INTERNATIONAL MONETARY FUND

Italy: 2010 Article IV Consultation Concluding Statement of the Mission

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A fragile recovery from the deepest recession since WWII

1. **The global economic crisis has hit a structurally weak Italian economy.** Italy's growth rate had already been slowing for over a decade, reflecting weakening productivity. Economic rigidities, along with Italy's specialization in products with relatively low value added, have also been contributing to a steady erosion of competitiveness. Consequently, Italy has been losing its market share of world trade.

2. **The global crisis affected the economy mainly through the trade, credit, and confidence channels.** The recession in Italy's main trading partners led to a sharp fall in exports. Although there was no fallout from the banking system, financing conditions tightened and credit growth fell. Despite strong household balance sheets, private consumption declined significantly, mainly reflecting higher uncertainty. Fixed investment and inventories also fell sharply, owing to weak demand prospects. The decision not to engage in a large fiscal stimulus (which was appropriate in view of the high level of public debt) meant that these effects on aggregate demand translated into one of the deepest output falls among large industrialized countries. However, unemployment rose only modestly, in large part thanks to the extension of the existing wage supplementation scheme (*Cassa Integrazione Guadagni*), and lower participation.

3. **A modest and fragile recovery based on external demand, restocking of inventories, and some government support is now under way.** As elsewhere in the industrial world, potential output in Italy may have been adversely affected by the crisis. The slow recovery of Italy's major trading partners and the significant competitiveness gap will limit export growth; the rise in non-performing loans and the need to shore up banks' capital will constrain credit supply; rising unemployment will undermine private consumption; and investment will be limited due to financing constraints, low capacity utilization, and falling profitability.

4. **Although the worst effects of the crisis have mostly passed, key vulnerabilities remain.** The high private savings rate, low private indebtedness, and the resilience of the financial sector, are important elements of strength. However, the high level of public debt and the disappointing growth performance could make Italy vulnerable to external shocks. Debt management has been conducted prudently, by lengthening the maturity of public debt and building buffers. These efforts should help strengthen the government's financial position. But they cannot be a substitute for a sustained fiscal consolidation.

The policy agenda: renewing the reform momentum to foster sustained growth

5. **The overarching goals should be to maintain fiscal discipline, reduce the burden of public debt, and raise the economy's long-term growth rate.** Although the fiscal stance was appropriate during the crisis, efforts must now be made to reduce the fiscal deficit. The burden of public debt needs to be put back on a declining path. Policies to reinvigorate growth should focus on removing structural bottlenecks, improving the quality of public expenditure, and strengthening the financial sector.

6. **The next few years offer an important opportunity to pursue an ambitious program of structural reforms.** The global crisis has exposed once again the structural weaknesses of the economy, underscoring the urgency of structural reform. Evidence suggests that recoveries from economic crises can serve as an opportunity for reforms. In the past, other countries have overcome similar challenges from very difficult starting positions with comprehensive policy packages.

Expenditure-based fiscal consolidation: improving the efficiency of the public sector

7. **The fiscal deficit in 2010 is expected to be broadly similar to the 2009 outturn.** The limited discretionary fiscal stimulus in 2009, designed to be deficit neutral, was in parts not fully utilized. The budget deficit nevertheless deteriorated by over 2½ percentage points of GDP, reaching about 5¼ percent of GDP in 2009, mainly reflecting cyclical factors. In 2010, revenues will likely drop, reflecting the one-off nature of some large tax receipts in 2009. Capital expenditures will also fall, while the unwinding of stimulus measures introduced in 2009 should be partially offset by modest increases in transfers to families, public wages and health spending (as envisaged in the 2010 budget).

8. **The authorities intend to gradually reduce the deficit to below 3 percent of GDP by 2012.** The strategy envisages a fiscal consolidation of 1¾ percent of GDP in 2010–12, slightly above the requirement under the Stability and Growth Pact (SGP). Staff endorses the authorities' fiscal targets, but cautions that the planned fiscal adjustment is based on the optimistic assumption of a strong and sustained recovery, full implementation of the earlier envisaged consolidation plans, and additional measures that have yet to be announced. Close monitoring of sub-national public finances should be maintained.

9. **In the longer term, the authorities envision an expenditure-based fiscal consolidation.** Staff concurs with this broad objective, in view of the already large tax burden, the necessity of reducing public debt, and the need for more efficient public expenditure. Containment of the public sector wage bill should be a key element of the consolidation strategy. The progressive reduction of public employment should continue, and a firm control of public wages is needed, especially at the local government level.

10. **The tax burden is high and weighs disproportionally on salaried and retired workers**. When the expenditure-based consolidation is firmly underway, the authorities should consider a tax reform with the view to reducing the tax wedge while increasing tax compliance. Ad-hoc revenue measures should generally be avoided.

11. **The modernization of the public finance management system should help secure a long-lasting fiscal consolidation.** The 2009 Accounting and Public Finance law (*Legge di contabilità e finanza pubblica*) marks a step in bringing Italy's public financial management in line with best international practices. Its focus on harmonizing accounting

systems and strengthening expenditure control and monitoring is welcome, but some key best practice elements, such as strict top-down budgeting, remain missing. Going forward, it will be important to design effective implementation mechanisms and ensure a smooth transition and coordination between these reforms and the ongoing fiscal federalism reforms.

12. **Fiscal federalism provides an opportunity to strengthen fiscal responsibility and discipline at all levels of government.** The 2009 framework law (*Delega al Governo in materia di federalismo fiscale*) sets the stage by outlining the main principles of fiscal federalism, including its consistency with Italy's commitments under the SPG. However, many important features remain to be defined. In the forthcoming implementation decrees, which will specify the details of the reform, the challenge will be to strike the right balance between regional autonomy, and transfers across regions in the context of large local income disparities. The appropriate linkage between the provision and financing of public services at the subnational level should help enhance accountability and could improve the quality of public spending.

13. **Italy has implemented bold pension reforms, which have significantly improved the sustainability of the pension system.** Most recently, the introduction of an automatic link between pension benefits and life expectancy has further strengthened the system. However, the remaining adjustment in benefits is back-loaded and long-term sustainability projections are based on optimistic assumptions about economic growth. These factors raise questions about intergenerational equity. Therefore, the authorities should consider bringing forward the already scheduled increase in the retirement age. Efforts to develop private pension schemes should also be intensified.

Financial sector: addressing the challenges ahead

14. **Banks have weathered the global financial crisis relatively well.** The strengths of the Italian financial system include a broad and stable funding base, a business model based on classical on-balance sheet lending-deposit activity, and strong customer relationships. These factors have been supported by a firm regulatory and supervisory environment. The authorities provided the banking system with a range of support measures during the crisis. However, unlike in many other countries, banks did not need substantial government capital injections.

15. **Italian banks will face a number of challenges over the medium term.** Owing to the weak economy, banks will continue to encounter a high level of credit risk, low lending growth, and significantly lower profitability than before the crisis. Furthermore, the international regulatory rules will be tightened in several respects, including capital requirements.

16. **Efforts to strengthen capitalization should thus continue.** Banks should be encouraged to dispose of non-strategic assets, retain earnings, and raise capital from the market. Staff welcomes the Bank of Italy's recommendation to banks to shore up their capital base. Consideration could also be given to relaxing the current tax rules on the deductibility of loan write-downs, which are stricter than in other major European countries, also in light of the possible new capital regulation on deferred tax credits. Italian banks should begin to adapt their capital strategies to the tougher regulatory framework in prospect.

17. **The expansion of government sponsored loan guarantee schemes in support of small and medium enterprises (SMEs) was appropriate.** Actions to sustain credit to SMEs are justified in the current circumstances, especially given the significance of SMEs in the Italian economy. However, recourse to government guarantees should be temporary and appropriately priced. Nor should government support to firms prevent needed

restructuring. The forthcoming private equity fund for SMEs could be a useful instrument to strengthen their capital base.

Structural reforms: unleashing growth potential

18. **Progress in the structural reform agenda will be the key to unleash Italy's growth potential.** This will require multi-faceted reforms to enhance competition, raise productivity, and reduce the high cost of doing business in Italy. Such reforms could include enhancing the efficiency of public services, improving the quality of public investment and infrastructure, eliminating minimum tariffs for professional services, streamlining bureaucratic requirements, reforming civil justice and accelerating legal processes, and strengthening enforcement of the rule of law.

19. **A number of recent reforms have set the stage for further progress.** The authorities have, inter alia, made competitive tendering the norm in local government procurement practices, enhanced the role of the Antitrust Authority, and began abolishing obsolete legislation. Further reforms are nevertheless needed to improve efficiency of the public sector and remove impediments to private sector competition. The EU Services Directive should be implemented without further delay, by ensuring the consistency of existing regulations on service activities at all government levels with the Directive.

20. **Despite substantial improvements over the past decade, labor market performance still lags behind that in other European economies.** Previous reforms have helped to reduce unemployment. Nevertheless, Italy's employment rate still remains among the lowest in Europe, productivity is lagging, and the labor market is split between highly protected workers with permanent contracts and ill-protected temporary workers. This gap needs to be bridged by making permanent contracts more flexible and temporary workers more protected while simplifying the labor market legislation. A second generation of labor market reforms is also needed to strengthen the link between wages and productivity, allow wages to better respond to regional differences, and foster adequate spatial mobility.