Italy: Staff Concluding Statement of the 2023 Article IV Mission

May 26, 2023

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 Apostolos Apostolou, Aleksandra Babii, Karina Garcia, Sylwia Nowak, Magali Pinat, and Sam Zhang, conducted discussions for the 2023 Article IV Consultation with Italy during May 8 – 23. At the end of the visit, the mission issued the following statement:*

The mission would like to express their heartfelt condolences for the tragic loss of life from the ongoing flooding in Northern Italy.

- *Economic activity and employment grew strongly in 2022 on the authorities' skillful management of gas supplies and the welfare support provided in response to the energy price shock. While still high, the public debt ratio declined and nonperforming loans remained low. However, from 2023, growth is forecast to shift to a lower gear while core inflation is expected to remain sticky, and high interest rates will keep financial sector risks elevated.*
- *Fiscal policy can help the economy to deal with shocks while protecting the sustainability of the public finances. Given still-high public debt, tighter financing conditions, and the need to support disinflation, opportunistically saving most of windfall revenue from inflation surprises and tax credit accounting changes is advised. A credible medium-term debt reduction plan, underpinned by specific measures, would further mitigate debt-related risks. Maintaining a sizable primary balance while also carving out room for public investment could deliver a rapid reduction in the public debt ratio and support potential growth.*
- *Continuing to closely monitor and address evolving risks in the financial sector would strengthen resilience to a more restrictive environment. Preserving adequate buffers on a forward-looking basis is advised. Recourse to public sector backstops or non-standard public-private instruments should be limited.*
- *Addressing the multiple challenges of population aging, climate change, energy security, and global fragmentation requires productivity-enhancing reforms and investing in skills and in green and digital infrastructure. Full and timely*

implementation of the National Recovery and Resilience Plan would support these goals.

The Italian economy grew robustly over the past year despite sharply higher energy prices . Generous tax credits for building refurbishment and strong tourism spurred growth to an impressive 3.7 percent in 2022, with a further expansion of 1.8 percent (year-on-year) in the first quarter of 2023. Downside risks were mitigated by extensive fiscal compensation to cushion households' and firms' real purchasing power, while a natural gas shortage was averted by securing replacement supplies, lowering gas demand, and a mild winter. Employment picked up strongly, with the unemployment rate falling sharply. The public debt ratio has declined by 10 percentage points from its peak in 2020 on the large rebound in nominal GDP. While the energy price spike has largely reversed, broadening price pressures have driven core inflation to high levels

Revival from the health and energy emergencies and withdrawal of exceptional policy stimulus will shift growth to a lower gear, even with support from the National Recovery and Resilience Plan (NRRP). Household consumption is forecast to grow modestly on higher employment and a temporary decline in the saving rate while fiscal support to disposable incomes has been reduced alongside the fall in energy prices. Tightening monetary policy and the gradual phasing out of the building tax credit schemes are projected to moderate private investment, while NRRP-financed public investment is scheduled to grow rapidly. In all, growth is forecast to moderate to 1.1 percent in 2023 and 2024 and to temporarily tick up from 2025 as NRRP spending peaks and remain modestly above its long-term trend. Core inflation is forecast to decline gradually, with inflation returning to target only around 2026. Over the longer term, the falling working-age population will be a drag on growth in the absence of a sustained improvement in productivity.

While positive surprises are possible in the near term, downside risks dominate the growth outlook. A sharper tightening of monetary policy brought by more persistent euro-area inflation could transmit asymmetrically to Italy and further raise borrowing costs. Renewed global financial stress triggered—for example—by the ongoing impasse on the U.S. debt ceiling, could reduce funding availability, causing public and private spending to retrench and reviving concerns about sovereign-bank-corporate linkages. Policies that slow public debt reduction or prolonged delays in receiving NextGenerationEU disbursements could raise financing concerns. Escalating geopolitical tensions or extreme weather events could create supply disruptions. Stalled progress on implementing the NRRP would lower support to output and weaken future productivity prospects. On the upside, growth could prove more resilient, supported by improved confidence among consumers and service sector firms, especially in the tourism industry that could benefit from pent-up demand by foreign tourists, especially from Asia.

Fiscal policy to navigate shocks and protect sustainability

The unwinding of temporary crisis measures is welcome but a faster than planned improvement in the primary balance is warranted and feasible, including to support disinflation . The authorities' planned gradual deficit reduction path mainly reflects the phasing-out of COVID and energy relief measures. Nonetheless, the primary balance for 2023 remains below the pre-COVID level, partly on account of conservative revenue forecasts and the still-high capital spending related to tax credits. The revised statistical treatment of these tax credits and projected higher price deflators suggest revenue outturns could be considerably higher than projected and a more ambitious deficit

reduction is therefore within reach. Saving these revenue windfalls is advised given high public debt, tighter financing conditions, and less-favorable automatic debt dynamics. It would also help to smooth across time the significant fiscal effort needed to firmly place the public debt ratio on a downward path and provide support to disinflation.

There is scope to further increase spending efficiency, including in the near term . The government has implemented or approved several welcome measures to improve the targeting of benefits, including reducing the degree of indexation for higher pensions, and reinstating some taxes and charges on energy. There is room to further refine targeting to households and firms while limiting compensation to the temporary portion of higher energy prices. Redistribution through balanced-budget financed spending was appropriately used in 2022 to respond to the temporary energy price shock, but is not well suited for permanently raising structurally-low incomes, which instead requires improving labor productivity and boosting potential growth (*see below*).

Beyond the near term, a credible fiscal framework with well-identified measures, accompanied by growth enhancing reforms, is needed to anchor fiscal policy and mitigate debt sustainability risks. Saving windfall revenues should over time be replaced with efficient fiscal measures that promote sustainable and inclusive growth and boost productivity. A reform of the tax system to improve efficiency and equity would be welcome, and the design that is ultimately selected should encourage employment, abolish ineffective tax expenditures, reinforce revenue collection and protect progressivity. To contain aging-related spending the retirement age should be linked to life expectancyand benefits should be better aligned with lifetime contributions, while early retirement arrangements should be discontinued. >Pursuing a spending path—including tax expenditures—whereby primary current spending grows 1-2 percentage points below nominal GDP growth whilemaintaining a 3 percent of GDP primary surplus from 2025 onwards would create room for much needed public investment while lowering the debt ratio. A comprehensive spending review could assist in identifying needed savings.

Strong centralized oversight and prudent management of public sector guarantees is encouraged. The current low default rate on guarantees may not be indicative of future risks. Prudent monitoring, management, and provisioning is essential to reduce the risk of guarantees being called and adding to government debt if losses were to exceed existing provisions. Stress testing the guarantee portfolio under adverse scenarios is advised. New guarantees should be strictly limited and coverage rates should be lowered, with enhanced credit risk assessments by banks at origination. Gradually reducing the stock of guarantees is recommended.

Ensuring financial sector resilience

Risks remain elevated amid the uncertain outlook for the macroeconomy and the future path of monetary policy. Banks' capital and liquidity buffers remained broadly stable at comfortable levels over the past year and nonperforming loans (NPLs) declined further. Higher net interest income and release of provisions accumulated during the pandemic boosted banks' return on equity. However, credit volumes are expected to decline and NPLs are likely to rise as borrowers' repayment capacity is crimped by rising interest rates and slower economic growth. Funding costs are expected to increase, especially for those banks where excess reserves are smaller than maturing targeted longer-term refinancing operations (TLTRO) borrowing. Greater competition for retail savings with the government could raise banks' funding costs. The value of fixed income securities portfolios has declined on rising yields, although hedging strategies by some

banks have dampened unrealized losses. Risks are likely distributed unevenly across the financial sector. Pockets of weakness exist among the less significant banks that in the aggregate have weaker credit quality, lower provisioning coverage, and larger holdings of sovereign bonds relative to their capital, although risks are mitigated by the temporary rise in net interest margins. Insurance companies have seen increased surrenders of life insurance policies, declines in premium income, and unrealized losses on securities holdings, although solvency remains solid. As in other countries, commercial real estate is an area of focus given the post-pandemic increase in remote work, although Italian real estate investment funds are mostly closed-end and therefore face limited risk of early redemptions.

Ensuring financial sector resilience to a more restrictive environment is essential .Close attention should continue to be given to individual banks'funding plans, the adequacy of their forward-looking liquidity buffers after TLTROs repayment, and the feasibility of using interest rate swaps to bridge duration risk. Stress tests for all banks should continue to be tailored to capture plausible credit, duration, and liquidity risks, including from concentrated yet potentially more volatile funding and sovereign exposures. Calibrating capital and liquidity buffers and challenging banks' dividend and share buyback plans also on the basis of the stress test results would ensure adequate headroom is preserved. In this regard, the more comprehensive supervision of less significant banks in recent years, accompanied by higher capital requirements and guidance, is welcome. With sizable exposure to commercial real estate, whose prices have been declining for a decade, completing data collection on current price loan-to-value on an individual loan basis is important for assessing risk in this segment. However, residential real estate risks appear to be limited.

Introducing a new windfall tax on bank profits could have unintended consequences. An extra tax on bank profits would tend to reduce interest rates on deposits, raise the cost of loans, and reduce the amount of financial intermediation at a time when loan volume is already declining. Design of such a tax, even if temporary, should consider the impact on credit availability, credit cost, financial institutions' ability to withstand shocks, and that banks generally did not pass the previously negative policy rate on to deposit rates.

Employing non-standard financial vehicles to mutualize banking sector costs, whether by the public sector or other banks, should be limited. Public-private partnerships that utilize resources of the Italian banking sector's deposit guarantee scheme or voluntary contributions to prevent bank failures outside of resolution or liquidation should be avoided except for cases with strong prospects for successful rehabilitation. Given the current low NPL rate and with sales and securitizations of NPLs continuing even after expiration of the Non-Performing Loan Securitization Guarantee (GACS) scheme, the bar should be high for its reintroduction. Instead, banks should strengthen their own in-house loan recovery performance. The size of the proposed Guaranteed Loan Active Management (GLAM) scheme, allowing the state-owned asset manager to purchase COVID-era guaranteed and related loans and provide additional financing to beneficiary firms, should be capped at the proposed level of ½ percent of GDP.

Structural priorities to raise and sustain growth

Full and timely implementation of Italy's NRRP is needed to lift productivity and boost potential growth. Ambitious, productivity-enhancing structural reforms are a

priority to offset the drag on output from the shrinking workforce due to Italy's rapidly aging population. This requires measures to reduce unemployment and inactivity traps, decrease informality, and avoid propping up declining firms. NRRP reforms are appropriately targeting numerous shortcomings that restrain productivity and should be fully and promptly implemented. Strengthening the administrative and execution capacity of implementing municipalities would support the efficient management of the large volume of projects and measures to accelerate procedures should promote competition and the integrity of financial resources.

Accelerating the transition to renewables would reinforce energy security and support the attainment of Italy's climate targets. While Italy met its energy needs during the winter 2022–23, it should prepare for adverse scenarios in the coming winter, including a complete shut-off of Russian gas or further disruptions to hydro-generated electricity. Full return to market-based energy pricing would encourage further efficiency gains and conservation and a faster shift to renewable energy. Identifying and resolving bottlenecks that continue to delay new renewable energy projects is essential to meet carbon emissions targets. New energy-related contracts should avoid locking Italy into long-term fossil fuel dependence. Excise taxes on electricity should be replaced with carbon taxes on input fuels to encourage investment in renewable capacity. The superbonus scheme should be amended to sharply reduce the subsidy component and limit eligible investments to those that achieve a significant improvement in energy efficiency, while embedding mandatory green standards into building codes.

Italy should assess and prepare for risks related to global economic fragmentation. The increase ingeo-political tensions heightens prospects of greater fragmentation of the world economy, which could create significant output losses and greater price volatility if flows of goods, knowledge, and capital were disrupted. At the EU level, Italy can support solutions that address these risks while preserving the benefits of global integration and multilateralism. Domestically, Italy can bolster its resilience against fragmentation by enhancing efficiency and productivity, identifying specific products exposed to fragmentation risk, and developing strategies to cope with potential disruptions. Accelerating the green transition would strengthen energy security.

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We are grateful to the Italian authorities and our private sector counterparts for their time, helpful discussions, and warm hospitality.