INTERNATIONAL MONETARY FUND

IMF Country Report No. 14/283

ITALY

September 2014

2014 ARTICLE IV CONSULTATION—STAFF REPORT; PRESS RELEASE; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR ITALY

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2014 Article IV consultation with Italy, the following documents have been released and are included in this package:

- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on September 12, 2014, following discussions that ended on June 18, 2014, 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 August 22, 2014.
- An **Informational Annex** prepared by the IMF.
- A **Press Release** summarizing the views of the Executive Board as expressed during its September 12, 2014 consideration of the staff report that concluded the Article IV consultation with Italy.
- A **Statement by the Executive Director** for Italy.

The following document has been or will be separately released.

Selected Issues Paper

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

Copies of this report are available to the public from

International Monetary Fund • Publication Services
PO Box 92780 • Washington, D.C. 20090
Telephone: (202) 623-7430 • Fax: (202) 623-7201
E-mail: publications@imf.org Web: http://www.imf.org
Price: $18.00 per printed copy

International Monetary Fund
Washington, D.C.

©2014 International Monetary Fund

INTERNATIONAL MONETARY FUND

ITALY

STAFF REPORT FOR THE 2014 ARTICLE IV CONSULTATION

August 22, 2014

KEY ISSUES

Unleashing Italy's Potential

The economy is struggling to emerge from a prolonged balance-sheet recession… Tight credit conditions, weak corporate balance sheets, and deeply-rooted structural rigidities continue to weigh on domestic demand. The high level of public debt and membership in a currency union highlight the importance of tackling these structural weaknesses.

…and the risks are tilted to the downside. External risks arise from geopolitical tensions, while Italy's high public debt, large public financing needs, and elevated NPLs leave the economy vulnerable to financial contagion and/or low growth and inflation. Without meaningful reforms, potential growth is projected to remain low.

Deep structural changes are urgently needed to secure a recovery and unleash Italy's growth potential. Moving to a single labor contract with gradually increasing protection would reduce duality. Judicial efficiency could be improved by promoting mediation and enhancing monitoring of court performance. Greater efforts to combat corruption would strengthen the business environment. Implementing reforms simultaneously could be self-reinforcing and generate significant growth synergies.

A greater push to clean up banks' bad loans is needed to support lending in the recovery. More provisioning and write-offs; a private distressed debt market; and enhanced insolvency regime would accelerate the reduction of NPLs. Improved corporate governance and deeper capital markets would support growth and financial stability.

A broad strategy to revive the SME sector would complement efforts to strengthen bank balance sheets. This strategy should promote restructuring support for viable, but distressed firms and a quick exit for those that are non-viable. A new fiduciary loan contract and greater sharing of credit information could support alternative financing for new endeavors.

Fiscal policy needs to strike a delicate balance between setting the debt ratio on a downward path while helping the economy recover. To support growth, the priority should be to lower marginal tax rates through spending savings and lower tax expenditures. But given the low growth and high interest rate environment, stronger fiscal balances are needed to bring down debt faster. Conditional on the recovery taking hold, a modest structural surplus next year would be appropriate.

Policies at the European level could also support growth by easing further monetary conditions should inflation remain too low, and reducing financial fragmentation.

Approved By
Aasim M. Husain and Hugh Bredenkamp

The mission took place in Rome, Naples, and Milan, June 5–June 18, 2014. Team comprised of Messrs Kang (head), Lanau and Tyson, Ms. Tuladhar (all EUR), Mr. Esposito (LEG), Ms. Jassaud (MCM), Mr. Chevauchez (FAD) and, Ms. Segal (SPR). Mr. Husain (EUR) also joined for a few days. Mr. Montanino (OED) attended the policy meetings. The mission met with Finance Minister Padoan, Bank of Italy Director General Rossi, other senior officials, regional government and finance industry, academic, and trade union representatives.

CONTENTS

A STRUGGLING ECONOMY 4

OUTLOOK: A FRAGILE AND UNEVEN RECOVERY 8

UNLEASHING ITALY'S POTENTIAL 12

A. Structural Reforms for Revitalizing the Business Environment 12
B. A Financial Sector That Supports Growth and Investment 16
C. Boosting Growth Through Fiscal Policy 25

STAFF APPRAISAL 30

BOXES

1. Impact of Financial Conditions on Growth 5
2. Spillover Implications from Geopolitical Risks and Low Inflation 11
3. A New Fiduciary Loan Contract for Efficient Collateral Enforcement 23
4. Italy's Spending Review and the Efficiency of Public Spending 29

FIGURES

1. Outlook: A Struggling Economy 7
2. The Case for Structural Reform 15
3. The Financial Sector Remains Under Pressure 19
4: Small and Medium Enterprises 24
5. A More Growth-Friendly Public Sector 27

TABLES

1. Summary of Economic Indicators, 2011–19 33
2. General Government Accounts (National Presentation), 2012–19 34
2.1. Statement of Operations—General Government (GFSM 2001 Format), 2010–18 35
3. Summary of Balance of Payments, 2011–16 36
4. Financial Sector Indicators 2009–13 37

ANNEX

I. Debt Sustainability Analysis 38

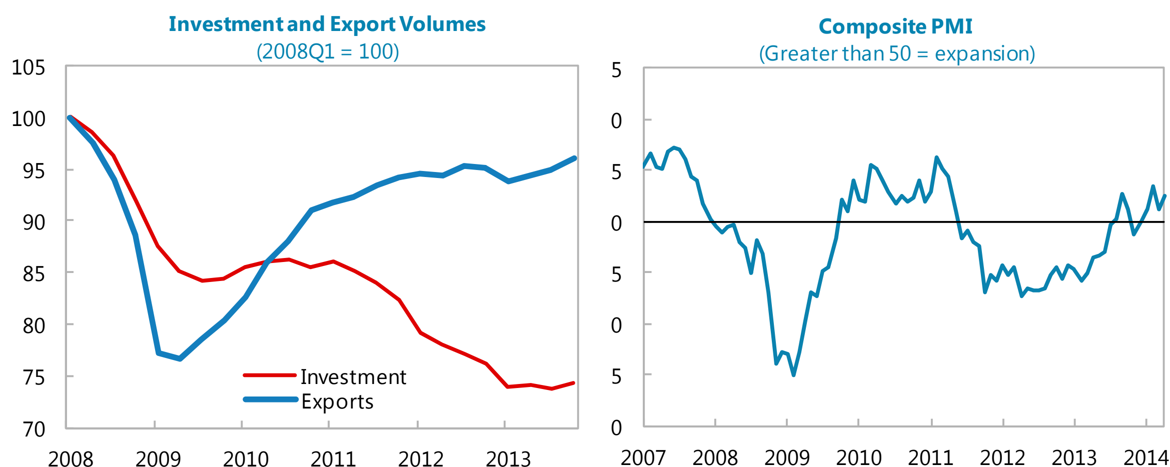
APPENDIXES

I. Progress Against IMF Recommendations 48
II. Key FSAP Technical Recommendations 51

A STRUGGLING ECONOMY

1. The economy is struggling to emerge from a deep balance-sheet recession. Real GDP contracted in the first half of 2014 by 0.1 percent compared to second half of last year, pushing Italy back into recession. Exports have held steady, led by demand from non-EU countries, but investment continues to decline and remains 27 percent below pre-crisis levels. Tight credit conditions and weak corporate balance sheets continue to weigh heavily on domestic demand. Moreover, despite the easing fiscal drag, the heavily indebted public sector faces the need of further consolidation. Leading indicators, such as PMI, point to activity expanding in 2014:H2, but at a subdued pace. The combination of weak domestic demand and improving global growth has led to a further narrowing of external imbalances and a modest current account surplus in 2013. Italy's share of global exports increased for the first time since 2007.

2. Sovereign spreads have narrowed significantly but credit conditions remain tight, holding back investment.



Source: Haver.

- Progress on the EU crisis prevention frameworks, the ECB backstop, and a better fiscal position in Italy have instilled market confidence and reduced sovereign spreads by 320 bps since 2011.

- The normalization of the sovereign market, however, has failed to transmit to the credit market, where real lending rates shot up to 3 percent as inflation fell and nominal rates barely reacted to accommodative ECB measures (Box 1).

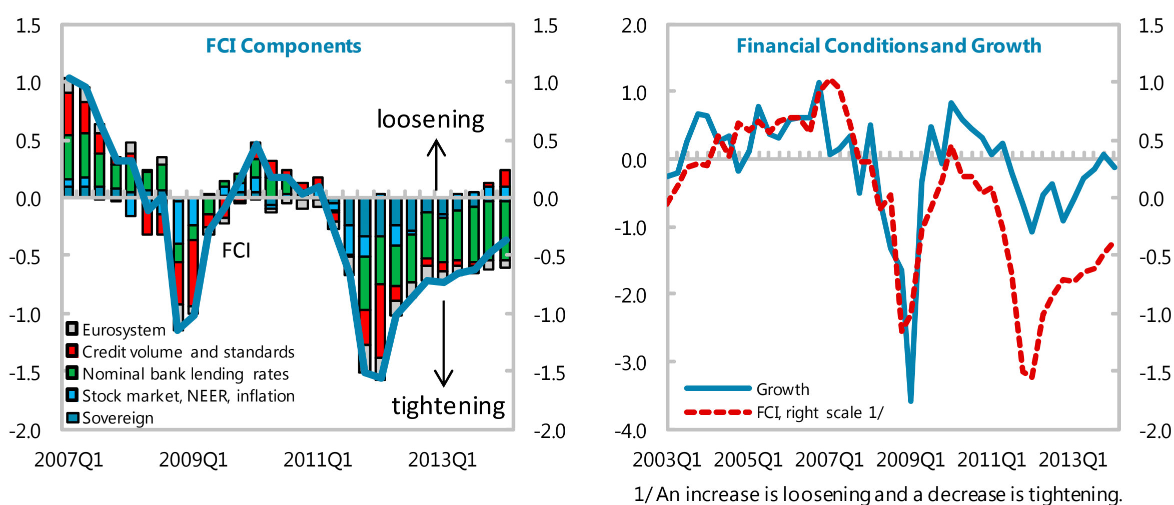
- The clearance of government arrears (1.6 percent of GDP to date) partly offset tight credit conditions. But, surveys indicate that a large share of the payments was used by firms to repay debt, rather than invest.

Box 1. Impact of Financial Conditions on Growth

Sovereign spreads and market volatility have declined since 2012 but domestic credit conditions have tightened. The former improves financial stability, but the latter holds back growth, mainly through investment.

Analyzing financial conditions. A Financial Conditions Index (FCI) constructed from a broad set of indicators permits an analysis of the interactions between financial conditions and the real economy. The FCI captures in one summary statistic the information in stock market returns, sovereign spreads, the NEER, inflation expectations, the ECB policy rate and balance sheet, EURIBOR-OIS spread, nominal bank lending rates, credit volume to the private sector (bank loans and bonds), and lending standards (see ECB WP 1541 for details). Negative values indicate tighter than average conditions.

Recent developments. The FCI tightened significantly in 2011 and early 2012, but has eased recently on the back of gains in equities and sovereign spreads and stable bank lending standards. However, nominal lending rates to the private sector have remained high, which combined with falling inflation, have driven real lending rates up. The tight conditions despite the ECB's accommodative stance reflect the persistence of financial fragmentation in the euro area.



1/ An increase is loosening and a decrease is tightening.

Growth impact. Financial conditions are closely correlated with growth and FCI shocks have a significant impact on growth. For example, a bivariate VAR under the identifying assumption that the FCI affects growth with a one-quarter lag suggests that a negative shock that raises real corporate lending rates by 260bps through a 200bps increase in nominal rates and a 60bps decline in inflation expectations (to 0.5 percent), would lower growth by a cumulative 0.4 percentage point over three quarters. As a reference, real rates have increased by around 300 bps since mid-2012.

Policy implications. The analysis suggests that measures to normalize corporate financial conditions would support a robust and sustained recovery, mainly through investment. Since bank lending rates account for the lion's share of the tightening in the FCI, domestic and euro area measures to address financial fragmentation, mend corporate balance sheets, and strengthen banks' capacity to lend would minimize the risk of a weak, creditless recovery.

Caveats. The quantitative results should be interpreted with caution since the model is very parsimonious, identifies shocks in a crude way, and does not capture factors such as fiscal tightening. Moreover, the model cannot disentangle different types of structural shocks, for example, both a productivity shock and an easing in monetary policy raise equity prices.

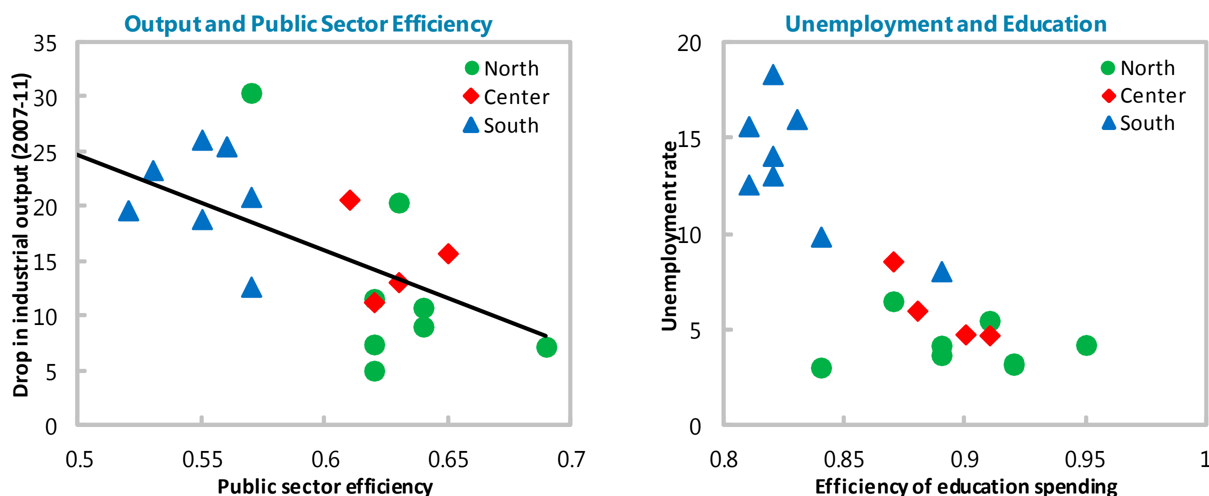
3. The persistent slack has resulted in high unemployment and low inflation.

- The unemployment rate has stabilized around a post-war high of 12.3 percent (another 2 percent of workers in the wage supplementation scheme are not in the official figures but are not working). The high incidence of long-term unemployment (58 percent, 20 points above the OECD average) highlights the difficulty to reemploy workers quickly.

- Headline inflation dropped to 0.4 percent (y/y) in 2014:Q2, 0.2 percentage points below the euro area rate. Volatile components such as energy explain part of the decline but low core inflation (0.7 percent, y/y) and the nonexistent pass-through of the October 2013 VAT hike suggest that weak demand and the large output gap (3.8 percent) are significant factors.

- Nominal wages increased 1.4 percent (y/y) in the first quarter as inflation dropped leading to a 0.9 percent real increase. Cross-country experience indicates that low-inflation recoveries with growing real wages are more likely to be jobless (Calvo et al. 2012).

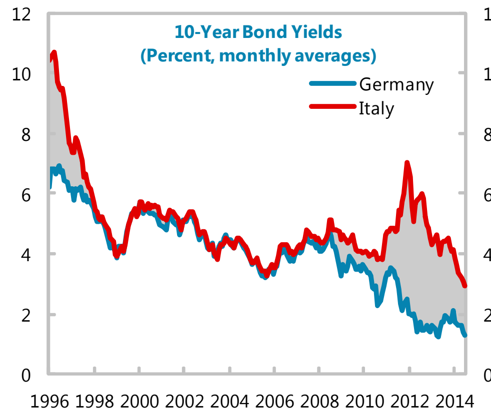
4. The crisis has affected the Italian regions unevenly. GDP fell 6.7 percent in the north over 2007–13, but as much as 13.6 percent in the south. The unemployment rate increased about 4 percentage points more in the south than in the north. Regional differences in institutions and policies help explain the large north-south productivity gap (60 percent) and mixed macroeconomic performance. These differences potentially offer important lessons for reform priorities going forward and are therefore explored in more depth in this report.



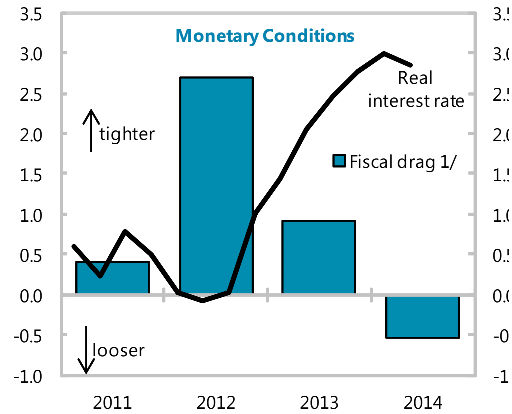
5. Progress against the reform agenda has slowed over the last year. The fiscal correction started by earlier governments continued through 2013. Nonetheless, coalition infighting over a controversial property tax put on hold further discussions on needed fiscal and structural reforms. Important reforms of the justice system and labor and product markets have been initiated, but according to the Bank of Italy (BoI), of the 69 reform laws passed over 2011–13, only half of the implementing measures have been issued. A new government was sworn in at end-

Figure 1. Outlook: A Struggling Economy

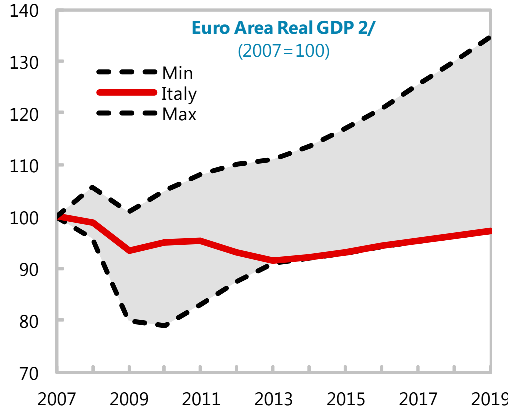
Sovereign yields have rallied strongly..



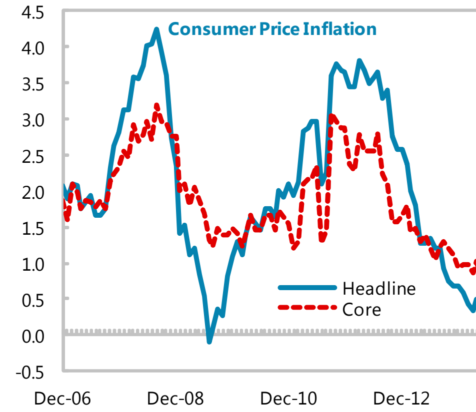
...while high lending rates are offseting easing fiscal drag.



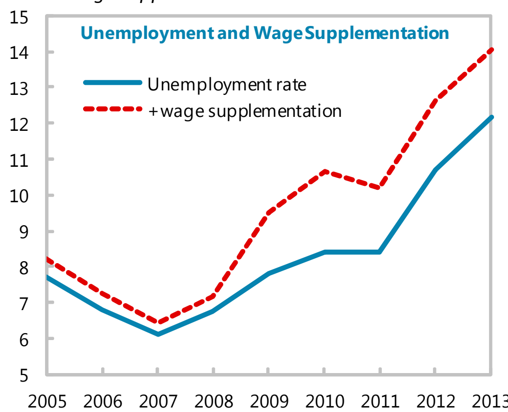
Italy is falling behind its peers in the recovery...



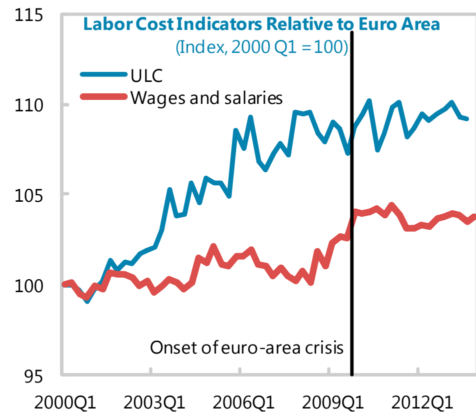
.. and faces the risk of prolonged "lowflation".



Unemployment is unacceptably high and those on wage supplementation have increased...



.. while competitiveness has yet to improve.



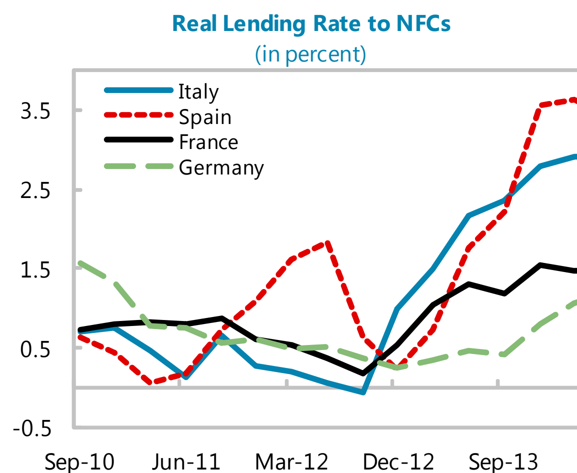
Source:Eurostat; IMF, World Economic Outlook; and IMF staff estimates.
1/ Change in structural primary balance.
2/ Excludes Cyprus and Greece.

February and was quick to reaffirm reforms in key areas. But product and service market reform implementation continues to lag, while efforts to push through the spending review and judicial reforms face stiff political resistance.

OUTLOOK: A FRAGILE AND UNEVEN RECOVERY

Outlook and risks

6. **Tight financial conditions are expected to persist and weigh on the recovery**. Reflecting the weak H1 outturn, tight credit and balance sheet pressures, staff projects growth to be -0.1 percent in 2014, lagging the rest of the euro area. For 2015, growth is expected to rise to 1.1 percent, as steady exports gradually lift domestic demand. Inflation should pick up slowly supported by the ECB measures announced in June, but given the large slack, will remain below the ECB's euro area target over the projection period.



7. **The risks to the outlook are still tilted to the downside**. These risks are interconnected (RAM) and if they were to materialize, regional and global spillovers could be significant (Box 2):

- ***Geopolitical tensions and export slowdown***. Disruptions in energy supplies from tensions in Russia/Ukraine or the Middle East would impact oil and gas prices (Italy imports 90 percent of its gas) and hurt growth. Italy's banking and investment exposure to Eastern Europe are another area of vulnerability. A slowdown in global growth or a further loss of competitiveness would derail the export-led recovery.
- ***Stagnation and low inflation*** could translate into a need for further fiscal adjustment in order to achieve favorable public debt dynamics, especially as growth is forecast to be lower than the real interest rate paid on debt (see DSA). Low inflation would also reduce prospects for real wage moderation and worsen corporate debt burdens.
- ***Bond market stress and financial instability.*** Domestic policy slippages, delays in EU reforms, or large negative surprises in the European AQR could undermine confidence and push Italy into a bad equilibrium. As the third largest sovereign bond market, the outward spillovers could be large.
- ***Reform upside***. Rapid progress on the reform agenda could see improved confidence and activity reinforce each other. The clearance of public sector arrears and unlocking of increased cash holdings by corporates (2 percent of GDP in 2012–2013) could boost investment more than expected.

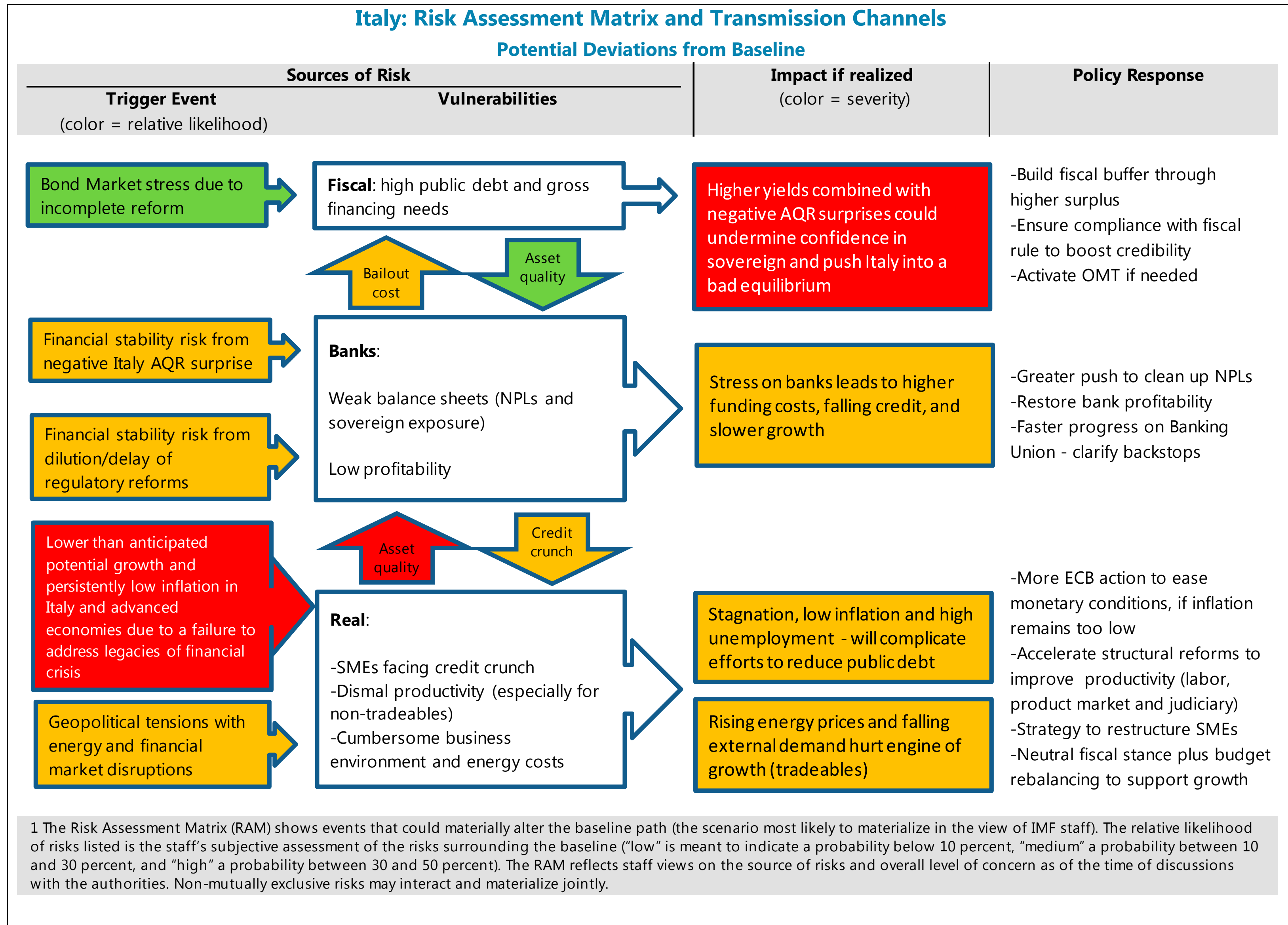
Competitiveness

8. Reforms are critical to sustaining the recovery and improving productivity and competitiveness. Growth is projected to average 1 percent during 2014–19, supported by a modest cyclical recovery. Potential growth estimates remain at around ½ percent, reflecting the trend decline in productivity and the collapse in investment. As detailed in the External Sector Report Assessment (Annex), Italy's external position is broadly consistent but likely still weaker than suggested by medium-term fundamentals and desirable policy settings. The cyclically-adjusted current account in 2013 was near balance (0.3 percent of GDP) and very close to the EBA-estimated norm. However, Italy's net international investment position (NIIP) has deteriorated by 16 percent of GDP since joining the Euro area, with net liabilities equal to 29 percent of GDP. Although foreign investment in portfolio debt securities turned positive in 2013, led by investment in government securities, Italy remains vulnerable to a loss of market confidence, owing to large refinancing needs of the sovereign and banking sectors. Given Italy's weak productivity and competitiveness, a modest weakening of the real exchange rate would lead to stronger growth, consistent with reducing high unemployment and public debt, while strengthening the external balance sheet. On this basis, a real effective depreciation of 0–5 percent, supported by structural reforms and continued progress in fiscal consolidation, would help close the competitiveness gap and address economic imbalances over the medium term.

Authorities' views on economic outlook and risks

9. The authorities agreed that financial conditions would weigh on the recovery, but emphasized potential upside risks. While acknowledging downside risks to their 2014 growth forecast of 0.8 percent, the MEF noted that activity will pick up on account of the reforms undertaken since 2011 (0.8 percent higher in 2015 relative to a no-reform counter-factual). With private consumption and machinery investment showing positive growth, they believed the recovery would take hold in the coming quarters. Tight credit conditions have reduced growth by about 1 percentage point, but this will be mitigated by the clearance of government arrears, reduced sovereign spreads, and post-AQR confidence going forward. Monetary policy should provide support as credit risk eases—the BoI estimates that the June ECB announcements would raise growth by 0.5 percent by 2016, mainly through lower interest rates and a weaker exchange rate. The authorities expect growth to approach 2 percent in 2018 once all reforms are implemented.

10. Domestic and external risks have receded against the background of improving global conditions and domestic political stability. The authorities considered the risk of deflation to be moderate since energy prices explain a large share of the decline and inflation expectations remain well anchored. However, the BoI cautioned that the length and depth of the recession had increased the sensitivity of inflation to the business cycle. Structural changes had increased the frequency of price adjustment and reduced firm pricing power, steepening the Phillips curve. Following the ECB actions, the BoI projects inflation to rise to a still low 0.8 percent in 2015 from 0.4 percent this year. In the short-run, lower inflation could support consumption through higher disposable income. The authorities agreed that geopolitical tensions, including developments in Russia/Ukraine, along with a growth slowdown impacting EMs, were the most salient external risks.



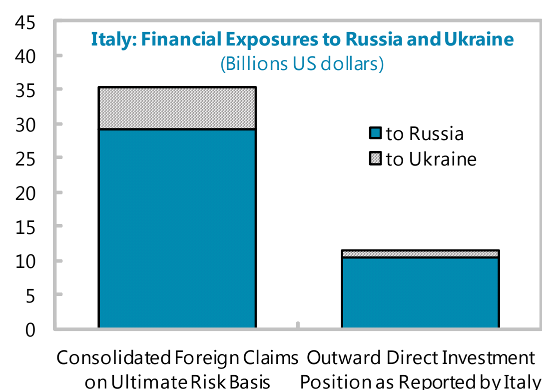
1 The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood of risks listed is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate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

Box 2. Spillover Implications from Geopolitical Risks and Low Inflation

Italy has sizeable trade and financial exposures to the rest of Europe with a high dependency on energy imports. On trade, while more than half of Italy's total merchandise exports are still directed to the EU, the rebound since 2009 has been driven by exports to non-EU countries exports, including EMs. Italy imports nearly 80 percent of its energy needs, and it is a net importer of both oil and natural gas. Financially, the direct exposure of Italian banks to the euro area is also considerable (23 percent of GDP), with the largest exposures to Germany and Austria.

An increase in geopolitical tensions in Russia/Ukraine and/or the Middle East could affect Italy through higher energy prices and weaker external demand. Simulations suggest an increase in Russia and Ukraine tensions that pushes up oil and gas prices by 15–20 percent and increases long-term sovereign yields by 100 bps could shave up to half a percentage point from GDP growth in Italy over the medium-term. The shock is modeled as temporary and affects Italy through its energy imports and sensitivities of investment to tighter financial conditions. The results are consistent with the average growth impact on EU countries included in the simulation.

Italy is also exposed to geopolitical tensions via financial and investment linkages. Italian banks' consolidated claims in Russia and Ukraine total roughly 2 percent of Italy's GDP, while a significant portion of profits from Unicredit, Italy's largest bank, come from operations in Russia and Ukraine. In addition, Italian direct investment into Russia and Ukraine has increased significantly in recent years, reaching US$3 billion in 2012 after averaging less than US$50 million annually during 2002-07. However, Italian direct investment stock in the two countries combined totals less than 1 percent of Italy's GDP.



Source: Bank for International Settlements and Coordinated Direct Investment Survey.

Italy can also be a source of outward spillovers to the rest of the world. The re-emergence of sovereign stress in the Euro area (due to incomplete reforms, unanticipated outcomes from the AQR and stress tests in the absence of a fiscal backstop) represents a source of global risk. As highlighted by the DSA, a prolonged period of low growth and inflation could also weaken the fiscal position and market confidence in the sovereign. Analysis conducted in the context of the recent FSAP[1] and highlighted in the 2014 Triennial Surveillance Review[2] shows potential spillover effects to global banks from an isolated shock to Italian banks and the sovereign are limited given the decline in global banks' exposure to Italy since 2008. However, GVAR estimates suggest there are notable spillover effects from an increase in Italian sovereign credit spreads to those in Ireland, Portugal and Spain. Spillovers from Italian sovereign spreads to the real sector are small, while cross-border spillovers to GDP are channeled primarily though real economic ties.

---

[1] SM/13/307 and Country Report No. 13/347.

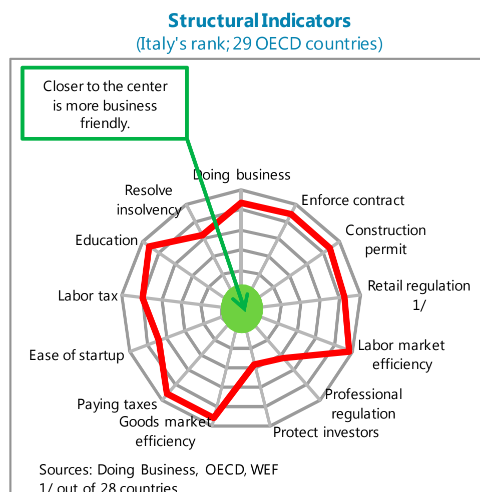
[2] Gray, Gross, Sydow and Paredes, *Modeling the Joint Dynamics of Banking, Sovereign, Macro and Financial Risk using CCA in a Multi-country Global VAR*, presented in *2014 Triennial Surveillance Review—Risks and Spillovers*.

UNLEASHING ITALY'S POTENTIAL

"Ours is a rusty country, a country bogged down, chained by stifling bureaucracy, by rules, regulations and codes…." - PM Renzi, February 2014

11. Improving the economy's growth potential is critical for addressing the debt overhang risks and exiting the balance-sheet recession. The challenge is to transform the institutions that have held back Italy's productivity. They include a fragmented labor market unwilling to invest in young workers; an inefficient and lengthy judicial system that discourages investment; an ineffective and indebted public sector reliant on high taxes; and a financial system saddled with bad loans and hamstrung in its ability to provide credit. As a member of a currency union, addressing these structural and balance sheet weaknesses takes on greater importance.

Structural Indicators
(Italy's rank; 29 OECD countries)



Sources: Doing Business, OECD, WEF
1/ out of 28 countries

12. PM Renzi's reform agenda aims to overhaul the system. A new government outlined an agenda to reform the electoral law, the labor market, judicial system, and public sector. Following the passage of the *Delega Fiscale* (tax reform) the government intends to take forward measures to simplify and improve the tax system.

13. Delivery of real change is now crucial for strengthening confidence and securing a robust recovery. Pursuing wide-ranging reforms simultaneously would also be self-reinforcing and generate growth synergies. The following structural reforms are priorities to unblocking Italy's productivity and growth potential.

A. Structural Reforms for Revitalizing the Business Environment

Labor reforms need to tackle pervasive duality and better align worker and firm incentives

Context

Labor market reform is one of the cornerstones of PM Renzi's agenda… The "Jobs Act" outlines ideas for universal unemployment benefits tied to training and job-search; a national agency responsible for coordinating active policies (ALMP); and rationalized contracts with more flexibility. Legislation thus far has focused on increasing flexibility at the margin, by reducing restrictions on short-term hires, and boosting female participation with tax incentives.

…but dismal labor prospects and stagnant productivity call for more radical action. With 70 percent of new contracts being temporary, additional flexibility at the margin does little to reduce duality and incentivize investment in workers.

Staff Advice	Implementation Status
Link unemployment support to employability. In deep recessions, the current wage supplementation scheme hampers reallocation of labor from unprofitable firms and should shift to a more universal support system conditional on job search and training.	Proposed in Jobs Act but not yet implemented.
Simple contracts. A single labor contract with gradually increasing protection would enhance fairness by reducing duality, especially if it were to replace open-ended contracts. Grandfathering could ease adjustment to the new system.	Staff proposal goes further than the "trial" contract in Jobs Act.
National coordination of ALMP. Build on the experience of successful schemes like Finland's, to reduce regional disparities and improve monitoring and evaluation. Greater information sharing on job openings and seekers could create new markets for more flexible work, especially among women and the elderly, similar to U.K. and U.S. job exchanges.	Staff goes beyond Jobs Act and suggests new market-based institutions for job matching.
Decentralized wage setting. To allow firms to adapt more quickly to changing economic conditions, Italy should promote more firm-level wage bargaining, together with greater flexibility in national contracts e.g. on non-wage terms such as shifts and working hours.	The idea is not included in the Jobs Act.

Authorities' Views

The authorities underscored that the short-term priority has been to create new jobs. Lifting restrictions on temporary contracts was an urgent measure to boost labor demand in the face of very high unemployment. Moving forward, the authorities will develop options to improve ALMPs and design an experimental contract with gradually increasing protection. Social partners noted the difficulty of implementing the new experimental contract, while keeping existing temporary contracts. They also highlighted the need to increase labor market participation and welcomed the idea of creating job exchanges.

On wage setting, the authorities pointed out that moving to a fully decentralized system could prove costly and disruptive. They agreed firm-level bargaining should be more representative, but noted that it would be costly to negotiate all terms of a labor contract at the firm level. Some national-level template is needed. Labor economists highlighted the importance of sufficient flexibility in national-level agreements to allow for firm-level differences linked to productivity.

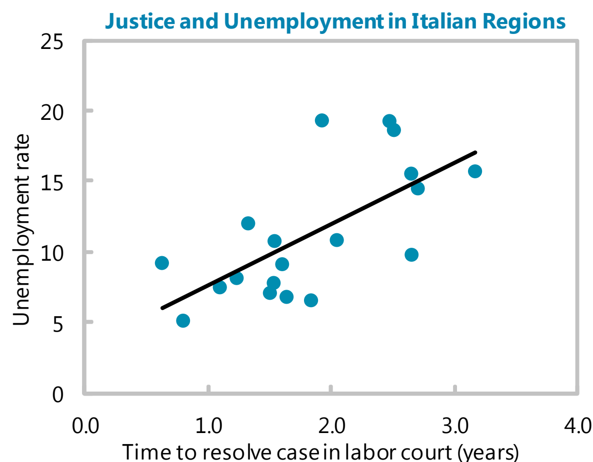
Judicial reforms to improve court efficiency would have wide ranging benefits

Context

The lengthy judicial process is a major factor behind Italy's weak business environment. It takes more than a thousand days to enforce a contract in Italy—

more than twice the OECD average. The huge backlog (5.2 million civil cases) is slowly decreasing but remains an obstacle to improving judicial performance.

Advice **Greater judicial efficiency would bring cross-sector benefits by lowering the cost of credit, encouraging investment, and facilitating employment**. Staff analysis of regional disparities finds that halving the duration of labor disputes is associated with an increase in probability of employment by about 8 percent. Recent reforms, such as the increase in court fees, are welcome, but the judicial system is still slow compared to the European average. Measures to accelerate the judicial process include: promoting the use of mediation and allowing all qualified professionals to be mediators; rationalizing the types of cases that reach the Supreme Court; requiring performance indicators for all courts; and disseminating regional best practices such as the Strasbourg Program to improve case management in the Turin Court (IMF WP/14/32).



Authorities' Views **Judicial reform remains a priority for the government**. The backlog of cases fell by 11 percent since 2009 and processing times were reduced by an average of 3.7 percent since 2011. The authorities are now exploring options to use assisted dispute resolution, restrict appeals to the Supreme Court, and reinforce commercial courts. They pointed to future efficiency gains from the introduction of electronic document filing, and the positive reaction to the idea of monitoring court performance. The authorities earlier proposed dropping the requirement for lawyers to participate in compulsory mediation—Italy is one of the few EU countries that requires lawyers to be present—but faced stiff resistance by the legal profession which succeeded in reinstating the requirement in parliament.

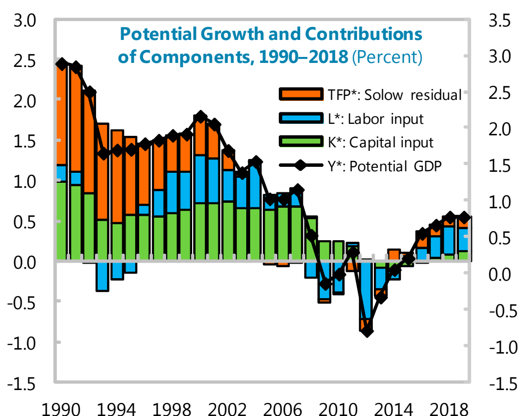
Greater efforts against corruption are needed to improve the business environment

Context **Public sector corruption remains a serious problem in Italy**. Although cross-country comparisons are challenging, Italy fares poorly in global rankings of perceptions of corruption, e.g. according to Transparency International Italy ranks 30 out of 31 among high income OECD countries in perceptions of corruption. The authorities highlighted linkages between corruption and money laundering.

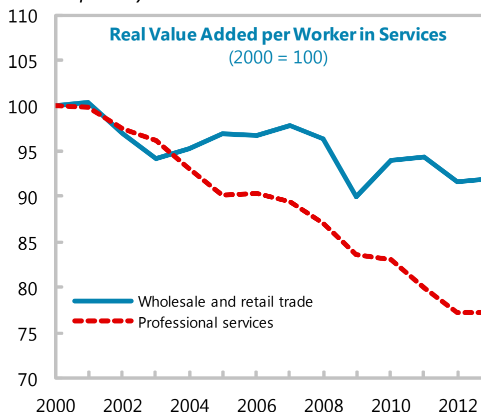
Advice **The anti-corruption legal framework should be further enhanced**. The effectiveness of anti-corruption efforts could be improved by criminalizing the false accounting offense and changing the statute of limitation provisions.

Figure 2. The Case for Structural Reform

Potential growth has steadily fallen...

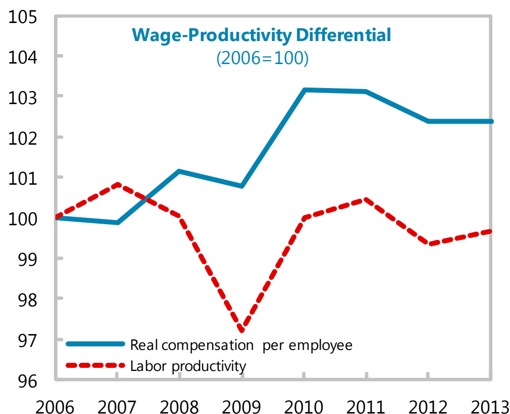


.. dragged down by weak productivity, especially in services.

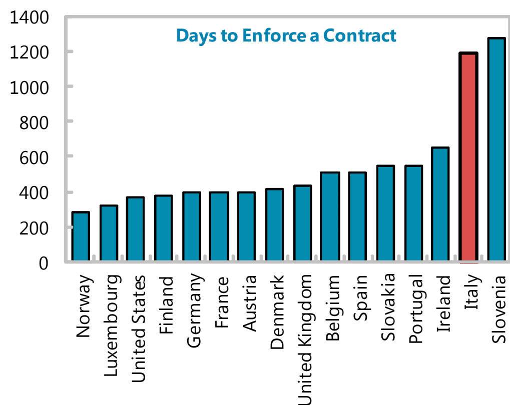


Labor market duality has increased...

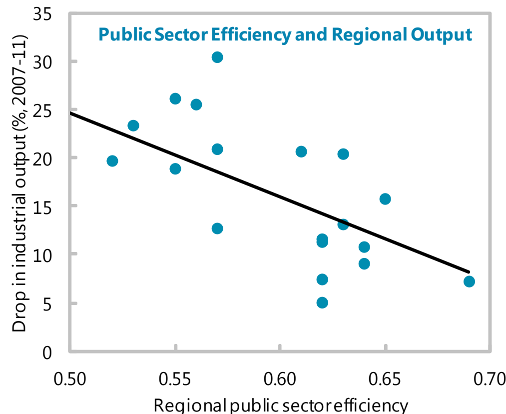
.. while productivity and wages have diverged.



The judicial system is very slow...



...and regions with better public institutions are more resilient.



Sources: ISTAT; Ministry of Justice; Doing Business; Eurostat; and IMF staff estimates.

Currently, the statute of limitations continues to run after the first instance court judgment becomes final. This means that with typically lengthy appeals procedures for corruption, cases may be dismissed as time-barred even after a first instance conviction. One option could be to change the law to re-start the limitation period after the first instance court decision.

Authorities' Views **The authorities agreed on the importance of sustained action against corruption**. They noted that the 2012 anti-corruption legislation aligns the legal framework with relevant international standards and lays the foundation for effective anti-corruption activities. Since 2013, the BoI requires enhanced due diligence by financial institutions in their dealings with domestic "politically exposed persons", in line with international standards and as recommended by staff last year. The government recently approved measures to provide greater powers to the national anti-corruption authority (ANAC).

Accelerate competition policy reforms to improve the business environment

Advice **Rapid implementation of reforms in sectors that are essential inputs to production would support growth.** Progress has been made on some measures, such as the liberalization of the gas sector. But, in other areas, notably the opening up of professional services and privatization of local services, reforms have stalled. The transport authority was legally established in 2011 but is still understaffed. Addressing these staffing shortages, opening up the legal profession and enhancing competition in the retail sector would reduce markups and raise productivity. The short-term adjustment costs from liberalization could be offset by improved sentiment and new investment in deregulated sectors.

Authorities' Views **The authorities pointed to important liberalization measures on the horizon**. They have committed to legislate the recommendations of the antitrust authority by September 2014—an important first step to enhancing competition, encouraging new entrants, and lowering the cost of services. The reform timeline includes an initiative to restructure rail and local public transport by end-2014.

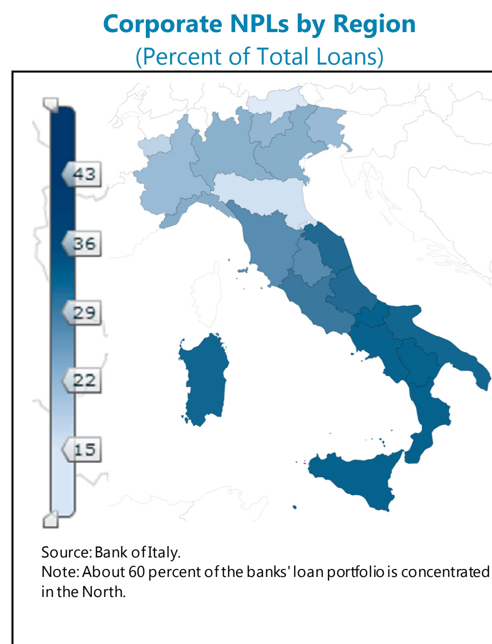
B. A Financial Sector That Supports Growth and Investment

A greater push to clean up bad loans would support new lending in the recovery

Context **The European AQR is leading Italian banks to recognize further losses and raise capital…** Ahead of the AQR, the large Italian banks booked net losses of nearly €22 billion in 2013, announced plans to dispose of NPLs and have raised €11 billion in capital. The foundation owner of Banca Monte dei Paschi di Siena sold most of its shares in the bank, and after raising €5 billion in capital in June, repaid the bulk of its state aid.

…but, NPLs continue to rise and deleveraging persists. Since 2007, the NPL ratio has tripled to 16 percent at end-2013, and has reached 29 percent for corporate loans (higher in the South). The largest increase has been for "bad debt" loans in insolvency ("sofferenze"). The continued rise in NPLs has weighed heavily on banks' profits, pushed up lending rates, and added to the pressures on banks to deleverage and reduce their risk exposure.

Corporate NPLs by Region
(Percent of Total Loans)



Source: Bank of Italy.
Note: About 60 percent of the banks' loan portfolio is concentrated in the North.

Low provisioning and lengthy foreclosure procedures are the main obstacles to cleaning up balance sheets. Despite the rising NPL stock, write-off rates continue to decline, while recent NPL sales have been limited to those in default over ten years. Provisioning has improved but the coverage varies—it is lower in mid-size banks where capital buffers are thin and weak governance has made it difficult to raise outside capital. NPLs disposal is also hindered by the slow recovery process (three years to foreclose on collateral and seven years to complete a bankruptcy). Italy ranks 21 out of 31 among high income OECD countries in resolving insolvency (Doing Business).

Advice

Cleaner balance sheets would free up resources for financing the recovery. Write-off rates would need to triple from their historic average to bring the bad debt ratio to pre-crisis levels within 10 years, suggesting that a greater push by all stakeholders is urgently needed to accelerate NPL disposals. A three-pronged approach should be considered:

a) ***Stronger provisioning and write offs.*** Supervisory guidelines could foster convergence in provisioning rates, including forbearance loans under the moratorium program—this could provide incentives for banks to coordinate and be more pro-active in addressing problem loans. To encourage write-offs, the supervisor could monitor bank progress in working out NPLs and conduct targeted on-site inspections of loan collection performance. As tried in other countries (Japan, United States), the supervisor could also impose higher capital charges or time-limits for writing off old NPLs.

b) ***Develop the distressed debt market.*** An active NPL market would provide an alternative to lengthy bankruptcy, draw in needed financing, and boost loan recovery values. Private NPL asset management companies (AMCs) could be encouraged through tax incentives (accelerated depreciation or preferential capital gains), while ensuring bad assets are transferred at fair market value.

c) ***Enhanced enforcement and insolvency regimes.*** The authorities should expand specialized insolvency benches within courts and introduce time-limits to expedite business reorganization. Adopting international best practice guidelines along the INSOL Principles for Multi-Creditor Workouts could encourage more out-of-court workouts. Also, greater reliance on online court filings could speed up foreclosures.

Authorities' Views

After weathering the crisis, Italian banks have made great efforts to clean up balance sheets without significant State support. The authorities stressed that the inflow of new bad debt is beginning to stabilize. Encouragingly, banks are exploring market-based solutions for NPL management and disposal, capitalizing on growing foreign interest. However, the financial and operational challenges for banks to work through large NPLs are significant. With respect to harmonizing provisions, they noted that supervisory responsibility, including for minimum prudential standards on provisioning, would be transferred to the Single Supervisory Mechanism (SSM) in the fall. Tax incentives to jumpstart the distressed debt market may also conflict with state aid rules.

The authorities highlighted that past BoI inspections had helped prepare banks for the ECB comprehensive balance sheet assessment. The 2012 BoI loan inspections covered 40 percent of NPLs using a conservative definition in line with the EBA standards, and tightened collateral valuation. One difference, however, is that the ECB's AQR is also looking at performing loans, including those under the loan moratorium program, which could push provisioning needs higher. In response to regulatory pressure, some mid-tier banks are preparing plans for possible capital needs later this year. In line with the European Council decision, the authorities are putting in place national arrangements for resolution mechanism and public backstops and stressed the need to coordinate closely these arrangements at the European level.

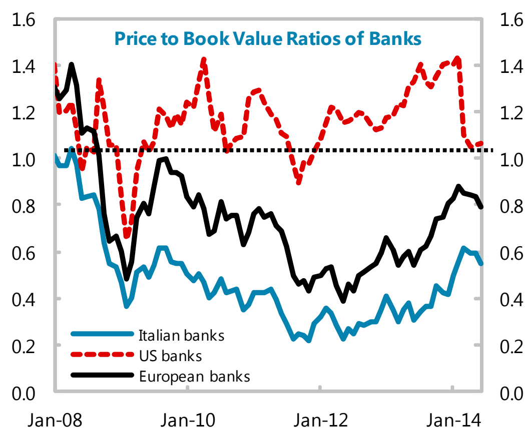
Improvements in corporate governance would also strengthen capital raising and stability

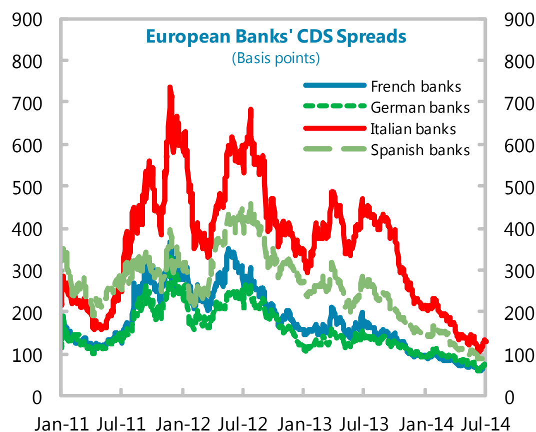
Governance

Reforms to improve bank corporate governance should continue. The BoI has taken steps to strengthen the role of independent board members and the "fit and proper" test for directors. The role of the foundations has also diminished, as banks have sought outside sources of capital. Governance reforms should continue by requiring published audited accounts by foundations participating in banks, limits on their leverage, and proper governance rules. The ban on foundations controlling banks should be applied in practice, and over time, foundations should reduce their stake in banks within proper concentration limits. The largest cooperative banks should also be encouraged to convert to joint stock companies and consolidate as a way to achieve synergies.

Figure 3. The Financial Sector Remains Under Pressure

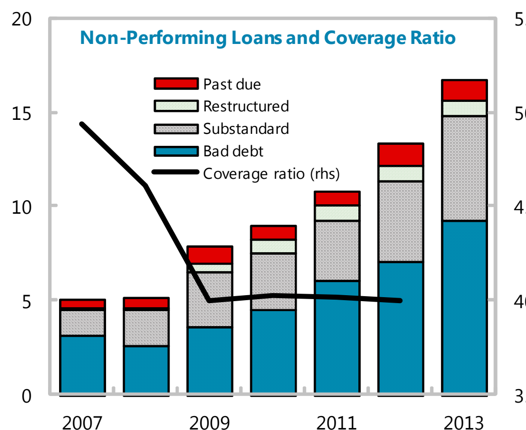
Price to book value ratios have increased, as concerns about financial stability have eased.

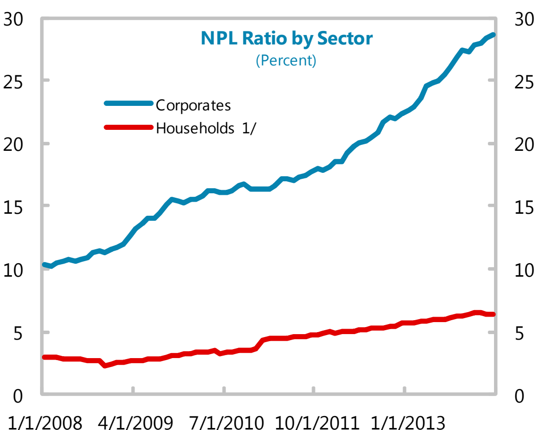




But NPLs continue to rise...

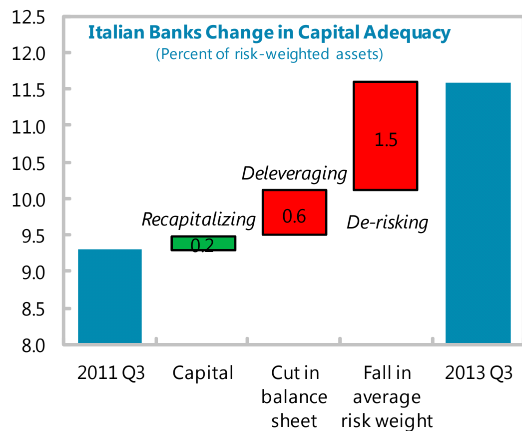
...particularly in the corporate sector.

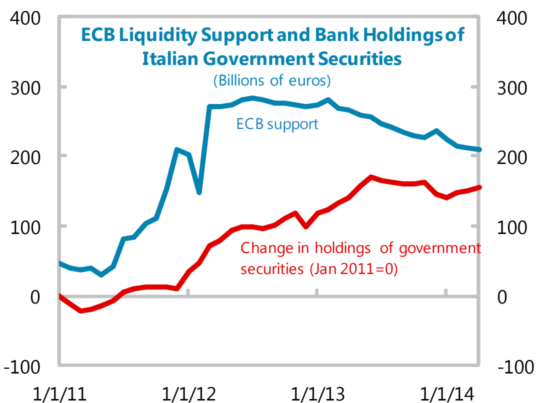




Capital ratio increases come largely from de-risking...

...supported by an LTRO funded increase in government securities.

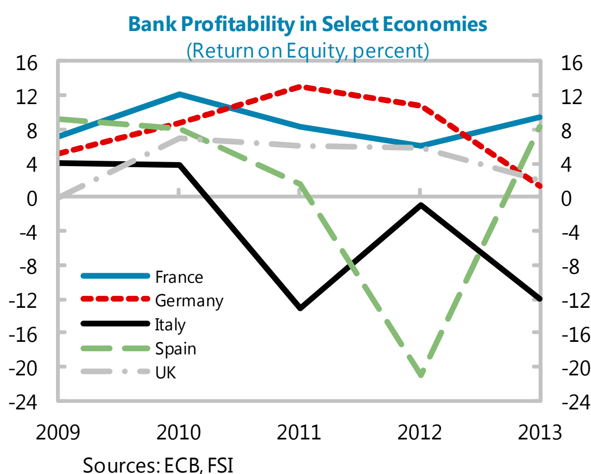




Sources: Bloomberg; Bank of Italy; SNL; ECB; and IMF staff estimates.
1/ Includes bad debt only.

The financial sector needs greater profitability, diversification and market-based funding alternatives

Profitability



Sources: ECB, FSI

The financial system faces a number of challenges to restore profitability in a weak growth environment. Shrinking loan volume, low net interest margins, and rising loan losses have weighed on bank profits. While large banks have cut costs, through staff reductions and branch closures, mid-size banks have lagged behind. In an environment of low growth and weak asset quality, the supervisor should encourage banks to reduce their operational costs further through continued rationalization of branch networks, digitalization of retail banking, and mergers.

Capital Markets

Deeper capital markets could diversify sources of finance and support new lending activity. Italian corporates rely more on debt versus equity—with debt-to-equity ratios 17 percentage points higher than the Euro area average (123 percent). Italian institutional investors' exposure to equities is limited, with just 16 percent of pension assets in equities (compared to 50 percent for the largest international pension funds) and less than 1 percent in Italian equities. Encouraging institutional investors, such as pension funds, to raise their allocation in equities and alternative assets, to be more in line with those of other large global investors with the appropriate benchmarks would expand the supply of long-term risk capital. Reducing the tax bias against equity financing would encourage family-owned firms to seek more outside equity. Over time, reducing the gap between the taxation of public and private securities would also support more investment in the private capital markets.

Authorities' Views

The authorities highlighted that the shift to the SSM could foster Europe-wide consolidation and a rethink of banks' business models. Italian banks have made progress in cutting branch networks (by 7 percent since 2008), while scope still exists to incorporate technology in retail banking. Rising compliance costs and greater competition at the European level will likely add to bank pressures to lower costs and seek out appropriate mergers. On corporate governance, a newly issued BoI regulation and a draft decree pending Parliament's approval will implement most of the IMF's FSAP recommendations, including the power to remove board members (Appendix II). On the foundations, the BoI has argued that the ban on foundations controlling banks be enforced to facilitate capital raising and consolidation.

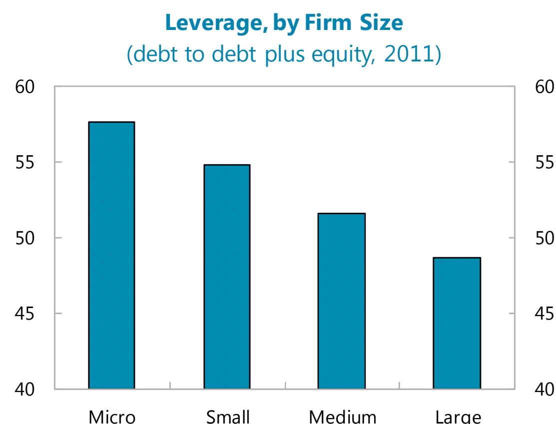
A range of measures have been undertaken to support equity investment in corporates and mobilize new sources of financing. These include an enhanced Allowance for Corporate Equity (ACE) program, which expands tax benefits for increasing retained earnings and raising public equity; elimination of withholding tax on medium- and long-term financing for foreign-based investors; proposals to allow direct lending to firms by insurance companies and other non-banks; and a proposal to allow for multiple-voting shares to encourage family-run SMEs to raise outside equity capital.

A broad strategy to revive the SME sector would complement financial sector reform

Context

SMEs are the backbone of the Italian economy… SMEs account for about 80 percent of the corporate workforce and 70 percent of firm value added in Italy. They are more prevalent and smaller than elsewhere in the euro area.

…but they are suffering more from the financial crisis. Italian SMEs suffer from high leverage and weak profitability and are more vulnerable to financial stress than large firms. Their small size and low productivity are particularly evident in the trade and tourism sectors. Compared to the euro area, business startup and firm exit rates are lower, limiting the economies ability to innovate and shift resources to more productive areas.



Source: Bank of Italy.

Advice

A broad based strategy to assist SMEs growth and restructuring will strengthen balance sheets and improve productivity. Such a strategy is complementary to efforts to reduce bank NPLs:

- *Guidelines for creditor-led restructuring.* Establishing standard criteria for assessing SME loans and guidelines for restructuring viable, but distressed, firms could help overcome creditor coordination problems and encourage greater use of the insolvency regime and out-of-court workouts. This would help identify non-viable firms for a quick exit and open opportunities for a "fresh start." Shifting public support schemes away from guarantees and moratorium for existing firms to financing for new firms could support the restructuring process.

- *New fiduciary loan contract.* Efficient collateral enforcement mechanisms that do not rely on court decisions could expand the availability and lower the cost of credit. A new loan contract based on fiduciary arrangements could allow quick

and efficient enforcement in the event of default (Box 3). Introducing a nationwide electronic registry for all types of collateral would support the use of fiduciary contracts.

- *Greater sharing of credit information*. The system of credit registries and bureaus is fragmented with limited sharing of information. Expanding access to the key registries by nonbanks and including other relevant data such as payments on taxes, retail credit, and utility bills would improve credit monitoring and support the shift from collateral-based to a more risk-based lending.

Authorities' Views

The authorities highlighted active government support as crucial for relieving the SME credit squeeze during the crisis. These included a moratorium scheme for SME loans (currently covering some €23 billion in principal), rapid expansion of the Central Guarantee Fund and support to bank lending through the *Cassa Depositi e Prestiti*. The payment of government arrears (some 60 billion planned over 2 years) would also give liquidity support to SMEs. The *Fondo Italiano d'Investimento* was created in 2009 to invest in SME risk capital to help them grow and aggregate.

On a new loan contract, the authorities had explored modifying existing contracts to allow for 3rd party collateral, but this was difficult to implement without a new law. Instead, they are now considering introducing guarantees on movable property and have presented draft legislation to Parliament in December 2013. Greater sharing of credit information is welcome but faces challenges from Italy's data privacy laws.

Policies at the European level could also support growth by easing monetary conditions and reducing financial fragmentation

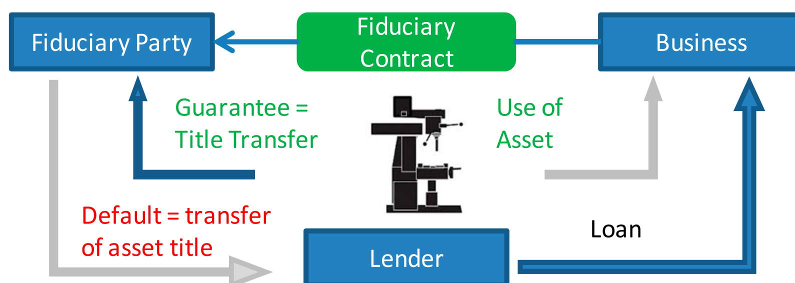
14. Recent ECB actions have helped to ease financial conditions... Bank funding costs have eased and several banks have reissued unsecured senior debt. The improvement in funding conditions has also facilitated a gradual repayment of the LTRO, with Italian banks having repaid one third of their Eurosystem borrowing. According to the BoI, recent ECB measures (T-LTRO) could provide liquidity of more than €200 billion over the life of the program. The BoI will extend the pool of eligible collateral for refinancing operations to SME loans and mortgages and is also exploring ways to allow for refinancing of overdraft bills, which are widespread among SMEs.

15. ...but more can be done. The spread between the yield on bank bonds and the swap rate has diminished, but fragmentation across the Euro area still persists and euro area inflation is below the ECB's target. If inflation remains too low, the ECB should consider a substantial expansion of its balance sheet, including through asset purchases. Faster progress towards the banking union will further reduce financial fragmentation. Italy needs to play its part, for example by completing national arrangements for resolution and backstopping in advance of the ECB assessment.

Discussions are ongoing between the MEF and BOI on the national backstop, while legal impediments to bail-in remain. Finalizing the national backstop and clarifying the bail-in process would enhance the predictability of the resolution framework.

Box 3. A New Fiduciary Loan Contract for Efficient Collateral Enforcement

Efficient collateral enforcement mechanisms that do not necessarily rely on court decisions could expand the availability and lower the cost of credit for small firms. Civil law jurisdictions, such as Italy's, are increasingly considering the concept of *fiducia* (fiduciary ownership agreements) as a way to facilitate contract enforcement of collateral outside the court system. In a fiduciary agreement, a borrower will receive a loan from a lender in exchange for transferring the title, but not the possession, of certain assets (collateral) to a fiduciary, third party. If the loan is repaid in full, the title reverts to the borrower. If the borrower defaults, the fiduciary party transfers the asset title to the lender without resorting to the courts. The lender benefits from reduced uncertainty, time and cost of securing the collateral. The borrower benefits not only from a lower cost and broader access to credit, but also from maintaining possession and use of the underlying collateral for his or her ongoing business, e.g. machinery.



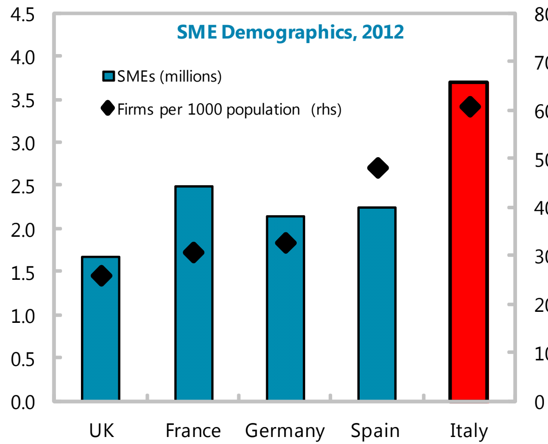
Brazil and France have introduced these types of contracts recently:

- **France**. In 2006, the French Civil Code was amended to include the so-called "*fiducie-sûreté*." This is a contract by which the full title is transferred to a lender or to a third party to secure the payment of the borrower's debt. On default, the "fiduciary party" may realize the assets and use the proceeds to repay the loan. Any surplus is repaid to the borrower. The French law is also very flexible, allowing all kinds of present or future assets to be transferred to the fiduciary.
- **Brazil**. In 2004, the notion of "Fiduciary Ownership Agreements" was introduced whereby a borrower, as security for its obligation, transfers the ownership of a movable property to the lender, keeping possession of the asset until the debt is repaid. The lender acquires a limited, transitory and conditional property, which is automatically extinguished upon repayment of the debt. The asset given in collateral may be recovered by the lender through summary proceedings in case of default.

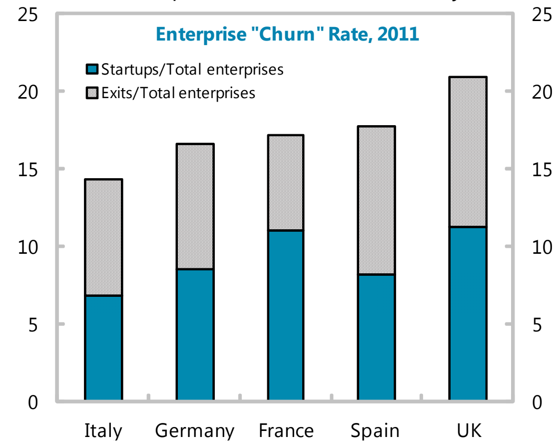
These types of fiduciary arrangements do not exist in Italy and could have cross-cutting benefits. In addition to expanding credit availability, such a fiduciary contract could also enhance market discipline by strengthening contract enforcement. Allowing borrowers to voluntarily switch to a fiduciary contract in exchange for a lower rate could also signal their willingness to repay. Efficient foreclosure arrangements could also support alternative means of financing, such as factoring or securitization of SME loans; unlock other forms of collateral besides real estate, and foster a market for credit insurance, such as for trade credit.

Figure 4. Small and Medium Enterprises

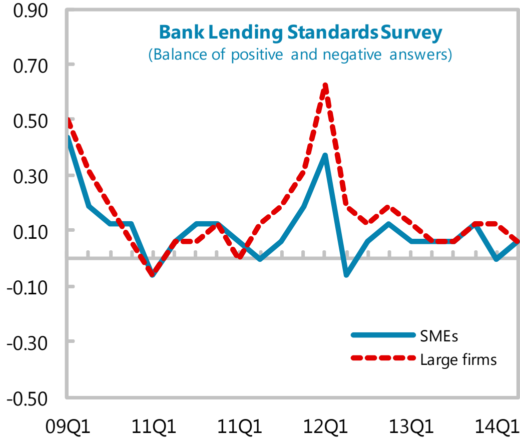
SMEs are more prevalent in Italy than elsewhere...



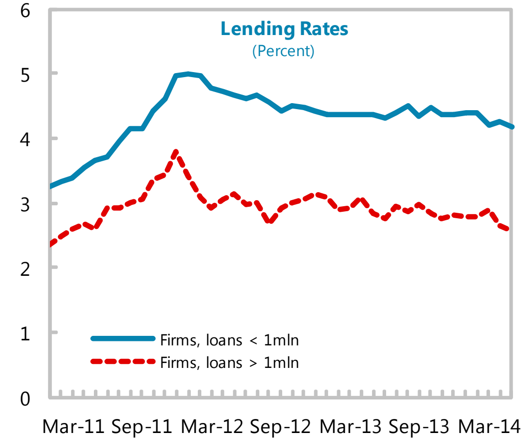
...and startup and exit rates are relatively low.



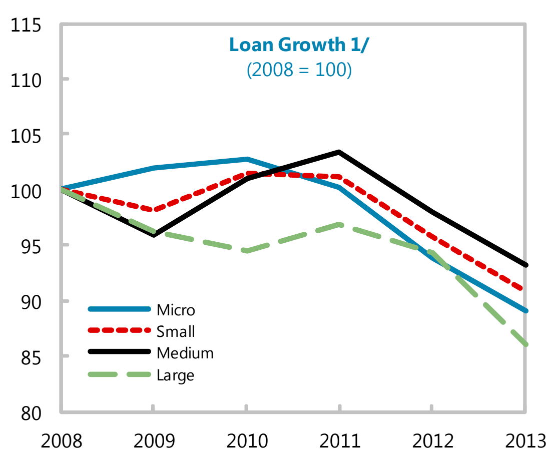
Lending standards have tightened for all firms...



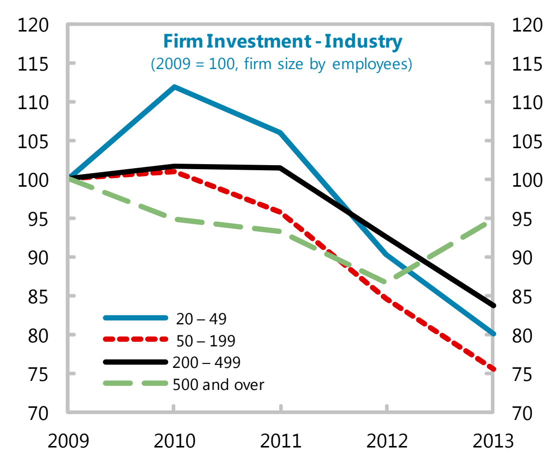
...but borrowing rates remain higher for smaller loans.



Lending has declined for all firms...



...with falling investment, especially by smaller firms.



Sources: Eurostat; Bank of Italy; Cerved Group; and IMF staff estimates.
1/ Data based on sample of limited liability companies.

C. Boosting Growth Through Fiscal Policy

An ambitious rebalancing to lower marginal taxes and boost productive spending is needed…

Context

The public sector budget in Italy suffers from a number of distortions that hold back growth. Marginal tax rates on capital and labor are high. The government reduced the personal income tax (PIT) for low earners by around ½ percent of GDP in 2014 (roughly 1,000 euro per household), but at around 48 percent of total labor cost, the labor tax wedge is well above the OECD average of 36 percent. Public spending has one of the highest elderly bias and lowest levels of education spending in the EU, leaving little room for ALMP and education policies to strengthen productivity and employment. The efficiency of public spending also varies considerably across regions, with the South being the weakest (Box 4).

Advice

Lower marginal tax rates are needed… Further reductions in the labor tax wedge should come through lower social security contributions instead of cuts to personal income tax to better support new employment. The increase in the tax allowance for corporate equity returns (ACE) is welcome and should be extended.

…by generating more durable savings. The PIT cut was partly funded by one-off measures, such as the VAT on arrears payments and taxes on revalued shares at the BoI. More permanent measures to finance tax cuts are needed, including through lower tax expenditures, higher taxes on wealth (including inheritance taxes), and additional savings from the spending review. Stronger efforts to curb tax evasion would generate savings and raise the fairness of fiscal adjustment.

The spending review is an important mechanism to address intergenerational imbalance and improve public efficiency. Key areas for improvement are in pensions, health and addressing large regional gaps in efficiency. With previous pension reforms having strengthened long-term sustainability, the focus should shift to finding savings from current pensions, such as through higher progressive indexation. For health, large regional differences in spending efficiency suggest room for savings. Greater differentiation of public wages across regions would not only generate savings, but also better link wages to productivity in the private sector. Savings could be used not only to lower marginal tax rates, but also to shift resources towards education, active labor market policies, and public investments—including EU-co financed projects where absorption remains low.

Authorities' Views

The authorities agreed that reorienting budget priorities required more permanent savings, but this would be challenging. The cut in PIT was intended primarily to stimulate domestic demand, with the aim now to improve its targeting. Going further would be difficult, given the additional need to make the PIT cut permanent. The authorities viewed age-related spending as sustainable, albeit high.

Prospects for further pension changes, including progressive indexation for existing pensioners, was seen as limited given the significant reforms already enacted.

…while a stronger primary balance is needed to bring down public debt, given the low growth and high interest rate environment

Context

The pace of fiscal consolidation is set to ease after tough adjustment… The structural primary surplus improved from 0.7 to 4.5 percent of GDP between 2011 and 2013 and is now one of the highest in the euro area and close to its debt-stabilizing level. Given the weak growth, the nominal headline deficit is expected to remain at 3 percent of GDP this year but fall short of a zero structural balance under Italy's new fiscal rule. For 2015, the authorities plan a ½ percent of GDP adjustment to narrow the structural deficit to -0.1 percent of GDP.

…but not by too much. Italy's public debt is sustainable but subject to significant risks. Public debt is set to rise further, peaking at 136 percent of GDP in 2014, due to slower growth and one-off operations from arrears clearance. Under the baseline, public debt is projected to decline modestly to 125 percent of GDP by 2019 but remain vulnerable to adverse shocks, especially from weak growth and low inflation (see DSA). Market funding conditions have been relatively benign, supported by ample global liquidity, but real borrowing rates still exceed economic growth rates. With annual gross financing needs of 24 percent of GDP (almost €400 billion), Italy is also vulnerable to swings in market sentiment.

Advice

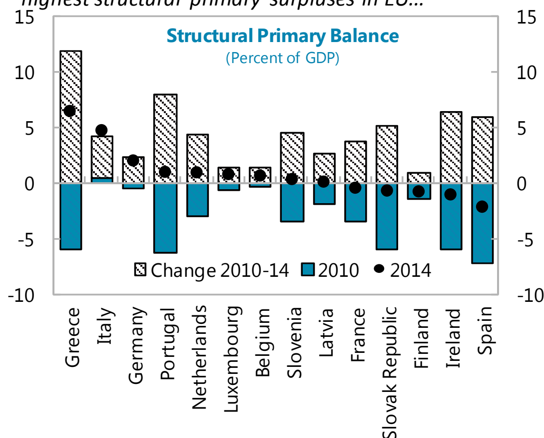
Conditional on the recovery taking hold, a modest structural surplus next year would be appropriate to bring down debt faster. In the short-term, fiscal policy needs to strike a delicate balance between setting the debt ratio on a downward path while helping the economy recover. An additional adjustment compared to the authorities' plans (up to ½ percent of GDP depending on the strength of recovery) would help achieve a small structural surplus by 2015. If growth turns out weaker than expected, a slower pace of consolidation—but still enough to reduce the debt ratio—would be appropriate.

2015 Additional Fiscal Measures: Staff Advice (percent of GDP)

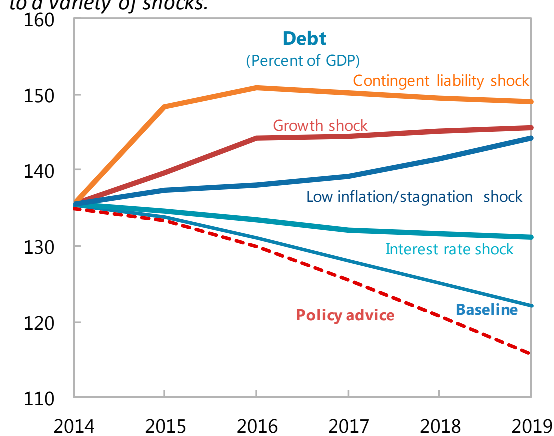
	Policy Advice
Fiscal Consolidation	
Additional fiscal effort (relative to authorities' plans)	0.5
Fiscal Rebalancing and Improving Efficiency	
Lowering the tax wedge	-0.9
Spending on ALMP/education/capital	-0.3
Savings Measures	
Reduction in tax expenditures	0.8
Expenditure savings/Spending Review	0.4
Wealth tax measures	0.3
Higher taxes on financial income	0.2

Figure 5. A More Growth-Friendly Public Sector

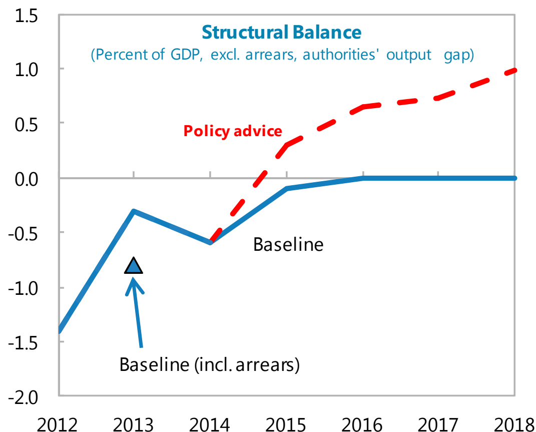
Following large consolidation, Italy has among the highest structural primary surpluses in EU…



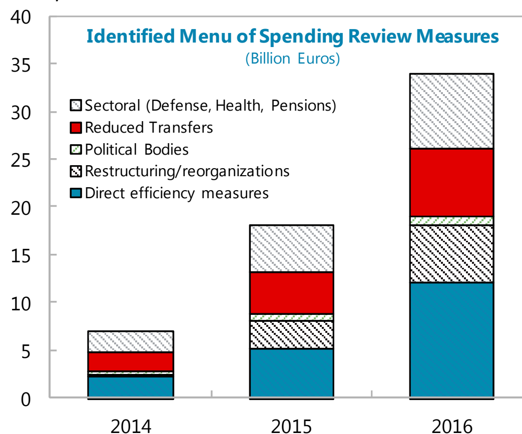
…but the high level of public debt leaves it vulnerable to a variety of shocks.



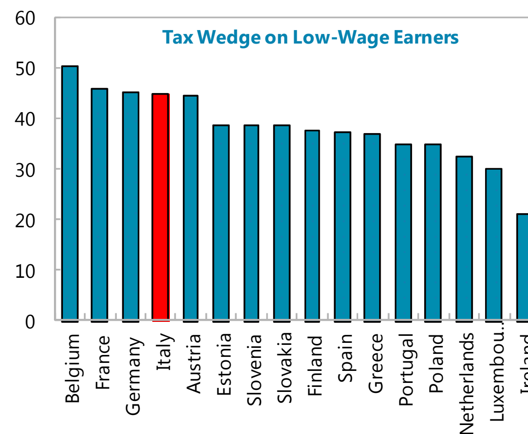
Staff advises a more ambitious adjustment path….



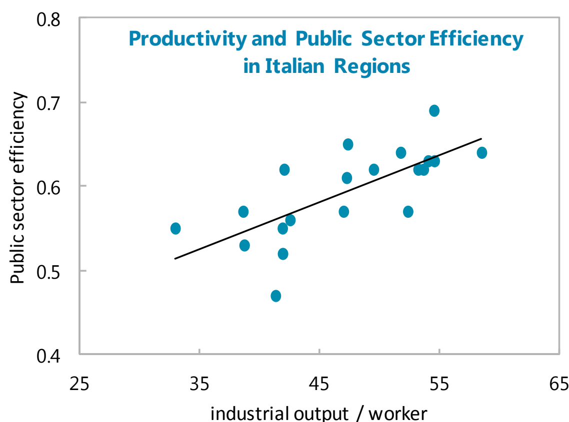
…through spending reforms and lower tax expenditures…



while rebalancing the budget to reduce the high tax wedge…



…and improve public spending efficiency.



Source: Italian authorities; Eurostat; Barone et al. (2009) and staff calculations.

Once the recovery is firmly underway, maintaining a structural surplus would bring down debt more quickly. Beyond 2015, after the recovery is entrenched, a 1 percent of GDP structural surplus buffer would provide valuable insurance against shocks and generate additional interest savings over time (to lower taxes further). Accelerating the privatization program (0.7 percent of GDP annually through 2017), particularly at the local level, would reduce debt faster and support investment.

Authorities' Views

The authorities believed that the key to sustainable debt reduction is higher growth rather than further consolidation. Given the impact of earlier fiscal consolidation and the fragility of the recovery, they viewed further near-term adjustment as having a potentially counterproductive impact on confidence and de-railing the recovery. They noted their intention to pursue greater flexibility within the EU fiscal governance rules in exchange for more structural reforms. Furthermore, while they agreed that a structural surplus buffer would be helpful over the medium-term, they viewed their target of a structural balance as appropriate for securing long-term sustainability.

Stronger budget institutions will improve fiscal performance and the quality of spending

Context

Progress has been made in building fiscal institutions. The creation of the Parliamentary Budget Office (PBO) lays the foundation for an independent institution that can strengthen monitoring and credibility of the fiscal rules. In June, the government approved a public administration reform plan that includes measures to simplify bureaucratic procedures. Steps have been taken to simplify tax procedures and reform the cadastral land survey.

Advice

Establishing a medium-term expenditure framework (MTEF) would improve budget planning and spending efficiency. The spending review should be a permanent feature of the multi-year budget process to enhance policy prioritization, monitoring and accountability. Performance information should be collected systematically to promote the use of output indicators and activity costing. Budgetary rules should facilitate reallocation of resources towards policy priorities, and ministries should be held accountable for achieving those priorities. For the newly established PBO, it would be important to ensure adequate access to fiscal data to strengthen its oversight function.

Stronger efforts to curb tax evasion would generate savings and increase fairness. These efforts should include greater use of the anti-money laundering framework, such as criminalizing self-laundering. Greater information sharing would also help e.g., between the Financial Intelligence Unit (FIU) and the "fiscal registry" (*anagrafe tributaria*).

Box 4. Italy's Spending Review and the Efficiency of Public Spending[1]

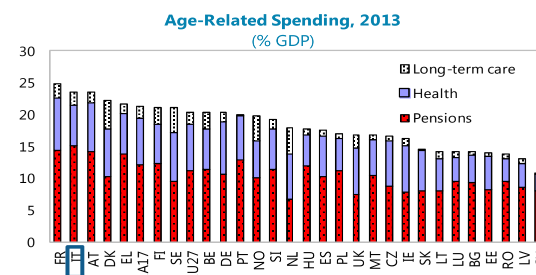
As part of their rebalancing efforts, the authorities have undertaken a spending review to identify potential areas of efficiency–enhancing savings. The spending review commission issued its report in March which identified potential savings of €34 billion over 2014–16 (Table) across various areas, such as in procurement and transfers. The government has approved measures of €3 billion for 2014, mainly focused on administrative efficiency measures.

Potential Savings Identified in Spending Review (in billions of euros)

	2014	2015	2016
Total	**7.0**	**18.1**	**33.9**
1 **Administrative efficiency measures**	**2.2**	**5.2**	**12.1**
o.w. Good and services savings through procurement reforms, etc.	0.8	2.3	7.2
Standards costs for municipalities		0.5	2
2 **Organizational restructuring**	**0.2**	**2.8**	**5.9**
o.w. Synergies in police forces		0.8	1.7
Computerization		1.1	2.5
3 **Political Reorganization**	**0.4**	**0.7**	**0.9**
4 **Lower transfers of state-owned enterprises and social transfers**	**2.0**	**4.4**	**7.1**
5 **Sectoral (Defense, Health, Pensions)**	**2.2**	**5**	**7.9**

Source: Italian authorities.

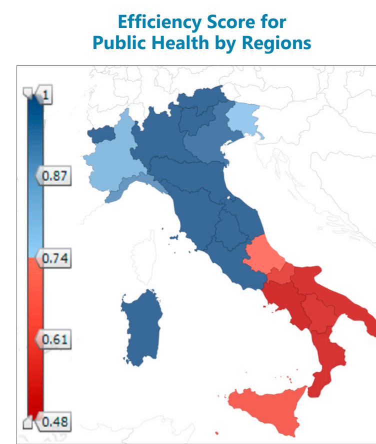
Staff analysis suggests that additional savings will be difficult without addressing the large pension spending. Public pension spending is the highest in the euro area, accounting for almost 30 percent of total spending. This reflects not only the high share of elderly population but also a high replacement rate for existing pensioners, who were largely unaffected by the recent pension reforms. Italy has one of the highest elderly biases in social spending in the euro area—it spends about 7 times more on an elderly compared to a non-elderly (Van Huyess, 2013). Spending on education and non-pension social spending, on the other hand, is very low, providing little room for savings. However, outcome indicators, such as income inequality, poverty risk and tertiary education attainment are relatively weak, suggesting scope for improving spending efficiency.



Sources: OECD; and IMF staff calculation.

Regional analysis also shows that spending efficiency is generally weaker in Southern regions that are poorer and more reliant on outside transfers.

Health care spending, which has been a major source of spending pressure over the past decade, represents a large share of regional spending and is much higher in the south. Staff analysis suggests that bringing efficiency scores in 2011 to national average levels in the low performing regions could have provided savings of almost 1 percent of GDP; the figure is likely smaller now following the spending reforms in recent years. The introduction of standard costs in health care was important in this regard. Improving allocation of regional transfers in other functions using standard costs based on more efficient benchmarks (*fabbissogno standard*) could provide another source of savings. Swift parliamentary approval of the legislation determining standard costs would be needed.



[1] See Selected Issues paper: "An Efficiency Analysis of Public Spending in Italy."

Authorities' Response **Reforms to fiscal and budgetary institutions are ongoing**. The authorities agreed on the MTEF as a useful policy tool, which will be introduced in the near term. The authorities have also intensified their fight against tax evasion and have raised their target of collecting unpaid taxes by €2 billion for 2015. Additional PFM reforms such as electronic invoicing and cash budgeting at local levels are being implemented to fight tax evasion and ensure that new arrears do not arise. The PBO is working on a MOU with the Treasury on the PBO's involvement in the budget process and plans to issue its first report in the fall on compliance with the fiscal rule.

STAFF APPRAISAL

16. The economy is struggling to emerge from its deep balance-sheet recession… Steady exports and an easing fiscal drag are being offset by the stiff headwinds to investment from tight credit conditions, especially for indebted SMEs, and deeply-rooted structural rigidities. Growth is projected to be -0.1 percent in 2014, rising gradually to 1.1 percent in 2015. Inflation is forecast to remain low.

17. …and the risks are tilted to the downside. Italy is exposed to geopolitical tensions in Russia and Ukraine as well as the Middle East through trade and investment linkages. In addition, the high public debt, large public financing needs, and elevated NPLs leave Italy vulnerable to financial contagion and/or low growth and inflation. Failure to follow through on the reform agenda will exacerbate Italy's declining productivity and weak medium-term growth prospects.

18. The improvement in the current account has reduced external imbalances. However, productivity and competitiveness indicators point to an external position weaker than suggested by medium-term fundamentals and desirable policies. A modest weakening of the REER would lead to stronger growth, and a healthier external balance sheet.

19. Deep structural changes are urgently needed to unleash Italy's growth potential, secure a robust recovery and address debt overhang risks. Implementing structural reforms simultaneously would be self-reinforcing and generate significant growth synergies:

- ***Labor reforms.*** A labor contract with gradually increasing protection would reduce duality and encourage firms to invest in workers. Raising the quality of ALMP to the level of the best regions, with centralized monitoring, would help address long-term unemployment. Promoting firm-level bargaining through greater flexibility under national contracts would better align wages to productivity.

- ***Judicial reforms.*** To speed up the judicial process, consideration could be given to reviewing court fees, limiting excessive appeals, developing performance indicators for all courts, and incentivizing the use of mediation. Disseminating regional best practices would help reduce the performance gap.

- ***Competition policy***. Legislative initiatives have been put forward over the years to remove regulatory barriers in many markets, but implementation has been weak. Delivering on the commitment to legislate recommendations of the antitrust authority would enhance competition and lower the cost of services.

- ***Corruption***. The 2012 anti-corruption legislation and recent measures to enhance the power of ANAC represent important steps. The legal framework could be further improved, notably by criminalizing the false accounting offense and changing the statute of limitation provisions.

20. A greater push to clean up bad loans would support lending in the recovery… BoI inspections and the European AQR have improved provisioning coverage ratios and strengthened confidence, but NPLs continue to rise, weighing on bank profits and lending. Encouraging more provisioning and write-offs; developing the distressed debt market; and enhancing the insolvency regime would help accelerate the reduction of NPLs and free up resources for the recovery.

21. …while, a broad strategy to revive the SME sector would complement financial reforms. This strategy should support viable firms and identify non-viable firms for a quick exit. Key elements include adopting a more standardized approach to assessing SME loans and restructuring viable, but distressed firms through insolvency or out-of-court workouts; introducing a new fiduciary loan contract to speed up the enforcement of collateral; and greater sharing of corporate credit information to support the development of alternative financing sources. Forms of support that do not distinguish between viable and non-viable firms should be scaled back.

22. Further improvements in corporate governance and deeper capital markets would support growth and financial stability. Reducing the influence of foundations controlling banks and encouraging cooperative banks to convert to joint-stock companies would strengthen capital raising and market discipline. Promoting professional management of pension funds, while ensuring adequate safeguards are put in place, would draw in more equity investment in Italian firms.

23. Fiscal policy needs to strike a delicate balance between setting the debt ratio on a downward path while helping the economy recover. To support the economy, the priority should be to lower the tax burden financed by savings from the spending review and lower tax expenditures. Following difficult adjustment, Italy has achieved one of the highest primary surpluses in the euro area. However, more still needs to be done to bring down the high level of public debt given the low growth and higher interest rate environment. Conditional on the recovery taking hold, a modest structural surplus next year would be appropriate to strengthen public finances.

24. Adopting an MTEF would improve budget planning and spending efficiency. Making the spending review a permanent part of the multi-year budget process would enhance accountability and monitoring, while performance information should be integrated systematically to promote the use of output indicators and activity costing for budget allocation. For the newly established PBO, it would be important to ensure adequate access to fiscal data to strengthen its oversight function.

25. Policies at the European level could also support growth. If inflation remains too low, the ECB should consider further easing measures, while faster progress towards the banking union will help address financial fragmentation. Italy needs to play its part in the EU process, for example by completing arrangements for resolution and backstopping in advance of the ECB assessment.

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

Table 1. Italy: Summary of Economic Indicators, 2011–19 1/

(Annual percentage change, unless noted otherwise)

	2011	2012	2013	Projections 2014	2015	2016	2017	2018	2019
Real GDP	0.4	-2.4	-1.9	-0.1	1.1	1.3	1.2	1.0	1.0
Real domestic demand									
Public consumption	-1.3	-2.6	-0.8	-0.1	-0.5	-0.1	-0.1	0.0	0.0
Private consumption	-0.3	-4.0	-2.6	-0.1	0.6	1.0	1.0	0.8	0.7
Gross fixed capital formation	-2.2	-8.0	-4.7	-1.1	1.8	3.3	3.0	2.4	1.9
Final domestic demand	-0.9	-4.5	-2.6	-0.3	0.6	1.2	1.1	0.9	0.7
Stock building 2/	-0.1	-0.6	-0.1	-0.4	0.1	0.0	0.0	0.0	0.1
Net exports 2/	1.5	2.6	0.8	0.5	0.4	0.1	0.1	0.1	0.1
Exports of goods and services	6.2	2.1	0.1	3.0	3.6	3.7	3.6	3.5	3.4
Imports of goods and services	0.8	-7.0	-2.8	1.4	2.5	3.8	3.8	3.7	3.6
Resource utilization									
Potential GDP	0.1	-0.9	-0.4	-0.1	0.0	0.2	0.5	0.6	0.6
Output gap (percent of potential)	-1.3	-2.8	-4.2	-4.2	-3.2	-2.1	-1.5	-1.0	-0.6
Employment	0.4	-0.3	-2.1	-0.1	1.2	1.3	1.3	1.2	1.0
Unemployment rate (percent)	8.4	10.7	12.2	12.6	12.0	11.3	10.5	9.8	9.2
Prices									
GDP deflator	1.4	1.6	1.4	1.1	1.2	1.4	1.5	1.5	1.6
Consumer prices	2.9	3.3	1.3	0.4	1.0	1.1	1.3	1.5	1.6
Hourly compensation 3/	3.3	1.9	2.8	0.8	1.4	1.5	1.7	1.9	2.0
Productivity 3/	1.0	-0.8	-0.2	0.2	0.3	0.4	0.2	0.2	0.3
Unit labor costs 3/	2.3	2.7	3.0	0.6	1.0	1.1	1.5	1.7	1.7
Fiscal indicators									
General government net lending/borrowing 4/	-3.6	-2.9	-3.0	-3.0	-2.1	-1.1	-0.7	-0.5	-0.4
General government primary balance 4/ 5/	1.2	2.5	2.2	2.2	3.2	4.5	4.8	5.0	5.1
Structural overall balance (percent of potential GDP)	-3.7	-1.6	-0.6	-0.8	-0.3	0.0	0.0	0.0	0.0
Structural primary balance (percent of potential GDP) 5/	1.2	3.8	4.5	4.2	4.9	5.4	5.4	5.5	5.4
General government gross debt 4/	120.7	127.0	132.5	136.4	135.4	132.9	130.2	127.6	124.7
Exchange rate regime			Member of EMU						
Exchange rate (national currency per U.S. dollar)	0.7	0.8	0.7	...	...	...	...	...	...
Nominal effective rate: CPI based (2000=100)	101.6	99.1	101.3	...	...	...	...	...	...
External sector 4/									
Current account balance	-3.0	-0.3	1.0	1.5	1.5	1.2	0.9	0.5	0.1
Trade balance	-1.1	1.1	2.4	2.7	2.9	2.8	2.6	2.4	2.2

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), 2012–19

(Percent of GDP unless otherwise indicated)

	2012	2013	2014		2015		2016	2017	2018	2019
	Prel.	Proj.	Proj.	Auth.	Proj.	Auth.	Proj.	Proj.	Proj.	Proj.
Total revenues	48.1	48.2	48.6	48.3	48.6	48.2	48.9	49.1	49.2	49.2
Current revenues	47.7	47.6	48.0	47.9	48.0	47.8	48.4	48.6	48.6	48.6
Tax revenues	30.2	30.0	30.4	30.4	30.3	30.4	30.5	30.5	30.6	30.6
Direct taxes	15.1	15.3	15.2	15.3	15.2	15.2	15.4	15.4	15.5	15.5
Indirect taxes	15.0	14.5	14.8	15.0	14.8	15.1	14.8	14.8	14.8	14.8
Social security contributions	13.8	13.8	13.7	13.6	13.7	13.6	13.7	13.7	13.7	13.7
Other current revenues	3.8	4.0	4.2	4.0	4.3	3.9	4.5	4.6	4.6	4.6
Capital revenues	0.4	0.6	0.6	0.4	0.6	0.4	0.6	0.6	0.6	0.6
Total expenditures	51.1	51.2	51.6	51.0	50.7	50.0	50.0	49.9	49.7	49.5
Current expenditures	48.0	48.5	48.7	48.1	47.8	47.5	47.1	46.9	46.7	46.6
Wages and salaries	10.5	10.5	10.3	10.3	10.1	10.0	9.8	9.6	9.6	9.6
Goods and services	8.4	8.3	8.3	8.2	8.2	8.1	8.2	8.5	8.7	8.6
Social transfers	19.9	20.5	20.8	20.7	20.8	20.6	20.7	20.7	20.7	20.7
Other	3.7	3.9	4.0	3.8	3.3	3.7	2.8	2.7	2.3	2.3
Interest payments	5.5	5.3	5.2	5.2	5.3	5.0	5.5	5.5	5.6	5.4
Capital expenditures	3.1	2.7	2.9	2.9	2.9	2.6	2.9	2.9	2.9	2.9
Overall balance	-3.0	-3.0	-3.0	-2.7	-2.1	-1.8	-1.1	-0.7	-0.5	-0.3
Memorandum items:										
Primary balance (revenue minus primary spending)	2.5	2.2	2.2	2.5	3.2	3.3	4.5	4.8	5.0	5.1
Unidentified measures to achieve structural balance	...	...	0.0	...	0.5	0.3	0.5	-0.2	0.3	0.1
Cyclically-adjusted overall balance	-1.5	-0.8	-0.8	-0.7	-0.5	-0.3	0.1	0.0	0.0	0.0
Structural overall balance 1/	-1.6	-0.6	-0.8	-0.6	-0.3	-0.1	0.0	0.0	0.0	0.0
Change in structural overall balance 2/	2.1	1.0	-0.2	0.2	0.5	0.5	0.3	0.0	0.0	0.0
Structural overall balance (policy advice) 1/	-1.6	-0.6	-0.8	-0.6	0.2	0.4	0.5	0.6	0.8	1.0
Structural primary balance 1/	3.8	4.5	4.2	4.6	4.9	4.8	5.4	5.4	5.5	5.4
Structural primary balance (policy advice) 1/	3.8	4.5	4.2	4.6	5.4	5.3	6.0	6.0	6.3	6.4
Nominal GDP growth rate 2/	-0.8	-0.4	1.0	1.7	2.4	2.5	2.7	2.6	2.5	2.6
Output gap 1/	-2.8	-4.2	-4.2	-3.7	-3.2	-2.7	-2.1	-1.5	-1.0	-0.6
Public debt 3/	127.0	132.5	136.4	134.9	135.4	133.3	132.9	130.2	127.6	124.7
Public debt (policy advice)	...	...	136.4	...	135.1	...	132.3	125.0	120.7	114.2

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

1/ Percent of potential GDP.

2/ Percent.

3/ Assumes arrears clearance 33 billion euros and privatizaon receipts of 2 billion euros in 2014.

Auth. = Documento di Economia e Finanza 2014 (April 2014 update of the macro-fiscal framework document).

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	774.7	787.0	806.3	803.5	817.9	836.2	863.0	887.3	908.0
Taxes	447.4	455.0	473.1	468.4	478.4	488.7	504.5	518.7	532.3
Social contributions	213.8	216.5	216.0	215.0	216.5	221.3	226.9	232.6	238.2
Grants	2.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Other revenue	111.5	112.5	114.2	117.1	120.0	123.3	128.7	132.9	134.5
Expenditure	842.7	844.3	851.7	850.8	865.0	870.6	880.8	899.9	916.8
Expense	777.8	784.7	790.1	793.1	803.3	807.6	816.7	834.6	850.7
Compensation of employees	172.0	168.4	165.2	164.1	162.9	163.0	162.9	162.8	166.9
Use of goods and services	90.2	91.3	86.4	83.4	82.6	83.6	86.2	93.4	98.3
Consumption of fixed capital	-31.3	-31.3	-31.4	-30.4	-31.5	-31.8	-32.0	-32.3	-32.3
Interest	69.2	76.5	84.6	82.0	81.8	86.1	91.8	93.4	96.8
Social benefits	344.0	348.7	356.6	366.2	376.2	384.3	392.3	402.5	412.5
Other expense	133.8	131.1	128.8	127.9	131.3	122.4	115.6	114.9	108.6
Net acquisition of nonfinancial assets	64.9	59.6	61.6	57.7	61.7	62.9	64.1	65.3	66.1
Gross / Net Operating Balance 1/	-3.1	2.3	16.2	10.3	14.6	28.6	46.3	52.7	57.3
Net lending/borrowing	-68.0	-57.3	-45.4	-47.3	-47.2	-34.3	-17.8	-12.6	-8.8
Net acquisition of financial assets	19.1	-8.5	...	...	...	...	...	...	...
Net incurrence of liabilities	84.9	51.0	...	...	...	...	...	...	...
					(Percent of GDP, unless otherwise indicated)				
Revenue	49.9	49.8	51.5	51.5	51.9	51.9	52.1	52.2	52.1
Taxes	28.8	28.8	30.2	30.0	30.4	30.3	30.5	30.5	30.6
Social contributions	13.8	13.7	13.8	13.8	13.7	13.7	13.7	13.7	13.7
Grants	0.1	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Other revenue	7.2	7.1	7.3	7.5	7.6	7.6	7.8	7.8	7.7
Expenditure	54.3	53.4	54.4	54.5	54.9	54.0	53.2	53.0	52.6
Expense	50.1	49.7	50.4	50.8	51.0	50.1	49.3	49.1	48.8
Compensation of employees	11.1	10.7	10.5	10.5	10.3	10.1	9.8	9.6	9.6
Use of goods and services	5.8	5.8	5.5	5.3	5.2	5.2	5.2	5.5	5.6
Consumption of fixed capital	-2.0	-2.0	-2.0	-2.0	-2.0	-2.0	-1.9	-1.9	-1.9
Interest	4.5	4.8	5.4	5.3	5.2	5.3	5.5	5.5	5.6
Social benefits	22.2	22.1	22.8	23.5	23.9	23.8	23.7	23.7	23.7
Other expense	8.6	8.3	8.2	8.2	8.3	7.6	7.0	6.8	6.2
Net acquisition of nonfinancial assets	4.2	3.8	3.9	3.7	3.9	3.9	3.9	3.8	3.8
Gross / Net Operating Balance 1/	-0.2	0.1	1.0	0.7	0.9	1.8	2.8	3.1	3.3
Net lending/borrowing	-4.4	-3.6	-2.9	-3.0	-3.0	-2.1	-1.1	-0.7	-0.5
Net acquisition of financial assets	1.2	-0.5	...	...	...	...	...	...	...
Net incurrence of liabilities	5.5	3.2	...	...	...	...	...	...	...
Memorandum items:									
Primary balance 2/	-0.1	1.0	2.3	2.0	2.0	3.0	4.3	4.6	4.9
Structural balance 3/	-3.8	-3.7	-1.6	-0.6	-0.8	-0.3	0.0	0.0	0.0
Change in structural balance 3/	0.4	0.1	2.1	1.0	-0.2	0.5	0.3	0.0	0.0
Structural primary balance 3/	0.7	1.2	3.8	4.5	4.2	4.9	5.4	5.4	5.5
General government gross debt	119.3	120.7	127.0	132.5	136.4	135.4	132.9	130.2	127.6

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

Table 3. Italy: Summary of Balance of Payments, 2011–16

	2011	2012	2013	2014	2015	2016
				Projections		
Billions of Euros						
Current account balance	-47.3	-4.1	15.8	23.3	24.7	20.4
Balance of goods and services	-23.0	17.9	40.2	47.7	52.3	51.4
Goods balance	-17.4	17.0	37.2	42.8	46.7	46.1
Exports	376.6	390.9	391.6	399.6	413.6	429.2
Imports	-393.9	-373.8	-354.4	-356.8	-366.9	-383.0
Services balance	-5.6	0.9	3.0	4.9	5.6	5.3
Credit	76.2	81.8	83.5	88.8	91.9	95.4
Debit	-81.8	-80.9	-80.5	-83.9	-86.3	-90.1
Income balance	-8.5	-6.7	-9.8	-8.6	-11.5	-14.4
Credit	61.1	54.0	49.3	52.7	50.0	48.9
Debit	-69.6	-60.7	-59.2	-61.3	-61.5	-63.3
Current transfers (net)	-15.8	-15.2	-14.6	-15.8	-16.1	-16.6
Official (net)	-11.3	-10.0	-21.1	-10.0	-10.7	0.0
Capital and financial account balance	68.6	17.3	-24.5	-23.3	-24.7	-20.4
Capital account balance	1.0	3.9	-0.1	0.0	0.1	0.2
Financial account	67.6	13.4	-24.4	-23.3	-24.7	-20.6
Direct investment	-13.9	-6.1	-11.4	-11.9	-12.5	-13.0
Portfolio investment	-8.9	25.9	13.3	23.0	-7.6	-6.6
of which: government	-48.0	-53.5	12.2	25.2	0.0	0.0
Other investment	83.8	0.8	-21.7	-34.4	-4.7	-1.0
Derivatives (net)	7.5	-5.7	-3.0	0.0	0.0	0.0
Reserve assets (increase = -)	-0.9	-1.5	-1.5	0.0	0.0	0.0
Net errors and omissions	-21.3	-13.2	8.7	0.0	0.0	0.0
Official Financing		...	...	...	...	...
Percent of GDP						
Current account balance	-3.0	-0.3	1.0	1.5	1.5	1.2
Balance on goods and services	-1.5	1.1	2.6	3.0	3.2	3.1
Goods balance	-1.1	1.1	2.4	2.7	2.9	2.8
Services balance	-0.4	0.1	0.2	0.3	0.3	0.3
Income balance	-0.5	-0.4	-0.6	-0.5	-0.7	-0.9
Current transfers	-1.0	-1.0	-0.9	-1.0	-1.0	-1.0
Capital and financial account balance	4.3	1.1	-1.6	-1.5	-1.5	-1.2
Capital account balance	0.1	0.2	0.0	0.0	0.0	0.0
Financial account	4.3	0.9	-1.6	-1.5	-1.5	-1.2
Direct investment	-0.9	-0.4	-0.7	-0.8	-0.8	-0.8
Portfolio investment	-0.6	1.7	0.9	1.5	-0.5	-0.4
of which: government	-3.0	-3.4	0.8	1.6	0.0	0.0
Other investment	5.3	0.1	-1.4	-2.2	-0.3	-0.1
Derivatives (net)	0.5	-0.4	-0.2	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	-1.3	-0.8	0.6	0.0	0.0	0.0
Official Financing		...	...	...	...	...
Gross external debt	114.9	121.7	121.7	121.8	122.5	123.4
Public sector	54.9	62.1	59.5	58.5	54.2	50.0
Private sector	60.0	59.6	62.3	63.3	68.3	73.4

Sources: Bank of Italy and IMF staff estimates.

Table 4. Italy: Financial Sector Indicators 2009–13 1/

(Percent unless otherwise noted)

	2009	2010	2011	2012	2013
Core FSIs for Deposit-taking institutions					
Regulatory capital to risk-weighted assets	11.7	12.1	12.7	13.4	13.7
Regulatory tier 1 capital to risk-weighted assets	8.3	8.7	9.5	10.5	10.6
Nonperforming loans net of provisions to capital	54.8	60.2	64.6	79.7	89.9
Nonperforming loans to total gross loans	9.4	10.0	11.7	13.7	16.5
Sectoral distribution of loans to total loans					
Residents	72.3	74.8	75.5	75.5	75.7
Loans to Deposit takers	3.0	2.3	2.6	2.6	2.7
Loans to Central Bank	1.3	0.8	1.0	1.1	0.8
Loans to Other financial corporations	5.1	4.9	3.7	6.0	6.1
Loans to General government	3.1	2.8	2.5	2.6	2.5
Loans to Nonfinancial corporations	37.5	37.9	39.0	37.2	36.8
Loans to Other domestic sectors	22.4	26.1	26.7	25.9	26.9
Nonresidents	27.7	25.2	24.5	24.5	24.3
Return on assets	0.3	0.3	-0.9	-0.1	-0.8
Return on equity	4.0	3.7	-13.0	-0.9	-11.5
Interest margin to gross income	60.8	57.5	57.1	53.8	49.1
Net open position in foreign exchange to capital	1.6	1.7	1.7	1.2	2.0
Encouraged FSIs for Deposit-taking institutions					
Capital to assets	4.8	5.0	5.4	5.4	5.4
Large exposures to capital	11.9	89.5	89.2	91.8	81.9
Gross asset position in financial derivatives to capital	76.5	74.7	112.3	76.7	70.2
Gross liability position in financial derivatives to capital	77.8	78.1	117.9	83.2	75.5
Trading income to total income	3.2	1.3	3.1	9.6	10.3
Personnel expenses to noninterest expenses	57.5	58.3	56.5	55.7	57.7
Spread between reference lending and deposit rates (basis points)	336.2	298.6	305.2	263.9	284.1
Spread between highest and lowest interbank rates (basis points)	41.4	40.8	87.6	12.4	19.7
Customer deposits to total (noninterbank) loans	65.2	63.2	58.2	67.9	70.5
Foreign-currency-denominated loans to total loans	9.9	9.2	8.9	8.3	8.8
Foreign-currency-denominated liabilities to total liabilities	45.7	33.9	30.7	27.8	28.7

Source: Bank of Italy; ECB; IMF, Financial Soundness Indicators and IMF staff calculations.
1/ Data from the IMF Financial Soundness Indicators database have been updated, when possible, with Bank of Italy's or ECB's data.

Annex I. Debt Sustainability Analysis

Italy's public debt is sustainable but subject to significant risks. Italy's public debt ratio continues to rise, and at around 136 percent of GDP, is the second highest in the euro area. External financing requirements and gross public financing needs are also large due to the rollover of existing debt. Most of the public debt is held domestically. Market risks are mitigated by the long duration of debt, much of which is under a fixed interest rate. The main risk stems from a growth shock, in the absence of structural reforms, which could result in an unfavorable macro-fiscal dynamics. Contingent liabilities in the financial sector also constitute a significant risk.

1. Macroeconomic and fiscal assumptions: The assumptions underpinning the DSA are those of the baseline scenario of the staff report. Real GDP growth is projected at 0.1 percent in 2014, increasing to around 1 percent in the medium term. Inflation is projected at around 1.5 percent over the medium term. The structural balance improves annually to meet the zero balance as required under the fiscal rule. In 2014, however, cyclically adjusted balance implies a slight relaxation. Spreads are assumed to moderate from current levels. However, yields are expected to rise over the medium term and the effective interest rate is forecast to rise from 4.0 percent in 2014 to 4.4 percent in 2019.

2. The DSA tool that assesses the realism of the main assumptions on growth, primary balance, and inflation does not indicate systematic forecast errors.

- While growth outcomes in Italy have sometimes tended to be worse than projected, the current growth projections are in line with consensus but below the authorities' forecasts. Near–term risks are broadly balanced. The recent government initiative on electoral and structural reforms and arrears clearance provide upside risks for growth potential. Nevertheless, the trend decline in productivity and investment collapse along with risks of a confidence shock given the large debt levels pose downside risks for long-term growth. Inflation projection errors have been small historically. Nevertheless, the risk of deflation is a particular concern given its implications on debt dynamics and the weak medium-term outlook.
- The maximum projected 3-year adjustment in the cyclically-adjusted primary balance is large, but the bulk of that adjustment was already undertaken in 2012 and 2013 and Italy currently has the second largest structural primary balance in the Euro area. However, the weak recovery may create pressure to relax the fiscal targets, which raises the risks of a slower pace of future consolidations.

3. The definition of public debt comprises Excessive Deficit Procedure (EDP) debt of the General Government. The General Government includes the Central Government, Regional Governments, Local Government, and Social Security Funds. It excludes public enterprises. EDP debt is a subset of General Government consolidated debt such as trade credits and other accounts payable. Stocks are recorded at their face value and thus usually exclude unpaid accrued interest.

Baseline

4. Staff forecast that the debt-to-GDP ratio will peak at 136 percent in 2014, before declining to 124 percent in 2019. The debt profile is projected to be higher than a year ago as slower fiscal adjustment, the additional arrears clearance program (0.8 percent of GDP), along with the lower-than-projected nominal growth are forecast to push up the debt ratio.

5. While gross financing needs are expected to remain sizeable over the medium term, rollover risks are mitigated by the long–term debt structure. Italy remains vulnerable to a loss in market confidence, owing to the large refinancing needs. Government financing requirements, at 24 percent of GDP, and external financing requirements at 48 percent of GDP, remain large. Nevertheless given the public debt structure with an average maturity under 6½ years and 70 percent of debt with fixed interest rate, the refinancing risks are mitigated somewhat. The direct interest pass-through to the budget is relatively slow; a 100 basis points shock to the yield curve is estimated to raise the interest bill by just over 0.16 percent of GDP in the first year, 0.34 percent in the second year and 0.44 percent in the third year. Almost 2/3 of debt is held by domestic investors. Since banks now account for the largest share, at around 20 percent, the rollover of LTROs would likely be important for containing interest costs.

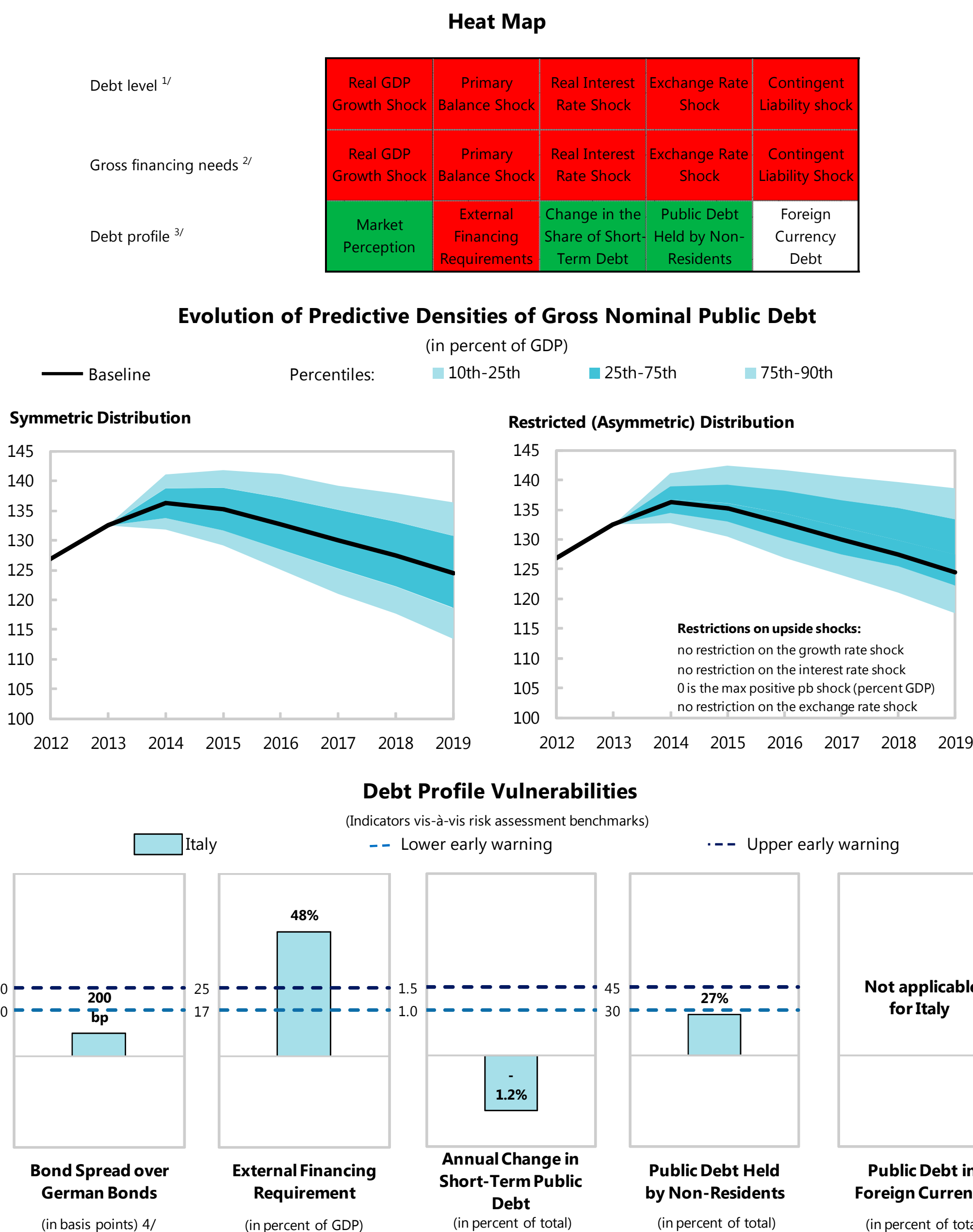
Shocks and Stress Tests

6. The heat map of the main risk shows susceptibility to a negative surprise to growth and macro fiscal shocks.

- ***Growth shock***. Real output growth rates are assumed to be lower by one standard deviation for two years starting in 2014, resulting in an average growth of -1.3 percent in 2015–16. Furthermore, for every 1 percentage point decline in growth, inflation declines by 0.25 percentage points. The nominal primary balance improves much more slowly than the baseline, reaching only 2.3 percent of GDP by 2019. Debt-to-GDP increases rapidly to about 147 percent during the growth shock and then fails to come down over the projection period. Gross financing needs also rise significantly.
- ***Interest rate shock.*** Market concerns about medium-term debt sustainability intensify increasing spreads by 200 bps. Higher borrowing costs are passed on to the real economy, depressing growth by 0.4 percent. The government's interest bill climbs reaching an implicit average interest rate of almost 5.3 percent by 2019. The debt-to-GDP ratio declines only modestly to 132 percent in 2019, despite sizeable primary surpluses.
- ***Contingent liability shock.*** Negative surprises, such as from the financial system, lead to a one-time increase in non-interest expenditure of about 10 percent of banking sector assets. This leads to a decline in growth for two consecutive years by about 1.2 percent depressing domestic demand and lowering inflation by 0.3 percent. Primary balance worsens by 12 percent of GDP in 2015 and by 1.4 percent of GDP from 2016 onwards. Debt rises and stabilizes at a higher level of 150 percent of GDP. Gross financing needs would remain elevated at around 30 percent of GDP.

- ***Primary balance shock.*** Reform fatigue weakens the implementation of fiscal adjustment plans—which are delayed by one year relative to the baseline. The slippage leads to a very slight 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 2019.
- ***Low inflation and prolonged stagnation.*** Inflation surprises on the downside given the large negative output gap and is lower by 1 standard deviation (0.6 pp) from 2015 onwards, rising from 0.6 percent in 2015 and reaching 1 percent in 2019. Annual GDP growth is 0.5 to 1 percentage points lower than in the baseline and there is a 100 bps increase in interest rates from 2015–19. This could potentially arise due to slow progress in structural reforms, increase in contingent liabilities, possibly from the banking sector, and loss of confidence as interest rates spike. The debt-ratio increases to 145 percent of GDP in 2019 and fails to stabilize over the projection period.
- ***Policy advice scenario.*** Under this scenario, additional adjustment of around ½ percent of GDP is undertaken in 2015 compared to the baseline. This is combined with structural reforms to rebalance the budget which provides a growth dividend of ¼ percent in 2016 that rises permanently to 1 percent of GDP in 2019. The higher fiscal surplus allows the interest rate to decline by around 20 bps. These assumptions allow the debt-ratio to decline firmly to about 117 percent of GDP by 2019 and continue on a declining path.

Figure 1. Italy: Public DSA Risk Assessment



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.

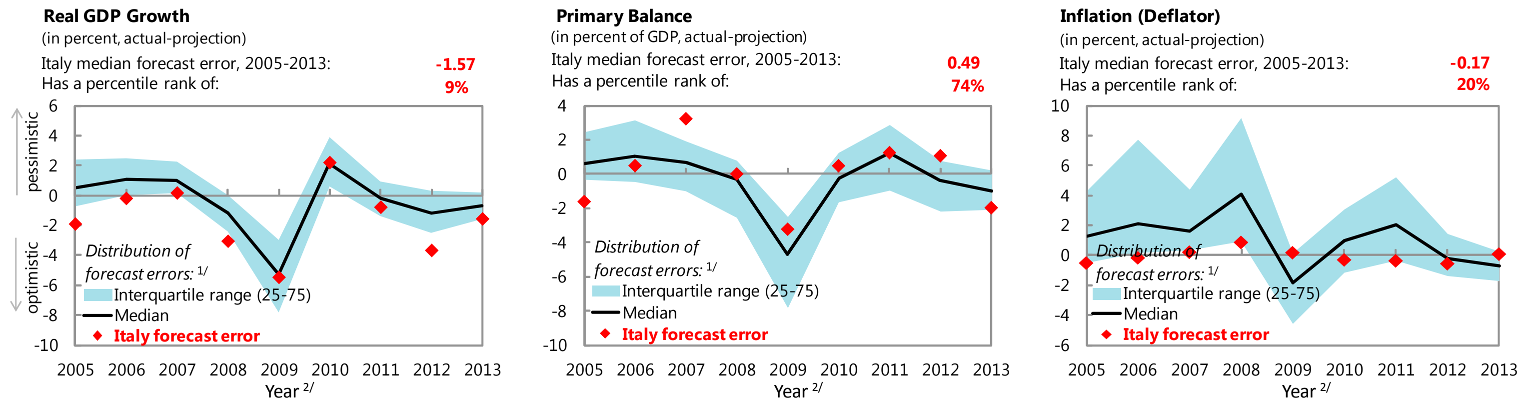
3/ The cell is highlighted in green if country value is less than the lower risk-assessment benchmark, red if country value exceeds the upper risk-assessment benchmark, yellow if country value is between the lower and upper risk-assessment benchmarks. If data are unavailable or indicator is not relevant, 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, 1/1/2014 through 4/1/2014.

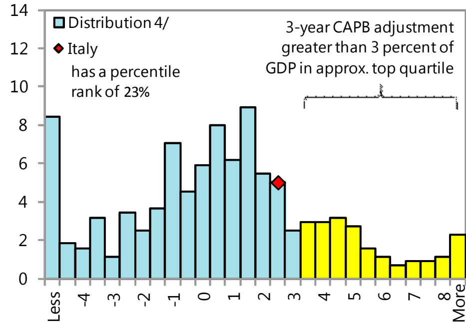
Figure 2. Italy: Public DSA – Realism of Baseline Assumptions

Forecast Track Record, versus surveillance countries

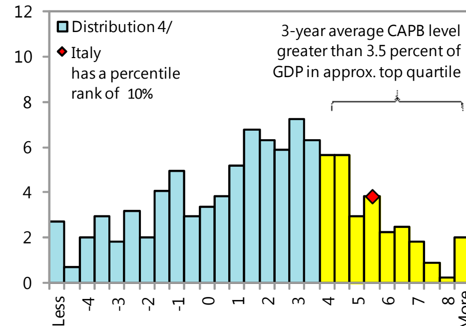


Assessing the Realism of Projected Fiscal Adjustment

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

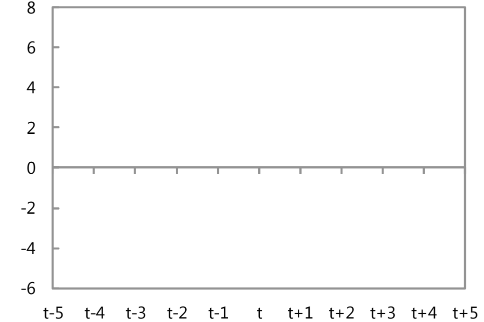


3-Year Average Level of Cyclically-Adjusted Primary Balance (CAPB)
(Percent of GDP)



Boom-Bust Analysis 3/

Real GDP growth
(in percent)
Italy



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.

Figure 3. Italy: Public Sector Debt Sustainability Analysis (DSA)—Baseline Scenario

(in percent of GDP unless otherwise indicated)

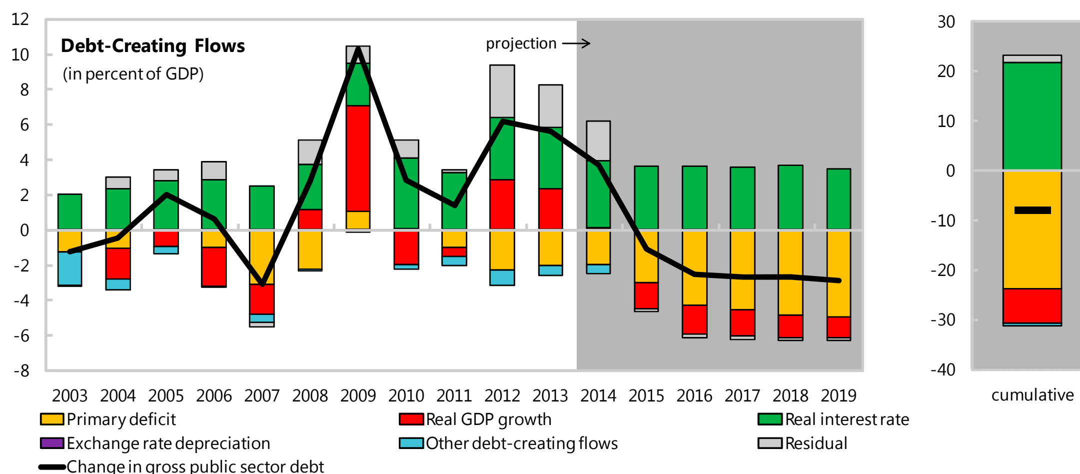
Debt, Economic and Market Indicators [1/]

	Actual			Projections					
	2003-2011 [2/]	2012	2013	2014	2015	2016	2017	2018	2019
Nominal gross public debt	109.5	126.9	132.5	136.2	135.2	132.7	130.0	127.4	124.5
Public gross financing needs	24.2	26.1	23.0	24.4	23.8	19.6	22.6	17.5	23.0
Real GDP growth (in percent)	0.2	-2.4	-1.9	-0.1	1.1	1.3	1.2	1.0	1.0
Inflation (GDP deflator, in percent)	2.0	1.6	1.4	1.1	1.2	1.4	1.4	1.5	1.6
Nominal GDP growth (in percent)	2.2	-0.8	-0.4	1.0	2.4	2.7	2.6	2.5	2.6
Effective interest rate (in percent) [4/]	4.6	4.4	4.1	4.0	4.0	4.2	4.2	4.4	4.4

As of April 01, 2014		
Sovereign Spreads		
Spread (bp) 3/		189
CDS (bp)		126
Ratings	Foreign	Local
Moody's	Baa2	Baa2
S&Ps	BBB	BBB
Fitch	BBB+	BBB+

Contribution to Changes in Public Debt

	Actual			Projections							
	2003-2011	2012	2013	2014	2015	2016	2017	2018	2019	cumulative	debt-stabilizing primary balance [9/]
Change in gross public sector debt	1.7	6.21	5.63	3.7	-1.1	-2.5	-2.7	-2.6	-2.9	-8.0	
Identified debt-creating flows	1.1	3.22	3.19	1.4	-0.9	-2.3	-2.5	-2.5	-2.7	-9.4	
Primary deficit	-1.0	-2.3	-2.0	-2.0	-3.0	-4.3	-4.6	-4.9	-5.0	-23.8	2.3
Primary (noninterest) revenue and gra	48.6	51.2	51.3	51.7	51.7	51.9	52.0	52.0	51.9	311.2	
Primary (noninterest) expenditure	47.6	49.0	49.3	49.7	48.6	47.6	47.5	47.1	46.9	287.5	
Automatic debt dynamics [5/]	2.5	6.4	5.8	3.9	2.2	2.0	2.1	2.4	2.3	14.9	
Interest rate/growth differential [6/]	2.5	6.4	5.8	3.9	2.2	2.0	2.1	2.4	2.3	14.9	
Of which: real interest rate	2.7	3.5	3.5	3.8	3.6	3.6	3.6	3.7	3.5	21.8	
Of which: real GDP growth	-0.2	2.9	2.4	0.1	-1.5	-1.7	-1.5	-1.3	-1.2	-6.9	
Exchange rate depreciation [7/]	0.0	0.0	0.0	…	…	…	…	…	…	…	
Other identified debt-creating flows	-0.5	-0.9	-0.6	-0.5	0.0	0.0	0.0	0.0	0.0	-0.5	
Privatization receipts (negative)	-0.3	-0.5	-0.1	-0.3	0.0	0.0	0.0	0.0	0.0	-0.3	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Other debt flows (incl. ESM and Euro	-0.2	-0.4	-0.5	-0.2	0.0	0.0	0.0	0.0	0.0	-0.2	
Residual, including asset changes [8/]	0.6	3.0	2.4	2.3	-0.2	-0.2	-0.2	-0.2	-0.2	1.4	



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.

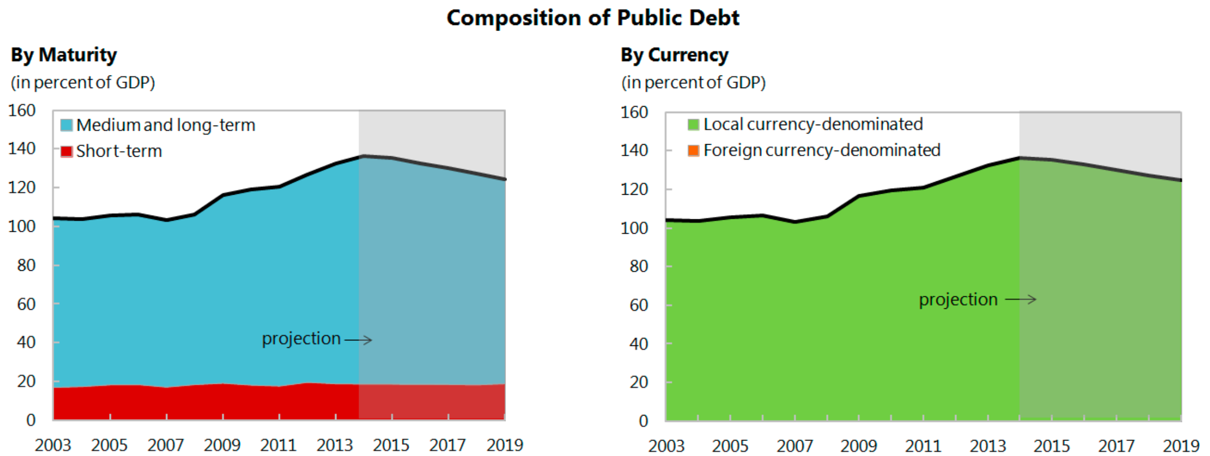
7/ The exchange rate contribution is derived from the numerator in footnote 2/ as ae(1+r).

8/ In 2013 and for projections, this line includes EFSF gurantees, arrears clearance payments, and exchange rate changes.

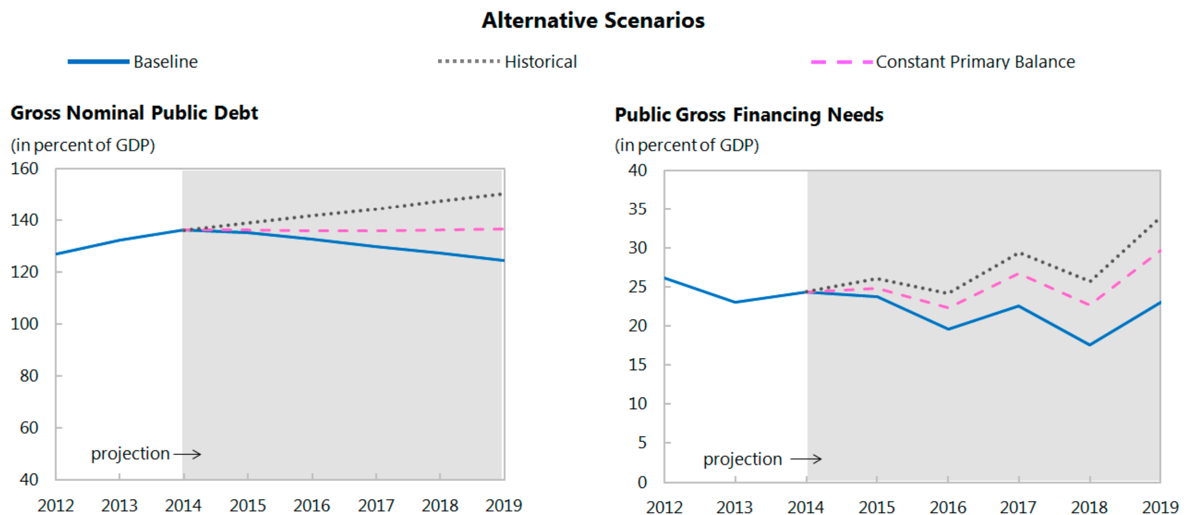
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Figure 4. Italy: Public DSA – Composition of Public Debt and Alternative Scenarios

Composition of Public Debt



Alternative Scenarios



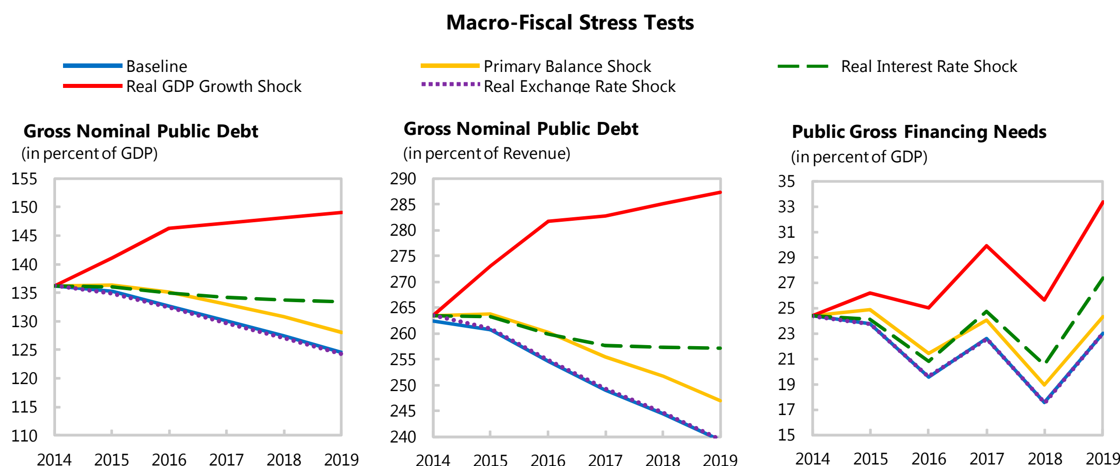
Underlying Assumptions
(in percent)

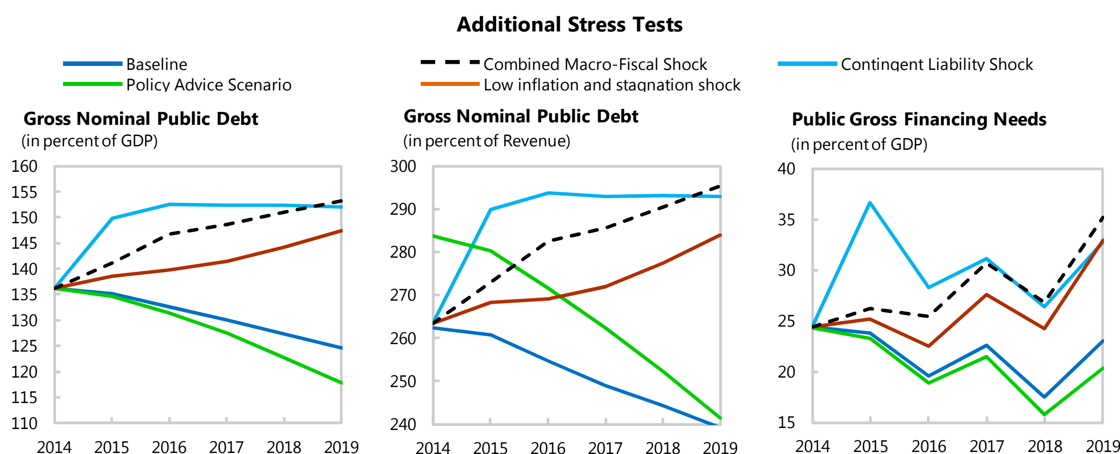
Baseline Scenario	2014	2015	2016	2017	2018	2019
Real GDP growth	-0.1	1.1	1.3	1.2	1.0	1.0
Inflation	1.1	1.2	1.4	1.4	1.5	1.6
Primary Balance	2.0	3.0	4.3	4.6	4.9	5.0
Effective interest rate	4.0	4.0	4.2	4.2	4.4	4.4
Constant Primary Balance Scenario						
Real GDP growth	-0.1	1.1	1.3	1.2	1.0	1.0
Inflation	1.1	1.2	1.4	1.4	1.5	1.6
Primary Balance	2.0	2.0	2.0	2.0	2.0	2.0
Effective interest rate	4.0	4.0	4.2	4.2	4.4	4.3

Historical Scenario	2014	2015	2016	2017	2018	2019
Real GDP growth	-0.1	-0.2	-0.2	-0.2	-0.2	-0.2
Inflation	1.1	1.2	1.4	1.4	1.5	1.6
Primary Balance	2.0	1.2	1.2	1.2	1.2	1.2
Effective interest rate	4.0	4.0	4.2	4.2	4.3	4.3

Source: IMF staff.

Figure 5. Italy: Public DSA—Stress Tests





Underlying Assumptions
(in percent)

Primary Balance Shock	2014	2015	2016	2017	2018	2019
Real GDP growth	-0.1	1.1	1.3	1.2	1.0	1.0
Inflation	1.1	1.2	1.4	1.4	1.5	1.6
Primary balance	2.0	2.0	3.0	4.3	4.6	4.9
Effective interest rate	4.0	4.0	4.3	4.3	4.5	4.4
Real Interest Rate Shock						
Real GDP growth	-0.1	0.7	0.9	0.8	0.6	0.6
Inflation	1.1	1.2	1.4	1.4	1.5	1.6
Primary balance	2.0	2.8	3.9	4.0	4.1	4.0
Effective interest rate	4.0	4.0	4.6	4.8	5.1	5.1
Combined Shock						
Real GDP growth	-0.1	-1.4	-1.2	0.8	0.6	0.6
Inflation	1.1	0.6	0.8	1.4	1.5	1.6
Primary balance	2.0	1.5	1.3	1.6	1.9	2.0
Effective interest rate	4.0	4.0	4.6	4.8	5.1	5.2
Policy Advice Scenario						
Real GDP growth	-0.1	1.1	1.5	1.7	2.0	2.0
Inflation	1.1	1.2	1.4	1.4	1.5	1.6
Primary balance	2.1	3.5	4.8	5.2	5.7	5.8
Effective interest rate	4.0	4.0	4.2	4.2	4.4	4.3

Real GDP Growth Shock	2014	2015	2016	2017	2018	2019
Real GDP growth	-0.1	-1.4	-1.2	1.2	1.0	1.0
Inflation	1.1	0.6	0.8	1.4	1.5	1.6
Primary balance	2.0	1.5	1.3	1.6	1.9	2.0
Effective interest rate	4.0	4.0	4.3	4.4	4.7	4.7
Real Exchange Rate Shock						
Real GDP growth	-0.1	1.1	1.3	1.2	1.0	1.0
Inflation	1.1	1.5	1.4	1.4	1.5	1.6
Primary balance	2.0	3.0	4.3	4.6	4.9	5.0
Effective interest rate	4.0	4.0	4.2	4.3	4.4	4.4
Contingent Liability Shock						
Real GDP growth	-0.1	-0.1	0.0	1.2	1.0	1.0
Inflation	1.1	0.9	1.1	1.4	1.5	1.6
Primary balance	2.0	-9.2	2.8	3.1	3.4	3.5
Effective interest rate	4.0	4.2	5.0	4.8	4.9	4.8
Low inflation and stagnation shock						
Real GDP growth	-0.1	-0.1	0.6	0.5	0.3	0.3
Inflation	1.1	0.6	0.8	0.8	0.9	1.0
Primary balance	2.0	2.1	2.8	2.5	2.1	1.6
Effective interest rate	4.0	4.0	4.4	4.5	4.7	4.7

Source: IMF staff.

	Italy – External Sector Report Assessment	Overall Assessment
Foreign asset and liability position and trajectory	**Background**. Italy's net international investment position (NIIP) has deteriorated by 16 percent of GDP since joining the Euro area, with net liabilities of 29 percent of GDP (September 2013) as compared with 13 percent at end 2000. 1/ Modest current account surpluses forecast over the medium-term will gradually shrink Italy's net liability position as a share of GDP. At 123 percent of GDP, Italy's external debt is in line with the Euro area as a whole; however the composition of external debt, of which 40 percent is owed by the government, underscores the vulnerabilities related to the high level of public sector debt. 2/ **Assessment**. In light of the current account's shift into small surplus, overall external sustainability is not a concern; however, some further strengthening of balance sheet is desirable. Italy is vulnerable to financial contagion given its large stock of government debt and the large share held by non-residents.	**Overall Assessment**: *The external position is broadly consistent but likely still weaker than suggested by medium-term fundamentals and desirable policy settings.* This assessment is supported by Italy's weak productivity and competitiveness indicators. In particular, stronger growth, consistent with reducing high unemployment and public debt, while strengthening the external balance sheet, would require a modest weakening of the real effective exchange rate. Part of the needed adjustment may reflect Italy's weak competitive position within the Euro area, where relative price effects may be magnified by the existence of a common currency. **Potential policy responses**: Implementation of structural reforms will be critical to improving competitiveness and boosting potential growth. Continued progress in medium-term fiscal consolidation will also help close the competitiveness gap and maintain investor confidence. Combined, these measures will support growth and employment over the medium-term.
Current account	**Background**. Italy's current account (CA) averaged a deficit of 2 percent of GDP over the past decade, and moved into balance starting in 2012. In 2013, the current account registered a surplus of 1 percent of GDP. The improvement in the current account reflects a modest trade surplus starting in 2012 (growing to more than 2 percent in 2013), owing both to higher exports and subdued imports, while the deficit in incomes and (EU) transfers continued. In terms of saving and investment, declining investment accounted for about three-fourths of the improvement in the current account, while increased public saving more than offset lower private saving. **Assessment**. With the recent improvement in the current account, the EBA model suggests the cyclically-adjusted level was very near balance (0.3 percent of GDP) in 2013, essentially matching the EBA-estimated norm implied by medium-term fundamentals and desirable policy settings. Given the need for stronger growth to reduce the high public debt and unemployment over the medium term, while improving the external balance sheet, staff assesses a gap of -1.5 to 0 percent of GDP.	
Real exchange rate	**Background**. Stagnant productivity and rising labor costs have resulted in a gradual appreciation of the real effective exchange rate (REER) since joining the Euro area, both in absolute terms and relative to the Euro area average. A comparison of price-based indices suggests misalignment on the order of 0 to 10 percent, with labor-based indicators showing a much wider gap than other price-based measures. **Assessment**. The EBA methodologies provide estimates of REER gaps of +3 percent (overvaluation, from the REER regression method) to -1 percent (undervaluation, from the CA regression method). On balance, and consistent with the staff assessment of the CA, a real effective depreciation of 0-5 percent would support further adjustment and address economic imbalances over the medium-term.	
Capital and financial accounts: flows and policy measures	**Background**. Portfolio and other-investment inflows typically have financed the current account deficit, and a modest net FDI outflow, without much difficulty. Over 2011-12, however, banks had difficulties raising funds in international markets, resulting in an increased reliance on euro system refinancing. As conditions in the Euro area stabilized starting in late-2012, TARGET2 liabilities have declined. Foreign investment in portfolio debt securities turned positive in 2013, following two consecutive years of outflows, led by investment in government securities. **Assessment**. Italy remains vulnerable to a loss in market confidence, owing to the large refinancing needs of the sovereign and banking sectors, and tight credit conditions from financial fragmentation.	
FX intervention and reserves level	**Background**. The euro has the status of a global reserve currency. **Assessment**. Reserves held by the euro area are typically low relative to standard metrics, but the currency is free floating.	

	Italy (continued)
Technical Background Notes	1/ The NFA position is somewhat more negative, at about -34 percent of GDP in 2012, than the NIIP position of about -28 percent of GDP in that year. While not very negative in relative terms, a stronger NIIP position would help reduce vulnerabilities to financial contagion. 2/ Total gross external liabilities are about 152 percent of GDP (2012), of which external debt represents about fourth-fifths.

Appendix I. Progress Against IMF Recommendations

Table 1. Italy: Progress Against IMF Recommendations

	2013 Art. IV Policy Advice	Actions since 2013 Art. IV	Next steps
	Structural Reforms to Improve the Business Environment		
Labor market	Improve active labor market policies through better coordination and information sharing	Jobs Act outlines principles to improve ALMPs. Youth Guarantee recently launched aims at improving training opportunities	Turn principles into an actionable plan including the proposed national coordination center
	Simplify contracts by shifting to a more flexible, single contract for new workers with gradually increasing protection	Jobs Act proposes a review of contract types and opens the door to experimental use of a contract with gradually increasing protection	Develop specific proposals and implement them
	Decentralize wage setting by operationalizing June 2011 agreement	In 2014 social partners agreed upon a Consolidated Act on Representation.	Move to an opt-in system for collective bargaining
	Boost female labor participation by reducing marginal tax rate for married second-earners	Jobs Act introduces tax credit for working women with children and family income below a certain threshold	....
Product markets	Complete steps to: appoint transport regulators; enhance competition in the electricity sector; reform the legal profession	The Transportation Authority's board is staffed and operational	Needs full implementation, especially at the regional and local level
	Accelerate opening of professional services	Reform of professional services was approved but needs further implementation	Needs full implementation
Public Services	Accelerate the privatization agenda, especially at the local level	Stocktaking exercise is ongoing	Be pragmatic: identify local governments with weak balance sheets and assets most in need of restructuring and take concrete actions
Judicial System	Conduct a comprehensive review of court fees	None. Judicial reforms to be unveiled in June	Comprehensive assessment of court fees, which remain modest and capped
	Develop and use performance indicators for all courts	None. Judicial reforms to be unveiled in June	Develop indicators and use them for court management and accountability purposes
	Align appeals system with international practice	A task force is studying options to reform the appeal system	Rationalize appeals system
EU-level	Strengthen common market through implementation of the Services Directive		

Fiscal policy - Reducing Vulnerabilities and Supporting Growth			
Rebalancing the budget	Implement a bottom-up spending review to improve efficiency of public sector and find additional savings	A recent spending review identified medium-term savings of 34 billion EUR covering subsidies, defense, SOE management, health, pension and housing. Some policy decisions approved for 2014.	Take policy decision on identified measures to achieve savings. Make spending review a permanent process combined with binding expenditure ceilings, to improve efficiency of spending allocations.
	Broaden the tax base by rolling back tax expenditures, review cadastral values and increase the inheritance tax	A tax reform bill that includes a review of cadastral values has been approved. Some subsidies identified in the spending review are tax expenditures.	Update cadastre as soon as possible. Take policy decisions on tax expenditure, especially VAT reduced rates and exempt regimes
	Lower marginal tax rates on labor and capital	PIT credit of 7 billion euro has been implemented for 2014 and measure is planned to make this permanent; 2014 budget increased ACE	Labor tax wedge should be reduced - with a focus on social security contributions
	Undertake well-targeted increase in public investment	Announced	Budget neutral rebalancing towards investment, labor market policy and education
Fiscal Stance	Build a primary surplus buffer over the medium-term by targeting a 1 percent of GDP structural surplus	The structural balance in 2014 is estimated at -0.6 (authorities' definition) and is planned to be narrowed to -0.1 percent of GDP, short of the strucutral balance rule.	Additional fiscal effort of up to 1/2 percent of GDP in 2015, if economic conditions allow, would help place debt firmly on a downward path and achieve the zero structural balance rule while building a buffer gradually over medium-term
PFM	Adopt a binding multi-year expenditure ceiling	Expenditure plans continue to be revised frequently. Discussions are ongoing for a Medium Term expenditure Framework.	Integrate spending review process with regular budget in a multi-year fiscal framework.
	Select qualified board members for the Parliamentary Budget Office and integrate PBO activities in the budget cycle	Three board members were selected in April.	The PBO should build capacity to measure progress against fiscal rule and establish a record of independent analysis. Integration of work program with the budget process is important.
Tax evasion	Further strengthen AML tools, broadening the scope of false accounting offenses and providing the revenue authorities with access to suspicious transaction reports	The tax reform bill has provisions broadening the scope of false accounting offenses	Revenue authorities should be able to undertake more targeted controls with greater information sharing with other public bodies while respecting confidentiality

	Banking Sector - Strengthening Balance Sheets to Revive Lending		
Tackling NPLs	Enhance provisioning and write-offs by expanding BOI inspections, publishing guidance on provisioning and strengthening prudential considerations	There is no information on whether the BOI special inspections were expanded to mid-tier banks	Enhance provisioning and write-offs by expanding BOI inspections to banks outside the AQR, issuing guidelines on provisioning and write-offs.
	Increase the tax deductibility of loan losses	Tax changes reduce the period in which loan-loss provisions are tax deductible to 5 years from the previous 18 years	Ensure deductibility of loan loss provisions the year provisions are booked
	Expedite judicial process by expanding use of specialized insolvency courts, greater use of on-line filing and introduction of best practice guidelines	....	Expedite judicial process by expanding use of specialized insolvency courts, greater use of on-line filing and introduction of best practice guidelines
Bank Buffers	Targeted action to support bank capital and prepare for the AQR. At the euro zone level, extension of an LTRO of sufficient tenor	As of April, 8 of the 15 banks covered by the AQR have announced capital raising plans	
Reducing Moral Hazard	Attach strict conditionality to public support for problem banks (bail-in of shareholders and junior debt-holders, replacing the board and management, restricting dividends, and targets for capital raising)	The authorities will align national policy and practice with the BRRD when it comes into effect in 2015	
	Monitor implementation of MPS restructuring plan and take action if targets are missed	MPS Foundation has reduced its share from 30 to 3 percent. Capital of 5 billion euros has been raised and state aid has been mostly repaid.	Continue to follow implementation of MPS restructuring plan
Corporate Governance	Cap on leverage and strict diversification rules for Foundations. Stringent fit and proper tests for directors and controlling shareholders. Cooperative banks should be converted to joint stock companies	New rules improve "fit and proper tests" for directors and strengthen role of independent Board members. Cooperative bank boards are made more representative. Status of a law to reform Foundations is unclear.	Cap on leverage, disclosure, strict diversification rules and supervision for Foundations. Cooperative banks should be converted to joint stock companies
Supporting SMEs	Monitor the expansion of public credit guarantees for SMEs and strengthen the fee system	....	Reform public support programs; encourage alternative market funding sources; remove obstacles to SME start-up and up-scaling ; and facilitate restructuring.
	ECB should consider LTRO linked to SME lending or direct purchase of select private assets	Recent ECB easures (T-LTRO) is expected to provide significant liquidity.	

Appendix II. Italy—Key FSAP Technical Recommendations

Recommendations	Implementation
Banking	
Issue prudential guidance to ensure a minimum level of harmonization in loan loss provisions and write-off practices [BI]	Not implemented. The supervisory responsibility, including for minimum prudential standards on provisioning, will be transferred to the SSM in fall
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]	Not implemented. Actions have been taken by BoI to strengthen the banks' corporate governance rules also in respect of the role of foundations, for example by increasing the role of independent bank board members, strengthening the boards' assessment on individual and collective skills and competences. The role of the foundations has also diminished, as banks have sought outside sources of capital.
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]	A draft Decree pending parliament's approval will address the second recommendation: the duty for directors to abstain in any decision in which they have a conflict of interest will be expressly introduced.
Gradually increase the tax deductibility of bank provisions in the same tax year [Parliament/MEF]	Tax deductibility of bank provisions has accelerated up from 18 years to 5 years and deductibility is also permitted for the regional tax on productive activities.
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]	The restructuring plan to restore viability is still ongoing. The bank has raised 5 billion EUR in capital and reimbursed most of its State Aid (the remainder is due by early 2015).
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]	A draft Decree pending parliament's approval will address this recommendation, introducing changes to the Banking Law and the Law on Finance on this matter.
Clarify in supervisory guidance for licensing that the assessment of financial suitability of major shareholders include the capacity to provide additional capital [BI]	The new supervisory regulation on licensing (BI Circular no. 285/2013) imposes BI to assess, by reference to the qualifying holdings provisions, also the capacity of major shareholders to ensure the financial soundness of the institution, when granting the authorization to perform banking activities. This new regulation will have to be translated into the supervisory practice.
Adopt a dedicated group supervisory approach for the nationally significant	IVASS has introduced a risk sensitive framework, through a secondary regulation and changes to its internal

insurers [IVASS]	supervisory handbook.
Increase use of onsite inspections of ISPs, including assets managers [Consob, BI]	In 2013, the number of inspections was increased to 34 (against 29 in 2012). In 2014, 32 inspections are planned.
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]	A draft Decree pending parliament's approval will address this recommendation.
Amend law to enable supervisors to remove individual board members, officers, and auditors of financial institutions [Parliament/MEF]	A draft Decree pending parliament's approval will address this recommendation, with the exception for the auditors.
Introduce risk sensitivity in the current solvency framework for insurers in anticipation of the EU implementation of Solvency II [IVASS]	The European Solvency II framework will introduce risk sensitivity in the current solvency framework. In the meantime, IVASS updated its national regulatory framework on Pillar 2 and issued a soft regulation (letter to the market) on Pillar 1 and Pillar 3 issues.
Financial safety nets	
Provide a statutory basis and detailed guidelines for RRPs to be prepared by all systemically important banks [MEF, BI]	The European Bank Recovery and Resolution Directive, approved at the European level in April 2014, will implement this recommendation, starting in January 2015 (January 2016 for bail-in tools). National authorities shall adopt and publish the relevant laws and regulation by December 2014.
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]	Same answer as above.
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]	The DGS Directive that has been approved at the European level will partially implement this recommendation (i.e. ex ante funding).

INTERNATIONAL MONETARY FUND

ITALY

August 22, 2014

STAFF REPORT FOR THE 2014 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

Prepared By

European Department
(In consultation with other departments)

CONTENTS

FUND RELATIONS 2

STATISTICAL ISSUES 4

FUND RELATIONS

(as of July 30, 2014)

Mission: Rome, Naples, and Milan, June 5–June 18, 2014. The concluding statement of the mission is available at: http://www.imf.org/external/np/ms/2014/061714b.htm

Staff team: Messrs. Kang (head), Lanau and Tyson, Ms. Tuladhar (all EUR), Mr. Esposito (LEG), Ms. Jassaud (MCM), Mr. Chevauchez (FAD) and, Ms. Segal (SPR). Mr. Husain (EUR) also joined for a few days. Mr. Montanino (OED) attended the policy meetings.

Country interlocutors: Finance Minister Padoan, 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; Parliamentary Budget Committee Technical Group; Fiscal Council; Regional Governments of Lombardia and Campania; Association of Municipalities – Fondazione IFEL; major Italian banks; rating agencies; the Securities and Exchange Commission (CONSOB); the Antitrust Authority; Consiglio Nazionale Forense; Court of Naples; 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 June 24–July 4, 2013. The associated Executive Board's assessment is available at: http://www.imf.org/external/np/sec/pr/2013/pr13362.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	6,019.41	76.37
Reserve Tranche Position	1,863.05	23.64
Lending to the Fund		
New arrangements to borrow	1,792.63	

SDR Department:	SDR Million	Percent Allocation
Net cumulative allocation	6,576.11	100.00
Holdings	6,140.45	93.38

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				
	2014	2015	2016	2017	2018
Principal					
Charges/Interest	0.19	0.39	0.39	0.39	0.39
Total	0.19	0.39	0.39	0.39	0.39

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 June 24-July 4, 2013, and the staff report (Country Report No. 13/298, 09/27/13) was discussed on September 25, 2013.

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. 13/300

STATISTICAL ISSUES

ITALY—STATISTICAL ISSUES APPENDIX As of July 20, 2014
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 July 25, 2014)

	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	July 2014	July 2014	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	June 2014	July 2014	M	M	M		
Reserve/Base Money	May 2014	July 2014	M	M	M	O,O,LO,LO	O,O,O,O,LO
Broad Money	May 2014	July 2014	M	M	M		
Central Bank Balance Sheet	May 2014	July 2014	M	M	M		
Consolidated Balance Sheet of the Banking System	May 2014	July 2014	M	M	M		
Interest Rates[2]	July 2014	July 2014	D	D	D		
Consumer Price Index	June 2014	July 2014	M	M	M	O,O,O,O	LO,O,LO,O,O
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	Q1 2014	June 2014	Q	Q	Q	LO,O,LO,O	LO,O,O,O,LO
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	June 2014	July 2014	M	M	M		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	June 2014	July 2014	M	M	M		
External Current Account Balance	May 2014	July 2014	M	M	M	O,LO,LO,O	LO,O,LO,O
Exports and Imports of Goods and Services	May 2014	July 2014	M	M	M		
GDP/GNP	Q2 2014	July 2014	Q	Q	Q	O,O,O,O	LO,LO,O,O,O
Gross External Debt	Q1 2014	May 2014	Q	Q	Q		
International Investment position[6]	Q1 2014	June 2014	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.

Press Release No. 14/430
FOR IMMEDIATE RELEASE
September 18, 2014

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

IMF Executive Board Concludes Article IV Consultation with Italy

On September 12, 2014, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with Italy.

The economy is struggling to emerge from a balance sheet recession. GDP contracted in the first half of the year but business surveys and resilient exports suggest a gradual increase in economic activity in coming quarters. Against the background of significant economic slack, inflation fell well below one percent and unemployment reached 12.3 percent. Sovereign spreads narrowed but financing conditions remain very tight for the corporate sector (especially for small and medium enterprises, SMEs) and non-performing loans (NPLs) continue to increase. Growth is expected to pick up to 1.1 percent in 2015 as credit conditions normalize and the effects of the easing measures by the European Central Bank (ECB) are felt. Risks are still tilted to the downside and include geopolitical tensions and the possibility of stagnation and low inflation

Prime Minister Renzi has outlined a bold reform agenda—firm implementation is now essential to create jobs, increase productivity, and lift potential growth from a low estimate of about ½ percent. The first phase of the labor market reform focused on increasing flexibility at the margin and future measures will explore a contract with gradually increasing protection and improve active labor market policies. Reforms in the judicial system and the public administration are in progress and competition-enhancing reforms are to be legislated soon. Implementing structural reforms simultaneously would be self-reinforcing and generate significant growth synergies.

The nominal budget deficit is expected to be around 3 percent of GDP this year. In structural terms, a deficit of 0.8 percent of GDP is expected. Public debt will peak this year at about 136 percent of GDP and is projected to decline thereafter. The passage of the *delega fiscale* establishes a framework for simplifying and improving the tax system and will be an important tool to achieve a growth-friendly fiscal rebalancing.

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board.

Executive Board Assessment[2]

Executive Directors noted that the Italian economy has yet to emerge from a prolonged recession and prospects remain uncertain with downside risks. Unemployment remains high and inflation has declined further. Meanwhile, tight credit conditions, weak corporate balance sheets, and deeply-rooted structural rigidities continue to weigh on domestic demand. Directors considered that the high level of public debt has magnified these challenges.

Against this backdrop, Directors agreed that deep structural changes are needed to unleash Italy's growth potential, secure a recovery, and address debt overhang issues. They welcomed the bold policy agenda set out by the new government. The proposed changes to the labor market, the judicial system, the public sector, and the electoral law are important steps for supporting future growth.

Directors stressed the urgency of labor market reforms to reduce duality and increase flexibility, building on recent gains. They saw the benefits of options such as simplified labor contracts with gradually increasing protection, and decentralized wage setting to promote firm-level wage bargaining and better align wages to productivity.

Directors welcomed initiatives to improve the business climate. They emphasized in particular the importance of judicial reforms, aimed at improving court efficiency and facilitating corporate restructuring. Directors supported continued efforts to enhance competition, especially in the retail and service sectors, and to strengthen the anti-corruption legal framework.

Directors agreed that cleaning up banks' bad loans remains an immediate priority. They encouraged more provisioning and write-offs, development of a private market for distressed debt, and an enhanced insolvency regime. Directors supported steps to improve corporate governance and promote diversification of financing sources through deeper capital markets.

Directors saw a broad strategy to reinvigorate the small- and medium-sized enterprise sector as a complement to financial sector reforms. They encouraged the authorities to provide restructuring support for viable but distressed firms, and facilitate a smooth exit for those that are not viable. Directors noted that steps to strengthen collateral enforcement would help support new financing.

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

Directors commended the Italian authorities for the remarkable fiscal consolidation over the past few years. Going forward, they underscored the need for fiscal policy to strike a balance between securing near-term growth and setting the debt ratio on a downward path over the medium term. In this regard, they agreed that the priority for growth-friendly adjustment should be to create space for lowering marginal tax rates through spending savings and lower tax expenditures. At the same time, Directors considered that, given the environment of low growth, high real interest rates, and large financing needs, it would be prudent to build up a structural balance buffer once the recovery firmly takes hold. Directors supported ongoing fiscal reforms, notably the planned expenditure review, efforts to fight tax evasion, and the intention to introduce a medium-term expenditure framework.

Italy: Summary of Economic Indicators, 2011—19 1/

(Annual percentage change, unless noted otherwise)

	2011	2012	2013	2014	2015	2016	2017	2018	2019
				Projections					
Real GDP	0.4	-2.4	-1.9	-0.1	1.1	1.3	1.2	1.0	1.0
Real domestic demand									
Public consumption	-1.3	-2.6	-0.8	-0.1	-0.5	-0.1	-0.1	0.0	0.0
Private consumption	-0.3	-4.0	-2.6	-0.1	0.6	1.0	1.0	0.8	0.7
Gross fixed capital formation	-2.2	-8.0	-4.7	-1.1	1.8	3.3	3.0	2.4	1.9
Final domestic demand	-0.9	-4.5	-2.6	-0.3	0.6	1.2	1.1	0.9	0.7
Stock building 2/	-0.1	-0.6	-0.1	-0.4	0.1	0.0	0.0	0.0	0.1
Net exports 2/	1.5	2.6	0.8	0.5	0.4	0.1	0.1	0.1	0.1
Exports of goods and services	6.2	2.1	0.1	3.0	3.6	3.7	3.6	3.5	3.4
Imports of goods and services	0.8	-7.0	-2.8	1.4	2.5	3.8	3.8	3.7	3.6
Resource utilization									
Potential GDP	0.1	-0.9	-0.4	-0.1	0.0	0.2	0.5	0.6	0.6
Output gap (percent of potential)	-1.3	-2.8	-4.2	-4.2	-3.2	-2.1	-1.5	-1.0	-0.6
Employment	0.4	-0.3	-2.1	-0.1	1.2	1.3	1.3	1.2	1.0
Unemployment rate (percent)	8.4	10.7	12.2	12.6	12.0	11.3	10.5	9.8	9.2
Prices									
GDP deflator	1.4	1.6	1.4	1.1	1.2	1.4	1.5	1.5	1.6
Consumer prices	2.9	3.3	1.3	0.4	1.0	1.1	1.3	1.5	1.6
Hourly compensation 3/	3.3	1.9	2.8	0.8	1.4	1.5	1.7	1.9	2.0
Productivity 3/	1.0	-0.8	-0.2	0.2	0.3	0.4	0.2	0.2	0.3
Unit labor costs 3/	2.3	2.7	3.0	0.6	1.0	1.1	1.5	1.7	1.7
Fiscal indicators									
General government net lending/borrowing 4/	-3.6	-2.9	-3.0	-3.0	-2.1	-1.1	-0.7	-0.5	-0.4
General government primary balance 4/ 5/	1.2	2.5	2.2	2.2	3.2	4.5	4.8	5.0	5.1
Structural overall balance (percent of potential GDP)	-3.7	-1.6	-0.6	-0.8	-0.3	0.0	0.0	0.0	0.0
Structural primary balance (percent of potential GDP) 5/	1.2	3.8	4.5	4.2	4.9	5.4	5.4	5.5	5.4
General government gross debt 4/	120.7	127.0	132.5	136.4	135.4	132.9	130.2	127.6	124.7
Exchange rate regime				Member of EMU					
Exchange rate (national currency per U.S. dollar)	0.7	0.8	0.7	...	...	...	...	...	...
Nominal effective rate: CPI based (2000=100)	101.6	99.1	101.3	...	...	...	...	...	...
External sector 4/									
Current account balance	-3.0	-0.3	1.0	1.5	1.5	1.2	0.9	0.5	0.1
Trade balance	-1.1	1.1	2.4	2.7	2.9	2.8	2.6	2.4	2.2

Sources: National Authorities; and IMF staff calculations.

1/ Staff estimates and projections, unless otherwise noted, based on fiscal consolidation measures included in the government's 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.

Statement by Mr. Andrea Montanino, Executive Director for Italy
September 12, 2014

Introduction

The bulk of the 2014 Article IV Report on Italy is dedicated to a set of reforms aimed at unleashing potential output. In a context where the most significant risks facing the Italian economy in the past few years have receded – thanks to a sizeable fiscal consolidation, the resilience of the banking sector, and strengthened European institutions – a Report tilted towards structural issues is appropriate. As staff notes, structural reforms are the fundamental component of the authorities' agenda. This has been the case for several years now, in a continued effort by the country to overcome all impediments to economic growth. However, this is a long and demanding process: making reforms requires political support, while implementing them takes time and unwavering commitment.

While the track record of the reform efforts undertaken since the outbreak of the crisis is relatively long and consistent, further momentum needs certainly to be gained. Some recent initiatives approved by the government during the most recent period – which are not included in the staff Report – go into this direction. Still, the process is far from complete and will require maintaining a resolute determination, to be extended to the implementation phase and to the monitoring of the results to ensure their effectiveness. At this juncture, it is important that economic policies are carefully calibrated to avoid further weakening economic prospects.

In this broad context, the collaboration between staff and the authorities continued to be excellent. As always, Fund staff recommendations are highly appreciated and are carefully considered in order to inform the policy agenda. Overall, there is broad agreement on the main objectives, priorities, and instruments to be adopted, with some qualifications. In what follows we elaborate on some of the issues touched upon by the Report, noting a few points of disagreement and providing evidence about the renewed reforming efforts of the authorities.

Structural reforms

Judicial

Improving the efficiency of the justice system is a central concern of the Italian authorities. As staff noted, a number of measures have been adopted over the course of recent years and some early positive results can now be seen. However, structural bottlenecks remain and further efforts are in progress. On August 29, 2014 the government presented a new set of measures which are broadly consistent with staff suggestions and include, among others, norms to discourage litigations and to enhance mediation in civil justice and to criminalize false accounting in criminal justice.

From a broader perspective, we were somewhat surprised by the emphasis given to corruption in the public sector in Para. 13 of the Report. The evidence referred to pertains to *perceptions* of corruption, which is a different concept and measure from corruption itself. Besides being challenging, the relevance of such statistics should not be overstated.

Labor market

The reform of fixed-term contracts and of the apprenticeship became law last May making it easier for firms to hire new workers. On other matters, the work is still in progress and should be completed in the coming months. The objectives and instruments of the reform are broadly consistent with staff recommendations, albeit with some differences in emphasis. With respect to the latter, and in particular to the issue of decentralized wage settings – which staff suggests that is somehow neglected – we note that a process of erosion of the centrality of national contracts has been ongoing for several years now. Further improvements are certainly possible, although staff did not consider that last January social parts agreed upon an Act on Representation which will help enforceability of industry-wide and company level agreements. On a more general note, it should be emphasized that a labor market reform was already undertaken in 2012 (*Fornero Reform*). Its provisions – which have been largely implemented – addressed issues related to employment protection, to the duality in the labor market, and to the design of a universal unemployment benefit system. Based on available evidence, the first results of these reforms are positive, but the difficult conditions of the labor market require further reform efforts that the authorities are determined to undertake.

Public Administration

An effective public administration is a pre-requisite for the implementation of structural reforms. On August 7, 2014 the reform provisions envisaged by the government in June were adopted by Parliament. Among others, the main measures are aimed at: i) fostering mobility (voluntary and compulsory) of public sector workers; ii) strengthening caps to salaries of top civil servants; iii) introducing the possibility for the public administration to unilaterally terminate labor contracts with its employees under specific circumstances; iv) disallowing the public administration and enterprises where central or local governments have a stake to assign consultancy contracts to retired workers. The government is determined to implement these provisions steadily and to closely monitor their effectiveness.

Legislative system

It has long been argued that the complexity of the Italian legislative process called for simplification, better coordination among different layers of government, and enhanced accountability. On August 8, 2014 a step forward was achieved: the Senate approved a draft constitutional bill to revise the general provision that assigns equal powers to both chambers of parliament – the House and the Senate – while intervening also on the relations between central and local governments. The House is now examining the draft bill.

Among the measures included in the provision, the following are particularly worth mentioning: i) only the House will be endowed with full legislative powers except for a few topics on which the Senate vote will be relevant; ii) the size of the Senate will shrink from the current 315 to 100 members, which will represent local authorities; iii) Provinces (one of the local governments layers) will be repealed.; iv) indemnities for the Regions' Presidents and for the members of Regional Councils will be capped and the allowances for regional political groups will be abolished.

Competitiveness

As can be inferred from the evidence provided in the previous paragraphs, the authorities fully concur with staff that the key instrument to address the competitiveness gap from which the Italian economy is suffering is the simultaneous pursuit of wide-ranging reforms. In order to inform the right choice of measures, it is important that the issue be assessed through a broad set of indicators. As staff correctly emphasized with an enlightening SIP included in the 2013 Art. IV Report, due to the effects of globalization "labor-cost measures may present an incomplete picture, and should perhaps be complemented" with other indicators. In particular, last year staff advocated for a more comprehensive approach, relying to a large extent on the assessment of export market shares together with other non-price factors. In view of this, with which my authorities fully agree, it is somehow puzzling to note that this year staff referred just to labor cost indicators to argue that "…competitiveness has yet to improve" (Fig. 1, page 7). While improvements are certainly needed, we emphasize that – when assessed through PPI-based measures – Italian competitiveness has improved by around 5 percent since 2008. Furthermore, recent econometric analysis shows that, compared to other measures (including ULCs), PPI-based indicators have a greater power in explaining Italian export dynamics. Finally, we also observe that, according to staff, "Italy's share of global exports increased for the first time since 2007" (page 4). The broad picture is thus rather complex and we remain convinced that a more comprehensive approach is warranted.

On a closely related issue, and in line with staff, we would like to stress that the recent rise of real wages was due to the sizeable decrease of inflation, rather than to nominal wage dynamics. Actually, as shown by some recent empirical research, neither centralized nor firm-level bargaining have been a source of rigidity for wage adjustment to the economic cycle. Of course, the role played by the staggered nature of bargaining rounds has also to be considered. The overall evidence confirms that productivity-enhancing reforms are the right way to tackle the Italian competitive gap.

Financial sector

Over the course of the recent difficult years Italian banks strengthened significantly their capital position relying almost exclusively on contributions by private capital. The share of the public sector has been minimal, reaching only 0.3 per cent of GDP in the first quarter of

2013, a level far below those of most of the other European countries. With the recent repayment of the largest share of the State's loan to Monte dei Paschi di Siena, the public contribution has been substantially wiped out.

As staff noted, in Italy banks play a central role in financing the economy. Their business model – centered on the traditional intermediation of savings, mostly within the country – allowed them to withstand the impact of the crisis, which originated in foreign markets and speculative financial products. Benefitting from the highest standards of supervision, the resilience of the system continued in recent years, despite the heavy toll taken by the effects of the protracted recession and the sovereign debt crisis. The very sharp contraction of GDP hit severely the soundness of many firms, increasing their debt-service burden. The repercussions for banks have been very serious, as shown by the rise of NPLs.

However, despite difficult circumstances, the Italian banking system has been able to absorb the shocks smoothly. Capital strengthening is proceeding, as is required by the new rules on bank capital (Basel 3) in force in the European Union since January. Thanks also to the continued efforts of the supervisory authority, the coverage ratio on NPLs keeps increasing; it reached 42 percent in 2013 (up from 39 percent in 2012). Regulation on the appropriateness of provisioning has been enhanced. It is also encouraging to note that the inflow of new bad debt has been declining since the third quarter of 2013.

Looking forward, further strengthening banks' capital necessitates increasing profitability, as pointed out by staff. The supervisor keeps encouraging banks to reduce their operational costs. In the last few years, progress on rationalization of the branch network and the curbing of administrative and staff expenses allowed to keep costs constant in proportion to revenues. We agree that further efforts have to be pursued along these lines, and we know that banks must reduce the volume of NPLs in order to free up the resources needed to finance the economy. In this respect, we observe that there is growing interest in these assets on the part of specialized investors. They are now willing to pay higher prices than in the past, thanks to the reduction in risk premiums. And banks are prepared to dispose of these loans at lower prices, as a consequence of the increase in provisioning. A positive contribution should come also by recent changes in tax treatment of loan losses. Some disposals of NPLs have already taken place, and others may be well received by national and international investors.

Financing of the economy

In Italy financial conditions are still tight, with hardest credit supply restrictions on small- and medium-sized firms (SMEs). To revive the SMEs sector, the staff Report includes several proposals that – for the most part – aim at complementing several initiatives already undertaken by the authorities. While we agree with many of the staff proposals, we do not concur with staff on the suggestion of "shifting public support schemes away from guarantees and moratorium for existing firms to financing for new firms". At a time when banks are concerned about borrowers' soundness and prospects, the dearth of credit has been

alleviated by the granting of government guarantees, which have the objective of preserving the flow of funding to firms with good growth opportunities. In this regard, we emphasize that the forbearance risks implied in these schemes are quite well controlled, as the access to the measures is precluded to financially distressed firms and the default rate of such schemes is among the lowest of comparable public guarantee schemes around the world.

We also don't agree with staff on the alleged fragmentation of the system of credit registries and bureaus. In fact, the Italian Credit Register ensures a very large coverage – by international standards – of credit activity by banks and other intermediaries granting credit (e.g. the size threshold for loans is 30,000 euro). Data covered only by private credit bureaus are limited to very small loans. From a broader perspective, we welcome staff proposals to develop further capital markets. This is indeed a crucial issue: bank lending cannot be the sole source of funds for the productive economy and several steps have been taken in recent years to address this concern, as also acknowledged by staff.

Fiscal policy

Against the background of the sizeable fiscal consolidation efforts implemented since the beginning of the crisis, Italy's fiscal prudence was confirmed in 2013, when the government continued to keep the deficit below the Maastricht threshold, in line with the official targets.

Looking forward, my authorities remain committed to a prudent and rigorous fiscal policy to keep public finance on a sustainable path; they also reaffirm that the spending review is a strategic tool to this aim. As envisaged by the domestic budgetary process, the government will present shortly by October 1, 2014 the Update to the Economic and Financial Document of last April, which will provide the updated macro-economic and budgetary projections for the Italian economy. Given the current juncture – characterized by more muted international economic perspectives and by the persistent weakness of domestic demand – we need to avoid the risk of further weakening economic conditions, which would perversely add a further heavy burden to Italy's consolidation efforts. For these reasons, we do not concur with staff recommendations that – under the baseline scenario – additional consolidation is needed. Furthermore, we also consider that – in the medium term – the target proposed by staff of a structural surplus of 1 per cent of GDP is not advisable, being well beyond what is requested by the EU fiscal rules, including the debt rule.

Conclusion

Over the course of the last year, the most pressing risks surrounding the outlook for the Italian economy have gradually lessened. The very sizeable consolidation efforts pursued since the outbreak of the crisis have been crucial to achieving this outcome, together with other important factors. While the authorities are firmly determined to consolidate these results, the "supply-side" emphasis of the 2014 Art. IV Report is welcome as a framework towards unleashing the Italian potential output. Indeed, at this juncture the return to a stable

and sustainable growth path is an essential complement to the policies aimed at repairing public and private balance sheets. The growth strategy has to be based on structural reforms and on measures to foster investments and competitiveness, while pursuing budget consolidation.