INTERNATIONAL MONETARY FUND

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ITALY

July 2015

2015 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; 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 2015 Article IV consultation with Italy, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its July 1, 2015 consideration of the staff report that concluded the Article IV consultation with Italy.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on July 1, 2015, following discussions that ended on May 18, 2015, 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 June 16, 2015.
- An **Informational Annex** prepared by the IMF staff.
- A **Statement by the Executive Director** for Italy.

The documents listed below will be released separately.

Selected Issues

The IMF's transparency policy allows for the deletion of market-sensitive information and premature disclosure of the authorities' policy intentions in published staff reports and other documents.

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IMF Executive Board Concludes 2015 Article IV Consultation with Italy

On July, 1, 2015, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with Italy.

The economy is emerging gradually from a prolonged recession. Financial market sentiment and confidence indicators have improved substantially since end-2014. Despite the recent bouts in volatility, sovereign bond yields have fallen to pre-crisis levels buoyed by the European Central Bank's quantitative easing (QE). Bank and corporate funding costs have declined. Rising business and consumer confidence has stemmed the decline in domestic demand. Against this backdrop, the economy is expected to recover moderately, with real GDP projected to expand by 0.7 percent in 2015, supported by domestic demand and net exports. With the favorable tailwinds from QE continuing and investment gaining further momentum, growth is projected to pick up to 1.2 percent in 2016.

Policies at the European level such as QE and more flexibility in the Stability and Growth Pact have been instrumental to support demand. At the national level, Prime Minister Matteo Renzi's government has set out an ambitious agenda to overhaul Italy's political and economic system. The Jobs Act, an overhaul of Italy's labor market, was approved by Parliament in December and has largely been implemented. A new law to convert Italy's largest cooperative banks into joint stock companies has spurred expectations of consolidation in the sector. Reforms of product and services markets, public administration, education, judicial, and tax system are also progressing.

There is now a window of opportunity to push ahead with deeper reforms to re-ignite growth. This requires continued actions and strong implementation efforts on multiple fronts, which are mutually reinforcing. A wide-ranging reform to raise the efficiency of public services is envisaged and would help tackle the long standing productivity problem. Product market reforms in sectors that remain highly regulated such as transportation would also improve productivity. A

[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.

broad-based strategy to strengthen bank and corporate balance sheets, including an enhanced insolvency regime and standard criteria for bank assessments of the viability of small and medium enterprises, will support recovery. Fiscal rebalancing is needed to further reduce the high taxes on labor and capital, through savings from past and ongoing spending reviews.

Executive Board Assessment[2]

Executive Directors commended the authorities for their bold policy actions, which, together with actions at the European level, have contributed to the turnaround of Italy's economy from a prolonged recession and have improved confidence. Nevertheless, the recovery is still fragile, and medium term prospects are held back by structural bottlenecks, high unemployment, weak balance sheets, and elevated public debt. Directors emphasized that addressing these challenges requires full implementation of policy efforts and broad-based structural reforms, building on the many achievements over the past year. They agreed with the focus on raising productivity, strengthening the financial health of banks and corporations; and pursuing growth-friendly fiscal consolidation.

Directors welcomed progress on structural reforms to improve productivity and the business climate, notably in the labor market, public administration, governance, and the judicial and tax systems. They encouraged the authorities to press ahead with the various initiatives to improve public sector efficiency, local public services, and competition in the product and service markets. Directors looked forward to prompt adoption of key draft laws in these areas, particularly those on public administration reform and annual competition.

Directors commended the authorities for the enactment of the Jobs Act, noting that its full implementation will help reduce segmentation and duality, and facilitate the reallocation of workers across jobs. They stressed the importance of completing the planned reforms of the wage supplementation scheme and the educational system. Directors also saw scope for decentralizing wage setting to make labor more responsive to economic conditions.

Directors supported the authorities' comprehensive strategy to strengthen bank and corporate balance sheets, thereby facilitating credit flows to the economy. They considered it a priority to accelerate the reduction of nonperforming loans with decisive actions to improve provisioning, speed up write-offs, revive the market for distressed debt, including through a carefully designed state-backed asset management company, and streamline insolvency procedures. Directors noted the benefits of complementing these measures with targeted action to tackle small- and medium-size enterprises in distress, by introducing standard criteria for bank assessments of their

[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.

viability and guidelines for creditor-led restructuring. Directors welcomed ongoing efforts to improve access to finance and to strengthen governance in the banking and corporate sectors more broadly.

Directors agreed that the current fiscal policy stance strikes the right balance between supporting economic growth and reducing the public debt ratio. They supported measures to lower labor and capital taxes, financed by cuts in spending and efficiency savings, informed by expenditure reviews. Directors looked forward to strict implementation of the 2015 budget, and saw merit in targeting a modest structural surplus over the medium term, complemented with ambitious privatization efforts, with a view to advancing debt reduction, building buffers, and ensuring compliance with EU fiscal rules.

Italy: Selected Economic Indicators[1/]

	2012	2013	2014	2015	2016
Real Economy (change in percent)					
Real GDP	-2.8	-1.7	-0.4	0.7	1.2
Final domestic demand	-4.4	-2.9	-0.6	1.0	1.0
Exports of goods and services	2.3	0.5	2.6	3.3	3.9
Imports of goods and services	-8.1	-2.3	1.8	3.1	3.2
Consumer prices	3.3	1.3	0.2	0.2	0.9
Unemployment rate (percent)	10.6	12.2	12.7	12.5	12.2
Public Finances					
General government net lending/borrowing 2/	-3.0	-2.9	-3.0	-2.7	-2.1
Structural overall balance (percent of potential GDP)	-1.5	-0.5	-0.8	-0.5	-0.3
General government gross debt 2/	123.1	128.5	132.1	133.3	132.1
Balance of Payments (percent of GDP)					
Current account balance	-0.4	0.9	1.9	2.3	2.3
Trade balance	1.0	2.1	3.1	3.3	3.3
Exchange Rate					
Exchange rate regime	Member of the EMU				
Exchange rate (national currency per U.S. dollar)	0.8	0.8	0.8	…	…
Nominal effective rate: CPI based (2000=100)	97.8	100.0	100.7	…	…

Sources: National Authorities; and IMF staff calculations.
1/ Staff estimates and projections, unless otherwise noted, based on fiscal plans included in the government's April 2015 Documento di Economia e Finanza and subsequent approved measures.
2/ Percent of GDP.

INTERNATIONAL MONETARY FUND

ITALY

June 16, 2015

STAFF REPORT FOR THE 2015 ARTICLE IV CONSULTATION

KEY ISSUES

Seizing the Window of Opportunity for Reform and Growth

Context: Euro area-wide policies and national efforts have supported a turnaround in market sentiment and real activity. Italy's performance since the crisis, however, has been among the weakest in the euro area. Real activity and investment are still far from their precrisis levels; unemployment is high; and public debt, at 130 percent of GDP, is a source of risk. Low productivity and impaired balance sheets continue to weigh on the recovery and cloud medium-term growth prospects.

Policies: There is now a window of opportunity to push ahead with deeper reforms to re-ignite growth. This requires actions on multiple fronts, which are mutually reinforcing:

- ***Tackling the long standing productivity problem.*** A wide-ranging reform to raise the efficiency of public services at all levels of government would not only provide better quality and cheaper services but would also raise private sector productivity. The implementation of the Annual Competition law would further liberalize product and service markets, benefiting producers and consumers. Completing the Jobs Act would create better incentives to hire and train workers, while greater firm-level wage bargaining will make labor more responsive to economic conditions.

- ***Supporting balance sheet repair.*** A broad-based strategy to strengthen bank and corporate balance sheets will support recovery. More provisioning and write-offs, a revived distressed debt market, and enhanced insolvency regime would accelerate the reduction of NPLs. Establishing standard criteria for bank assessments of the viability of SMEs and introducing guidelines for creditor-led restructuring would accelerate the process of dealing with distressed SMEs.

- ***Rebalancing fiscal adjustment and reducing public debt.*** Fiscal rebalancing is needed to reduce the high taxes on labor and capital, through savings from past and ongoing spending reviews. The planned small fiscal adjustment is appropriate in the near term, given the still-weak growth and high debt. In the medium term, a modest structural surplus would reduce debt faster, providing valuable insurance against changes in market sentiment, and helping comply with EU fiscal rules. More ambitious privatization targets would also help.

Approved By
Thanos Arvanitis and Hugh Bredenkamp

The mission took place in Milan and Rome, May 5–18, 2015. The team comprised Mmes. Koeva Brooks (head), Topalova, and Weber, Mr. Lanau (all EUR), Mr. Garrido (LEG), and Mr. Kopp (MCM). Mr. Arvanitis (EUR) joined for several days. Mr. Cottarelli and Ms. Quaglierini (OED) attended the policy meetings. The mission met Finance Minister Padoan, Bank of Italy Governor Visco, Minister of Public Administration and Simplification Madia, other senior officials, and finance industry, academic, parliament, civil justice, and trade union representatives.

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CONTEXT: A LAGGING RECOVERY

1. **The economy is emerging gradually from a prolonged recession.** Financial market sentiment and confidence indicators have improved substantially since end-2014. Despite the recent bouts in volatility, sovereign bond yields have fallen below precrisis levels buoyed by the ECB's quantitative easing (QE). The stock market has rallied; bank and corporate funding costs have fallen; and rising business and consumer confidence has stemmed the decline in domestic demand. In the second half of 2014, private consumption continued to recover, supported by pent-up demand for consumer durables and expectations of better employment prospects. Investment expanded slightly in the last quarter of 2014. After 14 quarters of almost stagnant or contracting real activity, the economy expanded by 0.3 percent q-o-q in 2015:Q1, on the back of rebounding investment (Figure 1).

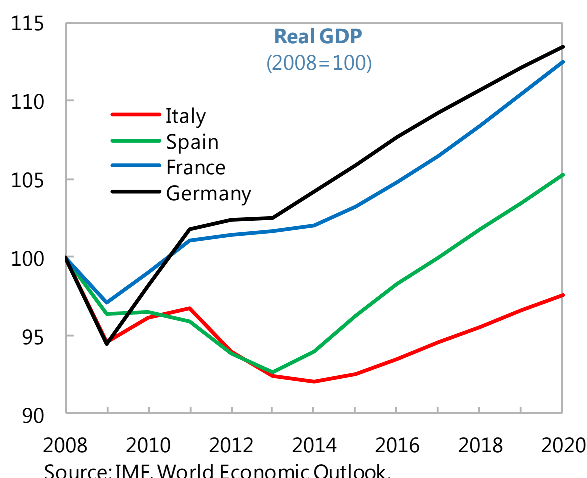
2. **The nascent recovery has been grounded in recent policy actions.**

- ***At the European level:*** Recent measures have provided much-needed demand support. QE has had a powerful effect on asset prices, including bond yields and the euro (Figure 2); TLTROs have improved funding conditions; the ECB's Balance Sheet Assessment (BSA) has helped resolve uncertainty about bank balance sheets; and the Stability and Growth Pact (SGP) flexibility has allowed Italy's fiscal stance to be fairly neutral in the near term.

- ***At the national level*:** Prime Minister Renzi's government has set out an ambitious agenda to overhaul Italy's political and economic system. While progress was initially slow and piecemeal—reflecting the resistance of vested interests—reform momentum has picked up, contributing to higher confidence. The Jobs Act, an overhaul of Italy's labor market, was approved by Parliament in December, and several of its elements have been implemented. A new law to convert Italy's 10 largest cooperative banks, representing 15 percent of banking system total assets, into joint stock companies has spurred expectations of consolidation in the sector and fuelled gains in banks' shares. Reforms of product and services markets, public administration, education, judicial and tax system are also progressing.

3. **Despite the positive uptick, the recovery is lagging and fragile.** Italy's performance since the crisis has been among the weakest in the euro area.

- Real activity is still far from precrisis levels and private investment is 30 percent below its 2008 level. The output gap in 2014 exceeded 4½ percent, one of the largest in the euro area.

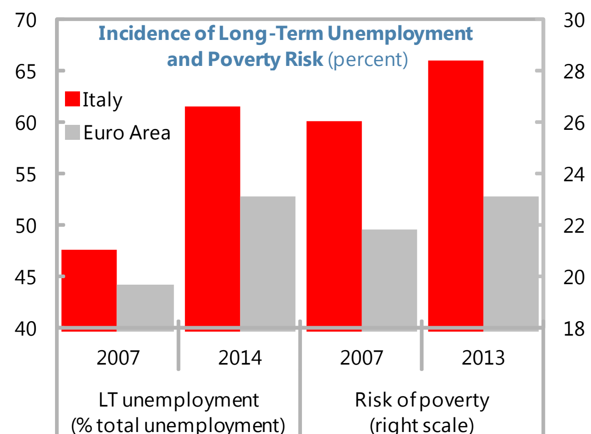


Source: IMF, World Economic Outlook.

- Headline inflation was positive in May 2015 after turning negative for some months in the second half of 2014 and early 2015, but continues to hover around low levels. Part of the decline in the price level is explained by the sharp drop in oil prices. Core inflation is below 1 percent, suggesting that weak demand and the large output gap also play a role. Long-term inflation expectations are still significantly below the ECB's objective.

- Real lending rates to small and medium-sized enterprises (SMEs) have come down but remain relatively high. More importantly, credit to the corporate sector continues to contract.

- Unemployment exceeds 12 percent and is even higher if workers in the wage supplementation scheme are included, and among the young.[1] With roughly 60 percent of unemployed without a job for at least a year, the risk of permanent skill destruction is high. Reflecting the large increase in unemployment, income inequality and the risk of poverty have also increased.



Source: Eurostat.

- Despite several years of difficult but necessary fiscal adjustment, public debt has continued to rise. At over 130 percent of GDP, it is an important source of vulnerability to changes in market sentiment and limits the room for fiscal maneuver.

Diagnosis

4. What is the root cause behind Italy's persistent growth weakness? Structural bottlenecks, depressed demand, impaired balance sheets, and subdued growth expectations have all reinforced each other, pushing the economy into low-growth equilibrium.

- ***Structural bottlenecks*****:** Productivity has been stagnant since the early 2000s (Figure 3). There are many possible explanations—including an inefficient public sector; high levels of taxation; a lengthy judicial process; a fragmented labor market and inflexible workplace practices; and underdeveloped corporate financing markets—which have perpetuated an unfavorable business model. As a result of these structural rigidities and the loss of an important adjustment mechanism with the adoption of the euro, Italy has struggled to respond to the rapid global changes of the 2000s (IT revolution, the rise of China).

[1] For a discussion of issues related to youth unemployment in Italy and the Euro Area more broadly, see speech by the IMF Managing Director, December 9, 2014.

- ***Depressed demand*:** With high public debt, there was little fiscal space to support the economy after the global crisis. Also, financial fragmentation along national borders led to a pro-cyclical tightening in monetary conditions. Given nominal wage and price rigidities and structural impediments to the reallocation of resources across firms and sectors, the economy was unable to adjust.

- ***Impaired public and private balance sheets*:** The collapse in demand deteriorated the health of firms and banks. In turn, balance sheet weaknesses exacerbated the decline in economic activity—investment was held back by reduced credit supply (due to financial constraints) and credit demand (due to muted confidence and debt overhang). The prolonged recession also contributed to a steady rise in the public debt-to-GDP ratio.

- ***Self-fulfilling expectations:*** Subdued growth expectations and policy uncertainty fed into lower investment and weak activity.

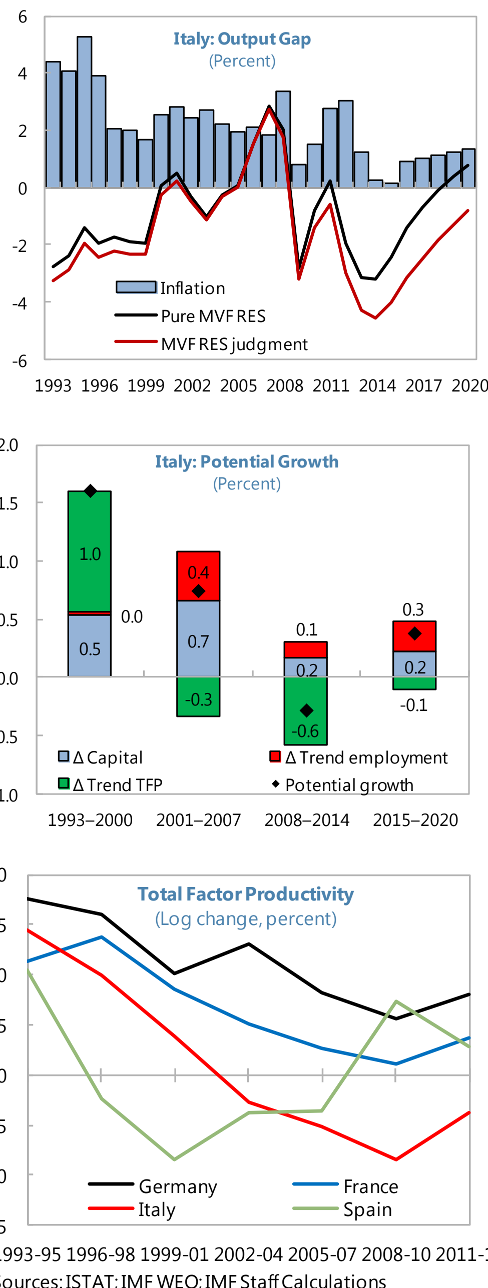
Outlook and Risks

5. Against this backdrop, the economy is expected to recover only moderately in 2015–16. Following a contraction of 0.4 percent in 2014, real GDP is projected to expand by 0.7 percent in 2015, supported by domestic demand and net exports. The latter will benefit substantially from the depreciation of the euro as a result of QE and the lower oil prices. With the favorable tailwinds from QE continuing—and with investment gaining further momentum—growth is projected to pick up to 1.2 percent in 2016.

6. The large output gap is projected to close only gradually given the deep output losses and the moderate pace of recovery. In the short term, loose monetary conditions, low oil prices, reduced policy uncertainty, greater confidence from the renewed reform momentum and policy efforts to strengthen lending will support the rebound of private investment from its current depressed levels, while the fiscal stance remains broadly neutral. Over the medium term, growth is projected to hover around 1.1 percent, with the contribution from net exports likely subdued due to a rise in imports as private demand strengthens. As a result, the output gap is projected to narrow slowly from 4 percent in 2015 to 0.8 percent in 2020. With real activity still below potential even at the end of the projection period, inflation is expected to stay below the 2 percent target and unemployment to remain over 10 percent throughout the period.

7. Without the full implementation of deep structural reforms, longer-term growth prospects remain bleak. Potential growth estimates are low, at about ½ percent, reflecting crisis legacies such as the collapse in investment, but also unfavorable demographics and the slowdown in productivity that predates the crisis (Box 1). Progress on the ambitious reform agenda has been important in lifting confidence and supporting the cyclical recovery. However, the weak implementation record of past reforms calls for conservative estimates of the long run growth dividend of ongoing and planned reforms. Similar to the approach taken by the authorities, the potential growth projections do not incorporate the likely effect of announced structural reforms.

Box 1. Potential Output in Italy



Sources: ISTAT; IMF WEO; IMF Staff Calculations

Identifying potential output is important at the current juncture. Estimates of potential output have been revised dramatically over the past 8 years, suggesting the crisis has had a lasting effect on labor, capital, and total factor productivity (TFP). A multivariate filter approach was used to re-estimate potential output for four EA countries (France, Germany, Italy, and Spain). This method incorporates empirical relationships between actual and potential GDP, unemployment, and inflation. Judgment using additional information on capacity utilization and the labor market improves the plausibility of results.

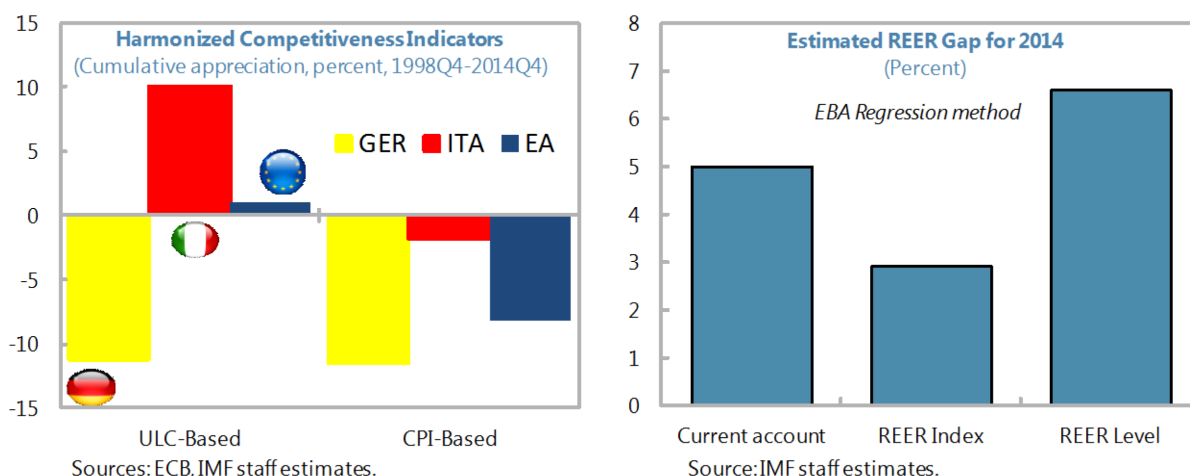
Potential growth in Italy declined significantly already in the precrisis period and then further during the crisis. A drop in TFP growth accounts for most of the decline prior to the crisis. During the crisis, around ½ of the drop in potential growth comes from lower capital contribution (due to the collapse in investment), with the remaining shortfall evenly split between TFP and labor (due to the increase in structural unemployment).

Compared to other large EA countries, Italy's TFP growth lags behind. Structural characteristics including government inefficiency, the small size of firms, and labor and product market rigidities may explain differences in average TFP growth rates. The analysis suggests that the slowdown in TFP growth in Italy may be related to the lower ICT diffusion in the Italian services sector—a result of rigid product market regulations. Previous studies have also found that the inability of Italian SMEs to (i) respond to the challenge of increased competition from China and (ii) take advantage of the ICT revolution given the lack of meritocracy in managerial selection and promotion, may explain some of the TFP slowdown.

Under current policies, potential growth is set to increase slightly in the medium term. Potential growth is projected to reach 0.4 percent over 2015–20, well below precrisis rates, supported by labor and capital. The latter is expected to pick up as a result of balance sheet cleanup and a return to positive investment. However, as capital and labor accumulation is likely to remain subdued in the near future, raising potential growth hinges on Italy's ability to lift productivity through structural reforms.

8. **Italy's competitiveness has suffered from stagnant productivity and rising labor costs.** As detailed in the External Sector Report Assessment (Annex I), Italy's external position as of 2014 is broadly consistent but likely still weaker than suggested by medium-term fundamentals and desirable policy settings. Despite the improvement in the current account surplus in 2014, in structural terms it is still 0–1.5 percent of GDP weaker than justified by fundamentals and

appropriate policies. And while Italy's share of world exports has generally moved in parallel with its European peers, price-based indicators of competitiveness—particularly those based on unit-labor cost—have deteriorated since Italy joined the euro area both in absolute terms and relative to the euro area average. Taking into account a broad range of indicators and model-based estimates of the REER gap for 2014, staff considers that a real effective depreciation of 0–10 percent—supported by structural reforms—would be appropriate to restore competitiveness. Given the 9 percent depreciation of the euro since the end of 2014, Italy's external position will likely strengthen in 2015.

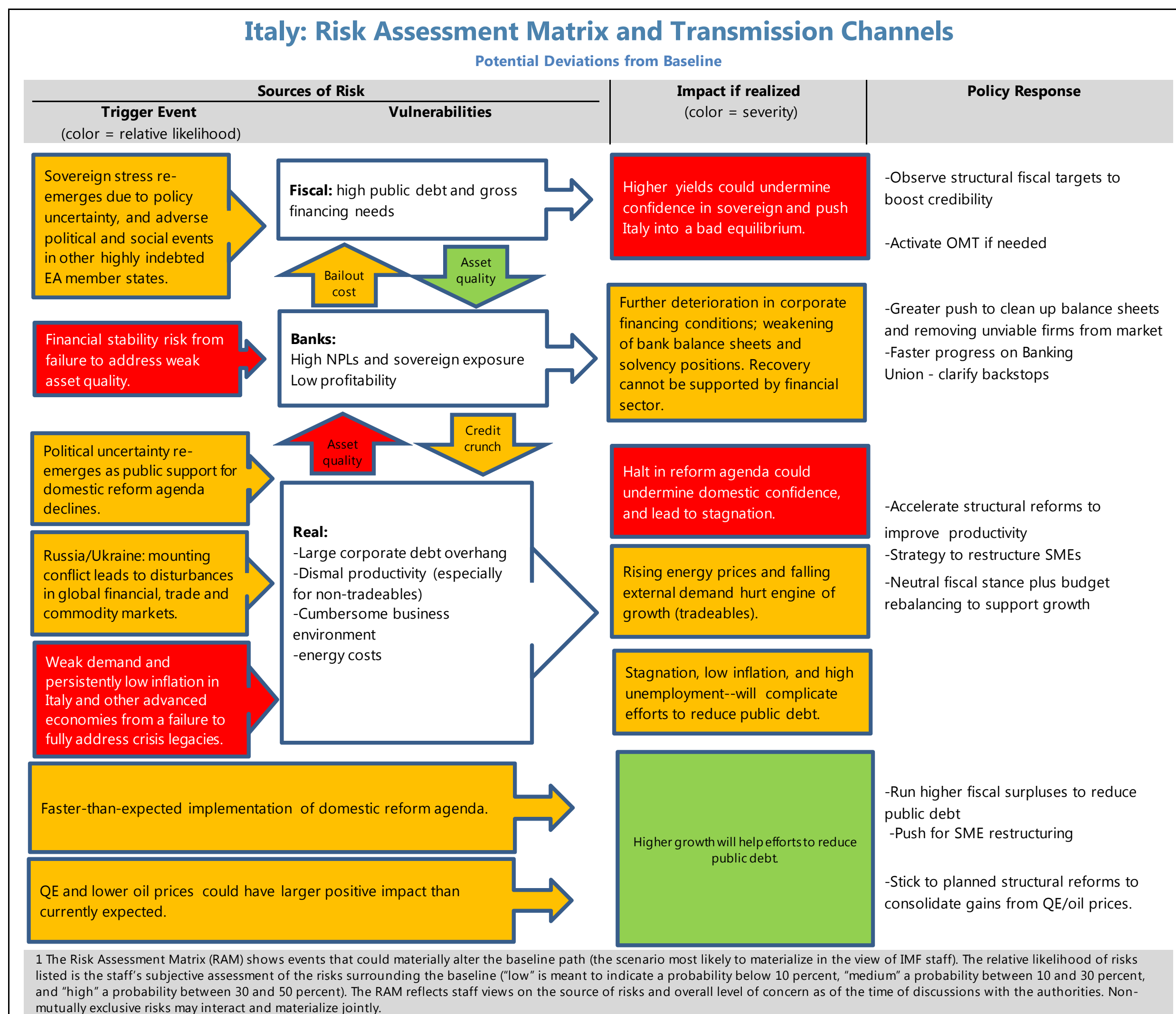


9. The risks to the outlook are broadly balanced. These risks are interconnected and if they were to materialize, regional and global spillovers could be significant (see RAM):

- ***Downside*:** Stagnation and low inflation that complicate efforts to reduce public debt remain an important downside risk. Confidence may suffer if public support for the reform agenda wanes. If unabated by a forceful area-wide policy response, adverse developments in Greece could have a substantial impact on Italy via confidence effects, though direct exposures are limited.

- ***Upside*:** QE, euro depreciation, and lower oil prices could have a larger positive impact than currently expected. Rapid progress on the domestic reform agenda could boost confidence further and spur a faster recovery. The authorities estimate that the structural reforms already announced could raise trend growth by about 1/3 percentage point by 2020, if fully implemented.[2]

[2] Italian Ministry of Economics and Finance, Economic and Financial Document (*Documento di Economia e Finanza)*, 2015.



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.

Authorities' Views on Economic Outlook and Risks

10. The authorities expected a slightly stronger pickup in growth in 2016. QE was anticipated to contribute significantly to the recovery through the exchange rate and interest rate channels—with an estimated cumulative impact of 0.7 (MEF) and 1.4 (BOI) percent in 2015 and 2016. The decline in oil prices could add another 0.3 percentage points cumulatively over 2015 and 2016. However, erring on the side of caution, the MEF incorporated only half of the impact of QE and oil prices, and no impact from structural reforms in its projections given uncertainties even under full implementation. The authorities acknowledged that financial conditions could weigh on the recovery. They noted that while bank lending to NFCs is still declining—mainly owing to credit demand factors—credit supply conditions

Italy: Real Growth Projections

	2015	2016
IMF	0.7	1.2
MEF (Budget Update, Apr 2015)	0.7	1.3
BoI (Economic Bulletin, Apr 2015)	>0.5	1.5

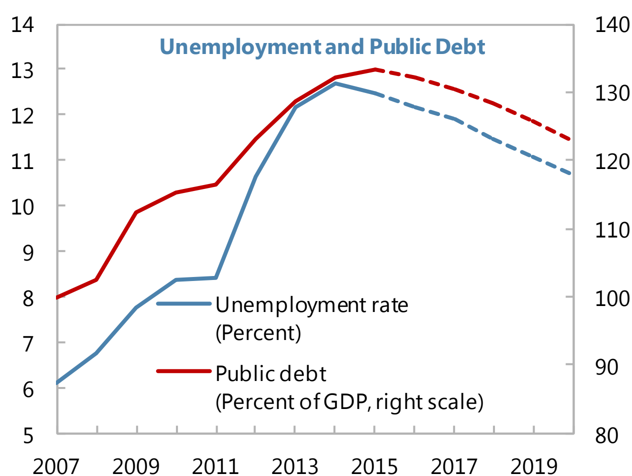
are improving, and lending rates have declined. Furthermore, the latest investment survey of Italian firms suggests widespread and growing optimism both in the construction and services sectors.

11. The authorities broadly agreed with the overall assessment of the external sector. They concurred that further improvement in competitiveness would be desirable to lift potential growth. However, they cautioned against relying too much on labor-based indicators of competitiveness, which show a much wider gap than other price-based measures.

12. Domestic and external risks have receded owing to recent actions at the EU level, domestic political stability, and the strong reform agenda. Important upside risks stem from their conservative estimates of the impact of QE, euro depreciation, and oil price decline, as well as the effect of recently implemented and planned structural reforms. The authorities considered that risks from very low inflation had diminished somewhat, in light of the recent pickup in inflation expectations. The BOI expected QE to push up inflation with an estimated impact of just over 0.5 percent both in 2015 and 2016. With confidence gathering momentum, contagion risks from adverse developments in Greece were seen as limited in the near term. However, there was more concern about longer-term implications, if perceptions about the irreversibility of the euro area were to change permanently.

SEIZING THE WINDOW OF OPPORTUNITY

13. There is now a window of opportunity to push ahead with deeper reforms to lift growth and reduce unemployment. This will help move the economy out of its low-growth equilibrium and deliver the high and sustained growth rates necessary to bring down faster unemployment and debt. Policy efforts should focus on the three root causes of Italy's growth weakness: (i) tackling the long-standing productivity problem; (ii) supporting bank and corporate balance sheet repair; and (iii) rebalancing fiscal adjustment and reducing public debt from its very high level. At the same time, policies at the European level will need to complement national efforts by supporting demand—thereby helping to close Italy's large output gap—through accommodative monetary conditions and reduced policy uncertainty.



Source: ISTAT; and IMF staff estimates.

14. PM Renzi's reform agenda includes ambitious initiatives in many areas. The National Reform Program (NRP) aims to revive the Italian economy by (i) improving the business environment through an overhaul of public administration, civil justice reform, and further liberalization of product and services markets; (ii) raising labor productivity through wide-ranging reforms of the labor market and education system; and (iii) supporting private investment through

better access to credit and other funding sources. According to the latest Economic and Financial Document, during the first 13 months of the new government, almost 60 percent of the newly announced reforms and 70 percent of the decrees inherited from previous governments were implemented (see also Appendix I).

15. The challenge now is to maintain the momentum and fully implement the reform initiatives. Only the delivery of real change on the ground will strengthen confidence in a lasting manner, secure a robust recovery, and lift potential growth in the long run. Simultaneous actions on multiple fronts would also be mutually reinforcing.

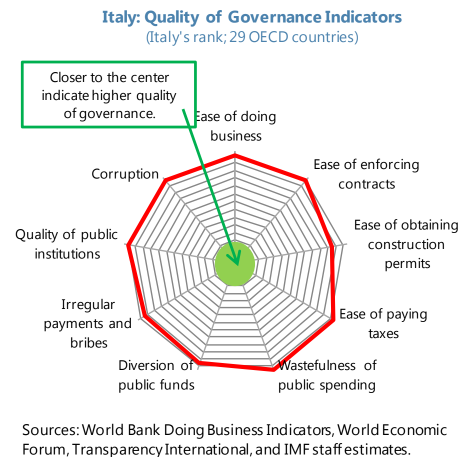
A. Reviving Productivity: Public Sector Efficiency and Other Policies

Raising Public Sector Efficiency

Context

The Italian public sector is inefficient. According to the World Bank's Doing Business Indicators for 2015, it takes more than 230 days to obtain a construction permit, 120 days to get an electricity connection, and more than 1,100 days to enforce a contract in Italy, substantially longer than the OECD average. Perception-based measures paint a similar picture, with Italy ranking amongst the worst on measures of government efficiency and public sector corruption. The authorities themselves have assessed corruption as a criminal phenomenon of great significance. As the services provided by the public sector are inputs into firms' production processes, their inefficient provision may lower the marginal productivity of the labor and capital employed by firms.

Italy: Quality of Governance Indicators
(Italy's rank; 29 OECD countries)

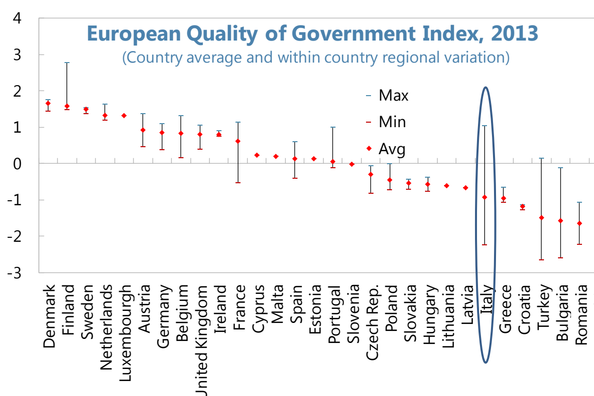


Sources: World Bank Doing Business Indicators, World Economic Forum, Transparency International, and IMF staff estimates.

Raising government efficiency would not only provide better quality services at a lower cost but would also raise private sector productivity. Exploiting the variation across provinces in Italy, staff analysis establishes that public sector inefficiency has a sizable effect on firm productivity. If public sector efficiency rose to that of the best province in Italy, productivity of the average firm could increase by 5–10 percent, and overall GDP by 2 percent (Box 2 and Figure 4). Limited geographical differentiation in public sector wages and downward rigidity in private sector wages (due to competition with the public sector) also prevent firms from adjusting wages in line with productivity.

Box 2. The Impact of Public Sector Inefficiency on Italian Firms

Do public sector inefficiencies hold back firm productivity? Italy ranks poorly on measures of public sector efficiency. It has also fallen behind many advanced economies in terms of labor productivity. Establishing a causal link between these two stylized facts is not easy but is possible given Italy's large regional heterogeneity. Within Europe, Italy has the largest variation in the quality of the public sector. It takes more than twice the number of days to get a construction permit in Sicily than in Lombardy. Similarly, the median firm in the North produces 9½ percent more per euro spent on employees than the median firm in the south.

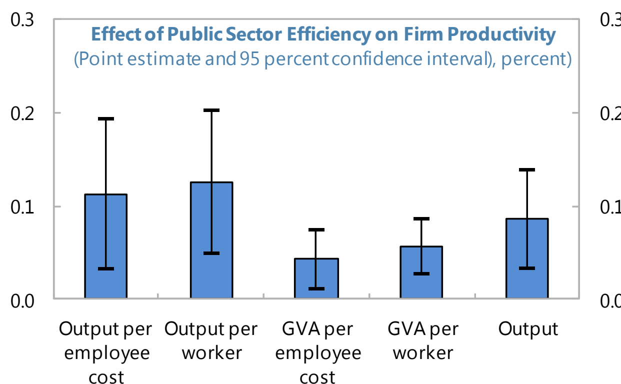


Sources: European Commission (DG REGIO), based on World Bank Governance indicator and regional-level survey data.

To estimate the causal effect of public sector inefficiency, staff analysis uses a simple difference-in-difference empirical strategy. The key identifying assumption is that productivity of firms in sectors that are more reliant on the government would be more affected by government inefficiency. In other words, the difference in productivity of firms in the construction industry—one of the most dependent on the government—located in Lombardy vs. Sicily should be larger than the difference in productivity of firms in the basic metals industries—one of the least dependent on the government—located in these two regions.

The analysis relies on a rich firm-level dataset and uses novel measures of government dependence. The productivity of about 450,000 micro, small, medium, and large firms in the Orbis database is measured as the ratio of operating revenue (or gross value-added) to costs of employees (or number of workers). Government dependence is proxied by the frequency of news about a certain sector mentioning the government (Pellegrino and Zingales, 2014). Giordano and Tommasino (2011) developed measures of government efficiency for Italy's roughly 100 provinces, which captures how efficiently government units transform inputs into outputs relative to the most efficient province in the area of health care, education, civil justice, child care, and waste collection. Data are from 2007.

There is strong evidence that the inefficiency of the public sector holds back firm productivity. For example, for a firm in a sector above the median in terms of government dependence, being in a province with above median public sector efficiency increases output per euro spent on salaries by 11 percent. These estimates imply significant macroeconomic benefits if public sector efficiency rose to the frontier in all provinces. Productivity measured as output per euro spent on salaries could increase by up to 22 percent in the sectors that depend the most on the public sector, while gross value added per employee costs could rise from 2 to 10 percent. For the average firm, output would expand by 3 percent.



Sources: Orbis; Pellegrino and Zingales (2014); Giordano and Tommasino (2011); and IMF staff estimates.

A comprehensive public administration reform is in the works. The draft enabling law on public administration reform, approved by the Senate and under discussion in the Lower House, outlines ideas to (i) reform the system of recruitment, selection, and evaluation of public employees by introducing new performance evaluation schemes for managers and maintaining pay to performance; (ii) reorganize the public administration, including substantial rationalization of local governments and enterprises, and deregulation of local public service; (iii) simplify and digitize administrative procedure to make them faster, more efficient, and more business friendly; and (iv) streamline legislation governing state-owned and local public enterprises to minimize overlapping regulations from different levels of government and peripheral government bodies, and promote competition.

Advice

The swift adoption and proper implementation of the public administration reform will be crucial to unlock the private sector growth potential. As the draft enabling law provides only the broad contours of the changes envisioned, the reform should include:

i. ***Public administration reform.*** It should increase the autonomy and accountability of public sector managers; strengthen benchmarking and performance-based budgeting; and improve mobility of workers and wage differentiation across regions and in line with productivity.

ii. ***Local public services reform.*** In many areas, the provision of local services is dominated by monopolies assigned to companies directly owned by (or related to) local governments. The existence of more than 8,000 local public enterprises has been highlighted as a source of inefficiency and a burden on public finances. Hence, reforming local public services and rationalizing local public enterprises would yield significant economic benefits.

iii. ***Public tenders.*** Public tenders for the provision of local public services are required, and the Competition Authority has been given the power to question actions by local authorities. However, data on contract award procedures suggest that the majority of contracts are still done through "in-house" awards or similar procedures. More transparency in tendering procedures and standardization of contracts— particularly for the provision of local public services—can help improve their quality and cost.

Improving the efficiency of the civil justice will have wide-ranging economic benefits. Despite incremental reforms, the judicial system remains highly inefficient. Building on the recently introduced measures, consideration could be given to rationalizing the type of cases that reach the Supreme Court (Corte di Cassazione); allowing for further specialization of the courts—including in commercial and insolvency matters; using ad hoc measures to reduce the backlog of pending cases; and pushing ahead with the project to develop court performance indicators.

Reducing corruption will improve the business environment. Legislative measures to enhance the anti-corruption framework should be adopted and effectively implemented. This includes increasing the powers of the Anti-Corruption Authority (ANAC), criminalizing the false accounting offense, and changing the provisions on statute of limitations for corruption crimes to ensure that these crimes can be prosecuted regardless of the delays caused by lengthy appeals.

Authorities' Views

Overhauling the public administration is a key building block of the government's agenda. The authorities emphasized their commitment to complete the legislative process of the draft enabling law on public administration reform by end-2015. In the current system of fiscal decentralization, the full implementation will take time, but process will be carefully monitored to ensure a leaner, faster, and more business-friendly public sector.

The reform of local public services is already in train. Guided by previous spending reviews, the 2015 Stability Law requires municipalities to submit concrete rationalization plans, with implementation timeframes and cost savings estimates. For economically important local public services (such as utilities), strong incentives were put in place to promote consolidation and pave the way for market deregulation.

The authorities also highlighted measures taken to improve procurement. A technical working table composed of a restricted list of procurement aggregator bodies is established, responsible for specifying the list of product categories and the respective spending thresholds. The Anti-Corruption authority publishes reference prices and is in the process of standardizing public contracts.

The authorities were optimistic that these reform efforts will increase significantly the efficiency of public services. Several academics, however, noted that the scope for rationalization and raising efficiency may be limited without addressing public sector employment, and rethinking the role of the state in providing services in a more radical manner.

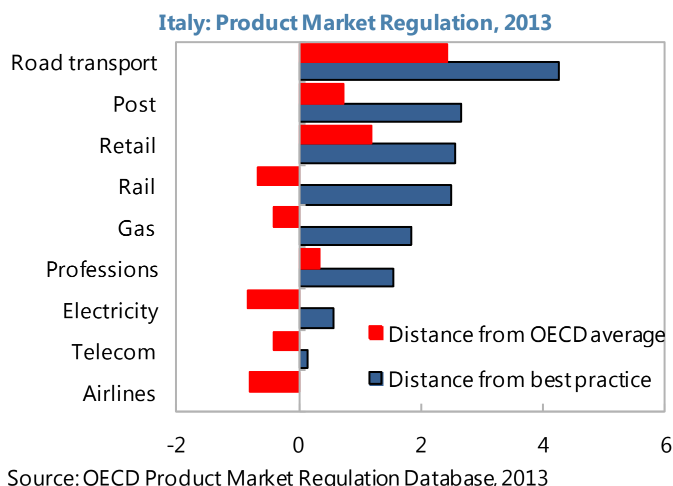
Judicial reform remains a priority for the government. The measures undertaken in the last few years have been bearing fruit, as evidenced by the 15 percent drop in the number of pending civil cases since 2009. The authorities have also adopted reforms to reduce the flow of cases by promoting alternative dispute resolution techniques, such as arbitration, negotiation assisted by counsel, and mediation. On-going efforts aim to reduce appeals, improve the recently created "enterprise courts," and develop court performance indicators and best practices (Strasbourg 2.0).

The authorities continue their fight against corruption. The anti-corruption legislation, approved in late May 2015, includes enhanced powers for the Anti-

Corruption authority, the criminalization of false accounting, and changes to the statute of limitations for certain crimes, including corruption.

Increasing Competition in Product Markets

Context **Regulatory hurdles and entry barriers limit competition in several nontradable sectors.** This has an adverse effect on the business environment, raising costs for the sectors that need to compete globally and eroding the competitiveness of the economy. Key problems are concentrated in some network industries (e.g., road transport, post), professional services (legal, accounting, engineering, pharmaceutical), and the provision of local public services. Taken together, these services account for about 30 percent of total value added, and contribute more than a third of inputs used by other sectors.



Source: OECD Product Market Regulation Database, 2013

Advice **Consumer and producers would benefit from more competition in product and service markets.** While Italy has taken significant steps to liberalize product markets since 2008, progress on legislating the needed reforms and implementing those already legislated has been uneven. The swift approval and implementation of the Annual Competition Law would be an important step to boost competition in a wide range of sectors. Additional measures in sectors that remain highly regulated (such as transport) would also help improve competition, lower markups, and increase the purchasing power of households. Careful consideration should be given to the regulation of services that have the potential to benefit from new technologies (e.g., the platform services in the new sharing economy), weighing the social cost that the adoption of these technologies might entail against the widespread productivity gains they would generate. Efforts to fully implement existing legislation should be strengthened, which would narrow the gap between legislated regulations and perceptions of product market efficiency.

Authorities' Views **The authorities emphasized the significance of the adoption of the Annual Competition Law.** This is the first time an annual competition law was adopted, following the 2009 legislation which introduced such a requirement, thus signaling the new government's commitment to open markets as a means to revitalize the economy. They agreed that there is scope to enhance competition in sectors, such as

roads, local transport, and ports. Some of these areas will be tackled in complementary draft bills. The authorities concurred that implementation remains the Achilles' heel of product and service market reforms in Italy, since measures legislated at the center are implemented by regional governments, often leading to uneven outcomes. The planned Constitutional reform, which will give the state the exclusive power over matters related to competition, should help with the consistent implementation of legislated regulation and the tangible improvement in product market efficiency.

Reducing Duality, Improving Labor Reallocation, and Raising Human Capital

Context

A pillar of the reform agenda, the Jobs Act is an overhaul of Italy's rigid labor market. The overarching goal of the reform is to improve reallocation of labor across firms and sectors by reducing the uncertainty and expected cost of dismissal; expand the social safety net to protect workers from the higher labor market flexibility; and enhance the job matching process to ensure their swift return to gainful employment. The reform also aims to tackle the pervasive duality in the labor market, which is inequitable and limits labor productivity; and raise female labor participation, which is very low and represents an underutilized source of growth. Several elements of the reforms have already been fully implemented; the legislative process for reforming the wage supplementation scheme and ALMP has also begun. Specific plans for the potential introduction of a minimum wage are yet to be presented.

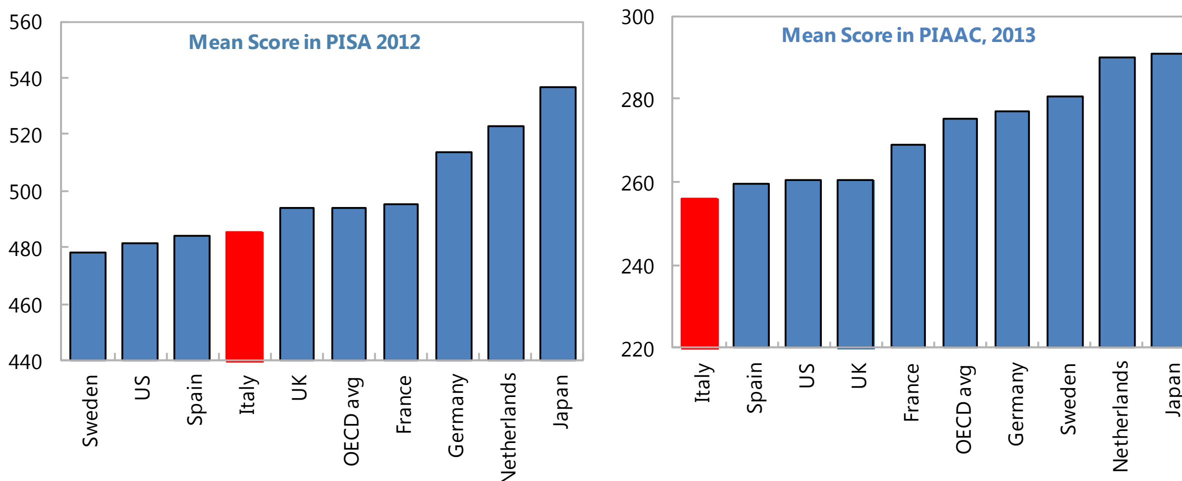
Advice

If fully implemented, the Jobs Act would create better incentives to hire and train workers. The introduction of a new open-ended labor contract with gradually increasing protection and the extension of the coverage of unemployment benefits are an important start. But other elements of the Jobs Act are equally important. The planned reform of the current wage supplementation scheme will encourage the transitions of workers from unprofitable to profitable firms and to jobs that better match their skills. The plan for national coordination of ALMPs—to reduce regional disparities and improve implementation, monitoring and evaluation—should speed up the process of filling vacancies.

Further decentralizing wage setting could enhance job protection and creation. Improving the ability of individual firms to adapt working conditions (such as working hours, tasks, and wages) to their specific circumstances could prevent costly labor shedding, better align wages with productivity, and alleviate regional disparities. This could be achieved by allowing greater flexibility in national contracts—by including top-up agreements for the most profitable businesses and opt-outs for firms in temporary difficulties; and by tackling the existing constraints to second-stage wage bargaining, which remains a rarely used option in Italy.

Improving the quality of human capital would play an important role in raising labor productivity. Educational outcomes in Italy are poor relative to other advanced economies: Italy has the fifth lowest share of population with upper secondary education among OECD countries; its students score below the OECD average in math, reading, and science; and its adult population has relatively low literacy and numeracy skills. Thus, if properly designed and implemented, government's efforts to prioritize spending on education and improve school outcomes could yield significant economic dividends.

Italy: Educational Outcomes of Students and Young Adults



Sources: OECD, Programme for International Student Assessment. Average test scores of 15-year-olds' competencies in mathematics, reading and science.

Sources: OECD, Programme for International Assessment of Adult Competencies. Average test scores of 16-24 year-olds' competencies in literacy and numeracy.

Authorities' Views

The authorities are committed to fully implement the Jobs Act. Authorities underscored that the Jobs Act is unlikely to create new jobs in the short run, but it will increase productivity by changing the composition of the labor force. While still early to judge, recent labor statistics showing an increase in the share of open-ended contracts are encouraging. The ultimate effect on labor market duality will only be discernible once the open-ended contract fiscal incentives expire. The authorities noted that strengthening ALMP will be crucial to decrease unemployment duration, but it is difficult given the decentralized provision of such services. The constitutional reform, which will transfer the responsibility of ALMP back to the state, will help in this regard. The successful implementation of the Youth Guarantee Scheme could serve as a positive example.

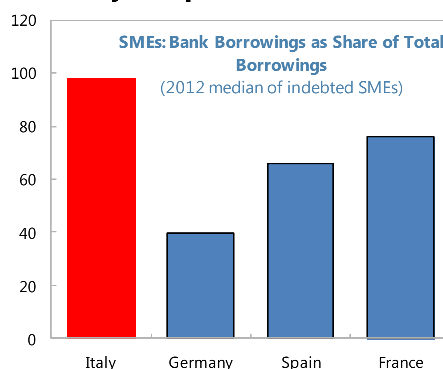
Both the authorities and social partners agreed that more firm-level bargaining is desirable. Several hypotheses were put forth about the reasons behind the low take-up of second-stage bargaining, including the lack of a general agreement on union representation, the high prevalence of small enterprises for which firm-level

bargaining is difficult and costly, the poor macroeconomic environment which has limited the scope for productivity bonuses above national agreements, and the lack of fiscal incentives.

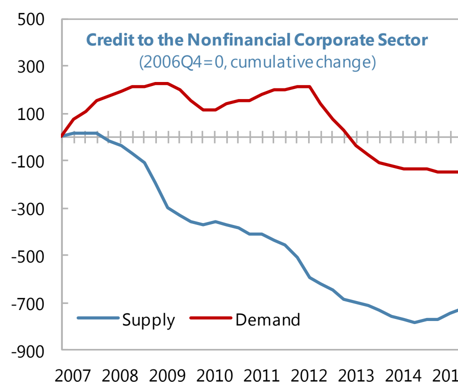
The authorities emphasized that the planned school reform is complementary to the overhaul of the labor market. The Good Schools plan aims to improve educational outcomes and raise labor productivity by (i) providing better incentives for teachers through open-ended employment, performance pay, and greater school autonomy; and (ii) enhancing the curriculum to better link education and employment. The planned reform, which was recently approved by the Senate, is expected to complete the legislative process by the end of 2015.

B. Repairing Bank and Corporate Balance Sheets

Context **Italian firms and banks have been severely affected by the protracted downturn.** A backbone of the Italian economy, SMEs rely predominantly on bank credit. In turn, Italian banks have a strong focus on traditional lending activities, with the bulk of bank credit going to the corporate sector. As a result, the transmission of the shock in the real economy to Italy's banks has been particularly strong. For a large number of firms, profits have sharply fallen and debt burden has increased since 2008 (Box 3). As a result, nonperforming loans (NPL) in the banking system have reached systemic levels, more than tripling to 17.7 percent of credit outstanding in 2014:Q4, with the largest increase in "bad debt," loans to insolvent borrowers (*sofferenze*) (Box 4). The continued rise in NPLs has weighed heavily on banks' profits, pushing up lending rates, and reducing banks' willingness to broadly extend credit (Figure 5). The decline in credit supply has further exacerbated the downturn in the real economy.



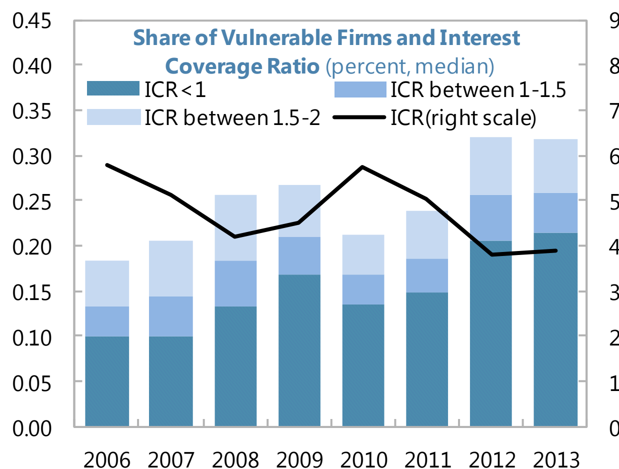
Sources: BACH database and CERVED.



Sources: Bank of Italy; and IMF staff estimates.
Notes: Based on Bank Lending Survey, Questions 1 and 6 Overall (Changes in Bank Lending Standards, Changes in Demand for Loans).

Box 3. The Health of Italy's Corporate Sector Through the Downturn

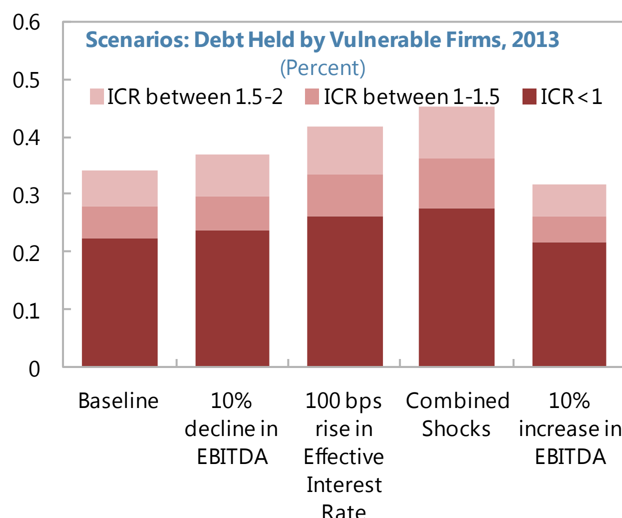
Italy's nonfinancial corporate sector was hit hard by the protracted economic downturn. Analysis of roughly 200,000 surviving Italian companies over 2006–13 reveals three key stylized facts: (i) the profitability of Italian firms has fallen dramatically; (ii) the process of deleveraging has been quite slow; and (iii) debt overhang has increased. As a result of the fall in profits and slow reduction in debt, firms' ability to service their obligations has declined: the interest coverage ratio (ICR) has fallen, and in 2013, about 1/5 of firms had insufficient income to cover their interest payments and more than 30 percent had an ICR<2.



Source: Orbis, and IMF staff estimates.

The corporate sector remains vulnerable to adverse shocks to profits and interest rates. A uniform decline in profits by 10 percent would increase the share of companies with ICR<2 by 2 percentage points and the share of debt held by these firms by 3 percentage point.

Conversely, a positive shock to corporate profits does little to improve the share of firms potentially unable to service their debt. A 10 percent positive shock to profits would lower the share of firms with ICR<2 by about 1 percentage points and debt of vulnerable companies held by banks by 2 percentage points. This finding suggests that a rebound in economic activity may have limited impact on firms in poor financial health, and a more active approach to resolving corporate weakness may be needed.



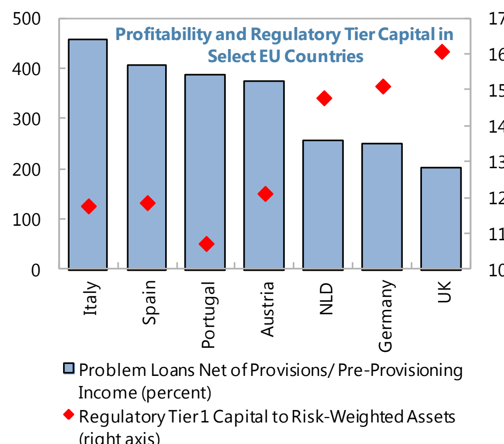
Sources: Orbis; and IMF staff estimates.

Econometric analysis suggests both weak firm balance sheets and high debt overhang play a role in holding back investment. The estimation of a standard firm-level investment model highlights the important role played by firm leverage, debt overhang, firm specific demand shocks, and access to liquid assets in determining investment decisions in Italy. Moreover, their role has intensified in the post-crisis period, consistent with the idea that financial constraints might become more binding during periods of heightened risk aversion.

The implications of the declining health of the corporate sector for aggregate business investment are nontrivial. Using the estimated sensitivities of investment to net worth, debt overhang, sales and profitability, and the change in these variables between 2006 and 2013, a simple back of the envelope calculation suggests that 8–10 percent of the decline in aggregate corporate investment could be due to firms' deteriorating health.

Box 4. Nonperforming Loans in Italy

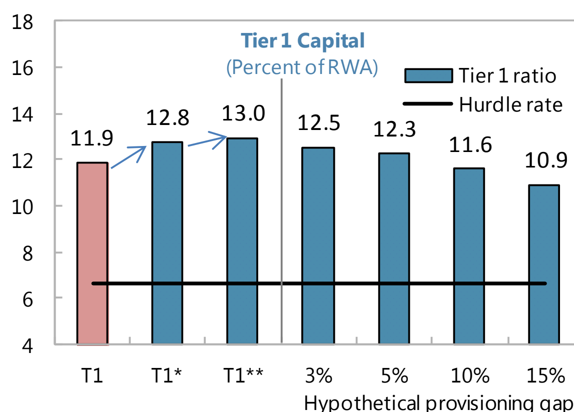
Nonperforming loans (NPLs) in Italy have reached systemic levels hindering the recovery. The vast majority of bad loans relate to the corporate sector, in turn affecting bank profitability and solvency and hampering attempts to further build up capital. Hence, despite ample and cheap liquidity, banks have become cautious in extending new credit, especially to SMEs. Given the absence of alternative sources of corporate financing, this has constrained investment and undermined the economic recovery.



Sources: SNL, FSI, and IMF staff estimates.
Notes: SNL data reflect lastest year available (2013 or 2014).

The crisis had a profound impact on the buildup of NPLs, which was exacerbated by bank-specific factors. Dynamic bank-by-bank panel regressions suggest that lower profitability and higher lending in the past are related with higher NPLs in Italy, indicating that faster loan book expansion on average results in worse asset quality. A number of macro-economic variables are significant as well. For instance, lower growth, exchange rate appreciations, and falling house prices are significantly associated with higher NPLs.

The prolonged recession also led to higher default risks in corporates and banks. Staff estimates show that corporate and bank default probabilities peaked in mid-2012. And while default probabilities have come down substantially since then, NPLs have continued to rise. A dynamic macrofinancial state space model illustrates how the dynamics have changed over the past few years. The estimates suggest that (i) further output losses would fuel credit risk considerably more than in the past; and (ii) higher interest rates would now have a much more substantial impact on corporates than in the past.

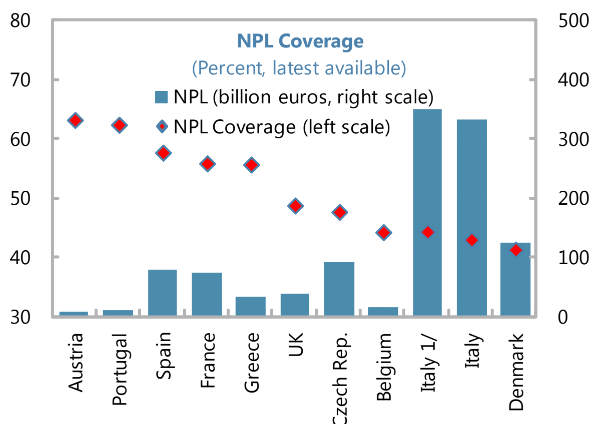


Sources: SNL; and IMF staff estimates.
Notes: * RWA effect (from removal of bad debt; and generation of new (average-risk) loans. ** RWA and profit effects.

The removal of bad debt from banks' balance sheets has the potential to boost solvency levels and increase lending to the real sector. Staff estimates show that under the assumption of adequate provisioning, a full write-off of existing *sofferenze* would (i) increase the banking system's Tier 1 capital ratio by 1.1 percentage points, or (ii) free up capital resources amounting to about €150 billion in new loans to the real economy.[1]

[1]See Special Issues Paper on Nonperforming Loans. Hypothetical provisioning gaps are calculated based on NPL gross values.

Balance sheet cleanup is yet to begin for a large share of the financial and corporate sectors. Over the last two years, large banks (Unicredit, Intesa) have taken steps to cleanse their balance sheets, including by establishing private Asset Management Companies (AMCs). However, smaller banks lack the capacity to do so. In the corporate sector, the process of deleveraging has also been slow. A fragmented banking system, substantive NPL provisioning and pricing gaps, the heterogeneity of the NPLs portfolio, the widespread reliance on relationship lending, and a lengthy insolvency process have been the main obstacles to cleaning up balance sheets.



Sources: IMF FSI Statistics; and Bank of Italy.
1/ Data reported by Bank of Italy in FSR April 2015.

Repairing Balance Sheets

Advice

A broad-based strategy to simultaneously strengthen bank and corporate balance sheets will support the nascent recovery. Repairing balance sheets will free up resources for new lending to productive firms and sectors. It would also unclog the transmission of monetary policy and allow firms and households to benefit more fully from QE. The comprehensive strategy could involve a "stick-and-carrot" approach:

i. ***Strengthen provisioning.*** Adequate provisioning would help narrow the sizable gaps between the book and market value of NPLs. The ECB's BSA revealed sizeable provisioning gaps and capital shortfalls among the 15 participating banks, which are expected to be filled by July 2015.[3] Remaining uncertainty about banks' asset quality would need to be resolved by applying the new EU-wide harmonized asset classification framework to all banks operating in Italy.[4] Strict supervisory enforcement is essential for ensuring correct classification and adequate provisioning.

[3] Banca Monte dei Paschi di Siena (MPS) increased the volume of the planned rights issue from €2.5 to €3.0 billion. MPS reclassified €5.7 bn of loans from performing to nonperforming, and increased NPL coverage to 49 percent. Similarly, Banca Carige's action plan comprises a rights issue up to €850 million (€200 million more than originally planned), fully pre-underwritten by Mediobanca. Banca Popolare di Milano and Banca Popolare di Vicenza had already closed their (arguably small) capital shortfalls at the time the ECB's results were published.

[4] A new asset classification framework, harmonized on the EU level and fully consistent with the past approach, has been introduced in January 2015, and is applicable to all banks operating in Italy. See Circolare n. 272 del 30 luglio 2008 (Matrice dei conti), 7 Aggiornamento, 20 January 2015.

ii. ***Accelerate write-offs.*** Supervisory actions that effectively introduce time limits for write-off of vintage NPLs can play an important role in encouraging banks to deal faster with the problem. One possibility is to raise considerably capital charges for vintage NPLs after a certain period. Separately, imposing macro-prudential limits on the (relative) size of the NPL (or bad debt portfolio) and using measurable performance indicators of banks' restructuring efforts can help limit a further build-up of NPLs.

iii. ***Improve further the insolvency regime.*** Additional reform efforts to rationalize and streamline procedures will facilitate the swift exit of nonviable firms and restructuring of viable firms. Remaining gaps in the pre-insolvency and reorganization procedures should be addressed to allow a seamless transition between different existing mechanisms and remove obstacles to advanced restructuring procedures such as debt/equity swaps (Box 5). Reforms should aim to accelerate the start and shorten the length of insolvency procedures, for example by increasing the effectiveness of asset sales and reducing litigation within the insolvency process. Establishing qualifications for insolvency practitioners and allowing the specialization of courts in insolvency law would help strengthen the institutional framework.

iv. ***Restart the NPL market.*** As part of an overall strategy, an active distressed debt market could play an important role in tackling the NPL problem. Private AMCs should be encouraged including through regulatory measures and tax incentives for NPL disposals. If properly designed, a centralized, system-wide, state-backed AMC that is consistent with the EU state aid rules and within the limited available fiscal space could help jumpstart the market for bad assets. Specifically, the vehicle should (i) purchase assets at market prices; (ii) use transparent and uniform valuation criteria; and (iii) have strong governance, including operational independence and accountability.

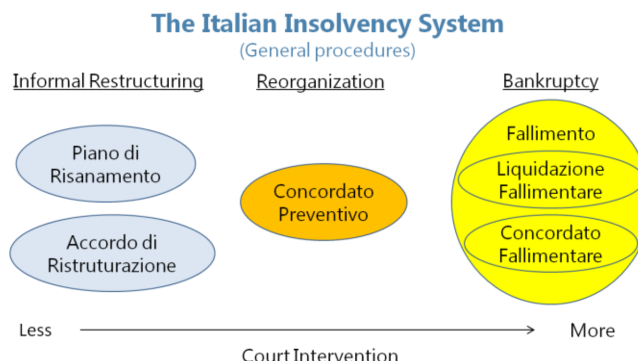
v. ***Provide tax incentives.*** To complement these efforts, tax incentives could motivate provisioning and write-off. Consideration could be given to shortening further the five-year period over which banks can deduct loan-loss provisions from taxable revenues. This would also eliminate the build-up of deferred tax assets.

vi. ***Foster restructuring or resolution of distressed SMEs.*** Given the high number of SME NPLs and the limited incentives for banks to tackle problem loans (in light of their close relationship with firms), a *triage* approach could speed up the process of dealing with distressed SMEs. Establishing standard criteria for bank assessments of the viability of SMEs and introducing guidelines for creditor-led restructuring would help with the separation of nonviable firms (for liquidation) from viable firms (for rehabilitation) and allow banks to concentrate efforts on those with better recovery prospects.

Box 5. The Insolvency System in Italy

The high levels of NPLs in the Italian financial system and the vulnerability of the corporate sector highlight the importance of addressing the regulation of insolvency procedures in Italy. A number of issues have been identified in the Italian insolvency practice that may prevent the speedy resolution of NPLs and the restructuring and liquidation of firms.

The insolvency regime is complex, with tools that lack coordination. The bulk of distressed enterprises in Italy can use debt restructuring procedures, formal reorganization or bankruptcy.[1] However, there are significant disincentives for the use of debt restructuring options. The two procedures of informal or hybrid debt restructuring (*piani di risanamento* and *accordi di ristrutturazione*) do not offer a flexible solution to distressed companies as the goal is often to achieve full payment to creditors. In contrast, formal insolvency procedures (*concordato preventivo* and *fallimento)* do not set limits to the haircuts creditors can suffer. Informal debt restructuring agreements cannot be easily transformed into a formal reorganization plan in the current system. In addition, there are obstacles to adopting advanced restructuring solutions, such as debt/equity swaps, because of shareholders' interference and the existence of preemption rights.



Insolvency procedures suffer long delays. Liquidation lasts more than 8 years on average, with preferential and unsecured creditors recovering 29 and 6 percent of claims respectively. Apart from the general inefficiency of civil courts, specific bottlenecks in insolvency procedures contribute to these delays: (i) litigation within the insolvency process, that may involve several rounds of appeals all the way to the Supreme Court; and (ii) difficulties in the collection and sale of assets, despite reforms that have introduced flexibility in the procedure.

Insolvency cases tend to be initiated too late, limiting the scope for recovery. Various incentives have been introduced for debtor companies, such as the possibility that management remains in control during reorganization (*concordato preventivo*). However, there are no effective disincentives for directors to continue trading even when insolvency is imminent (wrongful trading).

Courts and insolvency administrators are not specialized. While in smaller districts, the *de facto* specialization of judges would not be possible, courts in larger towns would benefit from having civil judges specialize in insolvency matters. The recently created enterprise courts do not have competences on insolvency matters. In addition, there are no specific qualifications for insolvency administrators, and their professionalization is limited.

[1]Very large firms (with more than 200 employees) can use special procedures. Small enterprises are not subject to general insolvency law.

Authorities' Views

The authorities acknowledged that asset quality had deteriorated, and write-offs had been limited. They noted that the adoption of the new asset classification framework by all EU member states in January 2015 should help resolve uncertainties about Italian banks' asset quality through harmonizing asset classification. However, this would not be enough to revive the market for NPLs—given the still-sizable pricing gaps—and a more proactive approach is needed. The advice on the potential use of supervisory actions to speed up the write-off process,

such as introducing time limits on vintage NPLs, was received well and could be implemented at the national level within the new SSM framework. The authorities noted, however, that such actions would be more palatable if combined with other elements in the strategy. This would also help alleviate concerns about pro-cyclical tightening in regulatory requirements.

Work on the design of a state-backed AMC, consistent with EU state-aid rules, was ongoing. But the authorities noted that it will focus on *sofferenze* loans transferred at fair market value. The intention is for the state-backed AMC to help jump-start the market, while enabling banks to continue supporting customers in temporary difficulty. The authorities agreed that the reduction in the period of tax deductibility would be useful, although the initial fiscal cost could be significant.

The authorities broadly agreed that a more efficient insolvency regime will be important to reduce the stock of NPLs. However, views on how this would best be achieved varied. Some considered targeted amendments to the existing regime to be sufficient given recent reforms to the insolvency framework; others favored a more systematic overhaul of the insolvency regime—as recommended by staff—which would target the remaining gaps in pre-insolvency procedures. There was wide agreement on the need to accelerate the start of the insolvency procedures, reduce delays from litigation and increase the effectiveness of asset sales, and introduce qualifications requirements for insolvency practitioners.

Views on the need to clean up corporate balance sheets were more varied. Some questioned the premise that there was debt overhang in the corporate sector. Others noted the increasing polarization within SMEs, with the "good" performers poised to lead the recovery, and the "bad" performers burdened with debt and holding up resources that might be better used elsewhere. While acknowledging the issue with these "bad" performers, the authorities noted that (i) it is a difficult problem to solve; and (ii) the case for policy intervention is less compelling than in the financial sector. Nevertheless, the authorities were intrigued by a creditor-led *triage* approach towards SME restructuring and the experience of other countries in establishing standard criteria for SME viability assessments and restructuring guidelines.

Strengthening Banks and Reviving Firms

Advice

Improving corporate governance would complement balance sheet repair. The recent decree law on the largest *banche popolari* (BP), which requires them to transform into joint stock companies—in line with past IMF advice—marks a historical change in the governance structure of BPs. It will spur consolidation and generate efficiency gains, improve risk and NPL management, and improve governance. The recent measures to reduce foundations' stakes in banks by applying diversification thresholds is potentially helpful. Broadening these efforts

would help tackle remaining issues in the governance of banking foundations and smaller cooperative banks.

Diversifying SMEs' funding will help ease credit constraints. Recent actions—such as launching mini-bonds; introducing tax credits for investment in innovation projects; allowing institutional investors to invest directly in SMEs; and creating incentives for listing on stock exchange—are important steps. Further efforts could include:

i. ***Enhance the use and enforcement of collateral.*** More efficient collateral enforcement mechanisms could expand the availability and lower the cost of credit. Introducing contracts based on fiduciary arrangements and expanding the possibilities for out-of-court enforcement will allow a quicker recovery. Reforming the secured transactions law and improving the registry for collateral will expand access to finance.

ii. ***Greater sharing of credit information.*** As emphasized in past consultations, expanding access to the key registries by nonbanks and including other relevant data (e.g., payments on taxes, retail credit, and utility bills) would improve credit monitoring and support the shift from collateral-based to risk-based lending.

Authorities' Views

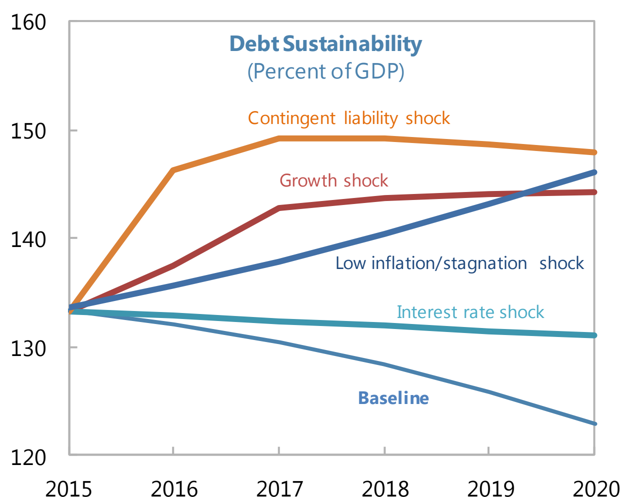
The authorities expressed their commitment to improve governance and enhance competition in the banking sector. In addition to the recently implemented reform of the BPs, steps were also being taken to strengthen the small cooperative banks—the weakest link in the banking system—that face difficulties managing risks and NPLs, and raising capital. These banks were given a year to self-reform, with the hope of establishing cooperative banking groups (in the spirit of Crédit Agricole).

The authorities stressed that government support had cushioned the decline in credit supply to SMEs. They were open to exploring options to improve enforcement of collateral. Besides fiduciary contracts, the authorities expressed interest in out-of-court enforcement and summary procedures for enforcement in commercial credit relationships. Reforming security interests and registration of movable collateral has been on the agenda since December 2013 but is yet to be completed.

C. Rebalancing Fiscal Adjustment and Reducing Public Debt

Context

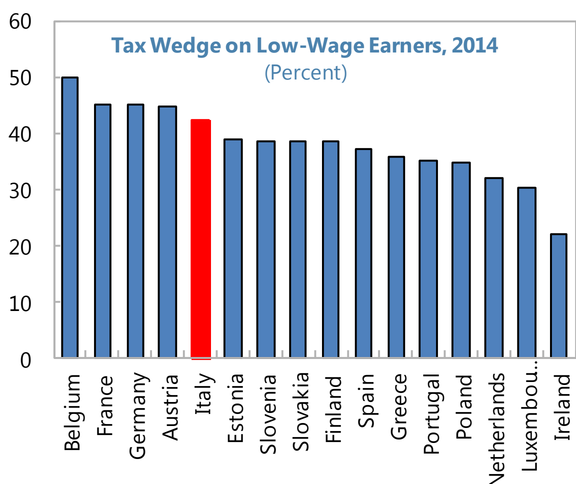
Government spending remains inefficient and very high public debt is a source of vulnerabilities. Italy scores the worst among OECD countries in the World Economic Forum (WEF) index of government spending wastefulness. At the same time, taxes on labor and capital remain high, despite the recent cuts. After years of painful but necessary adjustment, Italy has reached the second highest structural primary surplus in the EU. Despite these efforts, the debt ratio has increased every year since 2008, reaching 132 percent of GDP. Shocks such as a negative growth surprise would put debt on a rising path. The authorities' budgetary targets include a very mild consolidation in 2015, with a plan to reach the MTO of structural balance in 2017 through gradual adjustment.

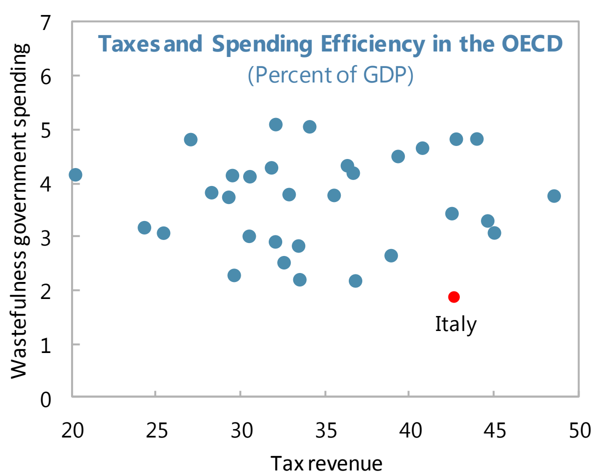


Sources: Bank of Italy; and IMF staff estimates.

Advice

Lower taxes and more efficient spending would support growth. The 2015 budget cut labor taxes by 0.7 percent of GDP, but the labor tax wedge remains well above the OECD median. The ongoing spending reviews—aiming for savings of €10 billion in 2016 and €17–18 billion by 2018—are crucial to raise the efficiency of public spending and create room for further labor and capital tax cuts, and targeted spending increases in areas such as infrastructure or R&D. These reviews should also identify possible efficiency gains in areas such as procurement, transfers to public

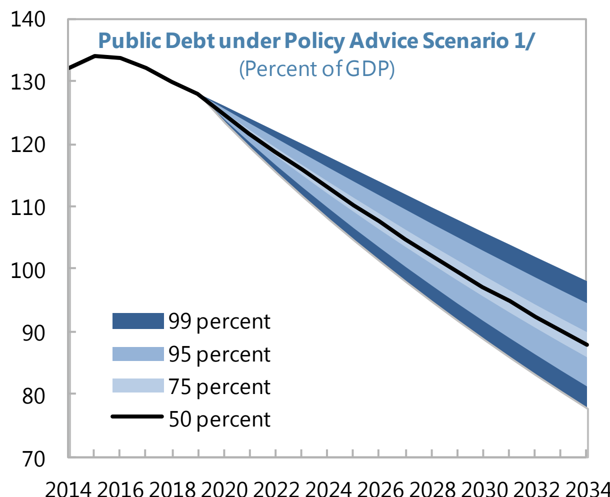




enterprises, and health, among others. Completing the review of tax expenditures envisaged in the *delega fiscale* would also contribute to fiscal rebalancing.

The planned modest consolidation of ¼ percent of GDP in 2015 strikes a balance between supporting growth and reducing debt. In this context, the re-indexation of pensions in accordance with the Constitutional Court ruling should not modify the fiscal stance this year and going forward. Specifically, any permanent impact on the budget should be compensated by reducing spending elsewhere. In 2016, the safeguard clause should be fully offset by spending cuts—to avoid damaging tax hikes while building fiscal buffers. The flexibility under the SGP could be used very modestly—to the tune of 0.2 percent of GDP—to cut taxes further and support specific structural reforms with high growth payoff (for instance, the rationalization of local public enterprises).

More ambitious medium-term targets would help reduce the substantial risks to the debt path (Annex II). Beyond 2017, after the recovery is well entrenched, a structural surplus of about ½ percent of GDP would provide valuable insurance against changes in market sentiment and reduce debt faster. It would also help comply with EU fiscal rules. Implementation of the measures indentified by the spending reviews could deliver the desired surplus. Faster privatization would also contribute to lower debt, although progress in this area remains disappointing. The recent sale of ENEL shares is a positive step, but more ambitious privatization targets, in line with previous plans, would take advantage of favorable market conditions.



Sources: IMF WEO; and IMF Staff Calculations
Notes: Assumes a structural surplus of 0.5 percent of GDP (with the windfall from lower interest rates saved in the medium term); average potential growth at 1 percent and inflation at 1.5 percent over 2020-2034. Stochastic shocks are based on a VAR of 1981-2014 quarterly data.

Stronger budget institutions would improve the quality of spending. A medium-term expenditure framework and the institutionalization of spending reviews would enhance policy prioritization and help deliver on fiscal targets in a growth-friendly way. Fully implementing the *delega fiscale* is essential to simplify the tax system. Stronger efforts to curb tax evasion would generate savings and increase fairness. These efforts should include greater use of the anti-money laundering

framework to pursue tax crimes. Greater information sharing would also help, e.g., between the Financial Intelligence Unit (FIU) and the "fiscal registry" (anagrafe tributaria).

Authorities' Views

The authorities agreed that fiscal policy should do more to support growth. The ongoing spending reviews will improve efficiency and yield savings of at least 0.6 percent of GDP. The reviews will focus on purchases of goods and services, reorganization of bodies at lower levels of government, health, and welfare programs. Avoiding the legislated tax increase in 2016 (the safeguard clause) was viewed as essential to keep the recovery on track. Offsetting the safeguard clause in full by spending cuts could be detrimental to growth, hence the decision to use part of the savings from lower interest rates to avoid the tax increase. In 2015, the windfall from the lower interest bill would help absorb the unexpected (one-off) cost associated with the Constitutional Court decision on pensions.[5] At the same time, the authorities were committed to offset any temporary or permanent impact on the budget.

The flexibility under the SGP could reinforce the structural reform program. A number of relevant reforms have been implemented recently or are being implemented, with a positive medium-term impact on the budget position. These include the reform of the public administration, the Jobs Act, and the Good Schools plan among others. The use of the structural reforms clause under the SGP for 0.4 percent of GDP is warranted to support reform implementation, since it would allow achieving the MTO of structural balance in 2017 more gradually.

A strategy to reduce public debt is in place. In their latest Economic and Financial Document, the authorities target a structural surplus of 0.2 percent of GDP in the medium-term to reduce debt faster and build buffers. Any additional savings would be used to boost growth by cutting taxes. Privatization will support the debt-reduction efforts but even if targets were increased, the pool of available assets is too small to have a significant impact on the debt path. The privatization target for 2015 is 0.4 percent of GDP, and includes the sale of participations in ENAV and Poste Italiane.

STAFF APPRAISAL

16. Italy is emerging slowly from a painful recession. Government bond yields have fallen to precrisis lows, and funding costs for banks and firms have declined. Confidence indicators have

[5] Following the Constitutional Court ruling on pensions, the authorities adopted a decree, currently in Parliament, reintroducing partial and progressive indexation and clearing arrears, while limiting the estimated net cost from about €14 billion to €2.2 billion in 2015 (with a permanent component of €0.5 billion).

rebounded and real activity expanded in Q1 2015. Supported by stronger exports and higher private spending, growth is projected at 0.7 percent in 2015, rising gradually to 1.2 percent in 2016, with risks broadly balanced.

17. Recent policy actions have been critical for this turnaround. *At the European level*, QE has boosted asset prices, including bond yields and the euro; the ECB's BSA has helped reduce uncertainty about bank balance sheets; and more flexibility in the SGP has allowed the fiscal stance to be fairly neutral. *At the national level*, the government has advanced important reforms of the labor market, banking sector, civil justice, and the tax and electoral system that have also lifted confidence.

18. But much higher growth is needed to bring down unemployment and debt at a faster pace. Persistent structural weaknesses, including due to incomplete implementation of previous reforms—together with depressed demand, weakened balance sheets, and subdued growth expectations—have been dragging down growth. Real activity and investment are still far from their precrisis levels, and medium-term growth prospects are lackluster. Unemployment remains high, especially among the youth, and public debt exceeds 130 percent of GDP.

19. Pressing ahead with deeper reforms is vital to revive growth. Policy efforts should focus on three areas: (i) tackling the deep-rooted productivity problem; (ii) supporting bank and corporate balance sheet repair; and (iii) rebalancing fiscal adjustment and reducing public debt. It is encouraging that the government's agenda includes ambitious initiatives in these areas. The challenge now is to maintain the reform momentum and fully implement ongoing and planned reforms, in order to bring about real change on the ground.

20. The prompt adoption of the draft law on public administration reforms is necessary to improve public sector efficiency and unlock the private sector growth potential. Reforms to civil justice, the provision of local public services, tendering procedures, and human resource management in the public administration would not only provide better quality and cheaper services but would also raise private sector productivity. Legislative initiatives have been put forward to address these areas; their full implmenetation will be crucial to overhaul the public sector.

21. It is critical to increase competition in the product and service markets—to benefit consumers and producers alike. The implementation of the Annual Competition Law will further strengthen competition in a number of sectors. The challenge is to fully implement the existing and new legislation, in order to raise the perception of product market efficiency, which remains very low. Removing regulatory barriers in sectors that remain highly protected such as transport would also help lower the cost of services.

22. The Jobs Act should be fully implemented—to make the labor market more inclusive, more responsive to economic conditions, and more productive. The new open-ended contract with gradually increasing protection and the expansion of the unemployment benefit scheme would help reduce duality, facilitate workers' reallocation, and support their transition between jobs. But implementing the remaining elements of the Jobs Act is equally important. Reforming the wage

supplementation scheme will free-up the labor currently tied in unprofitable firms. Strengthening ALMPs should help these workers find new jobs faster. Outside the Jobs Act, promoting firm-level bargaining through greater flexibility under national contracts would allow companies and workers to better adapt to changing conditions and productivity.

23. A broad-based strategy to strengthen bank and corporate balance sheets will support the nascent recovery. It will free up resources for new lending to productive firms and sectors:

- ***Banks.*** More provisioning and write-offs, incentivized by supervisory actions and fiscal measures; a revived distressed debt market, including through a properly designed, centralized, system-wide, state-backed AMC; and enhanced insolvency regime would accelerate the reduction of the stock of NPLs on banks' balance sheets. Further improvements in bank corporate governance would strengthen capital raising and market discipline.

- ***SMEs.*** A *triage* approach, which involves establishing standard criteria for bank assessments of the viability of SMEs and introducing guidelines for creditor-led restructuring, would accelerate the process of dealing with distressed SMEs. Improving access to finance, including through enhancing collateral use and enforcement and greater credit information sharing, would support investment.

24. Fiscal policy should maintain an appropriate balance between supporting growth and reducing debt. To support growth, fiscal rebalancing needs to continue by lowering still-high labor and capital taxes financed by savings from past and ongoing spending reviews. In the near term, the planned consolidation of ¼ percent of GDP in 2015 is appropriate—given still-subdued growth and high debt—and should be maintained. A very modest use of the flexibility under the SGP could support the structural reform program and create room for further tax cuts. Over the medium-term, a modest structural surplus of about ½ percent of GDP would reduce debt faster, providing valuable insurance against changes in market sentiment, and helping comply with EU fiscal rules. More ambitious privatization targets would also help.

25. Comprehensive policy actions on multiple fronts would be mutually reinforcing. Lowering the tax wedge and repairing bank and corporate balance sheets will boost jobs and investment in productive sectors and firms. And the Jobs Act will help workers transition more easily to these new job opportunities. The resulting productivity gains will be amplified by more efficient public sector and more competitive market for products and services. Conversely, a piecemeal approach could undermine the nascent recovery and leave the economy in its low-growth equilibrium.

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

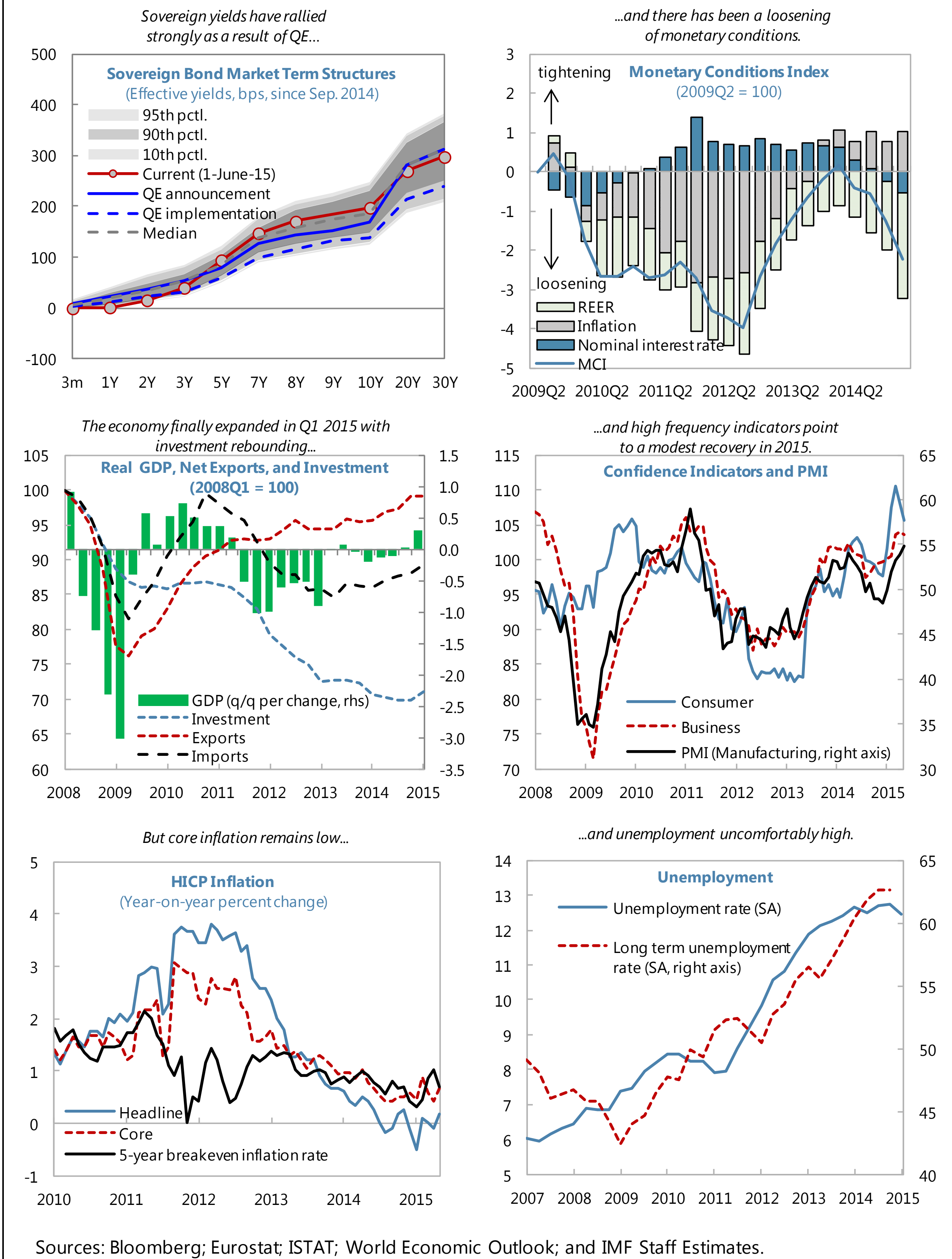
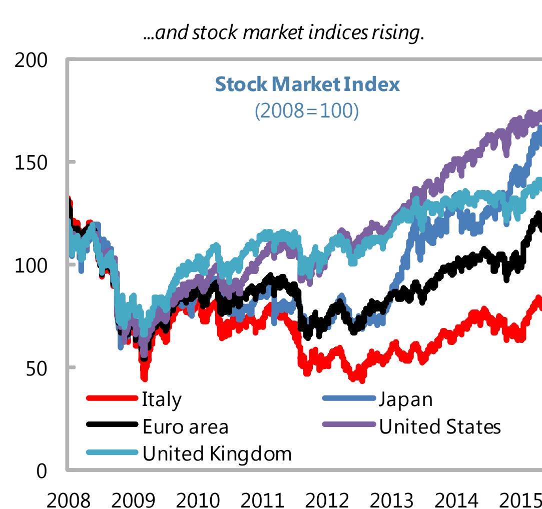
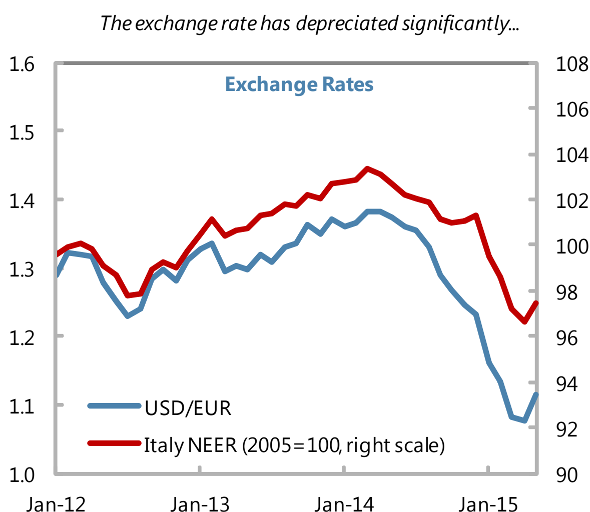
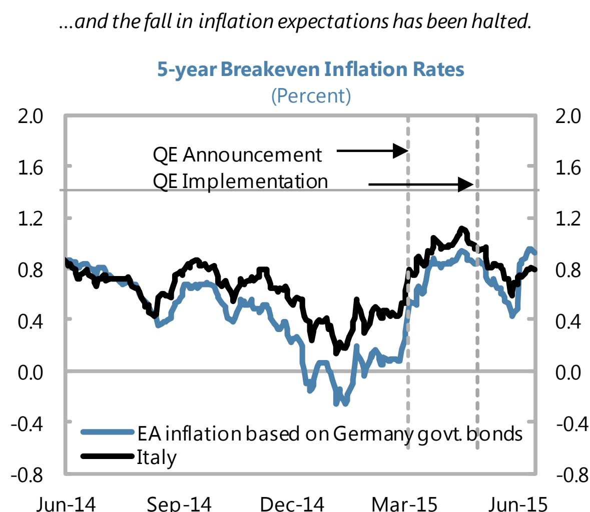


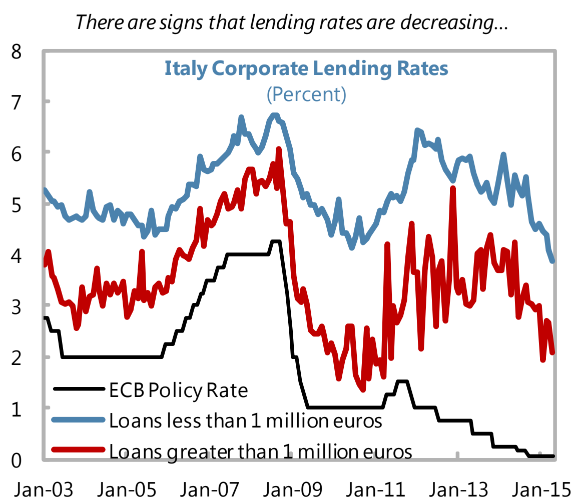
Figure 1. Italy: Outlook—Positive Momentum with Some Unevenness
Sovereign yields have rallied strongly as a result of QE...
Sovereign Bond Market Term Structures
(Effective yields, bps, since Sep. 2014)
95th pctl.
90th pctl.
10th pctl.
Current (1-June-15)
QE announcement
QE implementation
Median
...and there has been a loosening of monetary conditions.
tightening
loosening
Monetary Conditions Index
(2009Q2 = 100)
REER
Inflation
Nominal interest rate
MCI
The economy finally expanded in Q1 2015 with investment rebounding...
Real GDP, Net Exports, and Investment
(2008Q1 = 100)
GDP (q/q per change, rhs)
Investment
Exports
Imports
...and high frequency indicators point to a modest recovery in 2015.
Confidence Indicators and PMI
Consumer
Business
PMI (Manufacturing, right axis)
But core inflation remains low...
HICP Inflation
(Year-on-year percent change)
Headline
Core
5-year breakeven inflation rate
...and unemployment uncomfortably high.
Unemployment
Unemployment rate (SA)
Long term unemployment rate (SA, right axis)
Sources: Bloomberg; Eurostat; ISTAT; World Economic Outlook; and IMF Staff Estimates.

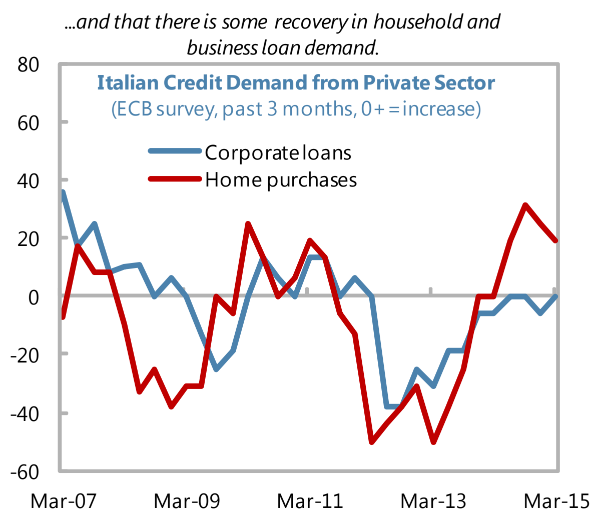
Figure 2. Italy: Impact of ECB's Quantitative Easing







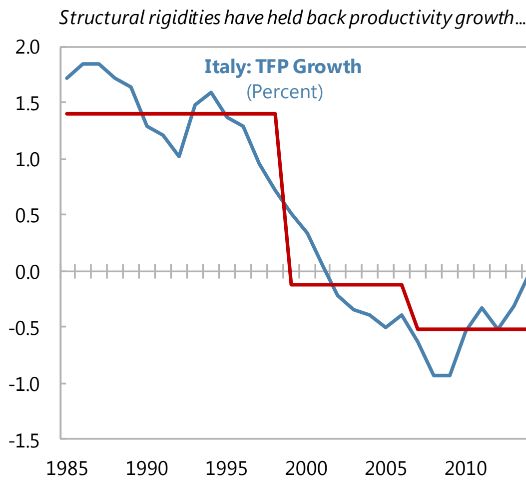




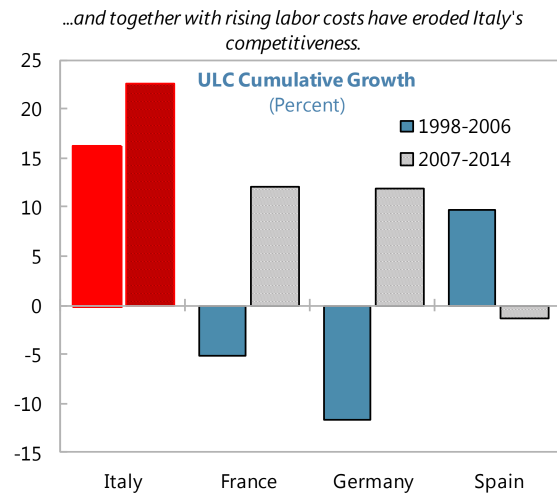
Sources: Bloomberg; Haver: European Central Bank; and IMF staff estimates.

Figure 3. Italy: The Case for Structural Reforms

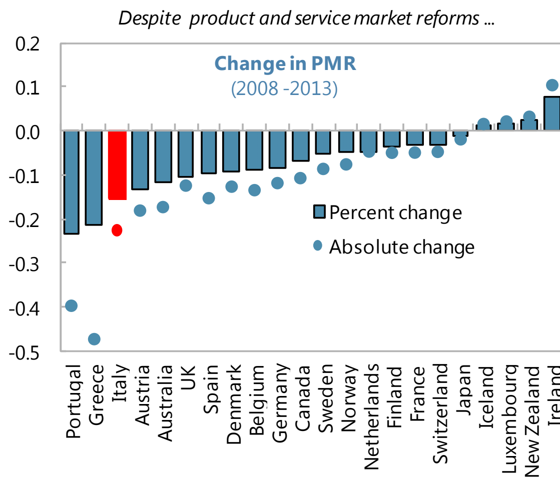
Structural rigidities have held back productivity growth...



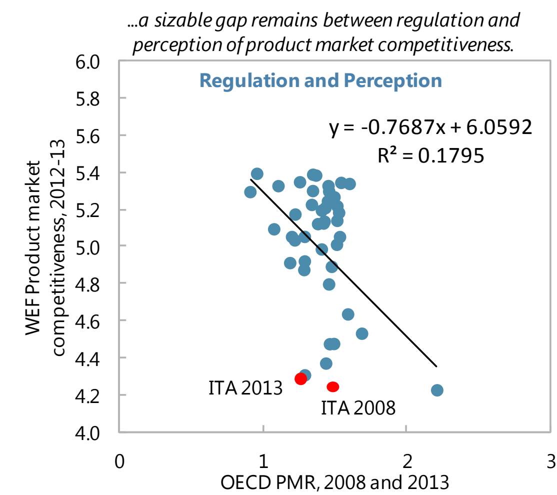
...and together with rising labor costs have eroded Italy's competitiveness.



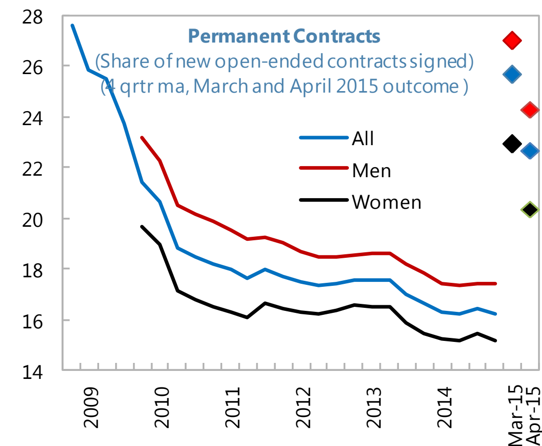
Despite product and service market reforms ...



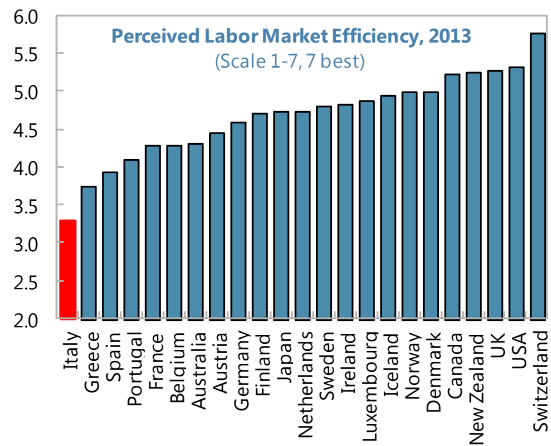
...a sizable gap remains between regulation and perception of product market competitiveness.



The Jobs Act should help address the duality of the labor market ...



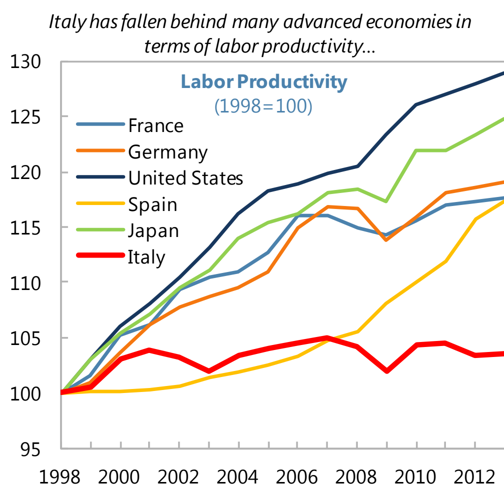
... and its perceived inefficiency.



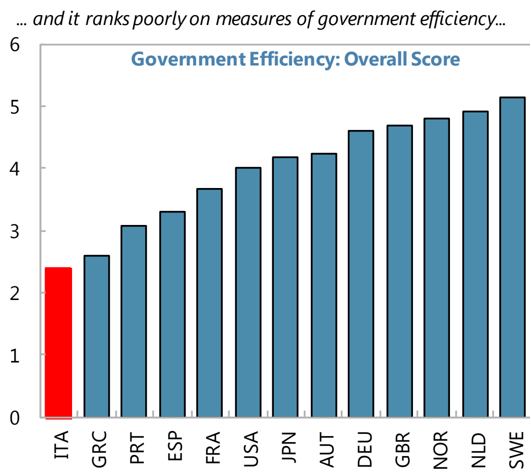
Sources: WEF Global Competitiveness Survey, 2014; OECD Product Market Regulation Database; Ministry of Labor, and IMF staff estimates.

Figure 4. Italy: Public Sector Efficiency and Firm Labor Productivity

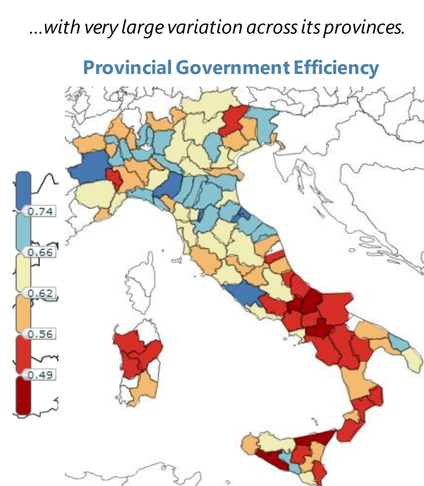
Italy has fallen behind many advanced economies in terms of labor productivity...



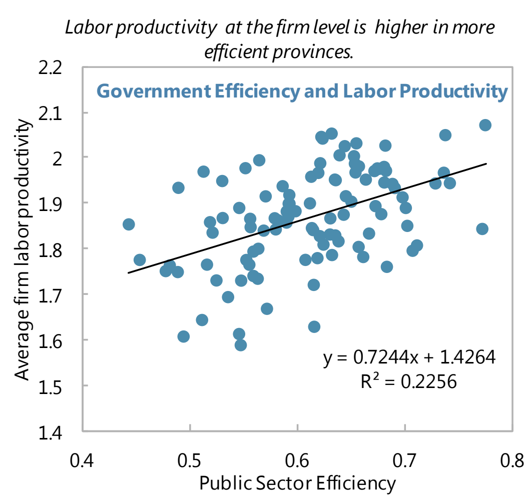
... and it ranks poorly on measures of government efficiency...



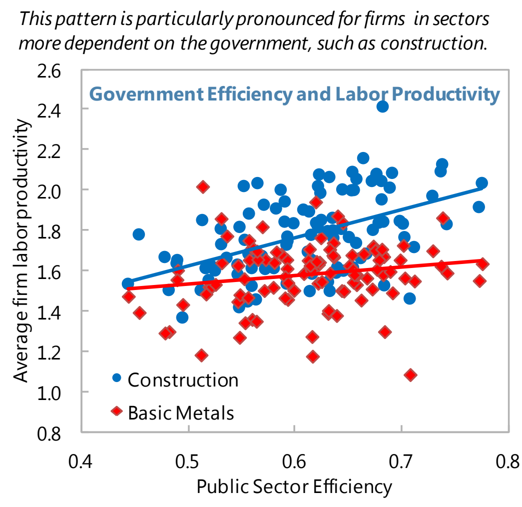
...with very large variation across its provinces.



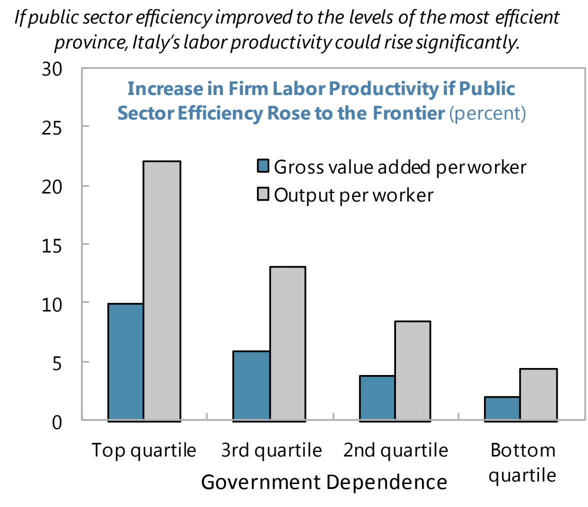
Labor productivity at the firm level is higher in more efficient provinces.



This pattern is particularly pronounced for firms in sectors more dependent on the government, such as construction.



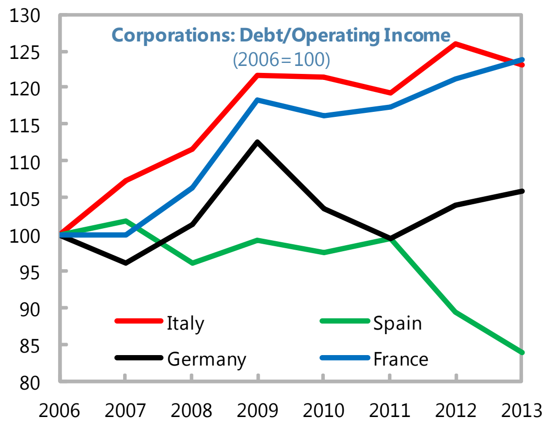
If public sector efficiency improved to the levels of the most efficient province, Italy's labor productivity could rise significantly.

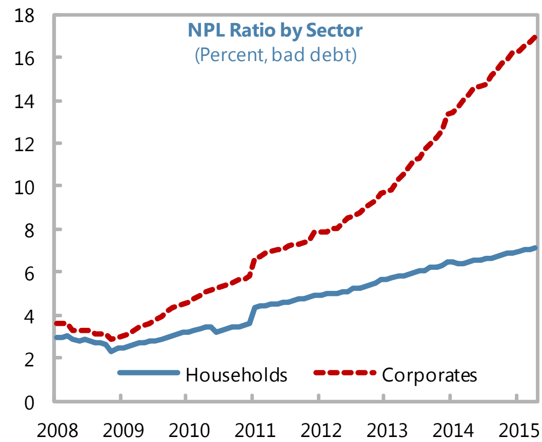


Sources: Total Economy Database (TED) 2014; Orbis Database 2014; Giordano and Tommasino (2011); World Economic Forum, Global Competitiveness Report 2014; and IMF staff estimates.

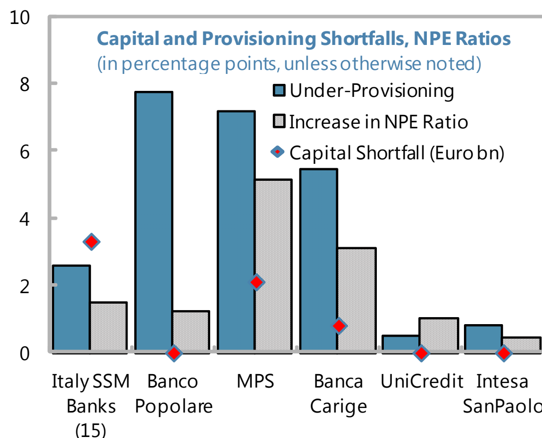
Figure 5. Italy: The Financial Sector Remains Under Pressure

The economic downturn has damaged corporate sector health leading to a signficant worsening of banks' balance sheets.

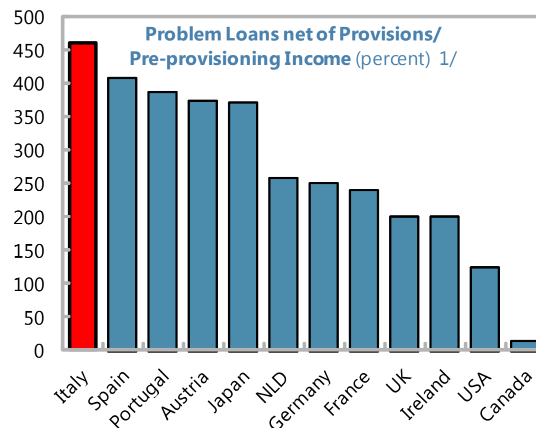




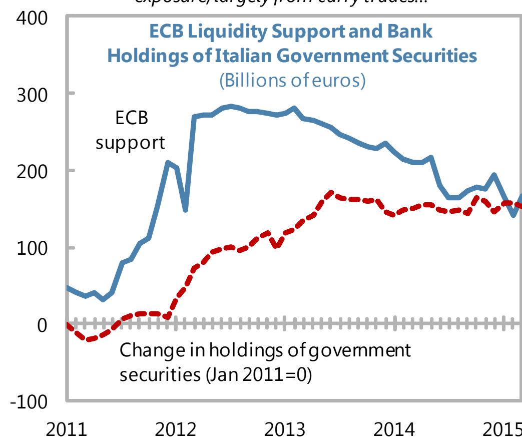
The ECB's AQR revealed sizable provisioning shortfalls.



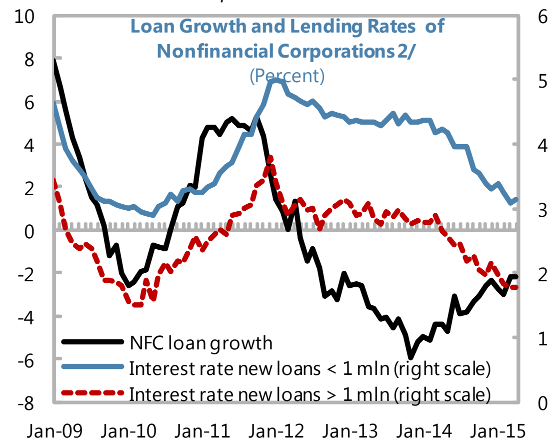
Legacy assets weigh heavily on profitability.



Banks continue to build up sovereign exposure, largely from carry trades...



... but credit has not restarted and lending rates to small firms remain elevated



Sources: Bank of Italy; Moody's KMV; European Central Bank; SNL; and IMF staff estimates.
1/ Data reflect latest year available (2013 or 2014). The chart shows a simple average across banks with full coverage by SNL.
2/ Adjusted for securitization.

Table 1. Italy: Summary of Economic Indicators, 2014–20[1/]

(Annual percentage change, unless noted otherwise)

		Projections					
	2014	2015	2016	2017	2018	2019	2020
Real GDP	-0.4	0.7	1.2	1.1	1.1	1.0	1.0
Real domestic demand	-0.7	0.5	0.9	1.0	1.0	1.0	1.0
Public consumption	-1.0	0.2	0.0	0.0	0.0	0.0	0.0
Private consumption	0.3	1.0	1.1	1.1	1.0	1.0	1.0
Gross fixed capital formation	-3.3	1.6	2.0	2.3	2.2	2.1	2.1
Final domestic demand	-0.6	1.0	1.0	1.0	1.0	1.0	1.0
Stock building 2/	-0.1	0.1	-0.1	-0.1	0.0	0.0	0.0
Net exports 2/	0.3	0.2	0.3	0.2	0.1	0.1	0.0
Exports of goods and services	2.6	3.3	3.9	3.4	3.2	3.2	3.0
Imports of goods and services	1.8	3.1	3.2	3.2	3.3	3.4	3.4
Resource utilization							
Potential GDP	-0.2	0.1	0.3	0.4	0.4	0.5	0.5
Output gap (percent of potential)	-4.6	-4.0	-3.2	-2.5	-1.8	-1.3	-0.8
Employment	-0.3	0.7	0.8	0.8	1.0	1.0	1.0
Unemployment rate (percent)	12.7	12.5	12.2	11.9	11.5	11.1	10.7
Prices							
GDP deflator	0.9	0.4	1.2	1.2	1.2	1.3	1.4
Consumer prices	0.2	0.2	0.9	1.0	1.1	1.2	1.3
Hourly compensation 3/	1.8	1.6	2.0	2.1	2.2	2.3	2.5
Productivity 3/	0.0	0.6	1.0	0.8	0.7	0.7	0.4
Unit labor costs 3/	1.8	1.0	1.0	1.3	1.5	1.7	2.1
Fiscal indicators							
General government net lending/borrowing 4/	-3.0	-2.7	-2.1	-1.4	-0.8	-0.4	-0.2
General government primary balance 4/ 5/	1.4	1.3	1.9	2.4	2.8	3.1	3.3
Structural overall balance (percent of potential GDP)	-0.8	-0.5	-0.3	0.0	0.2	0.3	0.3
Structural primary balance (percent of potential GDP) 5/	3.8	3.7	3.8	3.9	3.9	3.9	3.9
General government gross debt 4/	132.1	133.3	132.1	130.5	128.4	125.8	122.9
Exchange rate regime	Member of the EMU						
Exchange rate (national currency per U.S. dollar)	0.8	...	...	...	...	...	...
Nominal effective rate: CPI based (2000=100)	100.7	...	...	...	...	...	...
External sector 4/							
Current account balance	1.9	2.3	2.3	1.7	1.4	1.0	0.4
Trade balance	3.1	3.3	3.3	3.0	2.7	2.4	2.0

Sources: National Authorities; and IMF staff estimates.

1/ Staff estimates and projections, unless otherwise noted, based on fiscal consolidation measures included in the government's 2015 Budget and Economic and Financial Document.
2/ Contribution to growth.
3/ In industry (including construction).
4/ Percent of GDP.
5/ Excludes interest expenditure.

Table 2. Italy: Statement of Operations—General Government (GFSM 2001 Format), 2013–20

	2013	2014	2015	2016	2017	2018	2019	2020
			Projections					
			(Billions of euros)					
Revenue	772.5	777.2	784.2	802.9	819.8	838.7	859.0	879.9
Taxes	483.7	485.8	490.4	503.8	516.5	529.0	542.6	557.5
Social contributions	215.3	216.4	218.2	221.6	225.7	230.9	236.5	241.3
Grants	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Other revenue	70.5	72.0	72.6	74.5	74.6	75.7	76.9	78.2
Expenditure	819.9	826.3	828.8	837.6	843.1	853.1	866.8	882.8
Expense	819.5	825.9	828.8	837.6	843.1	853.1	866.8	882.8
Compensation of employees	164.9	163.9	164.8	168.1	169.9	172.3	174.5	178.8
Use of goods and services	86.5	86.0	80.7	80.9	83.7	79.4	82.4	83.0
Consumption of fixed capital	38.6	36.3	37.6	38.0	37.7	37.9	35.0	35.2
Interest	77.9	75.2	68.6	69.5	67.9	65.7	66.0	67.4
Social benefits	366.5	376.4	386.6	389.0	392.5	404.2	413.4	421.7
Other expense	123.6	124.5	128.2	130.2	129.1	131.4	130.4	132.0
Net acquisition of nonfinancial assets	0.5	0.4	0.0	0.0	0.0	0.0	0.0	0.0
Gross / Net Operating Balance 1/	-47.0	-48.7	-44.7	-34.8	-23.3	-14.4	-7.8	-2.9
Net lending/borrowing	-47.5	-49.1	-44.7	-34.8	-23.3	-14.4	-7.8	-2.9
			(Percent of GDP, unless otherwise indicated)					
Revenue	48.0	48.1	48.0	48.0	47.9	47.9	47.9	47.9
Taxes	30.1	30.1	30.0	30.1	30.2	30.2	30.2	30.3
Social contributions	13.4	13.4	13.4	13.2	13.2	13.2	13.2	13.1
Grants	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Other revenue	4.4	4.5	4.4	4.4	4.4	4.3	4.3	4.3
Expenditure	50.9	51.1	50.7	50.0	49.2	48.7	48.3	48.0
Expense	50.9	51.1	50.7	50.0	49.2	48.7	48.3	48.0
Compensation of employees	10.2	10.1	10.1	10.0	9.9	9.8	9.7	9.7
Use of goods and services	5.4	5.3	4.9	4.8	4.9	4.5	4.6	4.5
Consumption of fixed capital	2.4	2.2	2.3	2.3	2.2	2.2	1.9	1.9
Interest	4.8	4.7	4.2	4.2	4.0	3.8	3.7	3.7
Social benefits	22.8	23.3	23.7	23.2	22.9	23.1	23.0	22.9
Other expense	7.7	7.7	7.8	7.8	7.5	7.5	7.3	7.2
Net acquisition of nonfinancial assets	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Gross / Net Operating Balance 1/	-2.9	-3.0	-2.7	-2.1	-1.4	-0.8	-0.4	-0.2
Net lending/borrowing	-2.9	-3.0	-2.7	-2.1	-1.4	-0.8	-0.4	-0.2
Memorandum items:								
Primary balance 2/	1.9	1.6	1.3	1.9	2.4	2.8	3.1	3.3
Structural balance 3/	-0.5	-0.8	-0.5	-0.3	0.0	0.2	0.3	0.3
Change in structural balance 3/	1.0	-0.3	0.3	0.2	0.3	0.2	0.1	0.0
Structural primary balance 3/	4.2	3.8	3.7	3.8	3.9	3.9	3.9	3.9
General government gross debt	128.5	132.1	133.3	132.1	130.5	128.4	125.8	122.9

Sources: National Authorities; and IMF staff estimates.

1/ Revenue minus expense.

2/ Revenue minus primary expenditure.

3/ Percent of potential GDP.

Table 3. Italy: Summary of Balance of Payments, 2014–20

	2014	2015	2016	2017	2018	2019	2020
		Projections					
			(Billions of euros)				
Current account balance	30.9	37.0	38.3	29.8	24.4	17.1	8.0
Balance of goods and services	49.9	55.7	57.4	53.2	48.1	41.0	32.1
Goods balance	49.5	53.2	54.9	51.8	48.0	42.7	35.9
Exports	386.9	399.3	415.9	429.3	443.1	457.7	471.9
Imports	337.5	346.2	361.0	377.6	395.1	415.1	436.0
Services balance	0.5	2.6	2.6	1.4	0.1	-1.7	-3.8
Credit	87.8	90.5	94.3	97.3	100.4	103.8	107.0
Debit	87.4	88.0	91.7	95.9	100.4	105.5	110.8
Primary income balance	-2.3	-2.4	-2.4	-6.3	-6.1	-5.9	-5.7
Credit	75.9	73.6	75.9	74.5	76.2	78.6	78.2
Debit	94.8	92.4	94.9	98.0	99.8	102.4	102.3
Secondary income balance	-16.6	-16.3	-16.7	-17.1	-17.5	-17.9	-18.4
Capital account balance	3.4	1.6	1.7	1.7	1.8	1.8	1.8
Financial account	50.2	38.6	40.0	31.5	26.2	18.9	9.8
Direct investment	9.0	5.0	3.7	4.0	4.4	4.7	5.1
Portfolio investment	-4.5	-14.0	-9.3	-2.4	3.0	2.6	1.0
of which: government debt	58.8	31.3	24.3	16.3	10.1	5.4	5.4
Other investment	50.2	47.5	45.6	29.8	18.9	11.6	3.7
Derivatives (net)	-3.6	0.0	0.0	0.0	0.0	0.0	0.0
Reserve assets	-1.0	0.0	0.0	0.0	0.0	0.0	0.0
Net errors and omissions	15.9	0.0	0.0	0.0	0.0	0.0	0.0
			(Percent of GDP)				
Current account balance	1.9	2.3	2.3	1.7	1.4	1.0	0.4
Balance on goods and services	3.1	3.4	3.4	3.1	2.7	2.3	1.7
Goods balance	3.1	3.3	3.3	3.0	2.7	2.4	2.0
Services balance	0.0	0.2	0.2	0.1	0.0	-0.1	-0.2
Primary income balance	-0.1	-0.1	-0.1	-0.4	-0.3	-0.3	-0.3
Secondary income balance	-1.0	-1.0	-1.0	-1.0	-1.0	-1.0	-1.0
Capital account balance	0.2	0.1	0.1	0.1	0.1	0.1	0.1
Financial account	3.1	2.4	2.4	1.8	1.5	1.1	0.5
Direct investment	0.6	0.3	0.2	0.2	0.2	0.3	0.3
Portfolio investment	-0.3	-0.9	-0.6	-0.1	0.2	0.1	0.1
of which: government	3.6	1.9	1.5	1.0	0.6	0.3	0.3
Other investment	3.1	2.9	2.7	1.7	1.1	0.6	0.2
Derivatives (net)	-0.2	0.0	0.0	0.0	0.0	0.0	0.0
Reserve assets	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Net errors and omissions	1.0	0.0	0.0	0.0	0.0	0.0	0.0
Gross external debt	125.3	125.3	122.9	120.3	117.5	114.5	111.4
Public sector	64.0	63.4	61.5	59.3	56.9	54.2	51.6
Private sector	61.3	61.9	61.3	61.0	60.6	60.2	59.8

Sources: National Authorities; and IMF staff estimates. BPM6 presentation.

Table 4. Italy: Financial Soundness Indicators[1/]

(Percent, unless otherwise noted)

	2010	2011	2012	2013	2014
	Core FSIs for Deposit-taking institutions				
Regulatory capital to risk-weighted assets	12.1	12.7	13.4	13.7	15.0
Regulatory tier 1 capital to risk-weighted assets	8.7	9.5	10.5	10.6	11.8
Nonperforming loans net of provisions to capital	60.2	64.6	79.7	89.9	88.0
Nonperforming loans to total gross loans	10.0	11.7	13.7	16.5	17.3
Sectoral distribution of loans to total loans	0.0	0.0	0.0	0.0	0.0
Residents	74.8	75.5	75.5	75.7	75.1
Loans to Deposit takers	2.3	2.6	2.6	2.7	2.6
Loans to Central Bank	0.8	1.0	1.1	0.8	0.5
Loans to Other financial corporations	4.9	3.7	6.0	6.1	5.7
Loans to General government	2.8	2.5	2.6	2.5	2.1
Loans to Nonfinancial corporations	37.9	39.0	37.2	36.8	37.7
Loans to Other domestic sectors	26.1	26.7	25.9	26.9	26.4
Nonresidents	25.2	24.5	24.5	24.3	24.9
Return on assets	0.3	-0.9	-0.1	-0.8	0.1
Return on equity	3.7	-13.0	-0.9	-11.5	1.2
Interest margin to gross income	57.5	57.1	53.8	49.1	49.8
Net open position in foreign exchange to capital	1.7	1.7	1.2	2.0	2.3
	Encouraged FSIs for Deposit-taking institutions				
Capital to assets	5.0	5.4	5.4	5.4	5.9
Large exposures to capital	89.5	89.2	91.8	81.9	136.8
Gross asset position in financial derivatives to capital	74.7	112.3	76.7	70.2	68.8
Gross liability position in financial derivatives to capital	78.1	117.9	83.2	75.5	73.6
Trading income to total income	1.3	3.1	9.6	10.3	7.2
Personnel expenses to noninterest expenses	58.3	56.5	55.7	57.7	56.6
Spread between reference lending and deposit rates (basis point	298.6	305.2	263.9	284.1	3.0
Spread between highest and lowest interbank rates (basis points)	40.8	87.6	12.4	19.7	0.2
Customer deposits to total (noninterbank) loans	63.2	58.2	67.9	70.5	69.5
Foreign-currency-denominated loans to total loans	9.2	8.9	8.3	8.8	9.3
Foreign-currency-denominated liabilities to total liabilities	33.9	30.7	27.8	28.7	31.3

Sources: 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. 2014 data is latest available.

Annex I. External Sector Report Assessment

	Italy	Overall Assessment
Foreign asset and liability position and trajectory	**Background**. Italy's net international investment position (NIIP) has deteriorated significantly since joining the Euro area, with net liabilities of 28 percent of GDP as compared with 7 percent at end 2000, reflecting mainly current account deficits and valuation adjustments. Gross assets and liabilities grew steadily during this period, reaching 136 and 164 percent of GDP respectively, 39 and 60 percent higher than in 2000. External debt represents about ¾ of gross external liabilities. While the level of external debt is in line with the Euro area as a whole, its composition - half is owed by the public sector - underscores the vulnerabilities related to the high level of public sector debt. Looking forward, modest current account surpluses forecast over the medium-term will gradually shrink Italy's net liability position as a share of GDP. **Assessment**. In light of the current account's shift into a surplus, overall external sustainability is not a major concern. Still, some further strengthening of balance sheets is desirable, as Italy is vulnerable to financial contagion given its large stock of government debt and the sizable holdings of public and private debt by non-residents.	**Overall Assessment**: *The external position in 2014 was broadly consistent (but likely still weaker) than suggested by medium-term fundamentals and desirable policy settings. Developments as of May 2015 point toward some strengthening of the external position due to the depreciation of Italy's REER.* The assessment of 2014 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 from average 2014 levels. Part of the needed adjustment may reflect Italy's weak competitive position within the Euro area, where the existence of a common currency has removed an important adjustment mechanism to differences in relative prices changes. **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 1½ percent of GDP in the decade following the adoption of the euro. Starting in 2012, it moved into balance and by 2014, it registered a surplus of 1.9 percent of GDP (up from 1 percent of GDP in 2013). The improvement in the current account is accounted for by the growing trade surplus, which reached more than 3 percent of GDP in 2014, owing both to higher exports and subdued imports. In 2015, the current account surplus is projected to rise further to 2.3 percent of GDP, reflecting the lower oil bill and euro depreciation. In terms of saving and investment, declining investment accounted for about 60 percent of the improvement in the current account since 2010, while higher public and private saving contributed the rest. **Assessment**. Despite the recent improvement in the current account, the EBA model suggests that the cyclically-adjusted level, which stood at 0.7 percent of GDP in 2014, was about 1.3 percent of GDP below the norm implied by medium-term fundamentals and desirable policy settings. 1/ Given these estimates and the need for stronger growth to reduce 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 for 2014.	
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 that the appreciation over the 2000-2014 period has exceeded the Euro area average by about 0 to 10 percent, with indicators based on unit labor cost generally showing a wider gap than other price-based measures. 2/ The recent strengthening of the U.S. dollar vis-à-vis the euro contributed to a depreciation of the REER relative to the 2014 average of about 5 percent as of May 2015. **Assessment**. The EBA methodologies provide a relatively tight range of REER gap estimates in 2014. The REER regression methods suggest an overvaluation of 3 percent (EBA Index REER model) and 6½ percent (EBA Level REER model) in 2014. The CA regression method yields an overvaluation of about 5 percent. On balance, and consistent with the staff assessment of the CA in 2014, staff assessed that a real effective depreciation of 0-10 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. This was also the case in 2014, which saw a strong return of foreign investment in portfolio securities in the first half of the year, led by investment in government securities. TARGET2 liabilities, accumulated by banks over 2011–12, have declined. 3/ **Assessment**. While supported by the QE, 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 (concluded)
Technical Background Notes	1/ The weakening of the CA balance relative to the norm in 2014 is largely the result of a revision in the EBA methodology, which raised the CA norm for countries having both a relatively rapidly aging population and high dependency ratio, such as Italy. 2/ Depending on the measure used, Italy's REER appreciated by -0.4 to 1 percent between 2013 and 2014 (year average on year average). 3/ The sharp rise in Target 2 balances in the second half of 2014 reflected the policy adopted by Treasury to reduce issuance of new debt securities, and a temporary spike due to interbank transactions. Target 2 balances have since declined.

Annex II. Debt Sustainability Analysis

Italy's public debt is sustainable but subject to significant risks. While public debt is expected to decline as growth resumes and interest rates stay low, it is very high and requires large gross and external financing due to the rollover of existing debt. With most of the debt held domestically, the main risk stems from a stagnation scenario, where growth and inflation remain very low for an extended period. The ECB's bond buying program partially mitigates market risks.

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 0.7 percent in 2015, increasing to around 1 percent in the medium term. Inflation is projected at around 1.3 percent over the medium term. The structural balance improves over the projection period due to the measures in the budget and a falling interest bill. Spreads are assumed to remain at current levels. However, yields are expected to rise moderately to about 2½ percent as monetary policy normalizes.

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 were sometimes worse than projected, the current growth projections are in line with consensus but below the authorities' forecasts. Risks to the outlook are broadly balanced. Stagnation and low inflation that complicate efforts to reduce public debt remain an important downside risk. QE, euro depreciation, and lower oil prices could have a larger positive impact than currently expected. Rapid progress on the domestic reform agenda could boost confidence and spur a stronger recovery, lowering debt faster. Inflation projection errors have been small historically but the risk of deflation is a particular concern given its implications on debt dynamics.

- The projected cyclically-adjusted primary balance is large, but Italy has a history of running large primary surpluses for extended periods.

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. EDP debt is a subset of General Government consolidated debt, excluding items such as certain trade credits and other accounts payable. Stocks are recorded at their face value and thus usually exclude unpaid accrued interest.

Baseline

4. **Staff projects the debt-to-GDP ratio to peak at 133 percent of GDP in 2015, before declining to 123 percent in 2020.** The debt profile is lower than a year ago on account of lower interest rates. The revision of national accounts to adopt the ESA 2010 standard increased the level of GDP in 2013, lowering the debt ratio by 4.8 percentage points. The baseline scenario does not incorporate potential fiscal costs of a state-backed AMC and tax incentives to encourage loan-loss provisions.

5. Gross financing needs have fallen but are expected to remain sizeable, with rollover risks mitigated by the long–term debt structure and ECB bond buying. Italy remains vulnerable to a loss in market confidence, owing to still large government refinancing needs (15–18 percent of GDP). Refinancing risks are partially mitigated by the public debt structure. Average maturity is around 6½ years and 70 percent of debt features fixed interest rates. The direct interest pass-through to the budget is moderate; a 100 basis points shock to the yield curve is estimated to raise the interest bill by 0.3 percent of GDP in the first and second years. About two-thirds of debt is held by domestic investors.

6. The portfolio of Central Government derivatives accounts for 9 percent of total debt, with a notional value of €160 billion. Most of the portfolio comprises interest rates swaps to increase the duration of debt. The mark-to-market value of the Treasury's portfolio was -2.6 percent of GDP in 2014:Q3. A few contracts (for a notional of €16 billion) have early termination clauses. The authorities will not enter new derivatives contracts going forward, except for cross-currency swaps linked to foreign currency debt issuance.

Shocks and Stress Tests

7. 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 2016, resulting in an average growth of -1.2 percent in 2016–17. Furthermore, for every 1 percentage point decline in growth, inflation declines by 25bps. The primary balance improves more slowly than the baseline, reaching only 0.7 percent of GDP by 2020. The debt-to-GDP ratio increases rapidly to about 145 percent during the growth shock and then fails to come down over the projection period.

- **Interest rate shock.** Market concerns about medium-term debt sustainability re-emerge, 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 3.3 percent by 2020. Debt still declines but very modestly, staying around 130 percent in 2020.

- **Contingent liability shock.** Negative surprises, such as from the financial system, lead to a one-time increase in noninterest expenditure of about 10 percent of banking sector assets. This leads to -1.3 percent growth for two consecutive years, depressing domestic demand and lowering inflation by 0.3 percent. The primary balance worsens by 12 percent of GDP in 2016 and by 1.4 percent of GDP from 2017 onwards. Debt rises to 150 percent of GDP, after which it starts declining very modestly. Gross financing needs would be significantly higher.

- **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 premia (20 bps increase for each 1 percent of GDP slippage). The debt-to-GDP ratio is about 2 percentage points higher than the baseline by 2020.

- **Low inflation and prolonged stagnation.** Inflation surprises on the downside given the large negative output gap and is lower by 1 standard deviation (0.8 pp) from 2016 onwards, remaining at 0.4 percent for three years and reaching 0.6 percent in 2020. Annual GDP growth is 0.6-0.9pp lower than in the baseline and there is a 50bps increase in interest rates in 2016–20. 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 2020 and fails to stabilize over the projection period.

- **Policy advice scenario**. Under this scenario, structural reforms and fiscal rebalancing provide a growth dividend of ¼ percent in 2017 that rises permanently to ½ percent of GDP by 2020. The interest rate declines by around 10 bps. Annual privatization receipts of 1 percent of GDP materialize. In line with staff's advice, the structural surplus increases progressively to ½ percent of GDP by 2020. These assumptions allow the debt-ratio to decline to about 112 percent of GDP by 2020 and continue firmly on a declining path.

Figure A2.1. Italy: Public DSA Risk Assessment

Heat Map

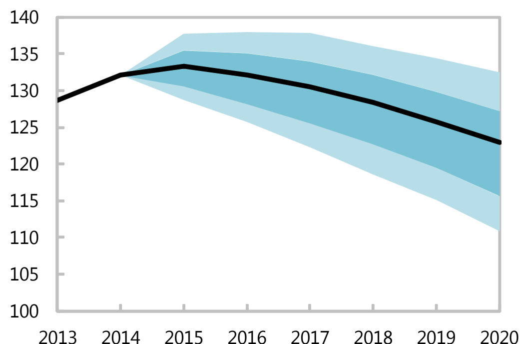
Debt level [1/]	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability shock
Gross financing needs [2/]	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability Shock
Debt profile [3/]	Market Perception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

Evolution of Predictive Densities of Gross Nominal Public Debt

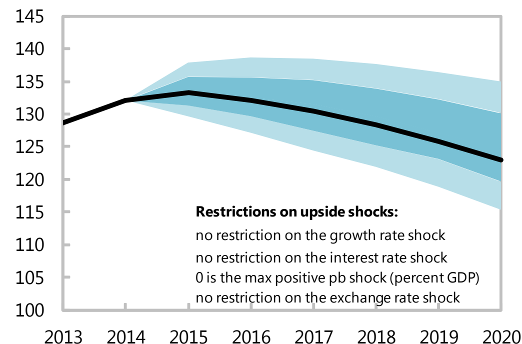
(in percent of GDP)

Baseline Percentiles: 10th-25th 25th-75th 75th-90th

Symmetric Distribution



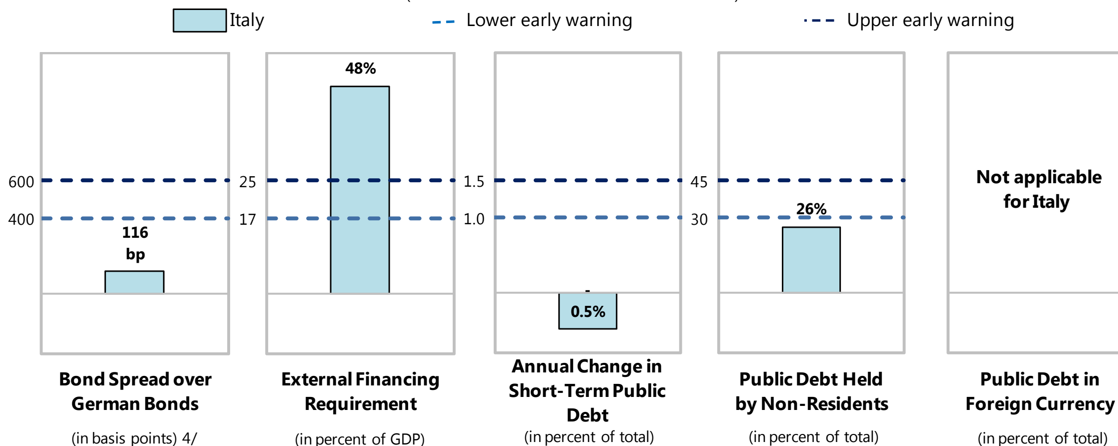
Restricted (Asymmetric) Distribution



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks)

Italy Lower early warning Upper early warning



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.

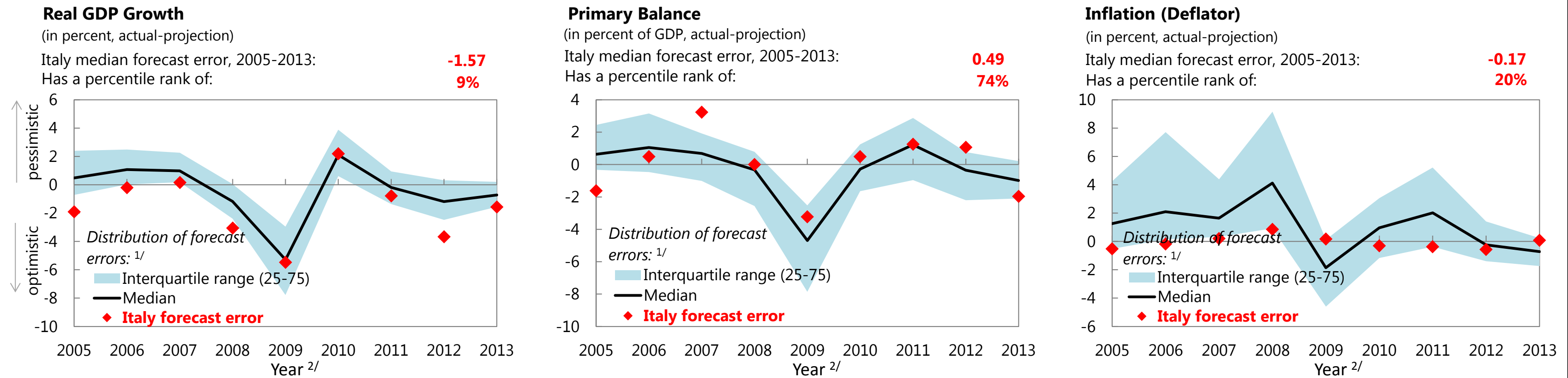
3/ The cell is highlighted in green if country value is less than the lower risk-assessment benchmark, red if country value exceeds the upper risk-assessment benchmark, yellow if country value is between the lower and upper risk-assessment benchmarks. If data are unavailable or indicator is not relevant,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

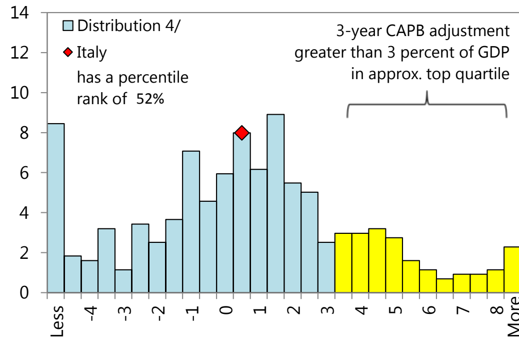
4/ An average over the last 3 months.

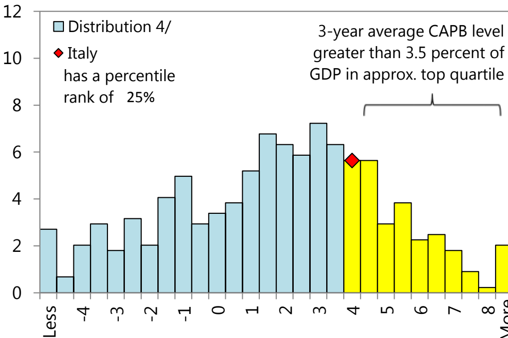
Figure A2.2. Italy: Public DSA—Realism of Baseline Assumptions

Forecast Track Record, versus surveillance countries

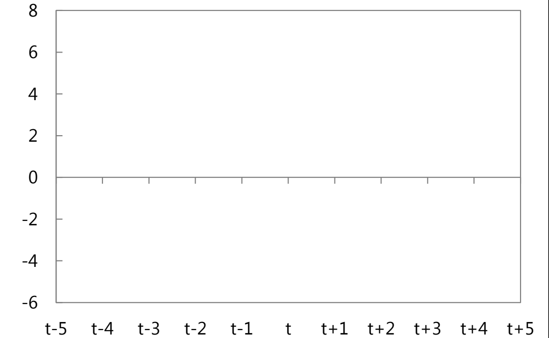


Assessing the Realism of Projected Fiscal Adjustment





Boom-Bust Analysis 3/



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.

Figure A2.3. Italy: Public Sector Debt Sustainability Analysis (DSA)—Baseline Scenario

(in percent of GDP unless otherwise indicated)

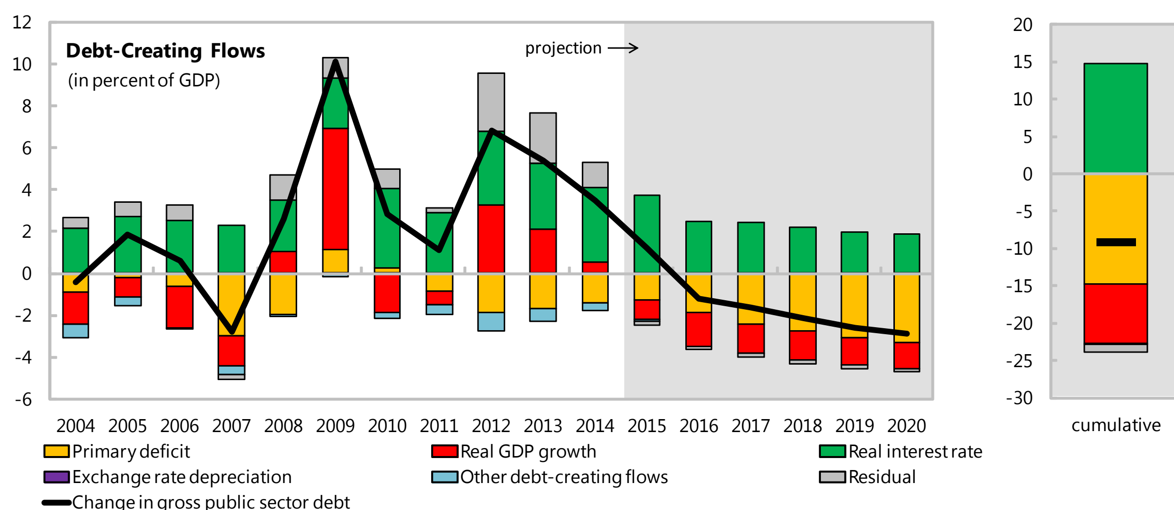
Debt, Economic and Market Indicators [1]

	Actual			Projections							
	2004-2012 [2]	2013	2014	2015	2016	2017	2018	2019	2020		
Nominal gross public debt	108.2	128.6	132.1	133.3	132.1	130.5	128.4	125.8	122.9		
Public gross financing needs	23.1	22.3	32.6	19.8	16.5	18.6	16.1	14.7	14.5		
Real GDP growth (in percent)	-0.1	-1.7	-0.4	0.7	1.2	1.1	1.1	1.0	1.0		
Inflation (GDP deflator, in percent)	1.8	1.4	0.9	0.4	1.2	1.2	1.2	1.3	1.4		
Nominal GDP growth (in percent)	1.7	-0.4	0.4	1.1	2.5	2.3	2.3	2.4	2.5		
Effective interest rate (in percent) [4]	4.4	3.9	3.6	3.2	3.2	3.1	2.9	2.9	3.0		

As of June 03, 2015		
Sovereign Spreads		
Spread (bp) 3/		132
CDS (bp)		112
Ratings	Foreign	Local
Moody's	Baa2	Baa2
S&Ps	BBB-	BBB-
Fitch	BBB+	BBB+

Contribution to Changes in Public Debt

	Actual			Projections							
	2004-2012	2013	2014	2015	2016	2017	2018	2019	2020	cumulative	debt-stabilizing primary balance [9]
Change in gross public sector debt	2.5	5.40	3.49	1.2	-1.2	-1.6	-2.1	-2.6	-2.8	-9.1	
Identified debt-creating flows	1.7	3.00	2.31	1.4	-1.0	-1.4	-1.9	-2.4	-2.7	-8.1	
Primary deficit	-0.9	-1.7	-1.4	-1.3	-1.9	-2.4	-2.8	-3.1	-3.3	-14.8	0.7
Primary (noninterest) revenue and gra	44.9	47.8	47.9	47.8	47.8	47.7	47.7	47.7	47.7	286.4	
Primary (noninterest) expenditure	44.0	46.1	46.5	46.5	45.9	45.3	44.9	44.6	44.4	271.6	
Automatic debt dynamics [5]	2.9	5.3	4.1	2.8	0.9	1.0	0.8	0.7	0.7	6.8	
Interest rate/growth differential [6]	2.9	5.3	4.1	2.8	0.9	1.0	0.8	0.7	0.7	6.8	
Of which: real interest rate	2.7	3.2	3.6	3.7	2.5	2.4	2.2	2.0	1.9	14.7	
Of which: real GDP growth	0.2	2.1	0.5	-0.9	-1.6	-1.4	-1.4	-1.3	-1.2	-7.9	
Exchange rate depreciation [7]	0.0	0.0	0.0	…	…	…	…	…	…	…	
Other identified debt-creating flows	-0.4	-0.6	-0.4	-0.1	0.0	0.0	0.0	0.0	0.0	-0.1	
Privatization receipts (negative)	-0.2	-0.1	-0.2	-0.1	0.0	0.0	0.0	0.0	0.0	-0.1	
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	-0.5	-0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes [8]	0.9	2.4	1.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-1.0	



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.

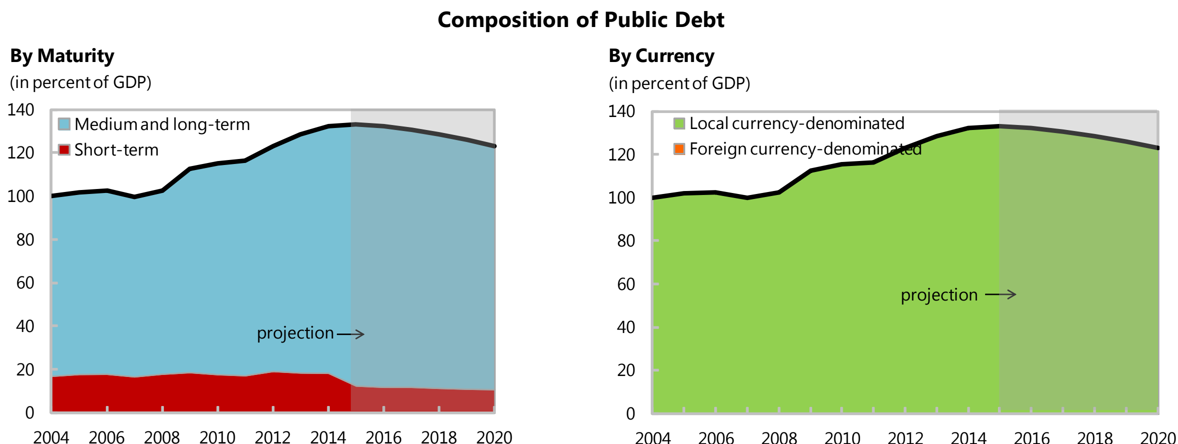
7/ The exchange rate contribution is derived from the numerator in footnote 2/ as ae(1+r).

8/ In 2013-4 and for projections, this line includes EFSF gurantees, arrears clearance payments, and exchange rate changes.

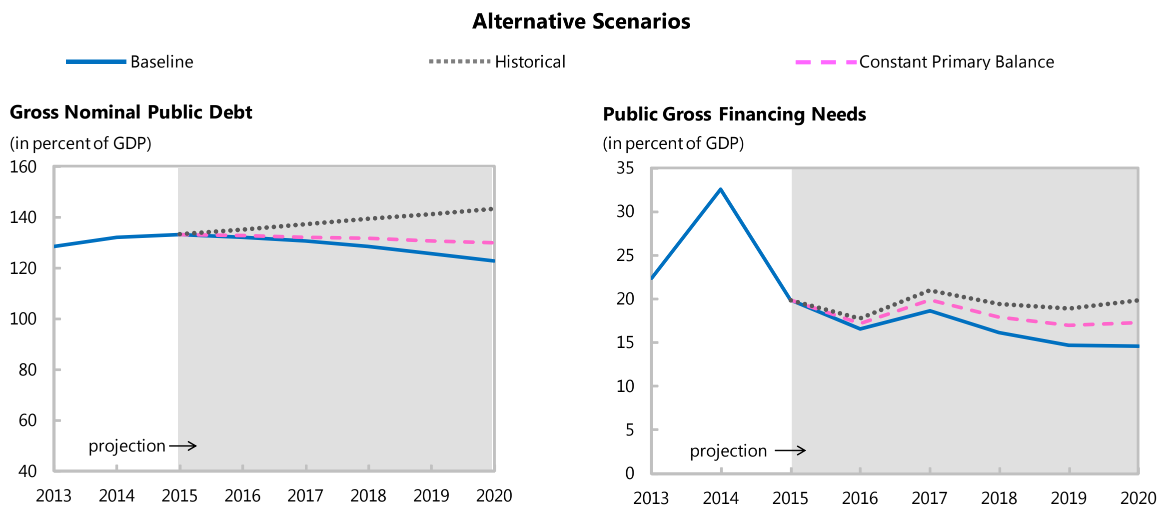
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Figure A2.4. Italy: Public DSA—Composition of Public Debt and Alternative Scenarios

Composition of Public Debt



Alternative Scenarios



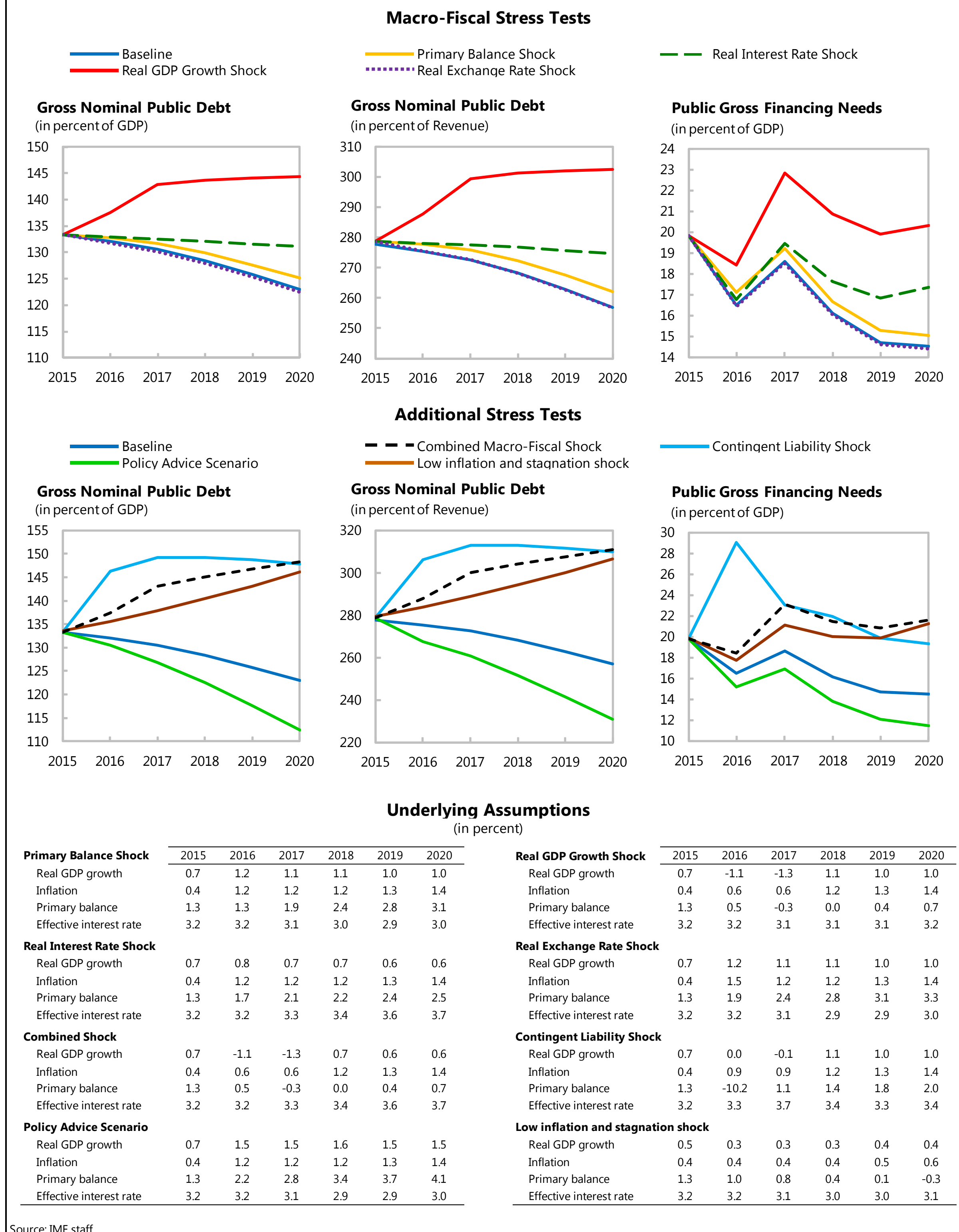
Underlying Assumptions
(in percent)

Baseline Scenario	2015	2016	2017	2018	2019	2020
Real GDP growth	0.7	1.2	1.1	1.1	1.0	1.0
Inflation	0.4	1.2	1.2	1.2	1.3	1.4
Primary Balance	1.3	1.9	2.4	2.8	3.1	3.3
Effective interest rate	3.2	3.2	3.1	3.0	2.9	3.0
Constant Primary Balance Scenario						
Real GDP growth	0.7	1.2	1.1	1.1	1.0	1.0
Inflation	0.4	1.2	1.2	1.2	1.3	1.4
Primary Balance	1.3	1.3	1.3	1.3	1.3	1.3
Effective interest rate	3.2	3.2	3.1	2.9	2.9	2.9

Historical Scenario	2015	2016	2017	2018	2019	2020
Real GDP growth	0.7	-0.5	-0.5	-0.5	-0.5	-0.5
Inflation	0.4	1.2	1.2	1.2	1.3	1.4
Primary Balance	1.3	1.0	1.0	1.0	1.0	1.0
Effective interest rate	3.2	3.2	3.1	3.1	3.1	3.2

Source: IMF staff.

Figure A2.5. Italy: Public DSA—Stress Tests



Primary Balance Shock	2015	2016	2017	2018	2019	2020
Real GDP growth	0.7	1.2	1.1	1.1	1.0	1.0
Inflation	0.4	1.2	1.2	1.2	1.3	1.4
Primary balance	1.3	1.3	1.9	2.4	2.8	3.1
Effective interest rate	3.2	3.2	3.1	3.0	2.9	3.0
Real Interest Rate Shock						
Real GDP growth	0.7	0.8	0.7	0.7	0.6	0.6
Inflation	0.4	1.2	1.2	1.2	1.3	1.4
Primary balance	1.3	1.7	2.1	2.2	2.4	2.5
Effective interest rate	3.2	3.2	3.3	3.4	3.6	3.7
Combined Shock						
Real GDP growth	0.7	-1.1	-1.3	0.7	0.6	0.6
Inflation	0.4	0.6	0.6	1.2	1.3	1.4
Primary balance	1.3	0.5	-0.3	0.0	0.4	0.7
Effective interest rate	3.2	3.2	3.3	3.4	3.6	3.7
Policy Advice Scenario						
Real GDP growth	0.7	1.5	1.5	1.6	1.5	1.5
Inflation	0.4	1.2	1.2	1.2	1.3	1.4
Primary balance	1.3	2.2	2.8	3.4	3.7	4.1
Effective interest rate	3.2	3.2	3.1	2.9	2.9	3.0

Real GDP Growth Shock	2015	2016	2017	2018	2019	2020
Real GDP growth	0.7	-1.1	-1.3	1.1	1.0	1.0
Inflation	0.4	0.6	0.6	1.2	1.3	1.4
Primary balance	1.3	0.5	-0.3	0.0	0.4	0.7
Effective interest rate	3.2	3.2	3.1	3.1	3.1	3.2
Real Exchange Rate Shock						
Real GDP growth	0.7	1.2	1.1	1.1	1.0	1.0
Inflation	0.4	1.5	1.2	1.2	1.3	1.4
Primary balance	1.3	1.9	2.4	2.8	3.1	3.3
Effective interest rate	3.2	3.2	3.1	2.9	2.9	3.0
Contingent Liability Shock						
Real GDP growth	0.7	0.0	-0.1	1.1	1.0	1.0
Inflation	0.4	0.9	0.9	1.2	1.3	1.4
Primary balance	1.3	-10.2	1.1	1.4	1.8	2.0
Effective interest rate	3.2	3.3	3.7	3.4	3.3	3.4
Low inflation and stagnation shock						
Real GDP growth	0.5	0.3	0.3	0.3	0.4	0.4
Inflation	0.4	0.4	0.4	0.4	0.5	0.6
Primary balance	1.3	1.0	0.8	0.4	0.1	-0.3
Effective interest rate	3.2	3.2	3.1	3.0	3.0	3.1

Source: IMF staff.

Appendix. Progress Against IMF Recommendations

Italy: Progress Against IMF Recommendations

	2014 Article IV Policy Advice	Actions since 2014 Article IV	Next steps
		Structural Reforms to Improve the Business Environment	
Labor market	Simplify contracts by shifting to a more flexible, single contract for new workers with gradually increasing protection	As part of the Jobs Act, a new open ended labor contract entered into force in March 2015. The contract limits the scope for reinstatement, introduces a fast track settlement of dismissal disputes, and provides monetary compensation which rises with tenure in case of unfair dismissal. A legislative decree, approved by the Government in June 2015, reviews existing temporary contracts and allows for more flexible use of labor within the firm, while promoting the use of the new open ended contract as the main form of labour contract for employees.	Monitor take-up of new open-ended contract, recourse to legal action, and judges' interpretation of new legislation. Implement legislative decree on streamlining of contracts and monitor use of enhanced flexibility in allocation of labor within the firm.
	Shift to a more universal support system conditional on job search and training	The introduction of NASPI (May 2015) broadens the coverage of unemployment insurance and increases conditionality of receiving unemployment benefits. Two additional schemes are introduced on an experimental basis: Dis-Col for workers on collaboration contracts, and ASDI for unemployed workers with children or close to retirement. A legislative decree for reforming the wage supplementation scheme was presented for preliminary examination in June 2015.	Finalize and implement legislative decrees reforming the current wage supplementation scheme.
	Improve active labor market policies through better coordination and information sharing	Legislative decree on the establishment of a National Agency for Active Work Policies (ANPAL) presented for preliminary examination in June 2015.	Finalize legislative decree and establish the proposed national coordination center; monitor its effeciveness.
	Boost female labor participation	A legislative decree, which reviews parental benefits and introduces new provisions for more flexible work arrangement, was adopted in June 2015 as part of the Jobs Act.	Monitor effectiveness of measures taken to improve work-life balance and raise female labor force participation.
	Decentralize wage setting by operationalizing June 2011 agreement	In March 2015, INPS and social partners signed a further agreement that would enable the implementation of the Consolidated Act on Representation.	Continue to promote the use of firm-level bargaining
Product markets	Complete steps to address staffing shortages of the transport authority; enhance competition in the retail sector; implement reforms in sectors that are essential inputs to production	The Transportation Authority is fully staffed and operational. The draft Annual Competition Law (ACL), presented to Parliament in February, proposes measures to enhance competition through a more effective demand mobility and transparency in a wide range of sectors.	Legislate and implement the Annual Competition Law. Implement the relevant legislation to eliminate existing regulatory barriers in sectors outside the ACL (e.g. transport). Fully implement already legislated reforms by all levels of government.
	Accelerate opening of professional services	The ACL envisions further liberalization in the legal, notary, engineering and architect professions.	Needs full implementation

Italy: Progress Against IMF Recommendations

	2014 Article IV Policy Advice	Actions since 2014 Article IV	Next steps
		Structural Reforms to Improve the Business Environment	
Public Services	Improve efficiency and accelerate the privatization agenda, especially at the local level	The 2015 Stability Law requires municipalities to present plans for local public enterprises rationalization by March 2015. Regions are also required to create and make operational "optimal basins" for the assignment of local public services by March 2015. A public administration reform was legislated in July 2014, increasing mobility of public sector workers. A draft enabling law on a comprehensive public administration reform is currently under discussion at the Lower House, having been approved by the Senate in April 2015.	Further reforming local public services and rationalizing local public enterprises to improve efficiency. Rationalise the legal framework related to local public services with a view of improving competition in services awards. Increase the autonomy and accountability of public sector managers; strengthen benchmarking and performance-based budgeting; and improve mobility of workers and wage differentiation across agencies and geographical areas. Further improve tendering procedures and standardization of service contracts.
Judicial System	Conduct a comprehensive review of court fees	Decree Law 9/12/14, converted into law 11/10/14, n.162, has introduced some measures regarding court fees	Comprehensive assessment of court fees, which remain modest and capped
	Develop and use performance indicators for all courts	Strasbourg Programme 2.0 under implementation	Develop indicators and use them for court management and accountability purposes
	Align appeals system with international practice	Proposal for legislative delegation on civil procedure, passed by the Council of Ministers (2/10/2015), and pending approval by Parliament.	Rationalize appeals system
EU-level	Strengthen common market through implementation of the Services Directive	In 2014 the infringments procedures have been reduced by 25% and the mechanisms for a swift and sound implementation of EU law have been further improved.	
		Fiscal Policy—Reducing Vulnerabilities and Supporting Growth	
Rebalancing the budget	Lower marginal tax rates on labor and capital.	The 2015 budget cuts labor taxes. For certain types of workers the labor tax wedge falls by 24 percentage points.	Reduce marginal rates further, as the labor tax wedge remains high by international standards.
	Find permanent measures to finance tax cuts.	The 2015 budget contains 0.6 percent of GDP in expenditure cuts.	Fully offset the safeguard clause with spending cuts identified by the spending review.
	Improve public efficiency in areas such as health and current pensions.	An ongoing spending review will cover health among other areas, with a view toward identifying at least 0.6 percent of GDP in cuts to be implemented next year.	Continue work on the spending review in an institutionalized manner to achieve larger savings, examining all spending areas.
Fiscal Stance	Build a primary surplus buffer over the medium-term by targeting a 1/2 percent of GDP structural surplus.	The structural balance target in 2019 is a surplus of 0.2 percent, up from zero in last year's budget.	Target a higher surplus to build buffers against shocks, bring debt down faster, and comply with EU fiscal rules.

	Italy: Progress Against IMF Recommendations		
	2014 Article IV Policy Advice	**Actions since 2014 Article IV**	**Next steps**
		Fiscal Policy—Reducing Vulnerabilities and Supporting Growth	
PFM	Establish a medium-term expenditure framework.	A process of regular and continuous analysis of the expenditure was put in place, through regular cooperation between administrative spending units and the Ministry of Economy and Finance. In the elaboration of the 2015 Budget Law, central administrations adopted a process of internal review of expenditures, identifying measures to reduce spending items.	Integrate spending review process with regular budget in a multi-year fiscal framework. Finish work to approve legislative decrees to complete the reform of the structure of the State budget, including the introduction of expenditure targets.
	Systematically collect performance information.	None. The decrees mentioned above will reinforce the use of performance indicators, measurable and attributable to the budget.	Collect systematic information to promote the use of output indicators and activity costing.
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 Law on "voluntary disclosure" (2014) introduced the crime of "self-money laundering", and provided for the opportunity of disclosing taxable income with reduced penalties. In May 2015 the Law on corruption in Public Administration, organized crime and against false accounting was approved. The law reintroduces the crime of false accounting for both listed and non listed companies. The Government is working on a review of the provisions applicable to tax crimes.	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.	New asset classification framework (Circolare n. 272 del 30 luglio 2008 (Matrice dei conti), 7 Aggiornamento, 20 January 2015), harmonized on the EU level, has been introduced in January 2015, and is applicable to all banks operating in Italy.	Ensure strict enforcement of loan classification and provisioning standards across all banks operating in Italy.
	Increase the tax deductibility of loan losses.	Period over which loan loss provisions are deductable from income has been shortened from 18 to 5 years.	A further shortening of the period to one year should be considered, conditional on fiscal space.
	Expedite judicial process by expanding use of specialized insolvency courts, greater use of on-line filing and introduction of best practice guidelines.	A commission has been set up by the Ministry of Justice to study and propose reforms to the insolvency framework (February 2015). Report due for December 2015.	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 2015, general assemblies of MPS and Carige, the two banks which had to close capital gaps, decided on measures to bring their capital levels above SSM requirements, including rights issuances.	Ensure preservation of Italian banks' existing capital buffers.
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 national public support policy is subject to European rules on state aid to the banking sector.	None.

Italy: Progress Against IMF Recommendations

	2014 Article IV Policy Advice	Actions since 2014 Article IV	Next steps
		Banking Sector—Strengthening Balance Sheets to Revive Lending	
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.	The latest changes to the framework enhance the criteria for the selection of board members, and strengthen role of independent board members. A new law, transposing the CRD IV, introduced provisions aiming at further enhancing the fit and proper tests. A recent reform of cooperative banks (banche popolari) forces the largest to convert into joint stock companies and improves the governance of the others (other mutual banks have been asked to self-reform). Furthermore, ACRI (the association of Italian Foundations) and the Treasury signed a MoU regulating portfolio management (diversification of investments, limits and conditions for debt, derivatives and investments in instrumental entities) and governance arrangements of Foundations. The memorandum guarantees that foundations comply fully with the ban on investee banks' control (also jointly or de facto).	Ensure that reforms are implemented decisively, and that the self-reform of mutual banks results in adequate corporate governance standards. Regulations of banking foundations' portfolio management and governance arrangements should have binding, legally enforceable (instead of intentional) character.
Supporting SMEs	Facilitate restructuring. Establish standard criteria for assessing SME loans and guidelines for restructuring viable but distressed firms.	The Commission set up to reform insolvency law has among its goals to simplify insolvency procedures	Implement a "triage" approach for distressed SMEs, by establishing standard criteria for assessing loans and introducing guidelines for restructuring viable firms. Improve further the insolvency regime by streamlining procedures and accelerating the start of the insolvency process to facilitate the swift exit of nonviable firms. Address remaining gaps in pre-insolvency and reorganization procedures.
	Encourage alternative market funding sources through, among others, the introduction of a new fiduciary contract, and enhancing sharing of credit information.	To increase supply of credit, insurance, securitization companies and credit funds are now allowed to lend directly to funds. There has also been liberalization of bonds issuance by unlisted companies. To encourage stock market listing, minimum capital requirements were reduced, tax credit for large capital increases was introduced; and multiple voting shares and loyalty shares can now be listed.	Monitor the effectiveness of the measures used and continue encouraging alternative market funding sources, through, among others, enhanced use and enforcement of collateral. Enhance sharing of credit information to improve credit monitoring and lending.
	Remove obstacles to SME start-up and up-scaling.	The program for supporting innovative startups was expanded to include non-startup SMEs of high technological value. The Innovative Startup and SME scheme encompasses: flexible corporate management tools; exemption from the regulations on companies reporting systematic losses and on dummy companies; flexible remuneration systems; tax incentives for investments; equity crowdfunding; fast-track and free access to public guarantees on bank loans.	Monitor the effectiveness of the measures adopted and keep on encouraging the creation and growth of innovative SMEs.

INTERNATIONAL MONETARY FUND

ITALY

STAFF REPORT FOR THE 2015 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

June 16, 2015

Prepared By

European Department
(In consultation with other departments)

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FUND RELATIONS

(As of June 2, 2015)

Mission: Milan and Rome, May 5–May 18, 2015. The concluding statement of the mission is available at: http://www.imf.org/external/np/ms/2015/051815a.htm.

Staff team: Mmes. Koeva Brooks (head), Topalova and Weber, Mr. Lanau (all EUR), Mr. Garrido (LEG), and Mr. Kopp (MCM). Mr. Arvanitis (EUR) joined for several days. Mr. Cottarelli and Ms. Quaglierini (OED) attended the policy meetings.

Country interlocutors: Finance Minister Padoan, Bank of Italy Governor Visco, other senior officials from Ministry of Economy and Finance; Bank of Italy; Ministry of Economic Development; Ministry of Labor and Social Policies; Ministry of Justice; Ministry of Public Administration and Simplification; Fiscal Council; Association of Italian Labor Lawyers; Association of Municipalities—Fondazione IFEL; major Italian and international banks; major Italian and international law firms; the Securities and Exchange Commission (CONSOB); Social Security Institute (INPS); the Antitrust Authority; Consiglio Nazionale Forense; High Council of the Judiciary; Insolvency Court; Supreme Court; Special Commission for the Reform of Insolvency Laws; Civil Courts; Consiglio Nazionale Dei Dottori Commercialisti; representatives of trade unions (CGIL, CSIL, and UIL); market participants; 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 5–18, 2014. The associated Executive Board's assessment is available at: http://www.imf.org/external/np/sec/pr/2014/pr14430.htm and the staff report and other mission documents at: http://www.imf.org/external/pubs/cat/longres.aspx?sk=41925.0. 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	6,803.64	86.32
Reserve Tranche Position	1,078.80	13.69
Lending to the Fund		
New arrangements to borrow	1,378.28	

SDR Department:	SDR Million	Percent Allocation
Net cumulative allocation	6,576.11	100.00
Holdings	6,092.21	92.64

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				
	2015	2016	2017	2018	2019
Principal					
Charges/Interest	0.12	0.35	0.35	0.35	0.35
Total	0.12	0.35	0.35	0.35	0.35

Exchange Rate Arrangement: Italy entered the final stage of European Economic and Monetary Union on January 1, 1999, at a rate of 1,936.27 Italian lire per 1 euro. The euro floats freely and independently against other currencies.

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 5–18, 2014, and the staff report (Country Report No. 14/283, 09/18/14) was discussed on September 12, 2014.

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 June 2, 2015)
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 (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 2010* (*ESA2010*).
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 Bank of Italy adopted the standards for reporting Balance of Payments (BOP) and International Investment Position (IIP) data on the basis of the *Balance of Payments and International Investment Position Manual, 6th edition (BPM6)* in the second half of 2014.

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). In 2015 Italy subscribed to SDDS Plus, together with the first group of adherents. **Implementing G-20 DGI recommendations:** The authorities have implemented all of the recommendations. 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. Italy: Common Indicators Required for Surveillance

(As of June 2, 2015)

	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	June 2015	June 2015	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	April 2015	May 2015	M	M	M		
Reserve/Base Money	March 2015	May 2015	M	M	M	O,O,LO,LO	O,O,O,O,LO
Broad Money	March 2015	May 2015	M	M	M		
Central Bank Balance Sheet	March 2015	May 2015	M	M	M		
Consolidated Balance Sheet of the Banking System	March 2015	May 2015	M	M	M		
Interest Rates[2]	June 2015	June 2015	D	D	D		
Consumer Price Index	April 2015	May 2015	M	M	M	O,O,O,O	LO,O,LO,O,O
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	Q4 2014	April 2015	Q	Q	Q	LO,O,LO,O	LO,O,O,O,LO
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	May 2015	June 2015	M	M	M		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	April 2015	May 2015	M	M	M		
External Current Account Balance	April 2015	June 2015	M	M	M	O,LO,LO,O	LO,O,LO,O
Exports and Imports of Goods and Services	April 2015	May 2015	M	M	M		
GDP/GNP	Q1 2015	May 2015	Q	Q	Q	O,O,O,O	LO,LO,O,O,O
Gross External Debt	Q4 2014	Mar 2015	Q	Q	Q		
International Investment position[6]	Q4 2014	Mar 2015	Q	Q	Q		

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.

[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.

[3] Foreign, domestic bank, and domestic nonbank financing.

[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.

[5] Including currency and maturity composition.

[6] Includes external gross financial asset and liability positions vis a vis nonresidents.

[7] Daily (D); weekly (W); monthly (M); quarterly (Q); annually (A); irregular (I); and not available (NA).

[8] Reflects the assessment provided in the data ROSC or the Substantive Update for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O); largely observed (LO); largely not observed (LNO); not observed (NO); and not available (NA).[9] Same as footnote 7, except referring to international standards concerning source data, statistical techniques, assessment and validation of source data, assessment, and revisions.

Statement by Mr. Carlo Cottarelli, Executive Director for Italy
July 1, 2015

We thank staff for fruitful discussions during the 2015 Art. IV Consultations with Italy. The Selected Issues Papers (SIPs) deal with critical issues and are of excellent quality, particularly the analysis of the link between public sector efficiency and productivity. We broadly concur with the thrust of the staff appraisal.

This said, the Staff Report sometimes gives the impression that the structural reforms Italy needs in its labor and product markets, as well as in its public administration and finances, are still in the planning stage including by frequent references to the "ambitious government agenda" (ambitious, yes, but still an agenda).[1] No, these are not just plans: during the last year several key actions have been undertaken to implement these reforms.

Thus, this statement starts by clarifying what has been already fully legislated and implemented, what is in the implementation phase, and what is in the planning stage. Of course the lists of what is still in the implementation and planning stages are also long. But what has already been achieved bodes well for the future.

One additional remark before proceeding: the Staff Report presents various indicators of the efficiency of the Italian economy to illustrate the need for reform, including the World Bank Doing Business Indicators and the World Economic Forum (WEF) perception-based indexes. There is no doubt that there are bottlenecks and inefficiencies in the Italian economy but, for the reasons that we explain below, the way these indicators are used in the Report conveys only a partial representation of the country to the detriment of the effectiveness of the Report.

Where Italy stands in the implementation of the ambitious government reform agenda

Since the last Article IV Consultation the following structural reforms have been implemented:

[1] In terms of presentation, it is also unfortunate that some of the actions already adopted are often listed in the sections on the "Authorities' views" – rather than in the sections describing the current situation – leaving the reader wondering whether staff shares the view that the actions were indeed implemented.

1. Probably the most important reform was the enactment of the Jobs Act, which deeply changes the working of the labor market by introducing more flexibility in laying off and hiring workers, reforming labor contracts and introducing a better protection for the unemployed. This part of the labor market reform—its core component—is fully legislated, including the necessary implementation decrees, and is thus fully operational. Only two components of the reform—the reform of the wage supplementation scheme and the reform of active labor market policies—still require the implementation decrees, but they have already been sent to Parliament (for comments, not for approval, which is not needed) in the first of these two areas.
2. Labor taxes have been cut and to an extent somewhat larger than suggested by staff (close to one per cent of GDP, rather than 0.7), taking into account the 3-year reduction of labor taxation for new permanent contracts. Based on our own estimates, this cut has almost halved the gap between Italy's tax wedge and that of the euro area. The initial results are encouraging: permanent hirings increased sharply in the first quarter of this year (+104,000); in April the unemployment rate decreased more than expected, though remaining at high levels also on the back of increased labor supply.
3. Primary spending has been cut by about ½ percent of GDP (and more net of spending increases that were necessary to implement some structural reforms such as the strengthening of unemployment benefits).[2] This decline in spending is not only the effect of "austerity measures" but also of deep reforms, including the reform of procurement, which does not require any further legislative action. It implies setting up 35 procurement agencies that will replace the over 30,000 offices that currently manage procurement activities in Italy. This is expected to be completed in July 2015.
4. New rules for the mobility of public sector employees have been legislated and are now being used to reallocate personnel from the reformed Provinces to other parts of the public administration. The 2014 law on the reform of the public administration (not to be confused with the new law now in Parliament to complete the reform process, which is the one mentioned in the Staff Report) introduced other simplification and streamlining measures.
5. Thanks to the reform of the Treasury management system introduced during 2014, the repayment of government arrears has been accelerated and payment delays have been dramatically reduced with the introduction of the electronic invoice system. According to the most recent data, €36.5 billion were paid to creditors, and the total resources provided by central government to local governments – the firms' debtors – totaled €42.8 billion. This is assessed to broadly match overdue commercial debt.
6. New measures have been adopted to improve the functioning of the civil justice, along the lines of the numerous provisions enacted since 2011. A paperless process for civil court cases (*processo telematico*) was introduced. Two new modalities for the extra-court resolution of disputes have been added. The possibility for judges to

[2] The reduction in spending to GDP ratios is not evident in the headline statistics because the cut in labor taxation of €80 per month for lower income dependent workers is not classified as a tax cut according to the methodology followed by the Statistical Institute. However, from an economic perspective, it has all the features of a tax cut, increasing the incentive to work.

resort to fast-track procedures has been widened. These and earlier reforms are already having an impact: in June 2014 the backlog of pending cases was down by 18 percent from the peak of 2009.

7. A new anti-corruption law was approved in May 2015 which criminalized false accounting, lengthened the punishment for corruption cases, changed the statute of limitations and increased the powers of the Anti-Corruption Authority established in 2014. The crime of self-laundering has been introduced in January 2015.
8. The cooperative banking sector (*banche popolari*) has been profoundly reformed with the aim of improving its corporate governance and its ability to access capital markets and enhancing investors' assessment. Measures on the portfolio management (diversification of investments, limits and conditions for debt, derivatives and investments in instrumental entities) and governance arrangements of banking foundations have also been introduced; they guarantee that foundations fully comply with the ban on investee banks' control (also jointly or *de facto*).
9. On June 23 the government adopted a set of new measures to overhaul the insolvency regime, reduce the length of recovery procedures and, consequently, speed-up the write-off of non-performing loans (NPLs) from banks' balance sheets. Moreover, loan loss provisions will be immediately deductible for tax purposes. These newly-adopted measures, which are in line with staff recommendations, will facilitate the development of a market for NPLs in Italy.
10. More generally, the issuance of implementation decrees to enact laws approved in the past has been accelerated with the current government reducing by 70 percent the backlog of implementation decrees arising from previous legislation.

Other elements of the government reform agenda are in progress but have not yet been completed:

1. A key element is the enabling law on the reform of public administration. We will not delve further into this as it is already discussed in the Staff Report. Its approval is expected before the summer break. The implementation decrees are being drafted already and are expected to be issued within a month after the approval of the law.
2. Early this year the Parliament approved the new electoral law, which has been designed with the aim of enhancing the stability of the political system. It is part of a broader strategy, including a constitutional reform whose discussion has further advanced in Parliament and that will simplify the legislative process and rationalize the attribution of competences between central and local governments.
3. In February 2015 the Government presented an Annual Competition Law aimed at enhancing competitiveness in several sectors (professional services, telecommunications, banking and insurance services, fuel distribution), meeting for the first time the requirement introduced in 2009.
4. In March a draft enabling law to reform the civil procedure code was presented to the Parliament with the aim of simplifying the procedures and widening the case-management powers of judges.

5. In May, the government draft bill to reform education was approved by the House and is now under evaluation by the Senate. It aims at enhancing meritocracy of teachers, fostering transparency in the management of schools, and strengthening training in professional schools.
6. The government adopted a multi-year privatization program, which includes the listing of major State controlled companies such as Poste, ENAV and Ferrovie. Revenues from privatization are by law earmarked to the reduction of public debt. In early 2015 the government sold on the market a 5 percent stake of ENEL, reducing its stake to 25 percent. The IPO of Poste Italiane is scheduled for the fall. Incentives have been provided to local authorities to privatize utilities under their control. In parallel, the reorganization, restructuring and, when appropriate, sale of public real estate continues, including by setting up several specific funds by Invimit, the government real estate management company.

Finally, some steps are still in the planning stage, including, among others, proposals to: reduce the appeal rate in civil justice and develop court performance indicators; improve the provision of public services; strengthen the governance and resilience of the mutual bank sector (*banche di credito cooperativo*); address the high stock of non-performing loans with targeted actions (in addition to those introduced on June 23).

Doing Business and other indicators

These reforms are critical for addressing what is perhaps the most severe problem affecting the Italian economy: its low productivity growth. The authorities' tangible reform achievements are a testament of how seriously this problem is acknowledged.

This said, we would caution against taking at face value some of the indicators presented in the Staff Report which—like the Doing Business and WEF indicators—suggest that Italy is at the bottom of OECD countries in virtually all respects. Indeed this is the impression that one gets in reading the Staff Report, given the selection of the indicators presented. In this regard, the list of the variables for the chart at page 10 excludes all the dimensions of the World Bank indices along which Italy is performing relatively better, such as: "Starting a business" (18th position among OECD countries); "Registering a property" (14th); "Protection of minority shareholders" (10th).

Furthermore, some of the indicators the Staff Report put a lot of emphasis on are probably not very revealing of actual conditions. Drawing from the Doing Business database, the Staff Report notes that it takes 120 days (for a business) to get electricity connection in Italy. The Staff Report does not say that, according to the same database, it would take 126 days to get a connection in the UK, 132 days in Los Angeles and 142 days in Canada. Admittedly, the Netherlands and Japan would be in a better position, but not by much (respectively 117 and 105 days). These data cast doubts on the quality of the reported indicator.

But the problems with these indicators are more general in the case of Italy for three reasons:

- The Doing Business indicators refer to central Italy, whose efficiency, for example in terms of public services, is not representative of the national average weighted by regional GDP (whose production is skewed toward the most efficient regions). It is strange that staff does not acknowledge this problem, as the Staff Report does underscore the major differences in the efficiency of public services across the country.
- The WEF indexes are typically based on perceptions and, for Italy (to a much larger extent than for other countries, based on econometric estimates) there is a wide gap between perceptions and more objective information. For example, according to a Eurobarometer survey, while a very large proportion of respondents (97 percent) argue that corruption is widespread in Italy, the proportion of those who personally know anyone who takes or has taken bribes in Italy is only 9 percent, at the lowest among the EU countries. Econometric evidence shows that, while there is in general a statistical relationship between perception of corruption and its direct evidence across countries, in the case of Italy the fit is very poor and the relationship does not hold. Therefore, while perception indicators are useful for many countries, for Italy they may not be so useful, and hence should not be overemphasized.
- Third, the reported indicators typically give a snapshot of the current situation but do not describe the trends. This may miss important developments. For example, OECD PISA surveys do indeed show that Italian pupils' competences are below the OECD average, but Italy is one of the countries which over recent years recorded one of the most marked improvements in competences in mathematics and science. Furthermore, between 2003 and 2012, Italy reduced the share of "low performers" by 7 percentage points, and increased that of the "top performers" by 3 percentage points.

Finally, it is difficult to square the image of the country conveyed by the indicators included in the Staff Report with some hard data. The Report appropriately underscores the disappointing productivity and GDP performance of the Italian economy over the last decade. It would have been more balanced to mention also some points of strength. Italy has the second largest manufacturing industry in Europe and the seventh in the world. While it is true that the productive system features a portion of small firms which are less innovative and able to compete, it also includes a large share of highly productive and competitive enterprises. According to WTO data, Italian firms are among the top-rank exporters in a wide range of industries (textiles, basic manufactures, transport equipment, machinery, clothing, electronic components). According to a 2013 SIP produced by staff, "*In an era dominated by the dramatic expansion of emerging-market exporters, Italy's tradable sector continues to rank among the world's leaders – in contrast to many other European countries.*" This is confirmed also by the fact that, after the trade collapse in 2009, the volume of Italian goods exports not only has kept up with, but has slightly outpaced potential demand (the weighted average of trade partners' imports). Against this background, competitiveness indicators based on unit labor costs may underestimate Italian firms' capacity to compete in

international markets. We reiterate our suggestion that the consideration of a broader set of both price and non-price indicators would be more appropriate.

Outlook

We concur with staff that the improvement in growth prospects is the result not only of the actions of the government but also of more favorable external conditions. The improved macroeconomic outlook has been reflected in the upward revision of earlier staff projections: GDP is now expected to grow by 0.7 percent in 2015 and 1.2 in 2016 (as against, respectively, 0.4 and 0.8 in the January 2015 WEO Update). Over the medium term staff has a somewhat less sanguine outlook than the authorities', but not by much as the latter have adopted a cautious approach, not including in the projections the likely effect of the structural reforms that have already been and are being implemented.

The improved macroeconomic outlook and the reform already introduced over the last few years have led to an improvement in companies' financial structure and to a more diversified access to financing for Italian business, particularly SMEs. The introduction in 2011 of the Allowance for Corporate Equity (ACE) scheme, and its recent enhancements, virtually cancelled out the tax advantage of debt finance. Positive results are emerging: in 2014 the gradual strengthening of firms' risk capital continued, also favored by increased foreign capital inflows and by a wave of new stock-exchange listings. Tax incentives have been introduced for venture capital and other measures have been taken to liberalize credit markets. The re-composition of firms' financial liabilities towards less reliance on bank funding has proceeded on the back of a greater recourse to bond emissions, including by new issuers and small unlisted firms benefitting from the provisions on the so-called mini-bonds adopted in 2012. Overall, corporate financial debt and leverage have decreased; firms' liquidity is high. This said, the authorities are well aware that more efforts are needed to enhance capital markets, whose weaknesses reflect long-standing structural features of the Italian productive system.

Financial sector

The banking system continues to be sound and resilient, as it has been throughout the crisis, even without receiving any significant state support. The results for the Italian banks of the Comprehensive Assessment conducted last year at the euro area level have been generally positive. They confirmed the system's overall resilience to extreme shocks. The two banks showing capital shortfalls under the adverse stress test scenario have presented recapitalization plans and already successfully completed substantial rights issues. At the end of 2014 Italian banks' common equity tier 1 ratio (CET1) was at 11.8 percent, with a sizeable rise from 10.5 percent the year before; the coverage ratio of the NPLs increased to 44.4 percent. Markets' assessment of the soundness of the Italian banks improved. Financial supervision remains attuned to the highest standards, as acknowledged by the 2013 FSAP.

However, the effects of the prolonged recession continue to unfold. In 2014, banks' overall profitability remained weak, but improved with respect to 2013, thanks to continued efforts

to enhance efficiency and cut costs. Operating profits were almost completely absorbed by loan loss provisioning as a consequence of the worsening in credit quality. The sharp rise of NPLs mainly reflected the impact of the recession on firms' capacity to generate income and thus service their debt, despite the corporate debt-to-GDP ratio being one of the lowest among the large euro area countries. The weaknesses of the insolvency regime and the unfavorable tax treatment of loan-loss provisioning have been impediments to the reduction of the stock of NPLs. In order to reduce it, targeted actions may be required, particularly by helping to develop a secondary market for this kind of assets. As previously mentioned, the authorities have recently adopted measures going in these directions.

Looking ahead, signs of improvement in the credit market are emerging, extending also to the business sector. Credit conditions are reported as gradually easing. Exposure to interest rate risk, even in the case of a prolonged period of low yields, is limited for both banks and insurances. Italian insurers benefit from balanced cash flows, with good matching of yields and duration between assets and liabilities.

Fiscal policy

As staff underscores, the fiscal stance, which continues to be guided by SGP rules, strikes the right balance between the need to strengthen the fiscal accounts and the need to support economic activity. The authorities remain well aware of the need to lower the public debt ratio. However, we would complement the information included in this respect in the Staff Report with two relevant points that are omitted:

- According to the Fund's structural fiscal indicators (see Table A.23 of the Fiscal Monitor most recent issue), Italy has one of the lowest pension and health care debt among advanced countries (26 percent against an average of almost 134 percent for advanced economic, measured by the NPV of projected increases in pension and health care spending over the next 40 years).
- The dynamic of the debt ratio in the last few years has been negatively affected by the above mentioned payment of arrears and, especially, by the support to the euro-area financial assistance mechanisms (for a total of 6.2 percentage points of GDP).

Conclusions

Italy is undertaking simultaneous reforms in multiple critical areas, consistent with the IMF policy advice. The implementation pace has significantly accelerated over the last year, and efforts are paying off: together with improved external conditions, they have favored the turning point of the business cycle.

It is now critical to consolidate the recovery. The stable return to a balanced and solid growth is essential to support the efforts to deleverage public and private balance sheets, reduce the unacceptable levels of unemployment (particularly among the young), and fully unleash the benefits of structural reforms. As argued earlier, the policy agenda is clearly defined and works are advanced on a number of fronts, in a context of continued prudence for fiscal

policy. The authorities are determined to keep momentum and to continue delivering. They look forward to further constructive interactions with IMF staff.