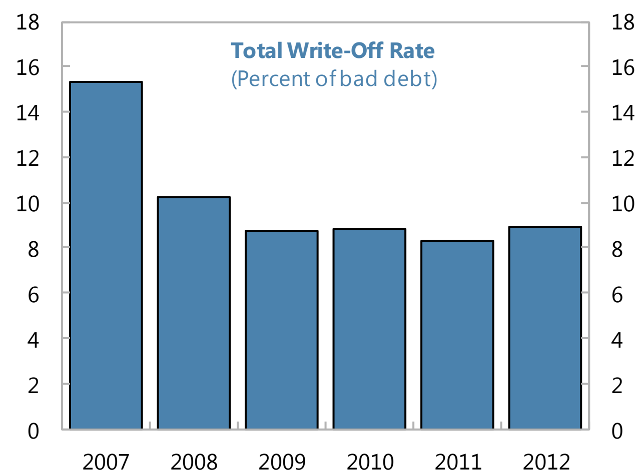
1/ Based on the accompanying Selected Issues Paper, titled, "Reforming the Corporate Governance Framework for Italian Banks."

2/ The clause establishing a 4 percent voting cap was removed in July 2013.

Authorities' Views

51. **The BOI stressed the importance of its special inspections of the 20 large and medium-sized banking groups in bolstering banks' resilience and market confidence.** The inspections covered 40 percent of NPLs and included the valuation of banks' real estate collateral. The BOI issued a report summarizing the main results at end-July and plans to expand these inspections to cover a wider range of loans and banks and make use of Pillar 2 requirements when providing further guidance on provisioning and valuation. Based on the results, the BOI has asked banks to build up buffers by cutting costs and limiting dividend and compensation payments where needed.

52. **The authorities and the banks saw the lengthy and inefficient judicial system as the main factor behind the slow pace of write offs**. The slow pace of write-offs, which have fallen further since the crisis, reflects mainly the inefficient foreclosure and bankruptcy process and partly explains the high steady state of NPLs in Italy compared to other countries. Rather than focusing on the level, the authorities emphasized the trend of the NPL ratio which is projected to decline in 2014, lagging the recovery. The authorities are studying options for providing more tax deductibility on new provisions but face a tight budget constraint.



Source: Bank of Italy.

53. **A market for distressed assets could help reduce NPLs and facilitate corporate restructuring.** The authorities noted that a market for distressed assets with the participation of foreign investors was active in the late 1990s and helped banks to reduce their NPLs. However, banks remain reluctant to sell bad loans in a weak economy and prefer to hold the underlying collateral. While interest is growing in selling to outside investors, the authorities stressed the need for transparency in market transactions and that the risk transfer from banks to investors be fully consistent with prudential rules and accounting standards.

54. **The authorities welcomed the recent steps towards strengthening the banking union but called for more flexibility for national authorities to intervene**. They welcomed the European AQR and saw their own special inspections as helping banks prepare for the AQR and stress tests. Adopting common rules and methodologies, especially for the definition of NPLs and risk weights, would help ensure its success. Given Italian banks' reliance on retail bonds, the authorities raised concerns that the forthcoming Bank Recovery and Resolution Directive (BRRD), which will require use of bail-in powers, would raise the cost of bank funding. To address any stability issues in the run up to a European resolution mechanism, they favored some flexibility in the bail-in rules under the BRRD. For MPS, delays agreeing with the Commission on the bank's restructuring plan have added to the difficulty in raising private

capital. The authorities do not expect further official support, but in the event the bank requires public help, any new capital would fall under new EU State Aid rules.

55. **Further improvements in corporate governance will strengthen bank soundness.** The authorities have taken steps to strengthen banks' corporate governance. To limit conflicts of interests, they introduced a related party lending regulation and a ban on cross-appointments in financial institutions with significant cross shareholdings. The authorities have also called on cooperative banks to transform to joint stock companies, ensure adequate representation of outside institutional investors, and raise capital from new members.

56. **The authorities saw the expansion of the credit guarantee and loan moratorium program as critical for relieving SME's credit constraints**. To support SMEs, the government has nearly doubled the size of the Central Guarantee Fund to €9.4 billion, raised the maximum guarantee coverage from 60 to 80 percent, and eased the selection criteria. Despite the weak economy, default rates on the guarantees have held steady at around 3 percent and are below those for bank loans.

STAFF APPRAISAL

57. **The economy is showing signs of stabilizing, but continues to face strong headwinds**. Sovereign pressures and the pace of fiscal adjustment have eased this year, but financial conditions are tighter in Italy than in many other euro area countries. Growth is projected at -1.8 percent in 2013, before rising to 0.7 percent next year, led by net exports.

58. **The risks, however, are tilted to the downside, stemming mainly from potential policy slippages and banking distress**. Italy remains vulnerable to financial contagion from its high level of sovereign debt, sizeable financing needs, and large NPLs. In a downside scenario, the outward spillovers from Italy could be considerable, given its central role in the global trading and financial system.

59. **Weak productivity continues to undermine Italy's competitiveness.** Staff considers a modest real effective depreciation of not more than 10 percent appropriate to restore competitiveness, which could be achieved through structural reforms.

60. **Maintaining the momentum for reform is also essential to improve the business environment and create jobs**. More is needed to boost productivity and raise the employment rate, especially of youth and women. To support the Youth Guarantee program, active labor market policies could be made more efficient at the local level. Shifting to a more flexible, single contract for new workers that increases job protection over time could lower the cost of new hires and support apprenticeships. Encouraging companies and workers to set more firm-level contracts would better match wages with productivity. Ongoing product market reforms should be implemented expeditiously. Moreover, a more efficient civil judicial system could also have significant cross-cutting benefits.

61. **Italy is set to reach its fiscal target of structural balance this year and should aim to build a buffer in the medium term to cope with vulnerabilities**. The sizeable consolidation in 2012 weighed heavily on growth but was crucial for Italy to exit the EU Excessive Deficit Procedure. The structural balance target this year appropriately provides automatic flexibility to the economic cycle. Over the medium term, after a recovery is underway, the authorities should consider building a buffer for the structural balance rule to more rapidly reduce vulnerabilities from the high public debt.

62. **A rebalancing of fiscal adjustment is urgently needed to support growth.** Effective implementation of the government's payments to clear arrears could significantly ease firms' credit constraints. Once legislated, the *Delega Fiscale* should improve the efficiency of the tax system. But more should be done quickly to support growth. Savings from expenditure cuts and a broader tax base would help achieve the government's objective of reducing taxes on labor and capital. The new local services tax should also cover primary residences for equity and efficiency reasons, and the review of cadastral values accelerated to ensure fairness. The privatization agenda should also be accelerated to reduce public debt.

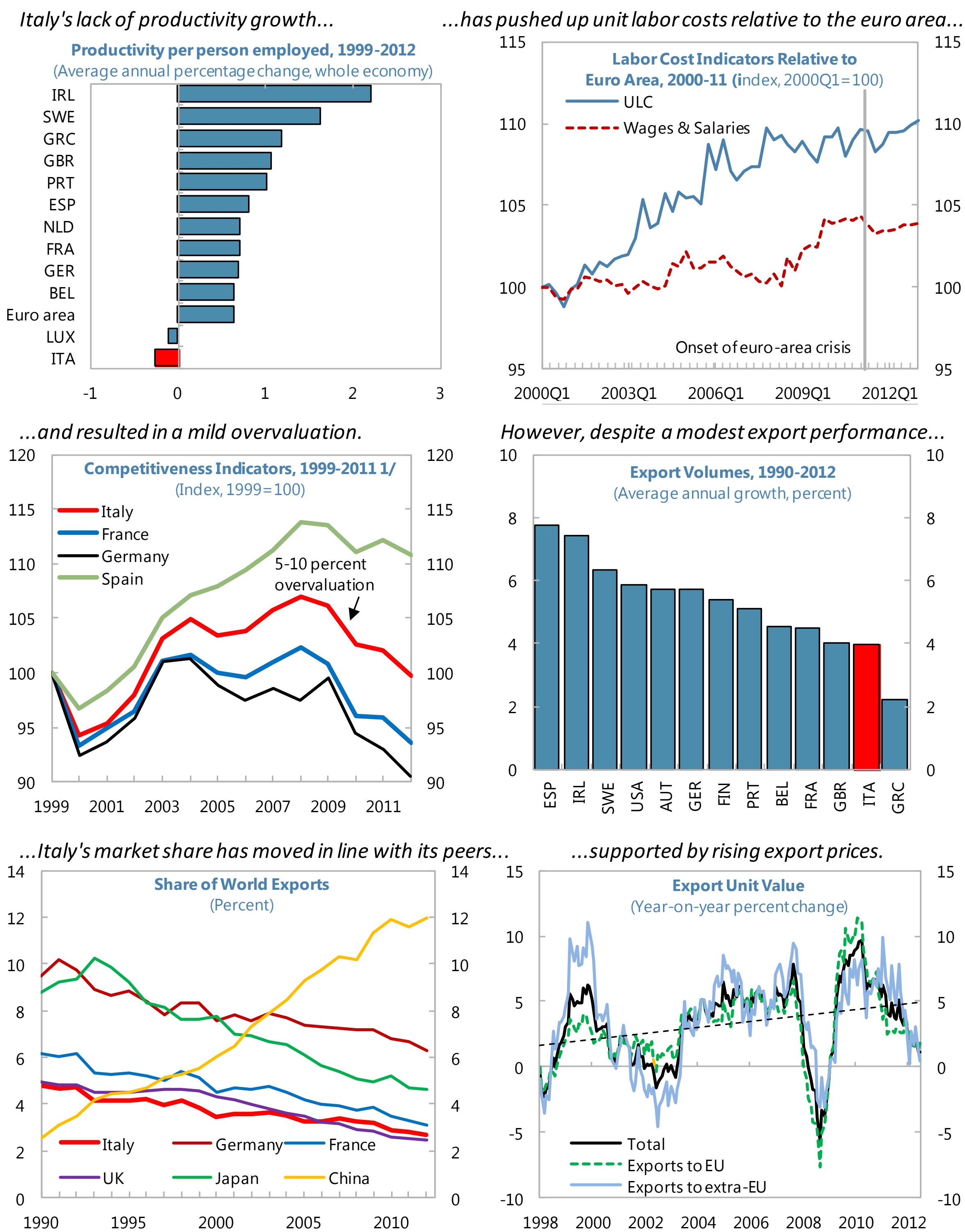
63. **Stepping up efforts to tackle tax evasion and corruption would more fairly distribute the tax burden and improve the business environment**. Making greater use of current AML tools, such as by broadening the scope of false accounting offenses, and strengthening the AML framework, including criminalizing self-laundering, would support the authorities' efforts in these areas.

64. **Banks should have adequate buffers and accelerate write-offs of bad loans, to strengthen their balance sheets and support lending**. The deep recession and financial fragmentation have undermined banks' asset quality and profitability. Targeted action to improve bank profitability and efficiency and to strengthen capital plans where needed would shore up the resilience of Italian banks and help prepare for the forthcoming ECB/EBA AQR. Encouraging further provisioning and write-offs, increasing tax deductibility of loan loss provisions, and expediting the judicial process would accelerate the reduction of nonperforming loans and the revival of new lending.

65. **Italy's efforts should be complemented at the euro area level with steps to strengthen the currency union and support growth**. Direct purchases of select private asset purchases by the ECB, an additional LTRO of sufficient tenor, and lower collateral haircuts and/or a targeted LTRO linked to new SME lending would help reverse financial fragmentation. Greater progress in the banking union, especially a strong single resolution mechanism, would help sever the sovereign banking link. Moves to strengthen the common market, such as the Services Directive, would enhance the cross-border benefits of reforms. Progress in European policies combined with vigorous reforms in Italy would go far in producing a more vibrant and dynamic currency union.

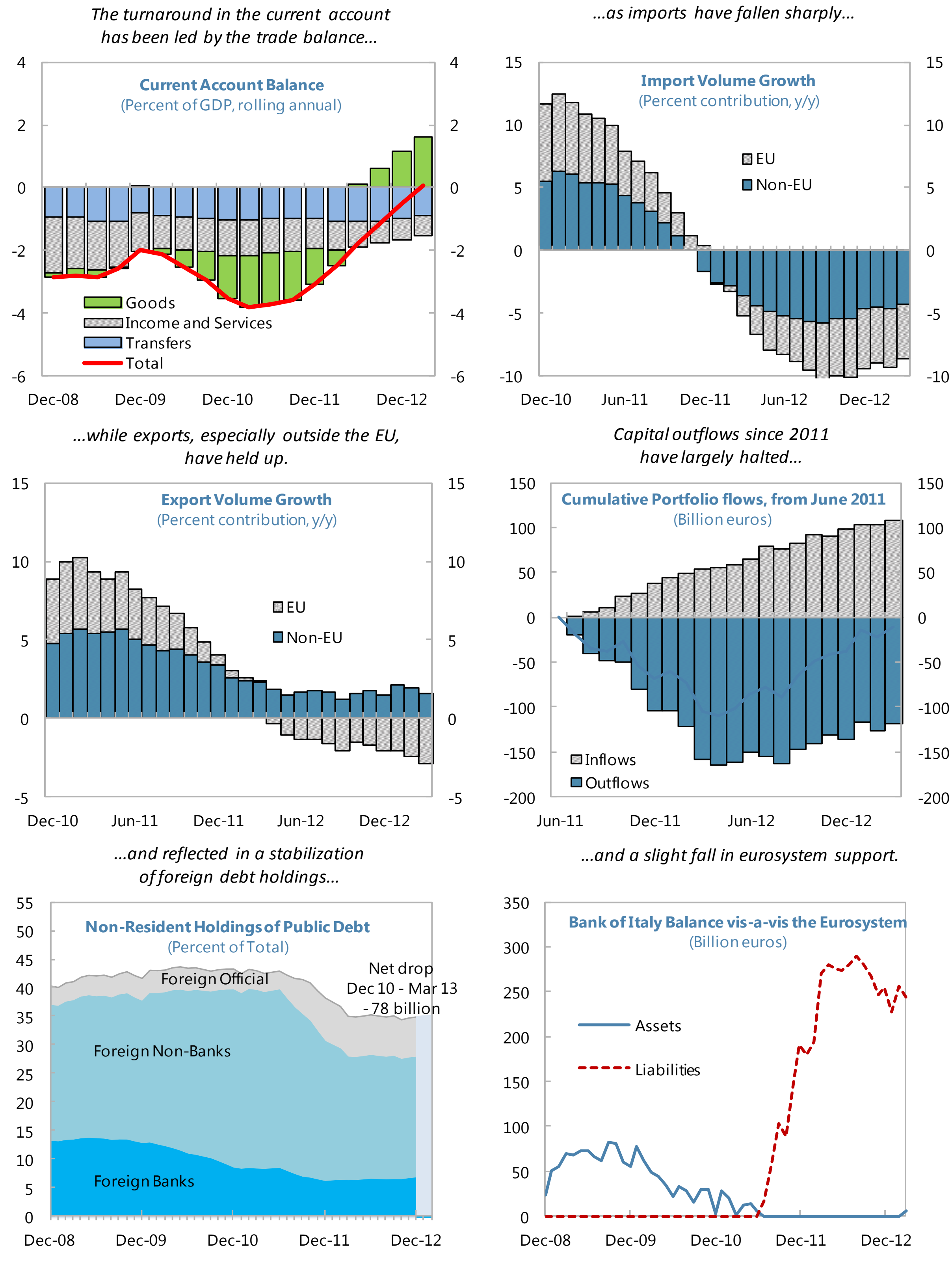
66. **It is recommended that the next Article IV Consultation takes place on the standard 12-month cycle**.

Figure 4. Italy: Competitiveness Indicators, 1990-2012



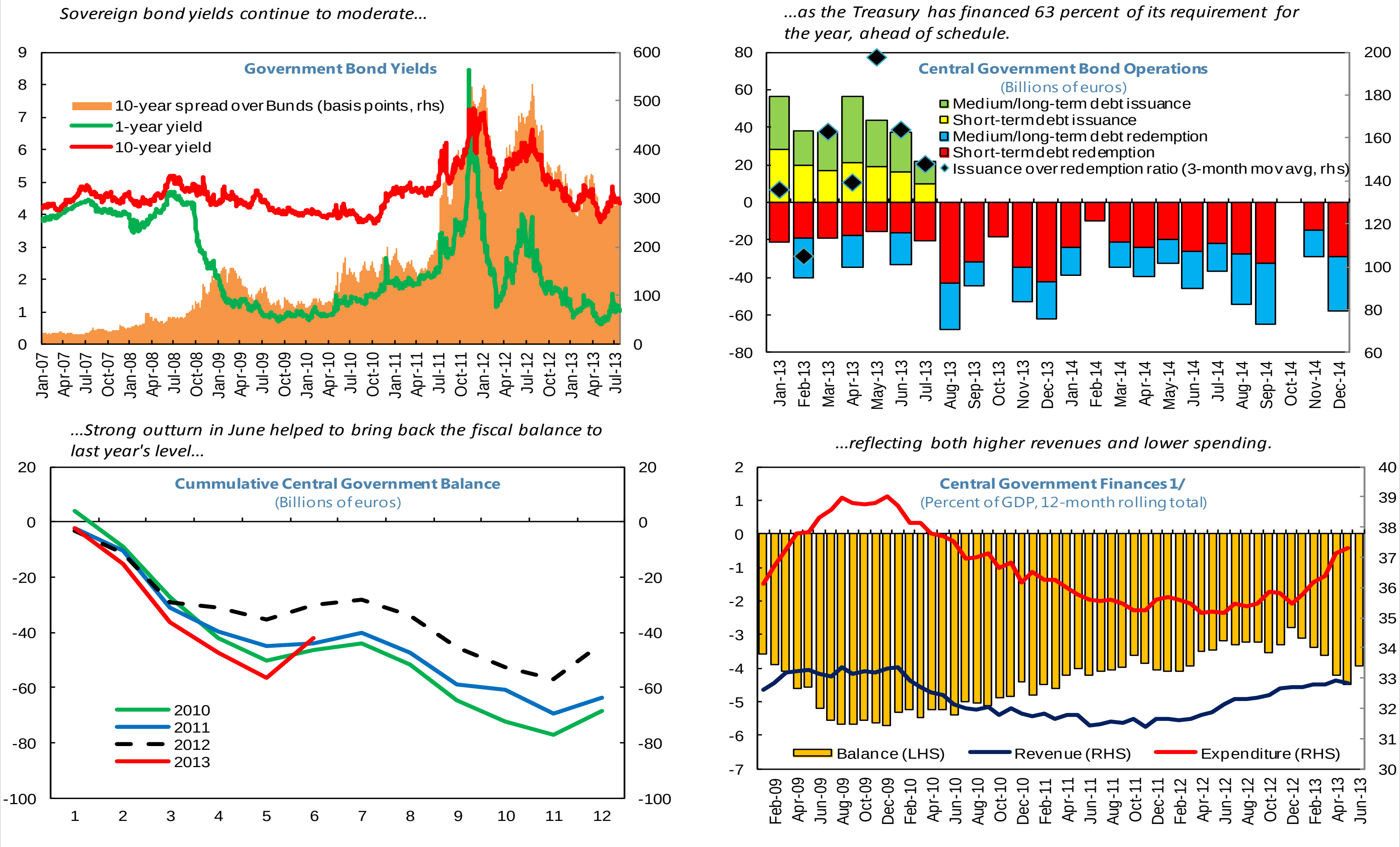
Sources: AMECO, Eurostat, OECD, Bank of Italy, IFS, DOTS and IMF staff calculations.
1/ Based on producer prices of manufactured goods for the domestic market; in relation to 61 competitor countries.

Figure 5. Italy: External Developments, 2008-13



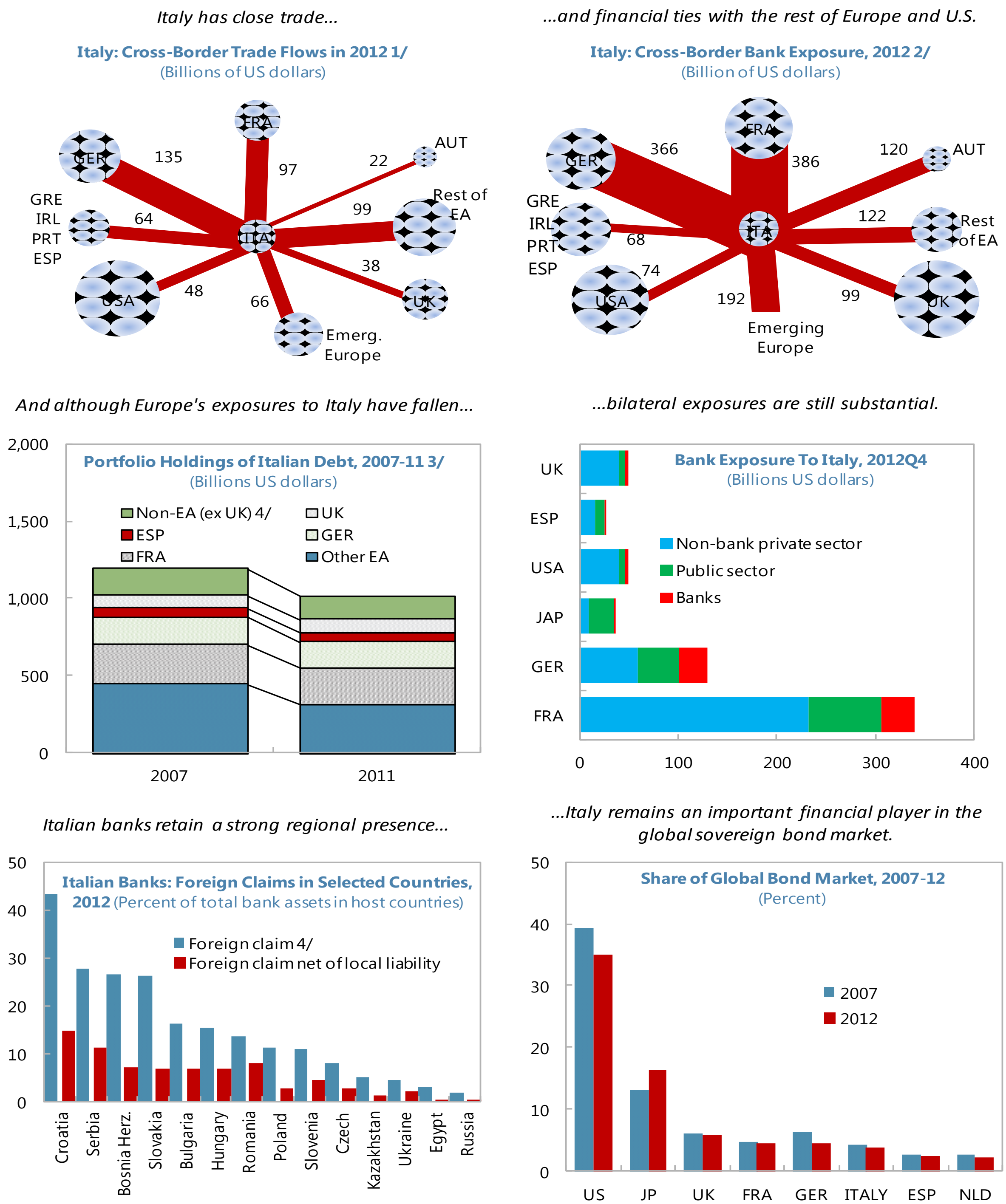
Sources: Haver; and IMF staff estimates.

Figure 6. Italy: Fiscal Sector Monitoring



Source: Bank of Italy; ISTAT; Bloomberg; IMF staff estimates,
1/ Excludes ESM payments in October 2012-December 2012.

Figure 7. Italy: Spillovers, 2007-12



Sources: BIS Consolidated Statistics, BIS Debt Statistics, CPIS, IFS, FSI, Bank of Italy, IMF staff calculations.
1/ Size of bubble represents total imports. Thickness of line represents trade between Italy and each country; i.e. the sum of the two countries or regions' exports.
2/ Size of bubble represents domestic banks' total exposure to non-residents. Thickness of line represents the twoway gross exposure of Italian banks to a country combined with that country's exposure to Italy. The figure covers only claims of banks in BIS reporting countries.
3/ Excludes holdings of non-CPIS reporters
4/ Includes official reserve holdings.

Table 1. Italy: Summary of Economic Indicators, 2010–18 1/

Table 1. Italy: Summary of Economic Indicators, 2010—18 1/

(Annual percentage change, unless noted otherwise)

				Projections					
	2010	2011	2012	2013	2014	2015	2016	2017	2018
Real GDP	1.7	0.4	-2.4	-1.8	0.7	1.1	1.4	1.4	1.2
Real domestic demand									
Public consumption	-0.4	-1.2	-2.9	-0.4	-0.6	-0.1	-0.2	-0.1	0.2
Private consumption	1.5	0.1	-4.3	-2.4	0.2	0.7	1.0	0.9	0.8
Gross fixed capital formation	0.6	-1.8	-8.0	-5.7	0.9	2.2	3.7	3.6	2.7
Final domestic demand	0.9	-0.5	-4.7	-2.6	0.2	0.8	1.2	1.2	1.0
Stock building 2/	1.1	-0.5	-0.6	0.2	0.1	0.0	0.1	0.1	0.0
Net exports 2/	-0.4	1.5	2.8	1.0	0.6	0.3	0.2	0.2	0.2
Exports of goods and services	11.4	5.9	2.3	-0.6	2.3	3.3	3.7	3.8	4.0
Imports of goods and services	12.6	0.5	-7.7	-4.3	0.5	2.8	3.8	3.8	3.8
Resource utilization									
Potential GDP	-0.1	0.2	-0.8	-0.3	-0.1	0.2	0.3	0.4	0.5
Output gap (percent of potential)	-1.9	-1.8	-3.4	-4.8	-4.0	-3.2	-2.1	-1.1	-0.4
Employment	-0.6	0.4	-0.3	-1.1	0.6	1.1	1.5	1.5	1.3
Unemployment rate (percent)	8.4	8.4	10.7	12.5	12.4	12.0	11.2	10.4	9.8
Prices									
GDP deflator	0.4	1.3	1.6	1.4	1.3	1.3	1.4	1.5	1.5
Consumer prices	1.6	2.9	3.3	1.6	1.3	1.2	1.3	1.4	1.5
Hourly compensation3/	3.4	2.8	2.0	0.9	1.2	1.1	1.2	1.3	1.4
Productivity3/	6.6	1.0	-1.3	0.3	0.5	0.6	0.8	0.8	0.8
Unit labor costs3/	-3.2	1.9	3.3	0.6	0.7	0.4	0.4	0.5	0.6
Fiscal indicators									
General government net lending/borrowing 4/	-4.4	-3.7	-2.9	-3.2	-2.1	-1.8	-1.1	-0.5	-0.2
Cyclically adjusted balance (in % of potential GDP)	-3.4	-2.8	-1.2	-0.7	0.0	-0.1	0.0	0.0	0.0
General government primary balance 4/ 5/	0.1	1.2	2.5	2.2	3.3	3.6	4.5	5.1	5.6
Structural overall balance (percent of potential GDP)	-3.6	-3.5	-1.3	-0.2	0.0	0.0	0.0	0.0	0.0
Structural primary balance (percent of potential GDP) 5/	0.9	1.4	4.0	4.9	5.1	5.2	5.5	5.6	5.7
General government gross debt 4/	119.3	120.8	127.0	132.3	133.1	131.8	129.3	126.2	123.0
Exchange rate regime				Member of EMU					
Exchange rate (national currency per U.S. dollar)	0.8	0.7	0.8	...	...	...	...	...	...
Nominal effective rate: CPI based (2000=100)	101.3	101.6	99.1	...	...	...	...	...	...
External sector 4/									
Current account balance	-3.5	-3.1	-0.7	-0.1	0.0	0.0	-0.3	-0.5	-0.8
Trade balance	-1.3	-1.1	1.1	2.0	2.1	2.2	2.2	2.3	2.4

Sources: National Authorities; and IMF staff calculations.

1/ Staff estimates and projections, unless otherwise noted, based on fiscal consolidation measures included in the September 2012 Documento di Economia e Finanza and the 2013 Budget.

2/ Contribution to growth.

3/ In industry (including construction).

4/ Percent of GDP.

5/ Excludes interest expenditure.

Table 2. Italy: General Government Accounts (National Presentation), 2010–18

(Percent of GDP, unless otherwise indicated)

	2010	2011	2012	2013		2014		2015		2016	2017	2018
		Prel.	Prel.	Proj.	Auth.	Proj.	Auth.	Proj.	Auth.	Proj.	Proj.	Proj.
Total revenues	46.6	46.6	48.1	48.5	48.6	48.4	48.4	48.4	48.2	48.5	48.6	48.7
Current revenues	46.2	45.9	47.7	47.9	48.2	47.8	48.0	47.9	47.8	48.0	48.1	48.1
Tax revenues	28.8	28.8	30.2	30.3	30.4	30.2	30.4	30.3	30.3	30.4	30.5	30.6
Direct taxes	14.6	14.3	15.1	14.9	15.0	15.0	15.0	15.1	14.7	15.2	15.3	15.4
Indirect taxes	14.0	14.1	14.9	15.3	15.3	15.1	15.4	15.1	15.5	15.1	15.1	15.1
Social security contributions	13.8	13.7	13.8	13.9	14.0	13.9	13.9	13.9	13.8	13.9	13.8	13.8
Other current revenues	3.8	3.8	3.8	3.8	3.8	3.8	3.8	3.8	3.7	3.8	3.8	3.8
Capital revenues	0.5	0.7	0.4	0.5	0.5	0.5	0.4	0.5	0.4	0.5	0.5	0.5
Total expenditures	51.1	50.4	51.2	51.7	51.5	50.5	50.2	50.2	49.9	49.6	49.1	48.8
Current expenditures	47.8	47.4	48.1	48.3	48.0	47.5	47.4	47.3	47.1	46.7	46.2	45.9
Wages and salaries	11.1	10.7	10.6	10.5	10.4	10.2	10.0	10.0	9.8	9.8	9.5	9.5
Goods and services	8.7	8.6	8.4	8.2	8.2	8.1	8.0	8.1	7.9	8.1	8.0	8.0
Social transfers	19.2	19.3	19.9	20.5	20.3	20.7	20.3	20.8	20.2	20.7	20.7	20.7
Other	4.1	3.8	3.7	3.7	3.8	3.2	3.6	3.0	3.5	2.4	2.3	1.9
Interest payments	4.6	5.0	5.5	5.4	5.3	5.3	5.6	5.4	5.8	5.6	5.7	5.7
Capital expenditures	3.3	3.0	3.1	3.4	3.5	2.9	2.8	2.9	2.7	2.9	2.9	2.9
Overall balance	-4.5	-3.8	-3.0	-3.2	-2.9	-2.1	-1.8	-1.8	-1.7	-1.1	-0.5	-0.2
Memorandum items:												
Primary balance (revenue minus primary spending)	0.1	1.2	2.5	2.2	2.4	3.2	3.8	3.6	4.1	4.5	5.1	5.6
Unidentified measures to achieve structural balance 1/	...	...	...	...	...	0.4	...	0.3	...	0.5	0.1	0.4
One-off measures (negative=balance-improving)	-0.2	-0.7	-0.1	0.5	0.0	-0.1	-0.1	0.1	0.1	-0.1	-0.1	-0.1
Structural overall balance 2/	-3.6	-3.5	-1.3	-0.2	0.0	0.0	0.4	0.0	0.0	0.0	0.0	0.0
Change in structural overal balance 2/	0.5	0.1	2.2	1.1	1.2	0.2	0.4	0.0	-0.4	0.0	0.0	0.0
Structural primary balance 2/	0.9	1.4	4.0	4.9	5.3	5.1	6.0	5.2	5.8	5.5	5.6	5.7
Primary current expenditure real growth rate 3/	-0.2	-2.9	-3.6	-1.2	-1.4	-0.9	-0.8	0.4	0.2	-0.5	0.2	1.7
Nominal GDP growth rate 3/	2.1	1.7	-0.8	-0.4	0.5	2.1	3.2	2.4	3.3	2.8	2.9	2.7
Real GDP growth rate 3/	1.7	0.4	-2.4	-1.8	-1.3	0.7	1.3	1.1	1.3	1.4	1.4	1.2
Output gap 2/	-1.9	-1.8	-3.4	-4.8	-4.8	-4.0	-3.8	-3.2	-2.6	-2.1	-1.1	-0.4
Public debt	119.3	120.8	127.0	132.3	130.4	133.1	129.0	131.8	125.5	129.3	126.2	123.0

Sources: ISTAT; Ministry of Economy and Finance; and IMF staff estimates.

1/ Including as yet unidentified measures to finance revenue shortfall from the abolition of the property tax on primary residences.

2/ Percent of potential GDP.

3/ Percent.

Auth. = Documento di Economia e Finanza 2013 (April 2013 update of the macro-fiscal framework document).

Table 2.1. Italy: Statement of Operations–General Government (GFSM 2011 format), 2010–18

Table 2.1. Italy: Statement of Operations–General Government (GFSM 2001 format), 2010–18

	2010	2011	2012	2013	2014	2015	2016	2017	2018
			Prelim.			Projections			
			(Billions of euros)						
Revenue	714.7	728.8	746.8	747.0	763.5	782.9	806.7	831.6	855.8
Taxes	447.5	455.0	472.2	472.3	480.6	493.3	509.2	525.5	540.9
Social contributions	213.4	217.0	216.7	216.7	221.3	226.3	232.3	238.6	244.8
Grants	1.8	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Other revenue	52.0	53.9	55.0	55.0	58.6	60.2	62.2	64.5	67.0
Expenditure	782.0	787.0	792.5	797.4	796.6	811.9	824.5	840.6	858.4
Expense	780.8	790.8	794.4	794.9	799.1	813.8	825.6	841.1	858.0
Compensation of employees	172.0	169.2	165.4	163.6	161.9	163.6	163.8	163.9	168.3
Use of goods and services	90.2	91.2	86.6	81.6	81.3	82.6	84.8	86.4	88.7
Consumption of fixed capital	31.3	31.2	31.4	33.6	31.6	31.8	32.2	32.5	32.5
Interest	69.2	76.5	84.8	84.0	84.9	88.3	93.9	97.4	101.5
Social benefits	344.0	348.9	357.1	366.9	377.4	388.4	398.4	408.7	419.6
Other expense	74.1	73.8	69.2	65.2	61.9	59.1	52.4	52.2	47.3
Net acquisition of nonfinancial assets	1.2	-3.8	-1.9	2.6	-2.4	-1.9	-1.1	-0.5	0.4
Gross / Net Operating Balance 1/	-66.1	-62.0	-47.6	-47.9	-35.6	-31.0	-19.0	-9.5	-2.2
Net lending/borrowing	-67.3	-58.2	-45.7	-50.5	-33.2	-29.0	-17.9	-9.0	-2.7
Net acquisition of financial assets	19.2	-7.1	…	…	…	…	…	…	…
Net incurrence of liabilities	85.3	51.4	…	…	…	…	…	…	…
					(Percent of GDP, unless otherwise indicated)				
Revenue	46.1	46.2	47.7	47.9	48.0	48.0	48.1	48.2	48.3
Taxes	28.8	28.8	30.2	30.3	30.2	30.3	30.4	30.5	30.6
Social contributions	13.8	13.7	13.8	13.9	13.9	13.9	13.9	13.8	13.8
Grants	0.1	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Other revenue	3.4	3.4	3.5	3.5	3.7	3.7	3.7	3.7	3.8
Expenditure	50.4	49.9	50.6	51.1	50.0	49.8	49.2	48.8	48.5
Expense	50.3	50.1	50.7	51.0	50.2	49.9	49.3	48.8	48.5
Compensation of employees	11.1	10.7	10.6	10.5	10.2	10.0	9.8	9.5	9.5
Use of goods and services	5.8	5.8	5.5	5.2	5.1	5.1	5.1	5.0	5.0
Consumption of fixed capital	2.0	2.0	2.0	2.2	2.0	2.0	1.9	1.9	1.8
Interest	4.5	4.8	5.4	5.4	5.3	5.4	5.6	5.7	5.7
Social benefits	22.2	22.1	22.8	23.5	23.7	23.8	23.8	23.7	23.7
Other expense	4.8	4.7	4.4	4.2	3.9	3.6	3.1	3.0	2.7
Net acquisition of nonfinancial assets	0.1	-0.2	-0.1	0.2	-0.2	-0.1	-0.1	0.0	0.0
Gross / Net Operating Balance 1/	-4.3	-3.9	-3.0	-3.1	-2.2	-1.9	-1.1	-0.5	-0.1
Net lending/borrowing	-4.3	-3.7	-2.9	-3.2	-2.1	-1.8	-1.1	-0.5	-0.2
Net acquisition of financial assets	1.2	-0.4	…	…	…	…	…	…	…
Net incurrence of liabilities	5.5	3.3	…	…	…	…	…	…	…
Memorandum items:									
Primary balance 2/	0.0	1.0	2.3	2.0	3.1	3.5	4.4	5.0	5.4
Structural balance 3/	-3.6	-3.5	-1.3	-0.2	0.0	0.0	0.0	0.0	0.0
Change in structural balance 3/	0.5	0.1	2.2	1.1	0.2	0.0	0.0	0.0	0.0
Structural primary balance 3/	0.9	1.4	4.0	4.9	5.1	5.2	5.5	5.6	5.7
General government gross debt	119.3	120.8	127.0	132.3	133.1	131.8	129.3	126.2	123.0

Sources: ISTAT; IMF GFS; and IMF staff estimates.
1/ Revenue minus expense.
2/ Primary revenue minus primary expenditure.
3/ Percent of potential GDP.

Table 2.2. Italy: General Government Balance Sheet, 2008–11

	2008	2009	2010	2011 Prelim.
	(Billions of euros)			
Net worth	…	…	…	…
Nonfinancial assets	…	…	…	…
Net financial worth	-1417	-1533	-1545	-1487
Financial assets	392	412	422	407
Currency and deposits	68	81	92	73
Securities other than shares	16	18	21	23
Loans	54	55	58	64
Shares and other equity	129	131	123	119
Insurance technical reserves	2	2	1	1
Financial derivatives	0	0	0	0
Other accounts receivable	125	126	126	126
Financial liabilities	1809	1945	1967	1894
Currency and deposits	211	221	222	215
Securities other than shares	1404	1527	1543	1467
Loans	140	142	145	150
Shares and other equity	0	0	0	0
Insurance technical reserves	0	0	0	0
Financial derivatives	2	2	2	2
Other accounts receivable	52	54	56	60
	(Percent of GDP)			
Net worth	…	…	…	
Nonfinancial assets	…	…	…	
Net financial worth	-89.9	-100.9	-99.5	-94.2
Financial assets	24.9	27.1	27.2	25.8
Currency and deposits	4.3	5.3	6.0	4.6
Securities other than shares	1.0	1.2	1.4	1.5
Loans	3.4	3.6	3.8	4.0
Shares and other equity	8.2	8.6	8.0	7.6
Insurance technical reserves	0.1	0.1	0.1	0.1
Financial derivatives	0.0	0.0	0.0	0.0
Other accounts receivable	7.9	8.3	8.1	8.0
Financial liabilities	114.8	128.0	126.7	120.0
Currency and deposits	13.4	14.5	14.3	13.6
Securities other than shares	89.1	100.5	99.4	92.9
Loans	8.9	9.4	9.3	9.5
Shares and other equity	0.0	0.0	0.0	0.0
Insurance technical reserves	0.0	0.0	0.0	0.0
Financial derivatives	0.1	0.1	0.1	0.1
Other accounts payable	3.3	3.6	3.6	3.8

Sources: IMF GFS; and Eurostat.

Table 3. Italy: Summary of Balance of Payments, 2010–15

	2010	2011	2012	2013	2014	2015
				Projections		
			Billions of Euros			
Current account balance	-54.7	-48.3	-11.6	-1.7	0.5	-0.7
Balance of goods and services	-30.1	-23.1	17.2	32.9	37.2	38.9
Goods balance	-20.9	-17.4	17.8	30.7	34.2	35.6
Exports	337.9	376.6	390.4	383.5	386.3	395.6
Imports	-358.8	-393.9	-372.6	-352.8	-352.1	-360.0
Services balance	-9.2	-5.7	-0.6	2.2	3.0	3.2
Credit	74.0	77.4	81.8	85.2	85.8	87.9
Debit	-83.2	-83.1	-82.4	-83.0	-82.8	-84.7
Income balance	-8.3	-9.4	-13.2	-14.1	-15.8	-18.2
Credit	55.9	61.1	50.8	51.4	51.4	49.3
Debit	-64.2	-70.4	-64.0	-65.5	-67.2	-67.5
Current transfers (net)	-16.3	-15.8	-15.6	-20.5	-20.9	-21.3
Official (net)	-7.5	-10.8	9.5	-9.9	-10.2	-10.9
Capital and financial account balance	86.2	73.5	10.9	1.7	-0.5	0.7
Capital account balance	-0.6	0.6	3.8	0.0	0.0	0.1
Financial account	86.7	72.9	7.0	1.7	-0.6	0.6
Direct investment	-17.7	-13.9	-16.2	-16.6	-17.2	-17.9
Portfolio investment	38.5	-34.4	29.2	6.6	25.1	34.3
of which: government	64.0	-73.5	-50.2	-27.1	-13.8	0.0
Other investment	71.8	114.5	-6.3	11.8	-8.4	-15.8
Derivatives (net)	-4.7	7.5	1.7	0.0	0.0	0.0
Reserve assets (increase = -)	-1.0	-0.9	-1.5	0.0	0.0	0.0
Net errors and omissions	-31.5	-25.2	0.7	0.0	0.0	0.0
Official Financing			…	…	…	…
			Percent of GDP			
Current account balance	-3.5	-3.1	-0.7	-0.1	0.0	0.0
Balance on goods and services	-1.9	-1.5	1.1	2.1	2.3	2.4
Goods balance	-1.3	-1.1	1.1	2.0	2.1	2.2
Services balance	-0.6	-0.4	0.0	0.1	0.2	0.2
Income balance	-0.5	-0.6	-0.8	-0.9	-1.0	-1.1
Current transfers	-1.0	-1.0	-1.0	-1.3	-1.3	-1.3
Capital and financial account balance	5.6	4.7	0.7	0.1	0.0	0.0
Capital account balance	0.0	0.0	0.2	0.0	0.0	0.0
Financial account	5.6	4.6	0.4	0.1	0.0	0.0
Direct investment	-1.1	-0.9	-1.0	-1.1	-1.1	-1.1
Portfolio investment	2.5	-2.2	1.9	0.4	1.6	2.1
of which: government	4.1	-4.7	-3.2	-1.7	-0.9	0.0
Other investment	4.6	7.3	-0.4	0.8	-0.5	-1.0
Derivatives (net)	-0.3	0.5	0.1	0.0	0.0	0.0
Reserve assets (increase = -)	-0.1	-0.1	-0.1	0.0	0.0	0.0
Net errors and omissions	-2.0	-1.6	0.0	0.0	0.0	0.0
Official Financing			…	…	…	…
Gross external debt	117.4	115.0	121.0	123.7	121.7	121.7
Public sector	52.5	55.0	62.1	62.8	58.2	52.5
Private sector	64.9	60.1	58.9	60.9	63.6	69.2

Sources: Bank of Italy and IMF staff estimates.

Table 4. Financial Soundness Indicators: Italy All Commercial Banks, 2007–12

Table 4: Financial Soundness Indicators: Italy All Commercial Banks, 2007-12

	2007	2008	2009	2010	2011	Jun-12
Basic data						
Total assets, in billions of euro	2,709	2,816	2,711	2,765	2,800	2,893
In percent of GDP	174	179	178	178	177	185
Total deposits, in billions of euro	1,542	1,431	1,358	1,458	1,436	1,497
In percent of GDP	99	91	89	94	91	96
Number of institution	70	68	62	62	69	68
GDP, in billions of euro (WEO)	1,554	1,575	1,520	1,553	1,580	1,564
Financial Soundness Indicators						
Capital adequacy						
Total capital ratio, in percent 1/	9.8	10.4	11.6	12.1	12.7	13.3
Tier 1 ratio, in percent	6.8	7.0	8.3	8.7	9.5	10.4
Core tier 1 ratio, in percent 1/	6.3	6.3	7.4	7.5	8.7	9.8
Tier 1 capital to assets, in percent	4.5	4.2	4.8	5.0	5.5	5.5
Core tier 1, in bilions of euro	111	106	118	119	139	150
Risk-weighted assets, in billions of euros	1,763	1,681	1,583	1,589	1,602	1,527
Credit Risk, in percent						
Large exposures to capital 2/ 3/	20	20	12	89	86	92
NPL net of provisions to capital 2/	27	36	55	60	65	73
NPL to gross loans	5.6	6.3	9.5	10.6	11.9	13.1
Provisions to NPL	50	46	40	40	40	38
Share of loans to top 5 borrowers	1.7	3.5	3.1	4.2	4.8	4.5
Share of loans to top 10 borrowers	2.4	5.1	4.6	6.5	7.2	7.0
Share of SME loans	…	9.0	8.5	8.4	8.3	8.2
Credit cost to total loans	0.4	0.7	1.1	0.9	1.0	0.5
Sectoral distribution of loans						
Residents	72	72	73	75	75	74
of which						
Deposit takers	4	5	3	2	2	2
Central bank	2	1	1	1	1	0
Other financial corporations	7	3	5	5	4	4
Government	2	2	3	3	3	3
Corporations	36	37	38	38	39	38
Other	20	23	23	26	27	27
Nonresidents	28	28	27	25	25	26
Profitability, in percent						
Return on assets 1/	0.7	0.3	0.3	0.3	-0.9	0.1
Return on equity 4/	9.2	4.9	4.0	3.7	-12.9	1.0
Return on equity, excluding impairment on goodwill 4/	…	…	…	…	2.2	…
Interest margin on gross income	55	66	60	58	57	55
Trading income to gross income	3	-7	4	1	3	9
Non-interest expenses to gross income	61	66	60	63	65	60
Personnel expenses to non-interest expenses	57	57	58	58	56	56
Cost to income ratio 1/	61	66	60	63	65	60
Liquidity, in percent						
Liquid asset to total asset	…	7	11	12	12	14
Liquid asset to short-term liabilities	…	42	86	85	72	80
Customer deposits to non-interbank loans	72	64	64	64	59	59
Customer deposits+retail bonds to non-interbank loans	109	98	99	96	93	92
FX and derivative risks, in percent						
Net open FX position to equity 4/	…	2.0	1.5	1.6	1.7	1.4
FX loans to total loans	9	11	10	10	9	9
FX liabilities to total liabilities	…	7	10	9	6	6

Sources: Bank of Italy, WEO, and IMF staff calculations.
1/ Excluding overseas subsidiaries.
2/ Total regulatory capital.
3/ Break in 2010 due to the new EU regulatory framework (increase of risk weights for exposures to other regulated entities, mainly interbank exposures).
4/ Equity includes total capital and reserves.

Table 5. Italy—Key FSAP Technical Recommendations

Recommendations	Priority*
Banking	
Issue prudential guidance to ensure a minimum level of harmonization in loan loss provisions and write-off practices [BI]	Short term
Amend law to ensure effective oversight of banking foundations by the MEF, require the largest foundations to publish audited financial statements, have an asset allocation policy aimed at diversification, and impose leverage limits [Parliament/MEF]	Short term
Amend regulation to require that related party transactions do not carry more favorable terms relative to those with unrelated parties, and that board members with conflicts of interest are excluded from the decision [BI/MEF]	Short term
Gradually increase the tax deductibility of bank provisions in the same tax year [Parliament/MEF]	Medium term
Monitor closely the implementation of the restructuring plan for Monte dei Paschi di Siena and prepare contingency measures if plan targets are not reached [MEF/BI]	Medium term
Financial sector oversight	
Expand the definition of fit and proper for bank and investment service providers (ISP) directors so that adverse regulatory judgments can be taken into consideration [Parliament/MEF]	Short term
Clarify in supervisory guidance for licensing that the assessment of financial suitability of major shareholders include the capacity to provide additional capital [BI]	Short term
Adopt a dedicated group supervisory approach for the nationally significant insurers [IVASS]	Short term
Increase use of onsite inspections of ISPs, including assets managers [Consob, BI]	Medium term
Amend law to empower BI and Consob to impose fines not only on individuals but also on financial sector entities and raise the ceiling for sanctions [MEF]	Medium term
Amend law to enable supervisors to remove individual board members, officers, and auditors of financial institutions [Parliament/MEF]	Medium term
Introduce risk sensitivity in the current solvency framework for insurers in anticipation of the EU implementation of Solvency II [IVASS]	Medium term
Financial safety nets	
Provide a statutory basis and detailed guidelines for RRPs to be prepared by all systemically important banks [MEF, BI]	Short term
Adopt depositor preference, expand the resolution tools to include bail-in, bridge bank powers and to recapitalize and transfer ownership, selectively transfer assets and liabilities, and be able to trigger these at an early juncture when the firm is no longer viable [MEF, BI]	Short term
Amend the deposit guarantee framework to provide for ex ante funding, with a back-up credit line from the MEF, and remove active bankers from the board and executive committees of deposit guarantee schemes [MEF, BI]	Medium term

* Short term: 12 months; medium term: one to three years.

Table 6. Italy—The Authorities' Response to Policy Recommendations from the 2012 Article IV Consultation

2012 Article IV Recommendation	Authorities' Response	Possible Next Steps
Labor market		
Pass labor market reform bill	Reform was approved in June 2012 and further measures were taken in July 2013	The reform could be strengthened further (see below)
Clarify conditions for reinstatement via the judicial process and facilitate out-of-court settlements of dismissal disputes	None	See earlier recommendations
Better bridge the gap between permanent and temporary workers	Incentives to firms offering permanent contracts to young workers but a large gap remains	Introduce flexible open-ended contract for new hires with graduated protection
Boost female labor participation by reducing marginal tax rate for married second-earners	None	Reduce marginal tax rate for married second-earners
Decentralize wage setting by operationalizing June 2011 agreement	Government held discussions with social partners on competitiveness	Promote firm-level contracts first, unless companies and workers agree to opt out and abide by national ones
Consider regional differentiation in public sector wages	Public sector employment reform is still pending; pay differentiation has not been discussed	Consider regional differentiation in public sector wages, including to support private wage flexibility and employment
Product market		
Complete ownership separation of gas distribution and production	Separation process completed in 2013	The separation could be accelerated so as to complete it by end-2012
Accelerate opening of professional services	Reform of professional services approved in August 2012. However, implementation of reforms to the legal profession has lagged	Needs full implementation
Push forward on privatization (especially local public services)	A law outlining privatization agenda was approved in August. But, there is little progress on implementation	Agenda needs implementation; clarify role of private sector in local public services
Support EU-level reforms of network industries,	Management of large transport and	The public sector should move swiftly in areas where it

infrastructure development, and reduction of the number of regulated professions in Europe	energy were networks are taken from regions and made the competency of central government	is a key actor
Firm growth		
Improve SME access to credit through risk-based lending; support venture capital and private equity industry; promote inward FDI	August law expanded financing possibilities for non-listed companies. Package of simplification measures adopted in July *(Decreto Fare)*	Continue improving SME access to credit, including through risk-based lending (rather than just collateralized lending)
Streamline tax and other regulations to help companies grow	Additional simplification measures were approved in August and further measures are under consideration	Implementation of tax reform bill (Delega Fiscale)
Fiscal adjustment composition		
Implement spending cuts to avoid VAT increases in 2012	VAT increase postponed till October	Abolish VAT increase only if fully financed
Shift the composition of adjustment toward expenditure cuts; reduce tax expenditure; step up efforts against tax evasion	Spending review cut €12 billion; tax reform foresees increase anti-evasion measures and some simplification of tax regime	Target more ambitious savings through bottom-up spending review, covering all levels of government, undertaken jointly with a review of tax expenditures
Reduce labor tax wedge; raise the ACE; well-targeted increase in public investment	Marginal tax cuts for lower incomes in budget proposal	Once savings are realized, lower tax burden on capital and labor. Well targeted investment.
Public Financial Management		
Target a 1 percent of GDP structural surplus (0.5 percent extra fiscal effort in 2014, legislated in 2012)	Authorities projected to meet structural balance (MTO) in 2013. Thereafter, unidentified measures are needed to maintain balance.	Target a 0.5 percent of GDP improvement in structural balance from 2014 (once the recovery is underway), until reaching a 1 percent of GDP surplus.
Strengthen role of spending review and adopt binding, multi-year expenditure framework	Authorities pulled together various strands of spending review process to identify savings (mainly for state budget)	Spending review process to be extended to sub-national functions; translate findings into binding multi-year ceilings; link to fiscal rule implementation
Take stock of arrears and adopt strategy to clear overdue	New program announced to clear	Underway

payments	40bn (2.5 percent of GDP) in arrears over 2013 and 2014.	
Maintain current debt-maturity structure and diversify investor base	Shift towards issuance at short-end partially corrected by longer-issuances	See earlier recommendations
Role of government		
Mobilize public assets, including through privatization	Sale of state shares in three companies announced; law outlining privatization agenda agreed in August; projected proceeds included in DEF	Implementation needed; accelerate process at sub-national level (where possible)
Improve banks' balance sheets		
Encourage banks to increase provisioning and maintain adequate capital buffers, while protecting credit growth	Five largest banks met the EBA 9 percent capital target; one with public support. Targeted BoI inspections helped maintain the coverage ratio constant in 2012	Maintain capital buffers and carry out comprehensive forward-looking asset quality reviews to enhance provisioning
Extend stress test to mid-sized banks and publish results	FSAP stress test, by BoI and IMF, covers more than 90 percent of the banking system	Publish FSAP stress test results (expected in September)
Encourage banks to sell, restructure, or write down impaired loans	Asset quality and profitability continue to deteriorate	See earlier recommendations
Assist market for distressed assets by aligning tax treatment of loss provisioning and write-offs	None	Allow full tax deductibility of new provisions and clarify the decree on write off deductibility
Broaden resolution toolkit under forthcoming EU directive	None	Broaden resolution toolkit under forthcoming EU directive
Justice system		
Streamline bankruptcy procedures and promote out-of-court workouts	Bankruptcy regime has been reformed to promote early crisis resolution	Start using new bankruptcy regime and monitor effectiveness

Annex I: Debt Sustainability Analysis

At close to 130 percent of GDP, Italy's public debt ratio is the second highest in the euro area and financing needs are large, at about 23 percent of GDP in 2013, due to the rollover of existing debt. At these high levels, the debt outlook is vulnerable to a variety of shocks, particularly contingent liabilities and growth shocks. Given the debt structure (average maturity around 7 years), the direct interest pass-through to the budget is relatively slow, but the impact of higher interest rates on economic activity presents a significant threat to debt dynamics. While most debt profile indicators are below early warning benchmarks, the country's high total external financing requirements point to continued vulnerability to changes in market perceptions.

Baseline and Realism of Projections[1]

- **Debt-levels**. Staff forecast that the debt-to-GDP ratio will peak at 133 percent in 2014, before declining to 123 percent by 2018. Despite fiscal effort, the debt-ratio is projected to be higher than a year ago, as EFSF/ESM contributions (3 percent of GDP), the arrears clearance program (2½ percent of GDP), along with the fiscal drag on growth, are forecast to push up the debt ratio.
- **Growth.** Growth outcomes in Italy have tended to be worse than projected. The current growth projections are slightly above consensus and incorporate a positive impact from the arrears clearance program. They assume a very slowly closing output gap. Nonetheless, risks are tilted to the downside, highlighting the relevance of growth shocks in the stress tests.
- **Debt Profile**. While the yields on Italian debt have moderated from earlier highs, the spreads against the German bund-yields remain significant at 276 bps. Although spreads are assumed to moderate from current levels, the effective interest rate is forecast to rise from 4.2 percent in 2013 to 4.7 percent in 2018. Given the debt structure (average maturity just under 7 years), the direct interest pass-through to the budget is relatively slow; a 100 basis points shock across the yield curve is estimated to raise the interest bill by about 0.2 percent of GDP. The government financing needs are large, at around 23 percent of GDP in 2013, due to the rollover of existing debt. Only 30 percent of marketable debt is held by non-residents, down from about 50 percent in mid-2011. This decline reduces the rollover risk attributable to international investor worries, but exacerbates domestic sovereign-bank links.
- **Fiscal adjustment**: The structural primary balance improves with the implementation of fiscal plans. From 2014, the constitutional requirement for a balanced budget in structural terms requires modest additional adjustments that have yet to be identified. While the maximum projected 3-year change of the cyclically-adjusted primary balance is in the top quartile of the historical experience for high-debt market access countries, the bulk of that adjustment was already undertaken in 2012. However, this large fiscal consolidation may lead to reform fatigue (see primary balance shock and reform fatigue stress test).

[1] The new DSA framework is described in (http://www.imf.org/external/np/pp/eng/2013/050913.pdf).

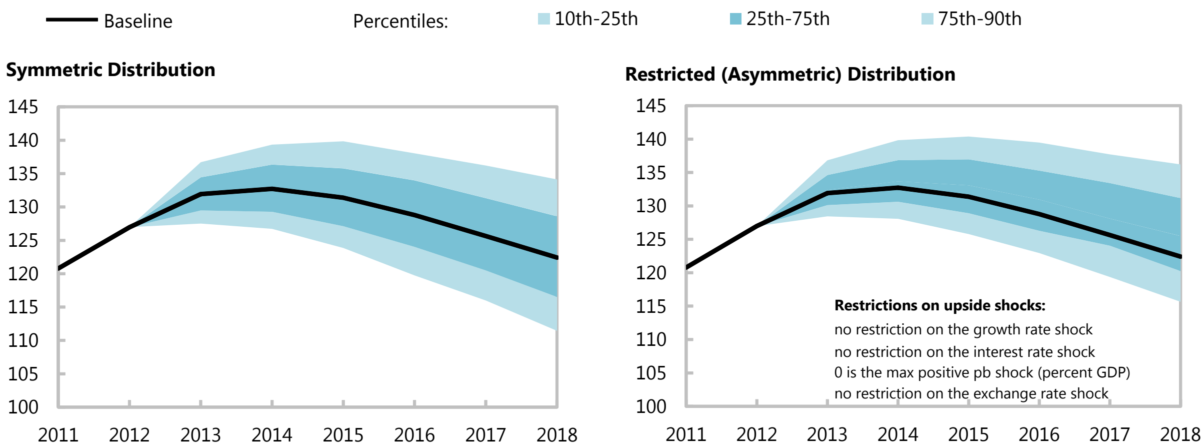
Italy Public DSA Risk Assessment

Heat Map

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

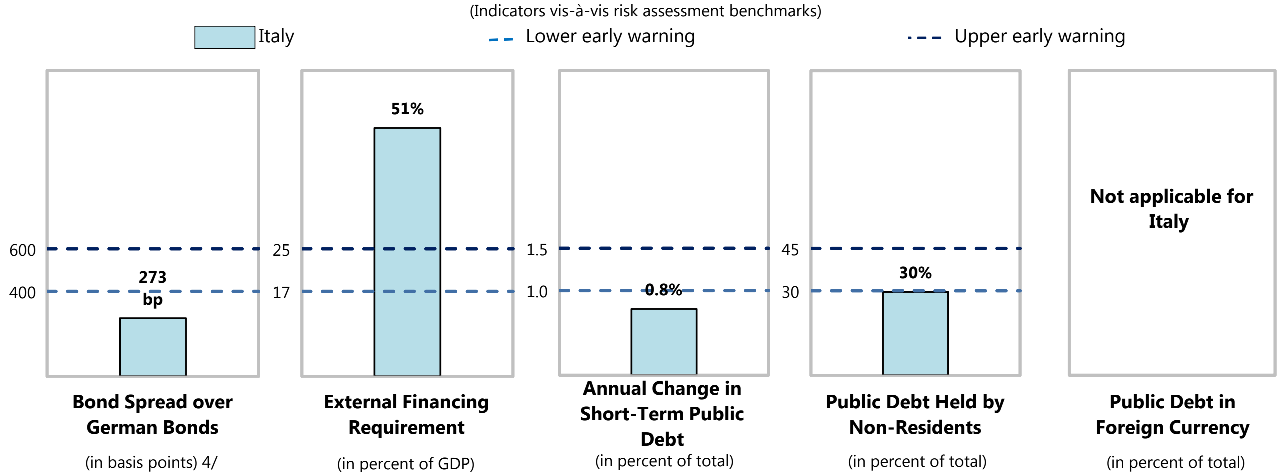
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks)



Source: IMF staff.

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

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

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

Lower and upper risk-assessment benchmarks are:

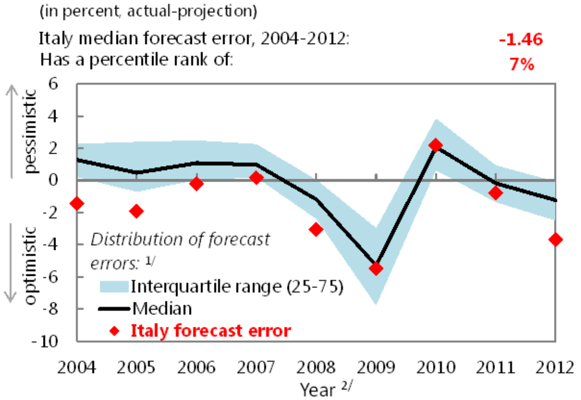
400 and 600 basis points for bond spreads; 17 and 25 percent of GDP for external financing requirement (both public and private); 1 and 1.5 percent for change in the share of short-term debt; 30 and 45 percent for the public debt held by non-residents.

4/ An average over the last 3 months, 21-Mar-13 through 19-Jun-13.

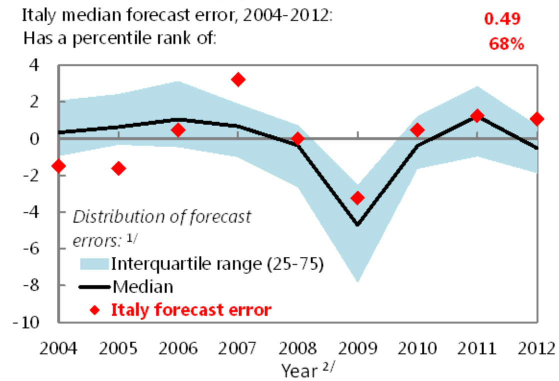
Italy Public DSA - Realism of Baseline Assumptions

Forecast Track Record, versus surveillance countries

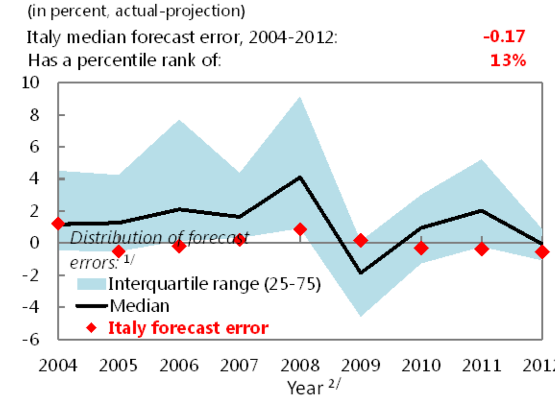
Real GDP Growth
(in percent, actual-projection)



Primary Balance
(in percent of GDP, actual-projection)

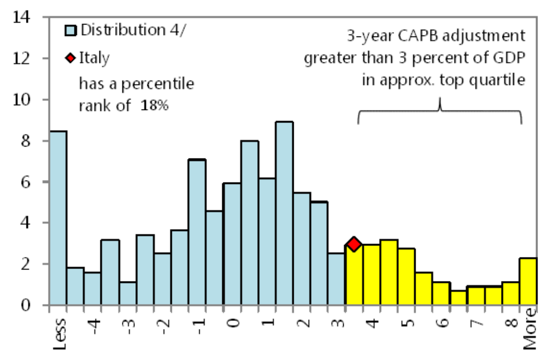


Inflation (Deflator)
(in percent, actual-projection)

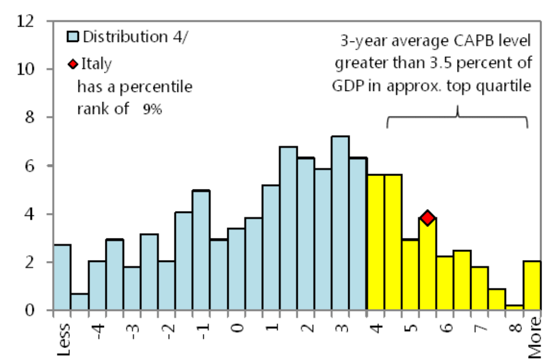


Assessing the Realism of Projected Fiscal Adjustment

3-Year Adjustment in Cyclically-Adjusted Primary Balance (CAPB) 5/
(Percent of GDP)

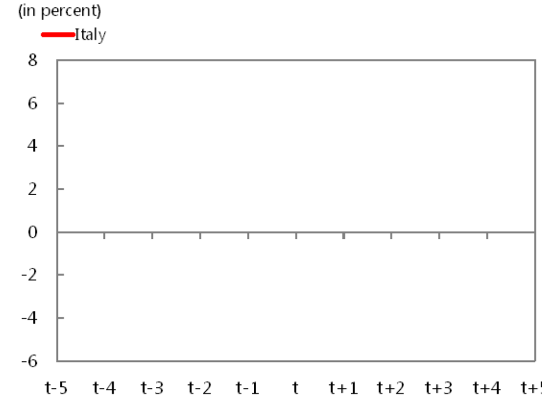


3-Year Average Level of Cyclically-Adjusted Primary Balance (CAPB)
(Percent of GDP)



Boom-Bust Analysis 3/

Real GDP growth
(in percent)



Source : IMF Staff.
1/ Plotted distribution includes surveillance countries, percentile rank refers to all countries.
2/ Projections made in the spring WEO vintage of the preceding year.
3/ Not applicable for Italy.
4/ Data cover annual obervations from 1990 to 2011 for advanced and emerging economies with debt greater than 60 percent of GDP. Percent of sample on vertical axis.
5/ For Italy the bulk of the adjustment already occurred in 2012 and the pace of consolidation slows to 1 percent of GDP in 2013.

Italy Public Sector Debt Sustainability Analysis (DSA) - Baseline Scenario

(in percent of GDP unless otherwise indicated)

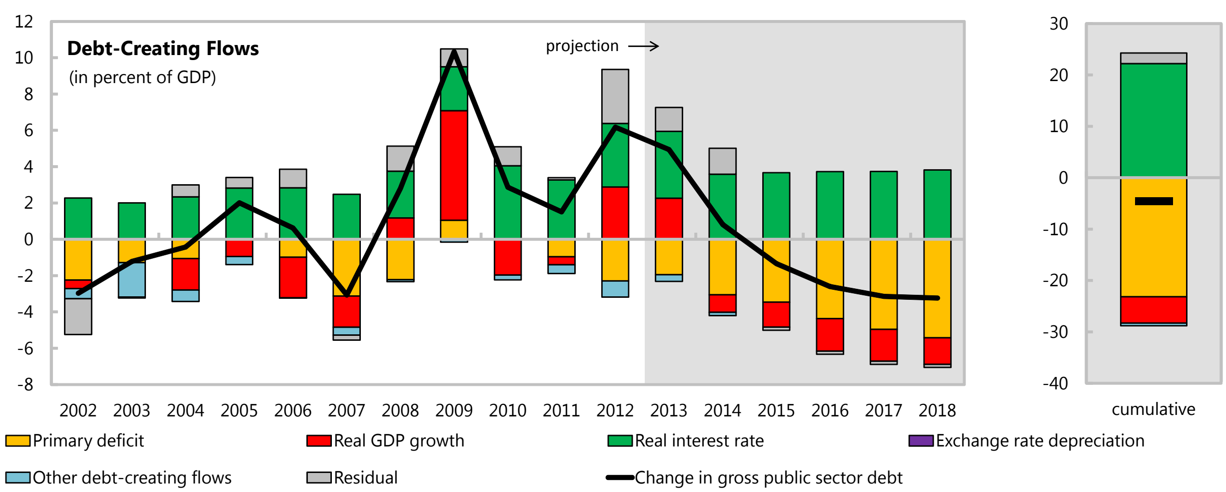
Debt, Economic and Market Indicators [1/]

	Actual			Projections					
	2002-2010 [2/]	2011	2012	2013	2014	2015	2016	2017	2018
Nominal gross public debt	107.8	120.8	127.0	131.9	132.7	131.4	128.8	125.6	122.4
Public gross financing needs	24.5	23.6	26.2	23.2	22.7	24.0	21.8	22.1	20.7
Real GDP growth (in percent)	0.2	0.4	-2.4	-1.8	0.7	1.1	1.4	1.4	1.2
Inflation (GDP deflator, in percent)	2.2	1.3	1.6	1.4	1.3	1.3	1.4	1.5	1.5
Nominal GDP growth (in percent)	2.4	1.7	-0.8	-0.4	2.1	2.4	2.8	2.9	2.7
Effective interest rate (in percent) [4/]	4.7	4.1	4.4	4.3	4.1	4.1	4.3	4.5	4.6

As of June 19, 2013		
Sovereign Spreads		
Spread (bp) 3/		276
CDS (bp)		258
Ratings	Foreign	Local
Moody's	Baa2	Baa2
S&Ps	BBB	BBB
Fitch	BBB+	BBB+

Contribution to Changes in Public Debt

	Actual			Projections							
	2002-2010	2011	2012	2013	2014	2015	2016	2017	2018	cumulative	debt-stabilizing primary balance [9/]
Change in gross public sector debt	1.2	1.51	6.18	4.9	0.8	-1.3	-2.6	-3.1	-3.2	-4.6	
Identified debt-creating flows	0.8	1.39	3.21	3.6	-0.6	-1.2	-2.4	-3.0	-3.1	-6.6	
Primary deficit	-1.1	-1.0	-2.3	-2.0	-3.1	-3.5	-4.4	-5.0	-5.4	-23.2	2.4
Primary (noninterest) revenue and grants	44.8	46.0	47.5	47.7	47.8	47.9	48.0	48.1	48.2	287.5	
Primary (noninterest) expenditure	43.7	45.0	45.2	45.7	44.7	44.4	43.6	43.1	42.8	264.3	
Automatic debt dynamics [5/]	2.4	2.8	6.4	6.0	2.6	2.3	1.9	2.0	2.4	17.1	
Interest rate/growth differential [6/]	2.4	2.8	6.4	6.0	2.6	2.3	1.9	2.0	2.4	17.1	
Of which: real interest rate	2.6	3.3	3.5	3.7	3.6	3.7	3.7	3.7	3.8	22.2	
Of which: real GDP growth	-0.2	-0.4	2.9	2.3	-1.0	-1.4	-1.8	-1.8	-1.5	-5.1	
Exchange rate depreciation [7/]	0.0	0.0	0.0	…	…	…	…	…	…	…	
Other identified debt-creating flows	-0.5	-0.5	-0.9	-0.4	-0.2	0.0	0.0	0.0	0.0	-0.5	
Privatization receipts (negative)	-0.3	-0.1	-0.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Other debt flows (incl. ESM and Euroare	-0.2	-0.4	-0.4	-0.4	-0.2	0.0	0.0	0.0	0.0	-0.5	
Residual, including asset changes [8/]	0.4	0.1	3.0	1.3	1.4	-0.2	-0.2	-0.2	-0.2	2.1	



Source: IMF staff.

1/ Public sector is defined as general government. Debt levels differ slightly from staff's baseline forecasts due to differences in the underlying mechanics of the DSA template.

2/ Based on available data.

3/ Bond Spread over German Bonds.

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

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

6/ The real interest rate contribution is derived from the denominator in footnote 4 as r - π (1+g) and the real growth contribution as -g.

7/ The exchange rate contribution is derived from the numerator in footnote 2/ as ae(1+r).

8/ In 2012 and for projections, this line includes EFSF gurantees, arrears clearance payments, and exchange rate changes.

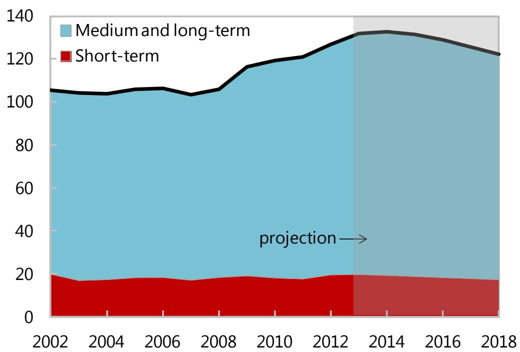
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Italy Public DSA - Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

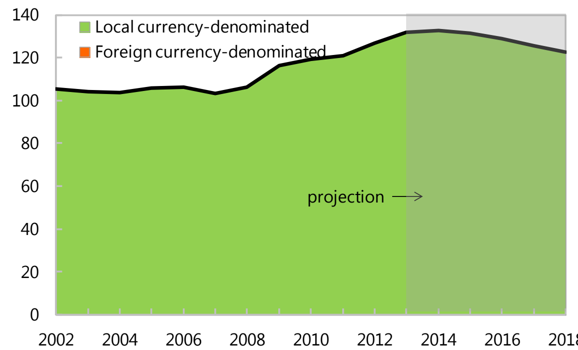
By Maturity

(in percent of GDP)



By Currency

(in percent of GDP)

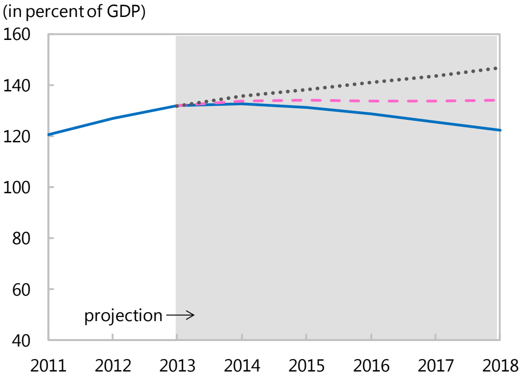


Alternative Scenarios

Baseline Historical Constant Primary Balance

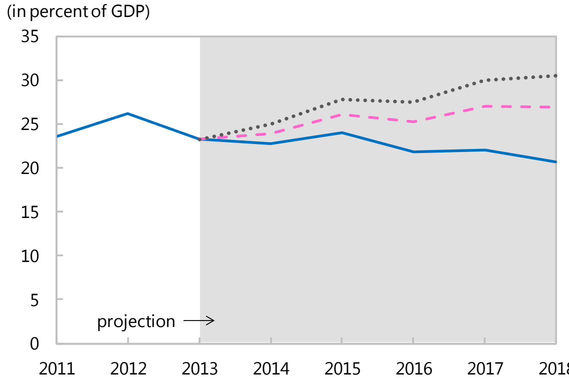
Gross Nominal Public Debt

(in percent of GDP)



Public Gross Financing Needs

(in percent of GDP)



Underlying Assumptions

(in percent)

Baseline Scenario	2013	2014	2015	2016	2017	2018
Real GDP growth	-1.8	0.7	1.1	1.4	1.4	1.2
Inflation	1.4	1.3	1.3	1.4	1.5	1.5
Primary Balance	2.0	3.1	3.5	4.4	5.0	5.4
Effective interest rate	4.3	4.1	4.1	4.3	4.5	4.6
Constant Primary Balance Scenario						
Real GDP growth	-1.8	0.7	1.1	1.4	1.4	1.2
Inflation	1.4	1.3	1.3	1.4	1.5	1.5
Primary Balance	2.0	2.0	2.0	2.0	2.0	2.0
Effective interest rate	4.3	4.1	4.2	4.3	4.4	4.5

Historical Scenario	2013	2014	2015	2016	2017	2018
Real GDP growth	-1.8	0.0	0.0	0.0	0.0	0.0
Inflation	1.4	1.3	1.3	1.4	1.5	1.5
Primary Balance	2.0	1.1	1.1	1.1	1.1	1.1
Effective interest rate	4.3	4.1	4.1	4.2	4.3	4.4

Source: IMF staff.

Shocks and Stress Tests

- ***Primary balance shock.*** The implementation of fiscal adjustment plans are delayed by 1 year relative to the baseline. The slippage leads to an increase in risk premiums (30 bps increase for each 1 percent of GDP slippage). The debt-to-GDP ratio is about 3.5 percentage points higher than the baseline by 2018. Gross financing needs average about 1¼ percent of GDP more than the baseline.

- ***Growth shock.*** Real output growth rates are lower by 1 standard deviation for 2 years starting in 2014. The nominal primary balance improves much more slowly than the baseline as nominal revenues fall against unchanged expenditure plans, reaching only 2.8 percent of GDP by 2018. The lower primary balance leads to an increase in risk premiums (30 bps increase for each 1 percent of GDP slippage). The debt-to-GDP ratio increases rapidly to about 145 percent during the growth shock and then fails to come down over the projection period. Gross financing needs climb toward 30 percent of GDP.

- ***Interest rate shock.*** Market concerns about medium-term debt sustainability intensify increasing spreads rise by 200 bps. The government's interest bill climbs reaching an implicit average interest rate of almost 5.5 percent by 2018. Higher borrowing costs are passed on to the real economy, depressing growth. The debt-to-GDP ratio remains at 131 percent in 2018, despite sizeable primary surpluses, and gross financing needs reach around 25 percent of GDP by 2015.

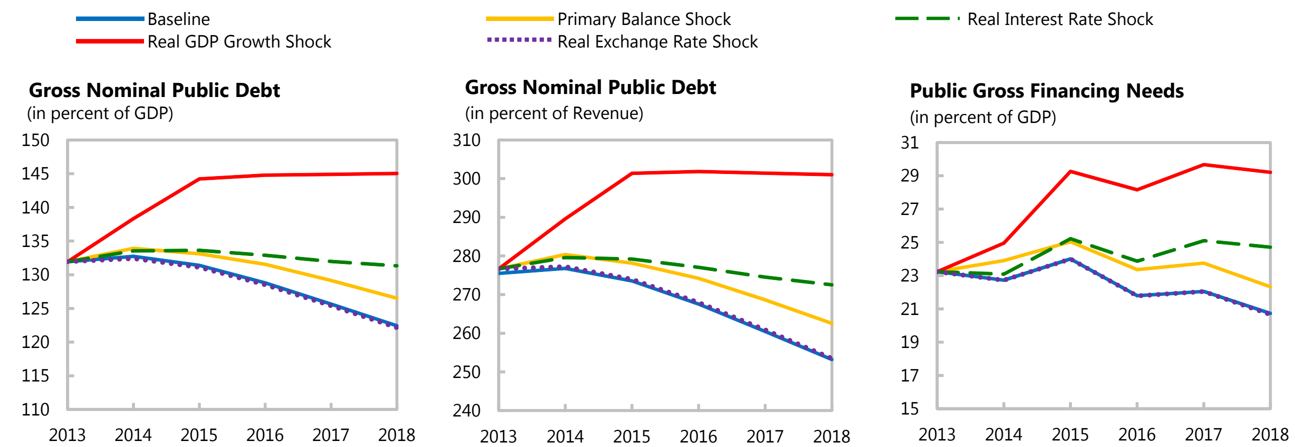
- ***Contingent liability shock.*** A one-time bail out of the financial sector increases non-interest expenditures by 10 percent of banking sector assets. This is combined with real GDP growth shock (1 standard deviation for 2 years). Sovereign borrowing costs are pushed up (30 bps for each 1 percent of GDP worsening in the primary balance). The debt-to-GDP ratio rises above 160 percent and fails to stabilize. Gross financing needs jump to about 35 percent of GDP.

- ***Reform fatigue stress test.*** Reform fatigue leads to a failure to improve on the forecast 2013 nominal primary balance. This is effectively a loosening in structural terms relative to baseline, which supports short-term growth through reduced fiscal drag. However, confidence effects kick in (30 bps for each 1 percent of GDP slippage in primary balance, plus 25 additional bps for each year in which the debt-ratio fails to decline), pushing up the interest bill and dragging down growth. Debt remains stuck at about 133 percent of GDP and gross financing needs reach 27 percent of GDP.

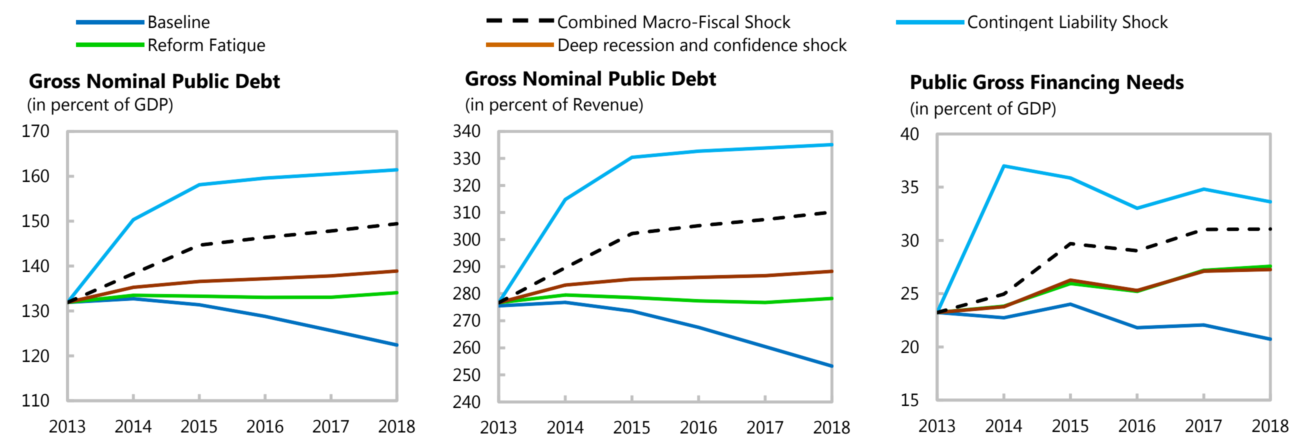
- ***Deep recession and confidence stress test.*** This could potentially arise due to contagion from the euro area crisis and slow progress in implementing domestic structural reforms. Annual GDP growth is 0.5 to 1 percentage points lower than in the baseline. There is a 100 bps increase in interest rates from 2014–18, which acts as a further drag on growth. These assumptions push the debt-to-GDP ratio above 135 percent in 2014 and keep it on a rising path. Gross financing needs rise about 27 percent of GDP by 2018

Italy Public DSA - Stress Tests

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions
(in percent)

	2013	2014	2015	2016	2017	2018
Primary Balance Shock						
Real GDP growth	-1.8	0.7	1.1	1.4	1.4	1.2
Inflation	1.4	1.3	1.3	1.4	1.5	1.5
Primary balance	2.0	2.0	3.1	3.5	4.4	5.0
Effective interest rate	4.3	4.1	4.2	4.4	4.6	4.7
Real Interest Rate Shock						
Real GDP growth	-1.8	0.3	0.7	1.0	1.0	0.8
Inflation	1.4	1.3	1.3	1.4	1.5	1.5
Primary balance	2.0	2.9	3.1	3.8	4.3	4.6
Effective interest rate	4.3	4.1	4.5	4.9	5.2	5.4
Combined Shock						
Real GDP growth	-1.8	-1.6	-1.3	1.0	1.0	0.8
Inflation	1.4	0.7	0.7	1.4	1.5	1.5
Primary balance	2.0	1.7	0.7	1.7	2.3	2.8
Effective interest rate	4.3	4.1	4.6	4.9	5.2	5.5
Reform Fatigue						
Real GDP growth	-1.8	1.2	1.5	1.8	1.8	1.3
Inflation	1.4	1.2	1.2	1.3	1.4	1.4
Primary balance	2.0	2.0	2.0	2.0	2.0	2.0
Effective interest rate	4.3	4.1	4.2	4.5	4.8	5.1

	2013	2014	2015	2016	2017	2018
Real GDP Growth Shock						
Real GDP growth	-1.8	-1.6	-1.3	1.4	1.4	1.2
Inflation	1.4	0.7	0.7	1.4	1.5	1.5
Primary balance	2.0	1.7	0.7	1.7	2.3	2.8
Effective interest rate	4.3	4.1	4.2	4.5	4.7	4.9
Real Exchange Rate Shock						
Real GDP growth	-1.8	0.7	1.1	1.4	1.4	1.2
Inflation	1.4	1.6	1.3	1.4	1.5	1.5
Primary balance	2.0	3.1	3.5	4.4	5.0	5.4
Effective interest rate	4.3	4.1	4.2	4.4	4.5	4.6
Contingent Liability Shock						
Real GDP growth	-1.8	-1.6	-1.3	1.4	1.4	1.2
Inflation	1.4	0.7	0.7	1.4	1.5	1.5
Primary balance	2.0	-10.1	0.7	1.7	2.3	2.8
Effective interest rate	4.3	4.3	5.1	5.0	5.1	5.2
Deep recession and confidence shock						
Real GDP growth	-1.8	-0.5	0.4	0.7	0.7	0.5
Inflation	1.4	1.1	1.1	1.2	1.2	1.2
Primary balance	2.0	2.4	2.4	2.9	3.1	3.2
Effective interest rate	4.3	4.1	4.4	4.6	4.8	5.0

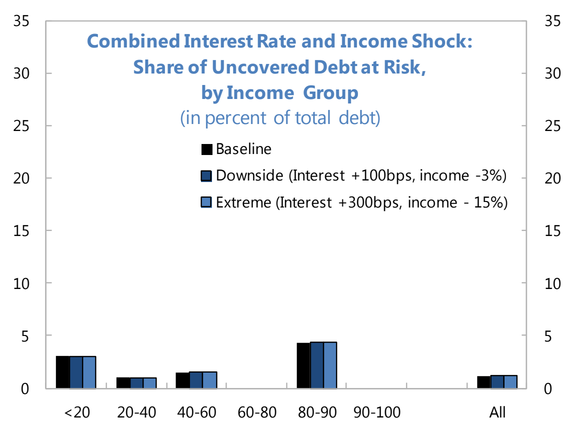
Source: IMF staff.

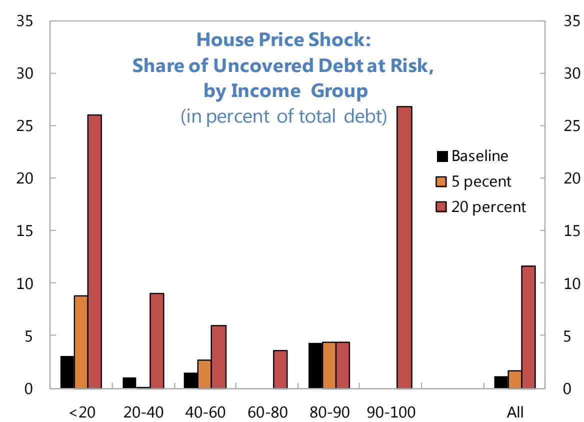
Annex II. Balance Sheet Vulnerabilities from the Italian Household and Corporate Sectors[11]

Italian households' considerable net wealth has mitigated credit risk to the banks. However, the financial situation of non-financial corporations, in particular SMEs, is fragile, and the sector is vulnerable to shocks. Given its importance as a source of collateral for loans, a shock to the real estate sector could also trigger vulnerabilities for the banks.

1. **The debt burden of Italian households is modest, and "vulnerable" households hold a small proportion of debt**. Household income has declined during the crisis, leading to tighter financial conditions, in particular for low-income and young households. However, only 22 percent of households are indebted. "Vulnerable households"—conservatively defined as households with debt service above 30 percent of income—represent 10 percent of indebted households, and hold 24 percent of total household debt, with total household debt representing about 50 percent of GDP. "Vulnerable" households that that have a negative net wealth position hold only 1.2 percent of household debt ("debt-at-risk").

2. **Credit risk from households is mitigated by their positive net wealth position**. Italian households hold close to 800 percent of disposable income in net wealth, defined as real and financial assets minus financial debt, of which two thirds are real assets. In a downside scenario where income declines by 3 percent (similar to the decline in gross household disposable income since 2008) and interest rates increase by 100 bps (similar to the increase in rates on new mortgages in 2011–12), the share of "vulnerable" households would increase to 11 percent and debt-at-risk would remain small at 1.3 percent. Even the combination of more extreme shocks to interest rates (+300 bps) and income (-15 percent) would modestly raise debt-at-risk to 1.6 percent.

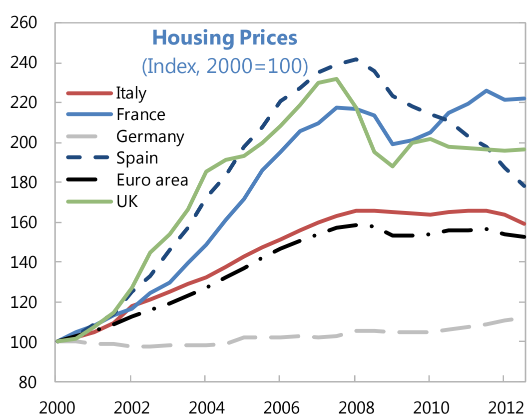




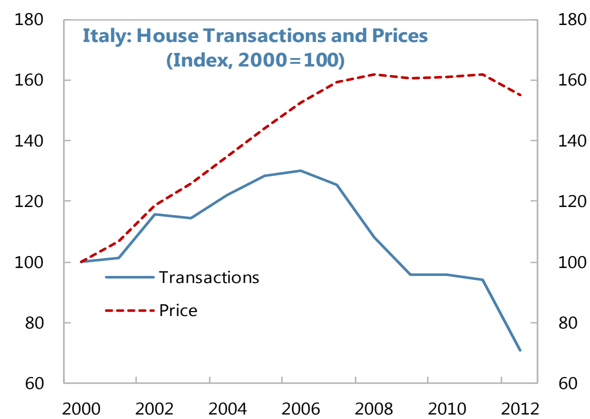
Source: IMF estimates on Bank of Italy data.

[11] See the FSAP technical note on "The Financial Situation of Italian Households and Non-Financial Corporations and Risks to the Banking System" for more information.

3. **However, a shock to real estate, as the predominant source of household wealth and collateral for loans, could increase bank losses**. During the decade preceding the crisis, housing prices and sales rose modestly, in line with euro area averages. However, since 2006, housing transactions have dropped by more than 50 percent, mainly due to the deterioration in households' financial situation and tighter lending conditions, while housing prices have fallen from their peak cumulatively by almost 7 percent since 2011. Affordability indices suggest that the gap between market and long-term prices is limited, but the weak economic outlook is likely to put further downward pressure on prices, consistent with the current slow sale times (more than 8 months) and considerable discount-to-ask price (16 percent). A sensitivity analysis shows that a further 5 percent decline in housing prices would increase debt-at-risk only modestly, reflecting the prudent loan-to-value ratios applied to mortgages. Nonetheless, given the important share of real assets, a larger shock to house prices (20 percent) would trigger household balance sheet vulnerabilities, as debt-at-risk would reach 12 percent.

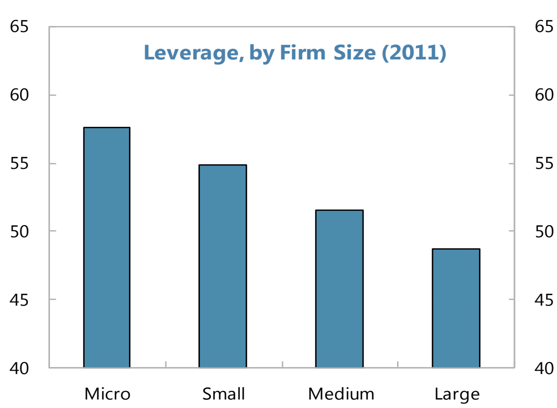


Source: ECB, Halifax and Nationwide Building Society.

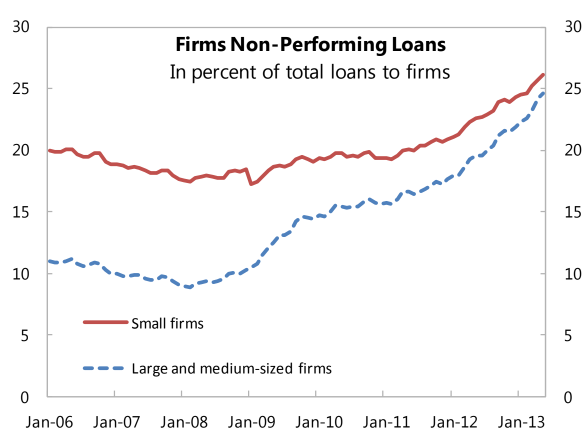


Source: Agenzia del Territorio, Bank of Italy, and ISTAT.

4. **The corporate sector was hit hard by the crisis, pushing up NPLs for the banks.** Although the level of indebtedness of Italian firms is moderate, at 115 percent of GDP, leverage is high at 57 percent, compared to 50 percent on average for the euro area (debt to debt plus equity), and concentrated mainly in SMEs. Weak corporate profitability and tight credit conditions have worsened asset quality, with the NPL ratio for firms rising to 25 percent in May 2013, up from 10 percent before the crisis. The gap between large and small firms has also closed considerably.

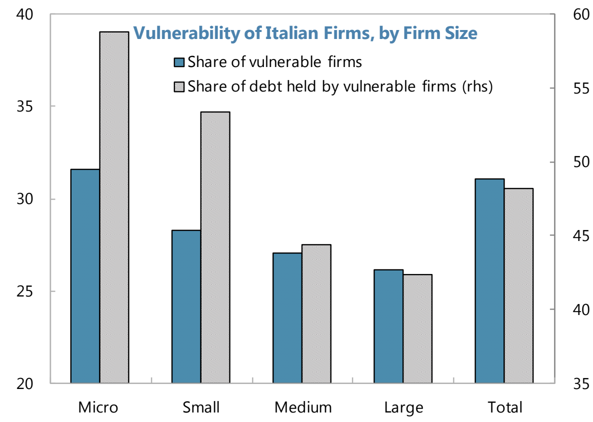


Source: Bank of Italy.



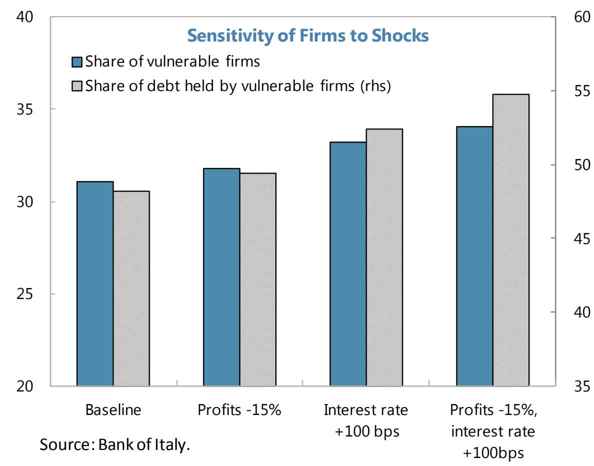
Source: Bank of Italy.

5. **About 30 percent of Italian firms, accounting for almost 50 percent of corporate financial debt, are considered to be vulnerable**. For the FSAP, a joint IMF-Bank of Italy analysis looked at the health of the corporate sector, using survey data through 2011, covering almost 700,000 firms. Considering a conservative threshold where a firm is considered vulnerable if its interest coverage ratio (gross operating income to interest payments) is less than two, we find that while the proportion of vulnerable firms has decreased since the peak in 2008, it has been rising over the past two years.[12] SMEs and firms in the construction and real estate sectors are found to have a larger proportion of debt at risk, consistent with the sectors' high and rising default rates.



Source: Bank of Italy.

6. **Italian firms are vulnerable to profit and interest rate shocks.** The impact on firms' debt-servicing capacity of a 15 percent decline in operating income or a 100 bps increase in interest rates is likely to be moderate, but a combined shock could increase the proportion of debt at risk to 55 percent. Reflecting a weaker starting point, smaller firms are most vulnerable to shocks, and up to 65 percent of their debt would be at risk in the combined shock scenario.



Source: Bank of Italy.

[12] Rating agencies estimate that coverage ratios below 2 are broadly consistent with B ratings or lower, suggestive of about 20 percent probability of default over a 5-year horizon.

INTERNATIONAL MONETARY FUND

ITALY

September 6, 2013

STAFF REPORT FOR THE 2013 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

Prepared By

European Department
(In consultation with other departments)

CONTENTS

FUND RELATIONS

(as of July 31, 2013)

Mission: Rome and Milan, June 22–July 6, 2012. The concluding statement of the mission is available at: http://www.imf.org/external/np/ms/2013/070413.htm

Staff team: Mr. Kang (head), Ms. Barkbu (from headquarters), Mr. Lanau, Mr. Tyson, (all EUR), Ms. Jassaud (MCM), Messrs. Eyraud (FAD) and Tiffin (SPR). Messrs. Demekas (MCM) and Husain (EUR), and Ms. Nardin (EXR) also joined for a few days. Mr. Montanino (OED) attended the policy meetings.

Country interlocutors: Finance Minister Saccomanni, Bank of Italy Governor Visco, Justice Minister Cancellieri, Bank of Italy Director General Rossi, other senior officials from the Ministry of Economy and Finance, the Bank of Italy, the Ministry of Economic Development, the Ministry of Labor and Social Policies, the Ministry of Justice; Senate Budget Committee Technical Group; Association of Municipalities – Fondazione IFEL; major Italian banks; rating agencies; Cassa Depositi e Prestiti; the Securities and Exchange Commission (CONSOB); the Antitrust Authority; Consiglio Nazionale Forense; High Council of the Judiciary; National Statistics Institute (Istat); representatives of trade unions (CGIL, CSIL, and UIL) ; Confederation of Italian Industry (Confindustria); Italian Banking Association (ABI); research centers; parliament and academic representatives.

Fund relations: The previous consultation discussions took place during May 3–16, 2012. The associated Executive Board's assessment is available at: http://www.imf.org/external/np/sec/pn/2012/pn1273.htm and the staff report and other mission documents at: http://www.imf.org/external/pubs/cat/longres.aspx?sk=26053.0 Italy accepted the obligations under Article VIII and, apart from certain security restrictions, maintains an exchange rate system free of restrictions.

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

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

General Resources Account:	SDR Million	Percent Quota
Quota	7,882.30	100.00
Fund holdings of currency	5,542.30	70.31
Reserve Tranche Position	2,340.02	29.69
Lending to the Fund		
New arrangements to borrow	1,775.93	

SDR Department:	SDR Million	Percent Allocation
Net cumulative allocation	6,576.11	100.00
Holdings	6,132.63	93.26

Outstanding Purchases and Loans: None

Financial Arrangements: None

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

	Forthcoming				
	2013	2014	2015	2016	2017
Principal					
Charges/Interest	0.15	0.35	0.35	0.35	0.35
Total	0.15	0.35	0.35	0.35	0.35

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 the exchange restrictions imposed by Italy solely for the preservation of national or international security that have been notified to the Fund pursuant to Executive Board Decision No. 144-(52/51).

Article IV Consultations: Italy is on the standard 12-month consultation cycle. The previous consultation discussions took place during May 3–16, 2012, and the staff report (Country Report No. 12/167, 07/10/12) was discussed on July 9, 2012.

ROSCs/FSAP:

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

STATISTICAL ISSUES

ITALY—STATISTICAL ISSUES APPENDIX As of July 23, 2013
I. Assessment of Data Adequacy for Surveillance
General: Data provision is adequate for surveillance. Italy's economic and financial statistics are comprehensive and of generally high quality. Data are provided to the Fund in a comprehensive manner (see Table 1). The authorities regularly publish a full range of economic and financial data, as well as a calendar of dates for the main statistical releases. Italy is also subject to the statistical requirements of Eurostat and the European Central Bank (ECB), including the timeliness and reporting standards,) and it has adopted the *European System of Accounts 1995* (*ESA95*).
National Accounts: Further improvements should be considered regarding changes in inventories in the quarterly national accounts, which are currently derived as a residual and lumped together with the statistical discrepancy.
Price Statistics:
Government Finance Statistics:
Monetary and Financial Statistics:
Financial Sector Surveillance: Participates in the IMF's Coordinated Direct Investment Survey (CDIS), Coordinated Portfolio Investment Survey (CPIS) and financial soundness indicators (FSIs) databases.
External Sector Statistics: The first transmission of International Investment Position (IIP) data on the basis of the *Balance of Payments and International Investment Position Manual, 6th edition (BPM6)* will take place in June 2014, as envisaged by the work plan agreed with the ECB and the Eurosystem national central banks.

II. Data Standards and Quality	
Italy has subscribed to the Special Data Dissemination Standard (SDDS) since 1996 and posts its metadata on the Dissemination Standards Bulletin Board (DSBB). Italy has shown interest in adhering to the SDDS Plus; an STA mission found that Italy could be among the initial adherents when the SDDS Plus is launched. **Implementing G-20 DGI recommendations:** The authorities have already implemented a good number of the recommendations and work is underway to implement the remaining ones. Further progress in the near future is likely to be made on the reporting frequency of Financial Soundness Indicators.	A data ROSC was disseminated in 2002.

Table 1. Common Indicators Required for Surveillance

(As of August 27, 2013)

	Date of latest observation	Date received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of Publication[7]	Memo Items:	
						Data Quality – Methodological soundness[8]	Data Quality – Accuracy and reliability[9]
Exchange Rates	Aug 2013	Aug 2013	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	July 2013	Aug 2013	M	M	M		
Reserve/Base Money	June 2013	Aug 2013	M	M	M	O,O,LO,LO	O,O,O,O,LO
Broad Money	June 2013	Aug 2013	M	M	M		
Central Bank Balance Sheet	June 2013	Aug 2013	M	M	M		
Consolidated Balance Sheet of the Banking System	June 2013	Aug 2013	M	M	M		
Interest Rates[2]	Aug 2013	Aug 2013	D	D	D		
Consumer Price Index	July 2013	Aug 2013	M	M	M	O,O,O,O	LO,O,LO,O,O
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	Q1 2013	July 2013	Q	Q	Q	LO,O,LO,O	LO,O,O,O,LO
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	July 2013	Aug 2013	M	M	M		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	July 2013	Aug 2013	M	M	M		
External Current Account Balance	June 2013	Aug 2013	M	M	M	O,LO,LO,O	LO,O,LO,O
Exports and Imports of Goods and Services	June 2013	Aug 2013	M	M	M		
GDP/GNP	Q2 2013	Aug 2013	Q	Q	Q	O,O,O,O	LO,LO,O,O,O
Gross External Debt	Q1 2013	June 2013	Q	Q	Q		
International Investment position[6]	Q1 2013	July 2013	Q	Q	Q		

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5] Including currency and maturity composition.
[6] Includes external gross financial asset and liability positions vis a vis nonresidents.
[7] Daily (D); weekly (W); monthly (M); quarterly (Q); annually (A); irregular (I); and not available (NA).
[8] Reflects the assessment provided in the data ROSC or the Substantive Update for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O); largely observed (LO); largely not observed (LNO); not observed (NO); and not available (NA).[9] Same as footnote 7, except referring to international standards concerning source data, statistical techniques, assessment and validation of source data, assessment, and revisions.

Statement by Mr. Montanino, Executive Director for Italy
September 23, 2013

Authorities wish to thank staff for the balanced analysis provided in the insightful set of papers on Italy. They agree on most recommendations, while on possible vulnerabilities of the private sector, both financial and non-financial, they wish to provide some remarks. Overall, Authorities concur that the most pressing goals are to:

1. Sustain economic recovery in the short term;
2. Raise potential growth over the medium term through measures that increase competitiveness and structural reforms;
3. Maintain market confidence through a rigorous execution of the public budget;
4. Further strengthening the financial sector.

Sustain economic recovery

After a negative GDP result in the first half of 2013, over the latest months a number of indicators have pointed to a gradual stabilization of the cycle. The upturn in GDP is expected to materialize by the last quarter of this year, in line with staff's forecast. To stimulate the recovery, Authorities have taken a number of measures:

i. Clearance of arrears. To ease tight credit conditions for firms and support domestic demand, the Government committed to pay arrears to non-financial firms for a total of €40 billion in 2013-2014. By the beginning of this month, the central government provided local authorities (firms' debtors) with 90 per cent of the amount projected for 2013 (i.e. €18 billion). In turn, local governments already paid €7.2 billion to their creditors.

ii. Ease credit constraints. Since one of the main constraints to growth are the very tight financing conditions, the Government enacted several policy measures to tackle the issue. They include: the expansion of the Central Guarantee Fund for SMEs which guarantees up to 80 per cent of the loan; the lending support from Cassa Depositi e Prestiti through additional liquidity to the banking sector; the development of alternative financing sources for SMEs (so-called mini-bonds); the development of publicly supported equity funds (Strategic Investment Fund for large companies and the Italian Investment Fund for SMEs).

iii. Property tax (IMU). To sustain confidence and households spending at this juncture, in August the Government decided on a one-off basis to repeal the payment of the first installment of the IMU tax. The measure is fully compensated in the public budget.

iv. Reduction in labor tax wedge. Last but not least, given the very difficult situation in the labor market, the Government is considering possible measures to reduce the very high tax wedge. This would add to the already implemented tax credits for firms to support new hiring; incentives are particularly sizeable for women and young people.

Raise potential growth

The Italian economy has been characterized by a disappointing productivity performance, with a highly negative impact on potential growth. Over the past few years, the Italian authorities have already adopted measures to improve the business environment. Specifically, measures have aimed to reform the labor market institutions, to provide firms with tax incentives to raise risk capital (so-called ACE), to boost the quality and efficiency of the public administration. In this regard, continued action has been taken to simplify the regulatory environment, to cut red tape, to enhance coordination between the different government levels, and to improve the functioning of the judicial system.

As indicated in the SIP on judicial reform, removing Italy's bottlenecks is key to attract foreign investment. The Government is launching a wide set of micro-measures to improve business confidence. Among others, further strengthening the role of specialized judicial courts for firms, promoting cooperative compliance between foreign investors and the Revenue Agency, implementing the Digital Agenda to enhance public administration efficiency and reduce the administrative burden on firms and households.

Rigorous execution of the public budget

Despite disappointing economic conditions, Italy has continued to deliver on its commitments. Last June, the country exited from the Excessive Deficit Procedure (EDP) started in 2009, having achieved in 2012 a general government deficit of 3.0 per cent of GDP, down from 5.5 per cent in 2009. It is worth noting that this result came well ahead many other advanced countries while, at 2.5 per cent of GDP last year, Italy's primary balance ranked among the highest in the euro area, together with Germany.

As for the fiscal framework, in 2013 the general government deficit target is firmly set within the 3 per cent of GDP limit. This will be reaffirmed by the Government in the coming days, before the Board discussion, when presenting to the Parliament the targets for coming years. The structural balance target by 2014 is now enshrined in the Constitution. According to staff's estimates, Italy is expected to come close to this target already this year, one year ahead of schedule.

With a more forward looking view, the Government is also committed to enhance the spending review to achieve structural savings in the budget. To improve coordination among ministers, a Special Commissioner for the spending review is going to be appointed shortly.

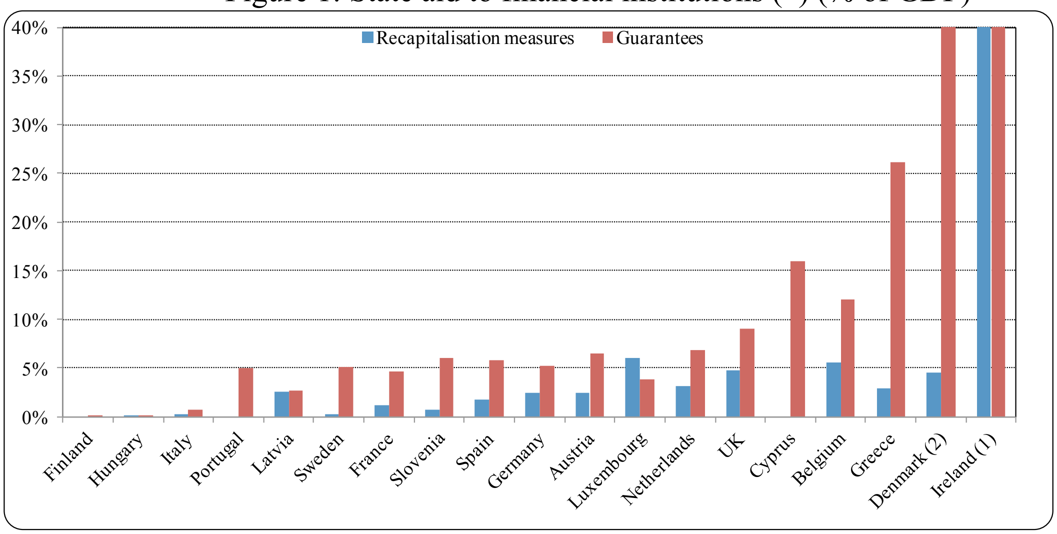
Moreover, to improve fiscal stability, authorities assign high importance to the fight against tax evasion. In the draft enabling law on tax issues ("Delega fiscale"), the Government is committed to provide a regular estimate on tax evasion elaborated by an independent Commission.

Finally, in line with the staff's suggestion to roll back tax expenditures, the "Delega Fiscale" engages the Government in presenting a systematic and regular annual report on tax expenditures, with the aim of repealing the inefficient ones.

Further strengthening the financial sector

Despite a string of unprecedented negative shocks over six years (global financial crisis, two domestic recessions, euro area sovereign debt crisis), Italy's financial system held up well, due to its traditional business model and effective regulation and supervision. Notwithstanding a difficult environment, Italy's banks were able to increase their capital ratios and raise residents' deposits. By end-2012, bank tier 1 and total capital ratios were respectively 11.1 and 13.8 per cent. The core tier 1 capital ratio rose on average to 10.7 per cent, achieved with very modest public support (0.3 percent of GDP, see Figure 1).

Figure 1: State aid to financial institutions (*) (% of GDP)



(*) Table represents only Member States that used aid in the period 1 October 2008 – 31 December 2011.
(1) The columns for Ireland exceed the chart area. Guarantees accounts for 181.7 per cent; recapitalization accounts for 40.1 per cent of GDP.
(2) The column for Denmark exceeds the chart area. Guarantees accounts for 60.6 per cent of GDP.
Source: European Commission

That said, Authorities broadly agree that the prolonged double-dip recession has deteriorated credit quality, weakened banks' profitability, and inflated NPLs. At end-2012, NPLs stood at 13.4 per cent of loans, for the most part attributable to non-financial firms. Although lower than in other countries, at 40 per cent, the coverage ratio has stabilized. To provide a meaningful comparison across countries, it should be recalled that Bank of Italy's definition of NPLs is stricter than elsewhere. For example, while some major European banks do not classify fully collateralized loans as NPLs, in Italy loans are classified on the basis of the borrower's creditworthiness irrespective of collateral guarantees. Applying the prevailing criteria used by foreign banks, the share of Italy's NPLs would decrease by one-third, lowering their NPLs ratio significantly and raising their coverage ratio; at the same time, the rise in NPL ratio in the recent years would be less pronounced, reflecting the sharp increase in collateral demanded by Italian banks in reaction to the deteriorating economic outlook.

Because of the credit quality deterioration, in the second half of 2012 the Bank of Italy enacted a strengthened inspection in 20 large and mid-sized banks. The coverage ratio of the banks under investigation rose from 41 to 43 per cent by end-2012. Authorities broadly agree with staff on the need to continue to be vigilant on this front. Regarding the staff's proposal of increasing tax deductibility of loan loss provisions and accelerating the write-offs of bad loans, the Government is fully aware of the shortcomings of the current situation and will examine all the options to remove the tax disincentives, provided that the conditions of the public accounts allow.

Authorities also welcome the progress towards an effective EU banking union. The asset quality reviews to be conducted in 2014 by the ECB will also allow a homogenous assessment of Italy's banking system towards its peers.

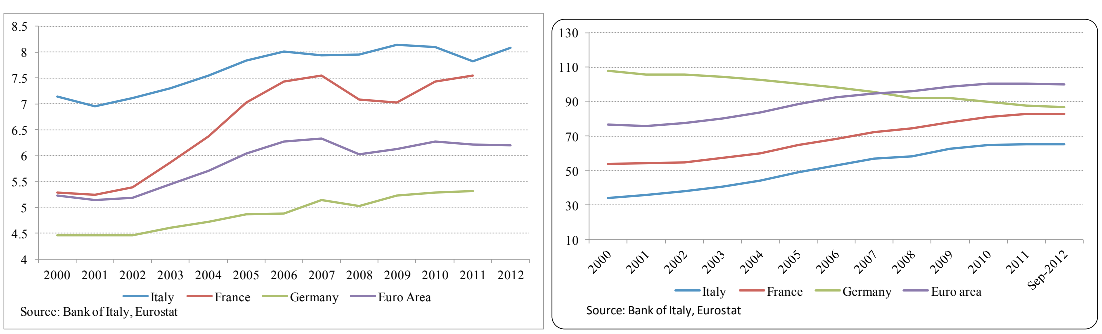
Despite the exceptional slack of the economic system, FSAP stress tests point out that, thanks to its capital strengthening, the Italian banking system is resilient. In all the scenarios considered, the capital adequacy of the system as whole remains above the Basel III minima. At a disaggregated level, only a few banks would face a capital shortfall. In any case, the amount of such a shortfall would be very limited (0.4 per cent of GDP in the most adverse scenario if the Core Tier 1 minima are considered).

Finally, as regards the assessment of the financial situation of households and corporate contained in Appendix II, we would like to provide a few remarks to complete the overall picture. First, on households, it has to be stressed that, by international standards, their debt level is low and their wealth is very high (Fig. 2a and b). The vulnerability coming from this sector is indeed very limited.

Figure 2

(a) Households' wealth (Households' wealth/gross disposable income ratio)

(b) Households' debt (% of gross disposable income)



Second, the stock of debt of the corporate sector measured as a share of GDP is below the euro area average although Italian firms traditionally rely significantly on bank credit, and less on risk capital. The recently growing financial tensions of Italy's firms are mainly due to the impact on their profitability coming from a very harsh recession and the effects of financial fragmentation in the euro area. In this respect, the lessening of these difficulties will benefit from the return to a positive rate of growth which, as said, is expected for the last part of this year. Besides, Authorities intend to pursue further efforts to help firms diversify their funding sources through the development of the capital market and the possibility for the unlisted companies to issue bonds.