Italy: Staff Concluding Statement of the 2024 Article IV Mission

May 20, 2024

A Concluding Statement describes the preliminary findings of IMF staff at the end of an official staff visit (or 'mission'), in most cases to a member country. Missions are undertaken as part of regular (usually annual) consultations under Article IV of the IMF's Articles of Agreement, in the context of a request to use IMF resources (borrow from the IMF), as part of discussions of staff monitored programs, or as part of other staff monitoring of economic developments.

The authorities have consented to the publication of this statement. The views expressed in this statement are those of the IMF staff and do not necessarily represent the views of the IMF's Executive Board. Based on the preliminary findings of this mission, staff will prepare a report that, subject to management approval, will be presented to the IMF Executive Board for discussion and decision.

Washington, DC: *An International Monetary Fund (IMF) mission, led by Rachel van Elkan, and comprising Aleksandra Babii, Aidyn Bibolov, Yan Chen, Gee Hee Hong, and Sylwia Nowak, conducted discussions for the 2024 Article IV Consultation with Italy during May 6 – 20. At the end of the visit, the mission issued the following statement:*

- *The economy recovered well from the sequential pandemic and energy price shocks on the rebound in tourism and substantial policy support. However, growth has moderated. While contributing to the recovery, expansionary fiscal policy has also kept the deficit and public debt very high, elevating Italy's risk premium and acting as a drag on private sector investment.*
- *Faster than planned fiscal adjustment to reduce debt with high confidence can be achieved with limited cost to growth by withdrawing inefficient and temporary crisis measures. Beyond the near-term, while maintaining a sizable primary surplus, additional fiscal effort will be needed to accommodate growth-enhancing investments and latent spending pressures and help restore fiscal space in the event of severe shocks.*
- *Adjustment to tighter financial conditions has proceeded smoothly and the banking system remains sound, but sustained high interest rates and declining liquidity buffers could weaken borrower's debt servicing capacity. The recent increases in bank-based and systemic risk buffers are welcome to strengthen safeguards against future risks. Continuing to identify and address pockets of vulnerability among less significant institutions, and strengthening mechanisms for bad debt workouts and disposal remain priorities.*
- *Reinvigorating productivity is urgently needed. Full and timely execution of the National Recovery and Resilience Plan, followed by a successor medium-term structural fiscal plan that focuses on critical public infrastructure, research and innovation, education system reform, and improving the business climate, would support this goal.*

The Italian economy recovered well from the sequential pandemic and energy price shocks on the rebound in tourism and provision of substantial policy support.

Activity expanded by 0.9 percent in 2023 and 0.6 percent (year-on-year) in Q1:2024. As a result, GDP surpassed its pre-COVID level by 4.5 percent—a stronger performance than in other large euro-area countries. Exuberant spending on home renovations financed with generous tax credits and a ramp up in utilizing large EU-financed National Recovery and Resilience Plan (NRRP) resources contributed to the strong performance. Nonetheless, the growth stimulus from housing tax credits has likely been fairly limited relative to the size of fiscal resources expended owing to leakage into imports, sizable invoice discounting, increased price markups in construction, crowding out of other investments, and misuse of public funds, with the contribution to real activity also diminishing over time. Other current and past policy supports, including publicly-guaranteed loans, energy compensation measures, and pandemic-era transfers, have also supported the recovery despite monetary policy tightening. Employment has risen broadly in line with GDP, notably in services and construction, in part due to labor cost subsidies. Led by the drop in energy prices, rapid and orderly disinflation is well advanced and the current account has returned to surplus from a large, but temporary, deficit.

Growth is forecast to moderate over the next few years, with disinflation continuing. GDP is projected to rise by 0.7 percent in 2024 and 2025 as accelerating NRRP-related spending—to be finalized by mid-2026—largely offsets the phasing out of Superbonus-boosted residential investment. A subsequent temporary growth slowdown could be expected in 2026 and 2027 as the NRRP is completed, with a more gradual slowing if the allowable spending period were extended. Thereafter, growth is expected to return to potential, which would increasingly reflect the shrinking national working-age population unless offset by rising productivity underpinned by effective structural reforms and investments, higher labor force participation, and continued absorption of foreign workers. Headline inflation is projected to fall to an average of 1.7 percent in 2024 and return to the 2 percent target in 2025. While wage growth is forecast to pick up this year and next, firms are expected to absorb the increase mainly from their expanded profits, thereby keeping core inflation on a moderating path.

While positive surprises could materialize, growth risks are tilted to the downside. Intensification of regional conflicts could generate new supply shocks and commodity price volatility that the limited fiscal space may be unable to accommodate. Spillovers from sharp slowdowns in major trading partners, deepening geoeconomic fragmentation, and extreme climate events could also impinge on Italy's GDP growth. Significantly higher-than-expected interest rates could weaken business confidence and lead to a repricing of Italian government bonds that could deteriorate public debt dynamics, reviving concerns about sovereign-bank-corporate linkages. Domestic factors could also weaken growth, including an inability to complete NRRP spending and effectively implement reforms, while still large fiscal deficits could erode investor confidence, further weakening public finances.

Fiscal policy: Shifting the focus to debt sustainability and growing productivity

Faster than planned fiscal adjustment is warranted to lower the debt ratio with high confidence and reduce financing risks. Already-accrued tax credit liabilities will further add to debt in the coming years. The primary deficit has decreased, but the gap with the 1¾ percent primary surplus that prevailed prior to the pandemic remains very large on the slow removal of temporary crisis-era policies despite the economy's strong cyclical position. A much higher primary surplus closer to 3 percent of GDP will be required to ensure a gradually declining debt ratio. Frontloading adjustment to reach close to that target by 2025-26 can be realized with a modest cost to growth by faster roll back of inefficient or temporary measures, including terminating housing renovation subsidies and

measures to compensate for high inflation, with activity cushioned by the simultaneous ramp up in NRRP spending and reforms. Frontloading is also supported by prevailing benign global risk perceptions and the ongoing buoyancy of tax revenues, and would boost confidence that the soon-to-be-adopted EU fiscal governance framework can deliver significant debt reduction. The adjustment path should take full account of the effects of the shift in 2024 to cash-based accounting for newly-authorized housing tax credits, which—under a welcome recent law—will no longer be transferable.

Beyond the near-term, over delivery on savings would create room for fiscal priorities and mandatory commitments. While maintaining a primary surplus of around 3 percent of GDP to ensure a gradually declining debt ratio, additional fiscal effort will be required to accommodate productivity-enhancing investments, latent spending pressures—especially from aging—and create the fiscal space needed in the event of a severe shock. Considerable savings are feasible and desirable to finance growth- and efficiency-enhancing measures, including by: (i) replacing tax wedge cuts and hiring subsidies with measures that permanently boost labor productivity; (ii) further streamlining pension spending by raising the effective retirement age and avoiding costly early retirement schemes; (iii) rationalizing tax expenditures to broaden the base, increase progressivity and reduce complexity; and (iv) improving control and oversight of tax credits—including in the context of the NRRP's credits for green and digital investments—by requiring explicit prior authorization, monitoring real-time take up, and annulling the tax credit in the absence of full ex-post compliance with program goals.

A new medium-term approach to budget formulation and execution is needed to ensure consistency between fiscal targets and pro-growth objectives. Current budget practice relies on identifying and utilizing on a year-by-year basis incremental fiscal space brought by nominal GDP growth. This practice has encouraged spending rather than saving of fiscal overperformance, and is not conducive to utilizing fiscal policy as a strategic development tool. A fully-fledged multi-year fiscal plan, as required under the new EU governance framework, would reconcile medium-term priorities with available resources. This requires realistic macroeconomic and fiscal forecasts and robust monitoring and control systems to limit deviations from agreed medium-term targets. Publicly-guaranteed loans should not substitute for on-budget spending as means to bypass fiscal limits under the new framework. Moreover, guarantees should be prudently managed, centrally monitored and well provisioned, with the stock of outstanding guarantees kept on a downward path.

Protecting financial sector resilience

Adjustment to tighter financial conditions has proceeded smoothly and the Italian banking system remains sound, but stability risks could rise as the tightening cycle matures and effects of exceptional support measures wane. Policy rate increases were quickly passed through to sovereign bond yields and bank lending rates. Widening interest margins and reduced need for loan-loss provisions pushed up bank profits, which together with lower risk-weighted assets, raised capital ratios to record levels. While the high cost of borrowing has led to a significant decline in the stock of credit to firms, some firms have used their cash buffers and current profits to accelerate loan redemptions. Indicators of credit quality have eroded only marginally so far from a strong initial level.. Banks maintain ample liquidity even as they reduced most of their pandemic-era long term liabilities to the ECB, but funding has become more expensive on monetary policy tightening and continuing competition for retail savings from government bonds. While borrowers exited the recent pandemic and energy price shocks in a generally healthy

financial condition, sustained high interest rates and declining liquidity buffers could lead to future weaknesses.

The current increase in bank profits should be used to reinforce resilience to potential future shocks while funding should be adequately diversified. Current exceptional net interest income provides an opportunity to make the banking system more robust by requiring banks to lock in a modest part of their existing capital headroom. While the reserve accumulation option under the excess profit tax on banks is helpful from this perspective, it was not calibrated to target systemic and individual bank risks and—because non-distributable reserves are fungible with other capital—it need not lower overall capital distribution. In contrast, the recent increase in the capital buffer requirement for “other systemically important institutions” and the decision to activate a releasable systemic risk buffer are welcome measures. To adequately reflect borrower risk, loan classification under the IFRS9 standard should be sufficiently forward looking, and the practice of replacing the borrower’s default probability with the guarantors’ should be discouraged. Ensuring that banks’ funding mix includes adequate long-term liabilities would help to limit liquidity risk.

Strengthening mechanisms for debt workouts and disposals is still crucial to prevent buildup of nonperforming exposures on banks’ books and reduce borrowers’ burden from legacy debt. Debt resolution and insolvency procedures should be less time consuming and costly, and—as required by Italy’s NRRP—time to conclude court cases should be considerably shortened by streamlining and digitalizing procedures and adding support staff to reduce the burden on judges. This would raise the absorptive capacity of secondary-market buyers of nonperforming exposures through faster case turnover and higher recovery rates, reduce warehousing of legacy claims, and speed up the cleansing of stressed borrowers’ accounts. Any scheme allowing borrowers to buy back at a lower price their previously-sold bad loans risks undermining the secondary market and eroding payment discipline.

Continuing to focus on the weaker segment of less significant banks remains a priority. The Bank of Italy’s strengthened supervisory and regulatory oversight of smaller banks is welcome. While these banks are experiencing a temporary boost to net income, some of them have structural weaknesses that limit their ability to benefit from scale economies or to modernize operations. Further consolidation or mutual cooperation in key areas, such as digitalization, could reinforce efficiency and resilience if driven by business synergies and provided sectoral and geographical concentrations are not increased.

Structural priorities to raise and support medium-to-long term growth

The current policy focus on near-term demand stimulus should be replaced with an agenda prioritizing market-friendly support to medium- and long-term growth. In recent years, fiscal policy has aimed to prop up wages, household savings, and firms’ profits. However, while wages in Italy are generally low, this reflects structurally weak labor productivity. To permanently increase workers’ living standards and GDP, scarce fiscal resources would be most effectively used for education reform and skill upgrading, and closing investment gaps. The NRRP—where implementation is accelerating, thanks to welcome operational improvements—supports these policy goals. Timely and effective execution of the Plan, without compromising transparency and the financial integrity of public funds, is critical. The more substantive is the implementation of reforms, the more durable will be the benefits for productivity. Building on the NRRP, a successor program of comprehensive structural reforms and investments is needed to continue to address long-

standing productivity challenges and investment gaps, and facilitate the green and digital transitions beyond 2026. The focus should be on critical public infrastructure, education reform, and diffusion of frontier technologies, while improving the business environment. Deepening capital markets within the EU context would diversify financing sources beyond traditional bank loans and support continuity and modernization of the corporate sector. Avoiding frequent changes to tax and other policies would increase the attractiveness of the investment climate. Recourse to industrial policies should be limited and targeted to specific objectives where externalities or market failures prevent effective market solutions.

Expanding Italy's labor force by addressing low fertility and low female labor force participation would provide a lasting boost to Italy's growth prospects. Italy underperforms most peer countries on both dimensions, with female activity rates at the national level picking up but still low, and pulled down by Southern regions. Balancing formal-sector work and family life requires both time and financial resources, and which of these constraints is binding likely varies by region, family income, and individual characteristics. Identifying relevant barriers and addressing them with well-targeted policies would avoid wasteful and ineffective measures. Making available sufficient childcare capacity, and ensuring that childcare and school opening times are compatible with regular working hours, would alleviate the conflict between full-time employment and parenting responsibilities. Policy-induced disincentives for female employment in the formal sector—including favorable tax treatment of single-earner families and minimum required lifetime social security contributions to qualify for a pension or else forfeit the amount paid in—should be removed. Greater focus on gender inequality in the workplace, such as increasing transparency of gender wage differentials for comparable work and making parental leave gender neutral, would help reduce female participation imbalances. Financial assistance to families and children should be well targeted to poorer households and structured to avoid discouraging women's labor market participation. Given the decline in the size of successive cohorts of childbearing age women, reversing demographic trends in the coming decades is unlikely, but well-designed policies may help slow the declining birth rate and also lift female participation.

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