IMF Country Report No. 22/255

ITALY

August 2022

2022 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 2022 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 27, 2022 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 27, 2022, following discussions that ended on May 17, 2022, 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 July 12, 2022.
- An **Informational Annex** prepared by the IMF staff.
- A **Statement by the Executive Director** for Italy.

The documents listed below have been or will be separately released.

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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Washington, D.C.

PRESS RELEASE

PR22/278

IMF Executive Board Concludes 2022 Article IV Consultation with Italy

FOR IMMEDIATE RELEASE

Washington, DC – August 1, 2022: On July 27, 2022, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with Italy.

The Italian economy rebounded vigorously from the COVID-related drop in output and has avoided economic scarring. Employment and labor force participation have fully recovered, and banks' nonperforming loans have continued to decline and their capital positions have strengthened. Nevertheless, the economy is now facing major new challenges. The war in Ukraine and COVID-related disruptions to global supply chains have pushed up energy prices and inflation more broadly and intensified shortages of key products, even as global demand is slowing. Ensuring an adequate supply of energy is a priority. A severe drought across the Northern part of the country will further pressure food prices and exacerbate energy security challenges. Yields on Italian government bond have risen and spreads have widened on the prospective tightening of monetary policies and political uncertainty amid a weakened global outlook. Reinvigorating trend growth is essential to strengthen public finances in order to meet social, climate and other goals, while also moderating the high level of public debt.

Growth is projected to moderate sharply and remain subdued owing to the war in Ukraine, monetary policy tightening, continued supply chain disruptions and higher and more persistent inflation. In all, the economy is forecast to expand by 3 percent in 2022, mostly on strong carryover from last year, with a further slowdown to around ¾ percent in 2023. Annual average inflation is expected to peak in 2022 at 6¾ percent and to moderate gradually thereafter. In subsequent years, as energy prices moderate, growth is forecast to pick up, reinforced by public investment spending under the National Recovery and Resilience Plan (NRRP).

Uncertainty surrounding the baseline forecast is high, and downside risks could materially affect the outlook, complicating the task of reducing public debt. A further spike in energy prices and/or a rapid tightening of financial conditions could compress growth, and weigh on fiscal consolidation efforts. Difficulties delivering NRRP investments and reforms would reduce support for demand, weaken longer-term productivity enhancements and delay EU financing. Sustained high inflation could erode recent external competitiveness gains. A complete suspension of Russian energy imports in the coming months could reduce output significantly this year and next relative to the baseline.

[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.

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Washington, DC 20431
USA

Executive Board Assessment[2]

Executive Directors commended the authorities' effective pandemic policy response, which delivered a robust and full recovery. However, major new challenges brought about by elevated energy prices related to Russia's invasion of Ukraine, as well as tightening financial conditions, global supply chain disruptions, and political uncertainty have considerably dimmed the economic outlook. Together with longstanding weak productivity, these factors bring to the fore risks associated with Italy's high public debt.

Directors underscored the need for sustained, decisive improvements in fiscal balances, commencing this year by saving part of revenue overperformance. They commended the authorities' pre-emptive efforts to strengthen the security of energy supplies and recommended that compensation for higher energy prices be temporary and targeted, and that price signals be retained. Rationalizing current spending, broadening the tax base, strengthening tax compliance, and implementing growth-enhancing reforms—including public administration, civil justice, and competition—are needed to achieve and maintain a sizable primary surplus to keep public debt on a firmly downward path.

Directors welcomed the resilience of the banking sector to the pandemic shock but suggested caution given the highly uncertain outlook. Banks should prepare for severe downside scenarios and temporary capital conservation may be warranted in specific cases, including to cope with potential weakening of asset quality. Continued close monitoring, including of smaller and weaker banks, will be important. More efficient debt restructuring to help firms avoid financial distress would also be necessary. Directors commended the progress in implementing the FSAP recommendations and encouraged prioritizing key remaining recommendations.

Directors welcomed the authorities' commitment to their National Recovery and Resilience Plan and commended the timely implementation of Next Generation EU-related targets and milestones. They recommended continued steadfast progress to lift labor productivity, investment, and potential growth, as well as accelerate the green transition. Efficient execution of public investment and strong reform momentum will be essential for success. Improving carbon tax design, making green investment incentives more cost-effective, and streamlining approval procedures for investments in renewables would help accelerate decarbonization and strengthen energy security. A number of Directors saw merit in a coordinated EU approach on carbon taxation. Directors encouraged a continued strengthening of the anti-corruption and AML/CFT frameworks.

[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.

Italy: Selected Economic Indicators, 2019–23

	2019	2020	2021	2022 Proj.	2023 Proj.
Output					
Real GDP growth (%)	0.5	-9.0	6.6	3.0	0.7
Employment					
Unemployment (%)	9.9	9.3	9.5	8.8	9.3
Prices					
Inflation (%, pa)	0.6	-0.1	1.9	6.7	3.5
General Government Finances					
Revenue (% GDP)	46.9	47.4	48.3	48.6	48.3
Expenditure (% GDP)	48.5	57.0	55.4	54.2	52.2
Fiscal balance (% GDP)	-1.5	-9.6	-7.2	-5.6	-3.9
Public debt (% GDP)	134.1	155.3	150.9	147.7	146.3
Money and Credit					
Credit to the private sector (% change) 1/	0.2	4.7	2.1	. . .	. . .
Corporate bank loan rates under 1 million euros (%)	1.9	1.9	1.8	. . .	. . .
Balance of Payments					
Current account (% GDP)	3.2	3.7	2.4	0.5	1.2
Outward FDI (% GDP)	0.1	1.2	0.2	0.0	0.0
External debt (% GDP)	124.2	139.9	137.6	137.2	137.1
Exchange Rate					
REER (% change)	-2.4	0.5	-0.2	...	...

Sources: Italian authorities; and IMF staff estimates.
1/ Twelve-month credit growth, adjusted for securitizations.

INTERNATIONAL MONETARY FUND

ITALY

STAFF REPORT FOR THE 2022 ARTICLE IV CONSULTATION

July 12, 2022

KEY ISSUES

Developments. GDP has fully recovered from the pandemic crisis, but government debt has risen to very high levels. The war in Ukraine triggered a surge in energy prices and the prospect of monetary policy tightening caused government bond yields to rise sharply. Implementation of the National Recovery and Resilience Plan (NRRP), which provides large EU grants and loans conditioned on implementing a comprehensive reform and investment program, is underway.

Outlook. The war in Ukraine and tighter monetary policy are projected to slow growth sharply and keep it subdued. Growth could be further compressed by an additional spike in energy prices and/or a rapid tightening of financial conditions, which could heighten public debt sustainability concerns. A complete suspension of Russian energy imports in the coming months could reduce output significantly.

Recommendations:

Fiscal policy: Compensation for high energy bills should be temporary, target vulnerable households and viable firms, and high wholesale prices should be passed through to end users to encourage conservation. Very high public debt and rising borrowing costs call for accelerating potential growth and steadily—but decisively—raising the primary balance. Over-performing the 2022 budget target is warranted by saving a significant part of revenue overperformance. Consistently growing non-interest current spending by 1–2 percentage points below nominal GDP and further improving tax compliance should commence in 2023, with the goal of reaching a primary surplus of 2 percent of GDP no later than 2030.

Financial and corporate sector policies: Banks should prepare for severe downside scenarios and temporary capital conservation may be required in specific instances. Any new guaranteed loan scheme should be selective, and banks should retain a sizable share of the credit risk. Identification of weak banks should continue alongside further consolidation of the sector. Streamlining debt resolution procedures would reduce debt overhangs, release trapped capital and attract new investment.

Structural policies: To accelerate the green transition, energy taxes should be based on their carbon content and equated across energy sources, while incentives for green investments should be made more cost effective. Full and timely implementation of the NRRP is critical to lift labor productivity, boost potential growth and accelerate the green transition. Reinforcing Italy's governance framework would strengthen the financial integrity of NRRP resources.

Approved By
Mahmood Pradhan (EUR) and Jeromin Zettelmeyer (SPR)

The mission took place in Rome during May 2–17, 2022. The team comprised Rachel van Elkan (head), Ernesto Crivelli, Anna Shabunina, Guillermo Tolosa, Zhongxia Zhang (all EUR), Alan Feng (MCM), and Natalia Stetsenko (LEG). Domenico Fanizza, Cristina Quaglierini, and Francesco Spadafora (all OED) also participated. The mission met with Finance Minister Franco, Bank of Italy Governor Visco, Public Administration Minister Brunetta, senior Italian and SSM officials, and representatives from the business community and trade unions. La-Bhus Fah Jirasavetakul (EUR) and Ivana Rossi (LEG) contributed to the report, and Marta Burova and David Velazquez-Romero (both EUR) assisted in preparing the report.

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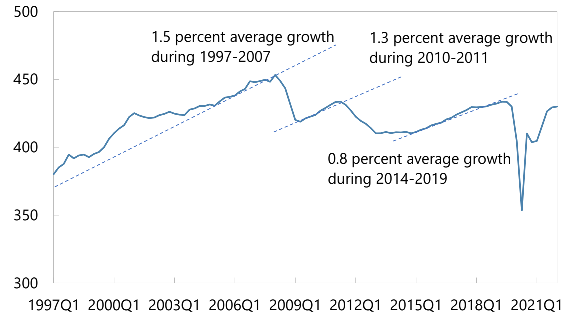
CONTEXT

1. The Italian economy rebounded vigorously from the COVID-related drop in output, avoiding the economic scarring that followed recent previous crises. Following a precipitous drop of nearly 18 percent in the first half of 2020, output recovered to its pre-COVID level by early 2022. This compares favorably with the post GFC and euro debt crisis, where the output path shifted down by a cumulative 8½ percent.

Italy: Real GDP
(Billions of chained 2015 euros)



Sources: Istat; and IMF staff calculations.

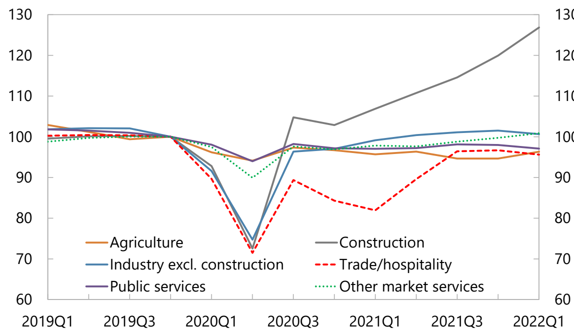
2. Nonetheless, trend growth is likely to remain weak in the absence of deep-seated reforms. Excluding crisis-period output declines, growth slowed from an annual 1½ percent in the decade prior to the GFC to under 1 percent following the euro debt crisis, reflecting weak investment, eroding labor productivity and a shrinking workforce. Reinvigorating trend growth is essential to strengthen public finances in order to meet social, climate and other goals, while also moderating public debt, which was already elevated prior to the pandemic and increased to 150 percent of GDP in 2021.

3. The economy is now facing formidable new challenges. The war in Ukraine and COVID-related disruptions to global supply chains have pushed up energy prices and intensified shortages of key products. Italy could be relatively more affected than many other EU countries owing to its high dependence on imported energy, much of it from Russia. Government bond yields have risen, and spreads have widened on the prospective tightening of monetary policies and concerns about Italy's high public debt amid slowing growth. Climate change has contributed to a severe drought across the Northern part of the country, which will further pressure food prices and exacerbate energy security challenges.

RECENT DEVELOPMENTS

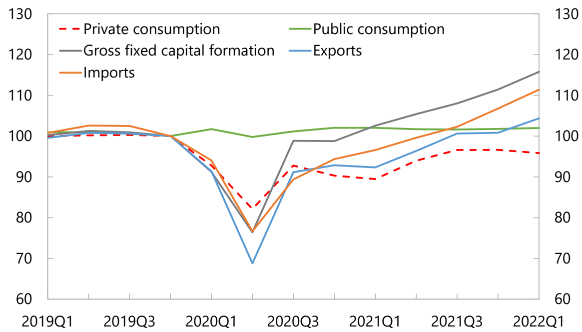
4. Following a 9-percent plunge the previous year, GDP surged 6.6 percent in 2021, although with activity softening toward the end of the year. Extensive pandemic-related policy support and the lifting of social distancing restrictions paved the way for a strong rebound in consumption from early-2021. Exports benefited from robust activity in major trade partners. Generous tax credits for housing refurbishment ("Superbonus" scheme) propelled construction and investment to well-above pre-pandemic levels and provided upstream support to manufacturing However, consumption and related key services—travel, tourism, hospitality—were slow to recover. Headwinds from the omicron wave, escalating energy prices and worsening supply chain disruptions slowed growth in Q4:2021–Q1:2022 (Annex VIII). More recently, with the energy price shock intensifying, consumer and business confidence have fallen. Nonetheless, growth likely remained positive in Q2:2022 on a strong rebound in foreign tourism while industry has remained largely resilient.

Italy: Sectoral Gross Value Added
(2019Q4=100)



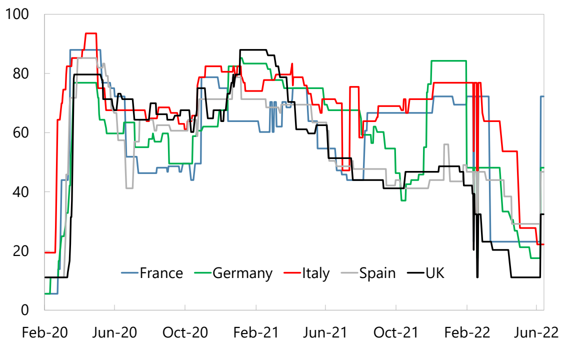
Source: Istat.

Italy: Real GDP by Expenditure Category
(2019Q4=100)



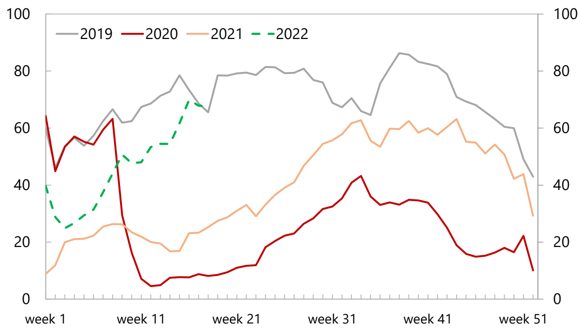
Source: Istat.

Europe: Stringency Index
(0 least restrictive to 100 most restrictive)



Sources: University of Oxford; and Moody's Investor Service.

Italy: Hotel Rooms Occupancy Rate
(Occupied rooms as percent of total available rooms)

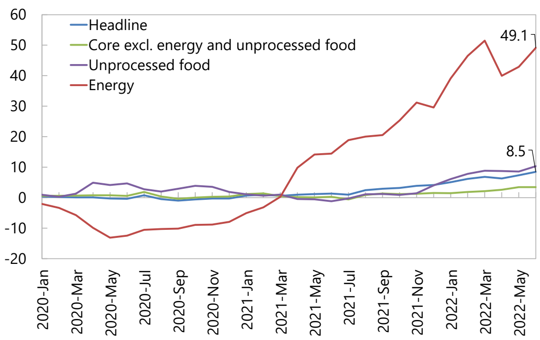


Sources: Smith Travel Research (STR); and IMF staff calculations.

5. **Soaring energy prices and broadening price pressures pushed headline inflation to 8½ percent in June 2022, while core inflation has accelerated from very low levels**. Producer price inflation has risen to around 35 percent, mostly due to the energy component, followed by intermediate goods. At the consumer level, energy price inflation spiked to over 50 percent in March before moderating slightly on cuts in fees and taxes. Price pressures are also broadening, with inflation running above the ECB's 2-percent target in just over half the consumption basket. Core inflation has recently accelerated, reaching 3.4 percent in June as firms are increasingly passing through the higher cost of inputs to their output prices, even as profit margins have declined and labor cost increases have been subdued.[1] Larger shares of energy and food in the total spending of poorer households is exposing them to higher inflation than their wealthier counterparts. Those in the lowest expenditure decile are facing an inflation rate of 8.5 percent—about 1½ times the pace of the top quintile—although targeted government compensation is lowering the impact on their incomes. Nonetheless, energy poverty (measured by arrears on utility bills), which stood at 6 percent of households in 2020, had risen to around 15 percent in early 2022.

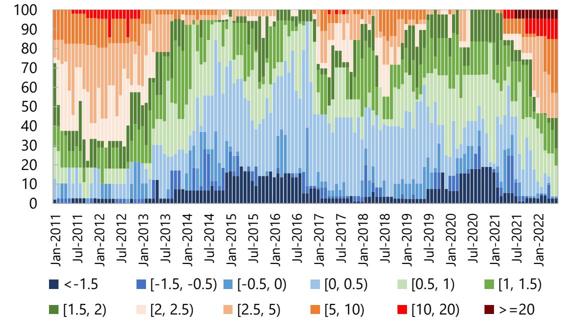
[1] Based on the input structure of Italian production (as described by the sectoral input-output tables), full pass through of higher energy costs would add an estimated 3–5 percentage points to non-energy producer and consumer price inflation.

Italy: HICP Inflation
(Percent, y/y)



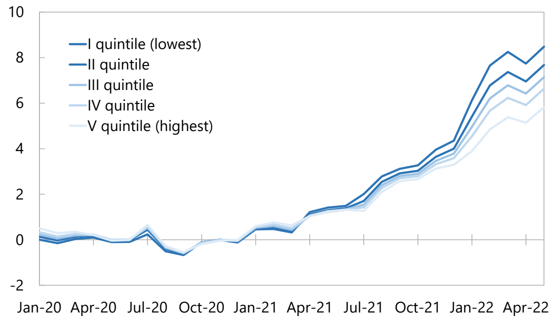
Source: Istat.

Italy: Inflation Dispersion 1/
(Percent)



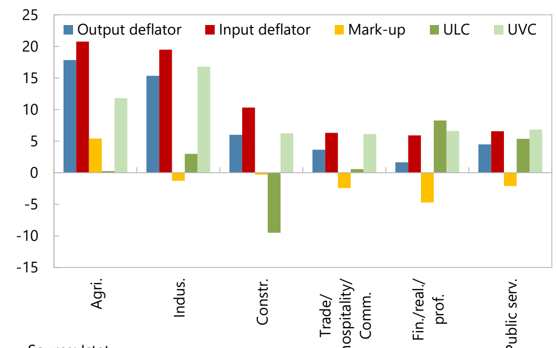
1/ Share of consumption basket within each inflation band.
Sources: Istat; and IMF staff calculations.

Italy: Inflation by Household Consumption Expenditure Quintile (Percent)



Sources: Istat; and IMF staff estimates.

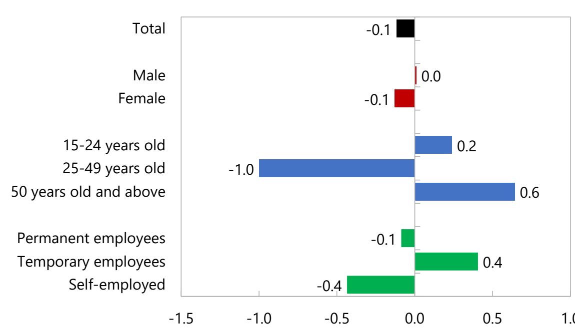
Italy: Prices, Costs, and Margins by Industry - 2022:Q1
(Percent, relative to end-2019)



Source: Istat

6. The post-pandemic drop in the working age population alongside recovery in employment has tightened the labor market, although nominal wage growth remains modest. Employment has nearly recouped its COVID losses, but the composition is now more skewed toward temporary contracts and older workers (Figure 3).[2] With the working-age population having fallen by 1½ percent—likely on net emigration—labor market slack has been reduced.[3] Job vacancies have risen to historical highs, especially in construction, but with early signs of easing in industry. Notwithstanding, nominal growth in contractual wages has been subdued so far reflecting: (i) benchmarking wages in collective agreements to official forecasts of headline inflation but excluding prices of imported energy; (ii) renewal in recent

Italy: Changes in Employment by Group
(Percent of 2019 working age population: May 2022 relative to end-2019)



Sources: Istat; and IMF staff calculations.

[2] Total hours worked remains somewhat below pre-pandemic levels, reflecting the large drop in the number of self-employed (who work longer hours), while hours worked per employee has fully recovered.

[3] Since the COVID crisis, direct labor market transitions from employment to inactivity—and vice versa—have increased significantly in Italy, bypassing unemployment. As a result, the unemployment rate can be a misleading indicator of labor market slack for Italy, as confirmed by D'Amuri and others (2022) who advocate supplementing with the participation rate.

years (but prior to inflation picking up) of multi-year wage contracts covering a large share of workers; and (iii) recovery in the share of foreigners in the workforce (Box 1). On the other hand, recent social benefit programs are thought to have discouraged labor force participation and increased reservation wages, especially in the South of Italy where the cost of living is relatively low.

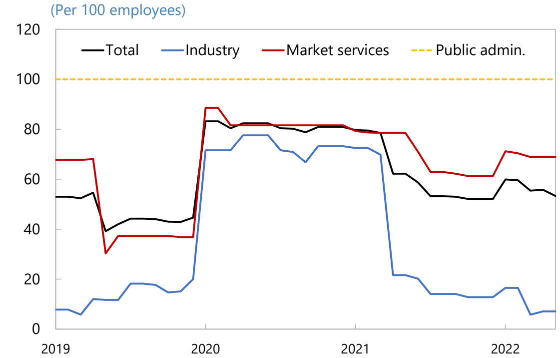
Box 1. Factors Affecting Wage Growth in Italy

Despite high inflation and signs of a tightening labor market, nominal wage growth has remained modest for several reasons:

- The benchmark for wage indexation in Italy is forward-looking and excludes energy prices. The collective bargaining framework (established in 2009) relies on the National Institute of Statistics (Istat)'s annual three-year forecast of the harmonized index of consumer prices (HICP) excluding imported energy products as the benchmark for sectoral-level wage agreements.

- The staggering of multi-year wage contracts across sectors creates variation in the timing and size of wage increases, which reflect prevailing economic conditions at the time of contract renewal. As a result, economy-wide wage increases tend to be smoother than price increases. Notably, several collective agreements occurred in 2021, just prior to the recent pick up in non-energy inflation. Recent wage agreements have also been modest. The March agreement for the construction sector provides a cumulative wage increase of 6 percent over three years, notwithstanding strong labor demand in that sector. The recent multi-year agreement for the civil service entails wage increases of around 4 percent, effective from June.

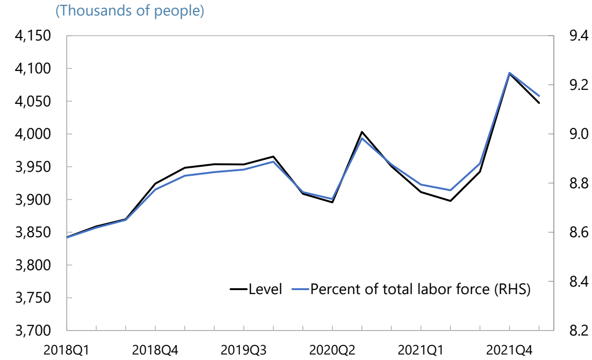
Italy: Employees Waiting for Renewal of Wage Contract
(Per 100 employees)



Source: Istat.

- In the context of the highly-open EU labor market, sizable in- and out-flows of Italian and foreign workers likely reduce the sensitivity of wages and prices to domestic indicators of labor market slack. The share of foreign workers in Italy has risen over time. The strong cyclicality in foreign worker flows limits the buildup in unemployment and inactivity during downturns and expands the pool of workers available to meet increases in demand. The recent recovery in the share of foreign workers is therefore likely to ease pressure on domestic wages in the context of a tightening domestic labor market. However, to the extent that labor markets in other EU countries are tighter than in Italy and have larger wage increases, these larger wage increases could eventually transmit to Italy.

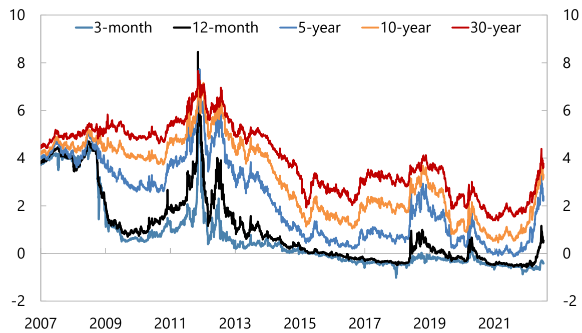
Italy: Foreign Workforce
(Thousands of people)



Source: Istat.

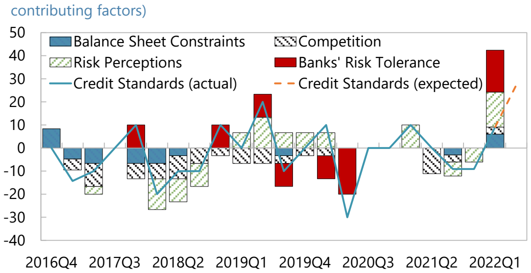
7. Financial market conditions have tightened on the ongoing global withdrawal of monetary accommodation and spillovers from the war in Ukraine, raising risk perceptions. Nominal yields on Italian government bonds have risen and spreads over German bunds have widened to around 200 basis points. Nonetheless, deflated by core inflation, real interest rates remain low. Credit default swap (CDS) spreads on bonds of Italian large banks and the sovereign have risen since the beginning of the year, but remain well below past peaks. Banks tightened credit standards in Q1:2022 according to the ECB's bank lending survey, amid a 30-percent drop in bank equity prices since mid-February and rollback of numerous pandemic-era regulatory and financing measures. After expanding briskly during the past two years, growth in bank lending to the corporate sector has slowed, while lending to households remains upbeat. Interest rates for new mortgage loans are picking up in response to rising market rates, while lending rates for NFCs are little changed so far. Households and NFC sectors remain net creditors to banks, with larger deposits than loans in the aggregate. Alongside expansion in their balance sheets, banks' holdings of Italian government bonds have remained around 10–12 percent of assets over the past several years. Holdings of Italian sovereign bonds by Eurosystem central banks—mainly the Bank of Italy—have risen to around 30 percent of the total stock.

Italy: Government Bond Yields by Maturity
(Percent)



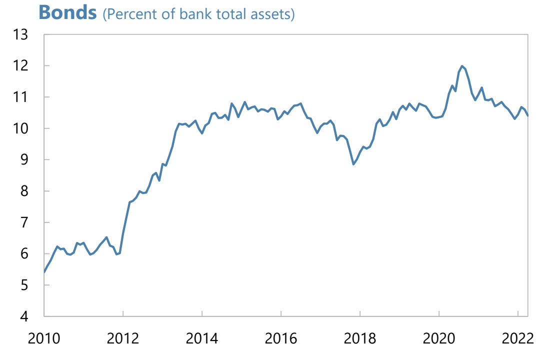
Source: Bloomberg, LLP.

Italy: Tightening of Bank Lending Standards
(Net percentages of banks reporting a tightening of lending standards and contributing factors)



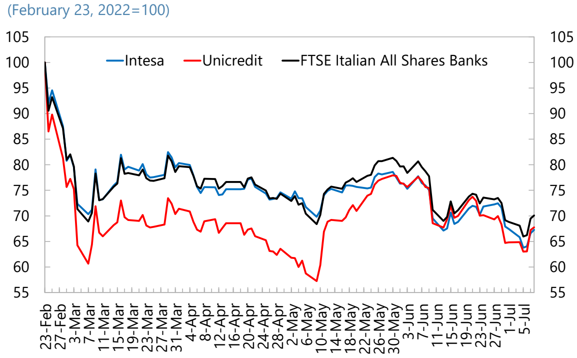
Sources: ECB Bank Lending Survey, IMF staff calculation.
Notes: The net percentages are defined as the difference between the percentage of banks reporting a tightening due to a given factor and the percentage of banks reporting an easing.

Italy: Banks' Sovereign Exposure to Italian Government Bonds (Percent of bank total assets)



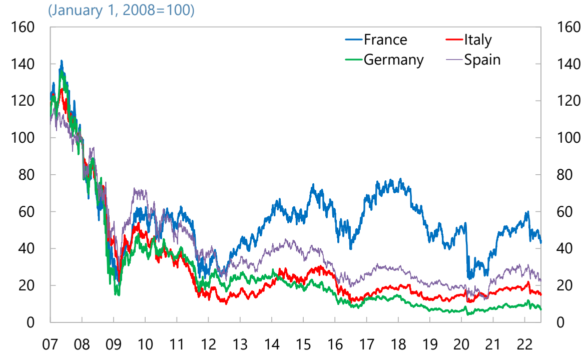
Sources: Bank of Italy; Haver Analytics; and IMF staff estimates.

Italy: Unicredit and Intesa Equity Prices
(February 23, 2022=100)



Sources: Bloomberg, LLP; and IMF staff estimates.

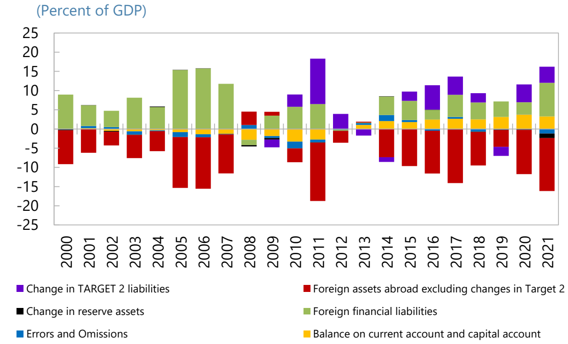
EA4: Bank Equity Prices
(January 1, 2008=100)



Source: Bloomberg, LLP.

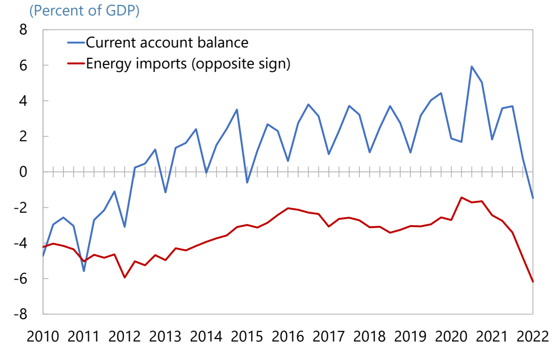
8. The current account surplus has fallen sharply on the surge in energy import prices despite strong export growth. The surplus moderated to around 2½ percent of GDP in 2021 from 3¾ percent of GDP in 2020 owing to the large adverse terms of trade shock that began late in the year as well as a pick up in private investment supported by the National Recovery and Resilience Plan (NRRP). Nonetheless, the external position in 2021 was broadly in line with the level implied by medium-term fundamentals and desirable policies (Annex III). Further increases in imported energy prices caused the trade balance and the current account to swing into deficit from Q1:2022. Receipt of the first installment of NRRP funds from the EU of around €22 billion in April 2022 broadly offset outflows from the decline in foreign holdings of government debt. Real effective exchange rates depreciated over the past year, with the unit labor cost-based measure considerably below its 10-year average.

Italy: Balance of Payments Flows
(Percent of GDP)



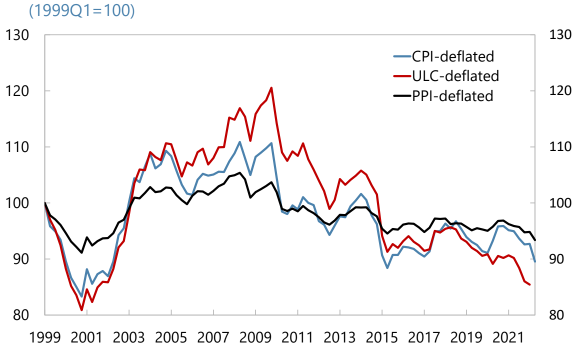
Sources: Bank of Italy; ECB; Haver Analytics; and IMF staff estimates.

Italy: Current Account Balance and Energy Imports
(Percent of GDP)



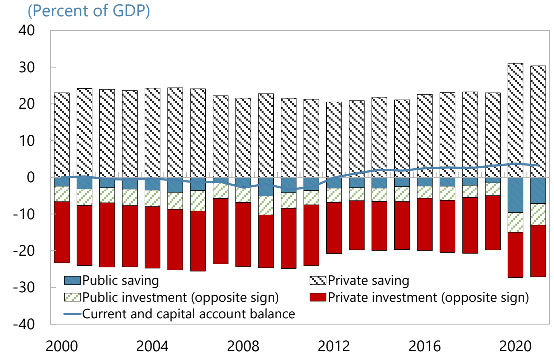
Sources: Istat; and Haver Analytics, LLC.

Italy: Real Effective Exchange Rate
(1999Q1=100)



Source: ECB.

Italy: Saving-Investment Balance Decomposition
(Percent of GDP)



Sources: Istat; and IMF staff estimates.

9. The authorities' policy focus has shifted in response to the retreating pandemic and the outbreak of war in Ukraine, but they continue to prioritize their NRRP commitments. An efficient vaccination campaign achieved high uptake rates, including of booster shots. COVID-related income, liquidity and regulatory support measures have been largely phased out and health restrictions lifted.[4] Several energy price relief packages have been adopted since H2:2021. In line

[4] See Annex I of Italy: 2021 Article IV Consultation for a description of COVID-related policy responses.

with EU-wide agreements, Italy has imposed sanctions on Russia and Belarus, including on the Central Bank of Russia and several Russian banks, and restricted imports of Russian coal and oil.[5] Italy is strengthening its energy security, including by sourcing additional gas from other suppliers. Budgetary resources have been allocated for refugees from Ukraine.[6] Italy's NRRP provides some 4 percent of GDP in grants and 8 percent of GDP in loans through the EU's Next Generation EU (NGEU) facility, conditional on completing a comprehensive package of structural reforms and investments (Annex IV). Italy met the first set of milestones and targets on schedule by end-2021 and the government recently announced it had satisfied all 45 conditions established for H1:2022.[7] With the Plan running through 2026, responsibility for the bulk of its implementation will be delegated to the next government following parliamentary elections scheduled for Spring 2023.

REPORT ON THE DISCUSSIONS

The discussions focused on: (i) the macroeconomic outlook and associated risks; (ii) managing the challenges brought by high energy prices and energy security concerns; (iii) dealing with economic legacies of the pandemic; and (iv) addressing structural reforms to raise labor productivity and policies to support the green transition.

A. Outlook and Risks

10. Pent-up demand will continue to support near-term activity, but growth is projected to further weaken from later this year owing to the war in Ukraine and monetary policy tightening. Notwithstanding the good performance through mid-2022, growth is expected to moderate sharply relative to 2021 in a baseline characterized by elevated energy prices (but no major supply shortages),[8] further increases in interest rates, ongoing supply chain disruptions and persistent inflation. Consumption is forecast to moderate on the erosion of real incomes despite partial fiscal compensation for higher energy bills and a lower aggregate household saving rate. Rising interest rates and weakening confidence are projected to dampen private investment, although tax credits will continue to support construction. Shortages of key inputs and shrinking profit margins will cause firms to scale down production. Net exports are expected to subtract from

[5] The list of EU sanctions adopted following Russia's invasion of Ukraine is available here. An analysis of the global spillovers of sanctions can be found here. In line with the recently revised Institutional View on the liberalization and management of capital flows, some of the sanctions imposed on Russia can be capital flow management measures (CFMs) imposed for national and international security reasons.

[6] As of May 2022, more than 115,000 Ukrainian refugees had arrived in Italy.

[7] These milestones and targets include reform of civil and criminal justice and the insolvency framework, as well as increasing the public sector's capacity to administer the NRRP and strengthen public procurement. More recently, further progress has also been made in the areas of healthcare and education (e.g., reform decrees to improve healthcare accessibility and a reform of teacher recruitment and training system). A description of targets and milestones that have already been met is available here and here.

[8] In the baseline, the reduced flow of Russian gas (to about half the rate of 2021) that began around mid-June 2022 is assumed to continue. Staff estimates that this shortfall from Russia can be largely offset with additional inflows from other suppliers and extra use of coal powerplants while still accumulating inventories to meet peak winter demand and end the 2022–23 winter season with a normal level of gas in storage.

growth on slower external demand. In all, the economy is forecast to expand by 3 percent in 2022, with growth slowing to about ¾ percent in 2023. Annual average inflation is expected to peak this year at 6¾ percent and to moderate gradually thereafter. The continuing high cost of imported energy is projected to further reduce the current account. In subsequent years, as energy prices moderate—but to levels still higher than before their recent increase—growth is forecast to pick up, reinforced by investment spending under the NRRP umbrella before slowing temporarily in 2027 as NRRP-related spending is wound down. Potential growth is expected to increase marginally to somewhat over ¾ percent, reflecting implementation to-date of NRRP-related investments and reforms.[9]

11. Uncertainty surrounding the baseline forecast is high, and downside risks could materially affect the outlook. A further spike in energy prices and/or a rapid tightening of financial conditions (including from repricing the future path of policy rates or domestic considerations) could compress growth and heighten public debt sustainability concerns. Difficulties delivering NRRP investments and reforms would reduce support for demand, weaken longer-term productivity enhancements and delay EU financing. Sustained high inflation could trigger a wage-price spiral that erodes external competitiveness. A complete suspension of Russian energy imports in the coming months could reduce output significantly this year and next relative to the baseline (Annex X).[10] In that context, funding costs for the sovereign and banks could further increase, leading to a procyclical tightening of fiscal policy and credit conditions, and intensifying sovereign-bank-corporate feedback channels.

Authorities' Views

12. The authorities agreed that the war in Ukraine has significantly reduced growth prospects, with a near-term shutoff of energy supplies from Russia among the key risks. The rise in consumer prices and heightened uncertainty have put a brake on strong growth. Assuming the war lasts through the end of this year, growth is expected to approach 3 percent on resilience to high energy prices and supply disruptions, and the substantial support to activity being provided by fiscal policy and the NRRP. Assuming geopolitical tensions and high energy prices ease next year, growth momentum would strengthen from 2023. Fiscal prudence and faster sustained growth—including through prioritizing investment and targeted measures for vulnerable households and firms—are needed in response to higher interest rates. A common tool to ensure that withdrawal of monetary accommodation is smoothly transmitted across the euro area is warranted. Pass through

[9] The cumulative increase in GDP from NRRP-related public investment and capital transfers relative to the no-NRRP counterfactual is estimated to be about 13 percent during 2021–31, with a peak increase in the level of output of near 5 percent in 2025 and 2026. In the early years of the Plan (2021–22), these demand-driven output gains are underpinned mainly by tax incentives for private investment, while subsequent effects reflect the rotation of spending toward public investment. Time-to-build considerations inherent in public investment are assumed to extend the positive output effects beyond the NRRP's 2026 end-date. The NRRP's effects on potential growth are expected to materialize mainly beyond the forecast horizon, and will depend significantly on the quality of the new infrastructure and how successfully the structural reforms are implemented.

[10] The further curtailment of Russian gas flows to Italy on July 11, to one-third of the normal flow but which is assumed to resume in the coming weeks in the baseline, highlights the risk of a full suspension.

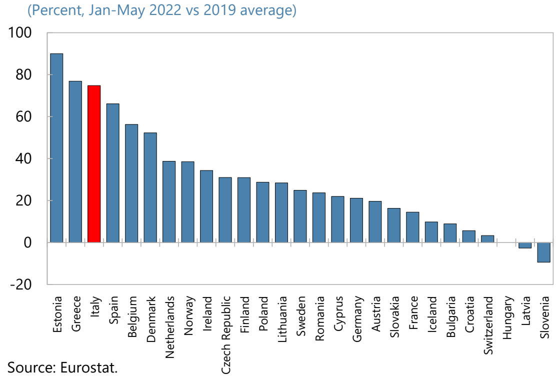
of prices to wages is expected to be gradual and partial, especially given some residual labor market slack, but wage pressures could intensify if inflation were to remain elevated. The decline in the current account largely reflects the terms of trade shock. The external position remains broadly in line with fundamentals, and external competitiveness has improved on account of sustained wage moderation, while export growth has been strong. If energy from Russia were cut off, supply shortages, higher energy prices, together with weaker confidence and external demand, would lower growth significantly relative to the baseline. Deglobalization would likely lead to marked changes in prices and weaken prospects for international cooperation on pressing global economic and social challenges.

B. Managing the Energy Shock

Background

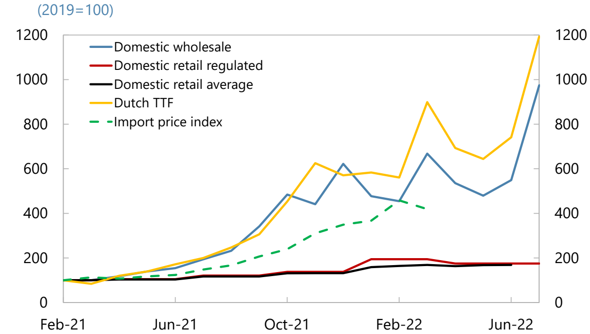
13. The government has incrementally rolled out a series of measures to compensate end-users for energy price increases, partly financed by windfall revenue from energy. Developments in international and regional energy markets have caused prices faced by Italian households and firms to rise by around 70 percent in the first few months of 2022 relative to the previous year. For households, this implies an average increase in energy bills of about €2,000 per year. For firms, production costs are estimated to have risen by 9 percent, which is higher than for other advanced European countries.[11] Beginning in Q4:2021, several compensation packages were adopted, totaling around 1.7 percent of GDP through Q3:2022. The measures are a mix of policies targeting the most vulnerable as well as across-the-board support. In addition, some measures preserve price signals, while others (such as cuts in fees and charges) compress prices (Annex IX). These measures have been extended and topped up in response to ongoing energy price developments, and most have been rolled over on a quarterly basis. Funding has been provided in part by windfall taxes from higher energy prices, including a surtax on additional profits of energy companies.

Europe: Electricity Price Increase
(Percent, Jan-May 2022 vs 2019 average)



Source: Eurostat.

Italy: Natural Gas Prices
(2019=100)



Note: July 2022 prices reflect prices on July 12th.
Sources: GME; ICE; ARERA; ISTAT; Eurostat; and IMF staff estimates.

[11] According to a recent report from Confindustria, the higher increase in Italy reflects the greater reliance on gas as an energy source.

Text Table. Italy: Mitigating High Energy Prices

Measures	Targeting	Distorts price signal	Cost (Percent of 2022 GDP) 2021-Q4	2022-Q1	2022-Q2	2022-Q3
Social bonus reinforcement1/	HH below income threshold	No	0.02	0.03	0.03	0.03
Elimination of system charges in electricity	Untargeted2/	Yes	0.20	0.19	0.19	0.11
Reduction of system charges in gas	Untargeted3/	Yes	0.04	0.03	0.03	0.03
Gas VAT reduction of 5 percent	Untargeted	Yes	0.03	0.03	0.03	0.03
Tax credits electricity, gas and gasoline	Selected Corporates4/	Yes		0.03	0.11	
Tax credits gas	Selected Corporates	Yes			0.09	
30.5 cents discount on gasoline and diesel5/	Untargeted	Yes			0.14	
Bonus 200 euro	Workers and retirees6/	No			0.32	
Total			**0.3**	**0.3**	**0.9**	**0.2**

1/ Pre-existing tariff discount on the basis of income/wealth with expanded coverage (until end-2022) and amounts (until Q3:2022)
2/ Expanded to all corporates from Q1:2022.
3/ Until budget is exhausted.
4/ 15-25 percent tax credit for firms with large gas and electricity consumption experiencing price increases of more than 30 percent.
5/ Applicable until July 8, 2022.
6/ Annual earnings below €35,000.

14. **Heightened concerns about energy security have prompted changes in the sourcing of energy.** The goal is to phase out Russian gas imports by end-2024. A severe drought in the North has reduced production of hydroelectricity. Guided by the REPowerEU plan, the government is securing alternative energy supplies through agreements with other gas producers (which they expect to replace about half of normal gas imports from Russia by next winter), expanding LNG regasification capacity and delaying the phase-out of coal power plants and increasing domestic gas extraction. The seasonal storage of gas is also being accelerated, and inventories stood at 54 percent in mid-June. Steps to speed up approvals procedures for renewable electricity capacity have also been adopted.

Staff's Views

15. **The adopted relief measures partially transmit energy price signals while providing significant compensation to the most vulnerable**. Less than half the measures (by cost) feature some form of targeting and explicit progressive aspects. As a result, after compensation, the incidence of the price shock is increasing with the level of income.[12] Targeted interventions for energy-intensive firms have helped to ease the burden of the price shock. However, the remaining measures entail across-the-board cuts in taxes and fees. While these prevented an even more rapid increase in energy prices, their universal coverage makes them fiscally costly, and by blunting price signals (though by less than in some other large EU countries), energy efficiency and conservation are discouraged. Moreover, energy suppliers may also have benefited from the cuts in fees and taxes by receiving higher sales prices. With natural gas futures prices pointing to prices remaining

[12] According to the Parliamentary Budget Office, households in the lowest income decile have been fully compensated. Moreover, with old-age pensions adjusted for 75–100 percent of headline CPI inflation, many pensioners may be over-compensated.

persistently higher than before the onset of the energy shock (but below their recent peaks), adjusting to this structural price shift requires scaling back fiscal support, restoring price signals and further improving targeting of benefits. One option could be to shift to a two-tier tariff on customer-specific electricity and gas bills, which could deliver market efficiency while also supporting conservation and equity objectives.[13]

16. Balancing energy security, affordability and decarbonization has become more difficult in the face of sharply higher energy prices and the risk of supply shutoffs. Strengthening near-term energy security is a priority, but the planned replacement energy mix implies that decarbonization will be temporarily set back. However, security and sustainability should be reinforcing over the longer term as higher fossil fuel prices would promote faster deployment of renewables and deeper improvements in energy efficiency (see climate section). If supply disruptions become severe, avoiding—to the extent possible—forced reductions in gas use by relying on market mechanisms, such as auctions to compensate industrial users who relinquish their gas usage rights, would be desirable. Reviewing pricing and tax arrangements for energy imports and renewables-based electricity within the EU context may be appropriate to limit excessive windfall rents and their transmission to end-user prices. In this context, the recently adopted guaranteed-price contracts for renewables-based electricity provides potential investors certainty on future prices, increasing their willingness to undertake the high upfront capital expenditure associated with renewables. However, associated fiscal risks should be adequately managed and the guarantee price in new contracts should be regularly reviewed to reflect changes in the cost of renewables capacity. Taxing windfall rents of energy companies is appropriate provided post-tax profits are adequate to incentivize investment in maintenance and new capacity and the tax base adequately reflects all relevant profit and loss components.

Authorities' Views

17. The authorities broadly concurred with staff views. Price-based compensation measures were adopted at the onset of the energy price shock to provide swift relief to households and firms in order to avoid severe social and economic disruption and to limit the impact on inflation. While the original measures remain in place, subsequent measures have generally focused on targeting the most affected, including energy-intensive firms and lower-income households, while preserving price signals. Additional energy-related fiscal revenue is expected to cover a large part of spending on compensation. Setting a price ceiling on all EU imports of piped gas that is above the historical level but below today's prevailing price could reduce extraordinary rents and moderate energy bills for end users. Fast-tracking authorizations of blocked renewable energy projects is essential for energy security and decarbonization.

[13] Specifically, the price of the initial block of energy (equal to past consumption in volume terms, minus a "conservation factor" that can vary by type of customer) would be set below the current spot market price, while volumes above that threshold would be priced at the spot price. Such pricing schemes (sometimes called "lifeline rates") have a long history for utilities sectors and have been adopted in Estonia during the current energy price shock.

C. Charting a Fiscal Strategy

Background

18. Withdrawal of pandemic-era support and a strong recovery lowered the deficit and debt ratios, and the authorities are planning further progress despite new spending initiatives. The 2022 budget introduced cuts in personal income taxes and a universal means-tested child allowance. Substantial additional fiscal support to activity is being provided through the Superbonus and other tax credits,[14] retroactive payouts on recently-agreed public administration wage contracts, and large planned new hiring to support implementation of the NRRP. The government intends to adhere to the original 2022 budget deficit target of 5.6 percent of GDP,[15] despite 1½ percent of GDP in additional spending to compensate households and firms for higher energy prices during H1:2022 and to support refugees from Ukraine. Nonetheless, the fiscal deficit through June 2022 is considerably smaller than in 2020 and 2021, reflecting large revenue gains. On current plans, the authorities would increase the primary balance by 3½ percentage points of GDP over four years to reach a small primary surplus by 2025. Together with their expectation of continued favorable automatic debt dynamics—somewhat more optimistic than staff's projections—the authorities expect to lower the debt ratio by 9 percentage points to around 141½ percent of GDP by 2025, with a further decline to the pre-pandemic 135 percent of GDP by 2030.

Italy: Projected Fiscal Measures in 2022
(Percent of GDP)

	2022
Change in Primary Balance	**1.5**
of which:	
Permanent Measures	**-0.2**
Universal Child Allowance	-0.2
Income Tax Reform	-0.2
Tax compliance	0.2
One-off Measures	**0**
Compensation for Higher Energy Prices	-1.5
Revenue from Higher Energy prices 1/	1.5
Other (including cyclical) 2/	**1.7**
Support to the Economy w/o impact on 2022 Deficit	**-0.8**
Spending from NGEU-Grants 3/	-0.4
Spending from Superbonus tax credits 4/	-0.4

Notes:
1/ Including from higher energy prices and the tax on windfall profits of energy companies.
2/ Including from withdrawal of Covid spending; and tax revenue from the cyclical recovery and higher non-energy inflation.
3/ Including on infrastructure spending and tax credits on investment.
4/ On-budget, to be accrued in fiscal accounts over time.

Italy: Fiscal Projections
(Percent of GDP)

	2022	2023	2024	2025
Primary balance				
Staff	-2.1	-0.6	-0.3	0.1
Authorities	-2.1	-0.8	-0.3	0.2
Overall fiscal balance				
Staff	-5.6	-3.9	-3.6	-3.1
Authorities	-5.6	-3.9	-3.3	-2.8
Public debt				
Staff	147.7	146.3	143.4	141.7
Authorities	147.0	145.2	143.4	141.4

Sources: Italy Economic and Financial Document (April, 2022); and IMF staff projections.

[14] Private spending supported by investment tax credits can precede the recording of the associated tax expenditures in the budget by several years.

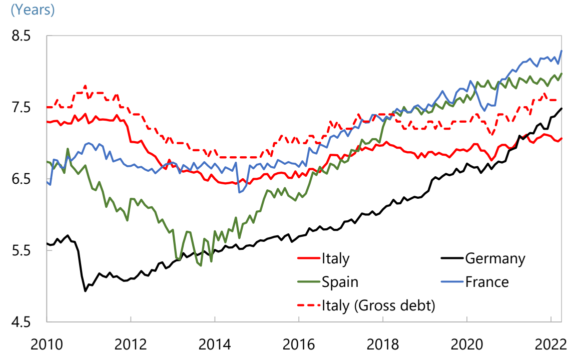
[15] However, owing to higher-than-envisaged interest payments on mainly inflation-linked bonds, this implies a smaller target for the primary deficit.

Staff's Views

19. Providing adequate—but temporary and targeted—fiscal compensation for higher energy prices is compatible with faster reduction in the deficit under the baseline scenario. Given Italy's at-risk fiscal space in the context of elevated public debt, rising borrowing costs and the resilience of demand and output to the energy shock, over-performing the 2022 budget target is warranted in view of risks surrounding automatic debt dynamics and to help tame inflationary pressures. This could be achieved by saving additional revenue from higher real growth and inflation and structural tax compliance gains.[16] On the other hand, extra revenue from higher energy prices and the tax on windfall profits of energy companies can be used in a budget-neutral manner for targeted support to households and firms on a strictly temporary basis. With energy prices projected to moderate somewhat from next year under the baseline scenario, compensation measures should be scaled back, increasingly focused on the most vulnerable and price signals should be restored.

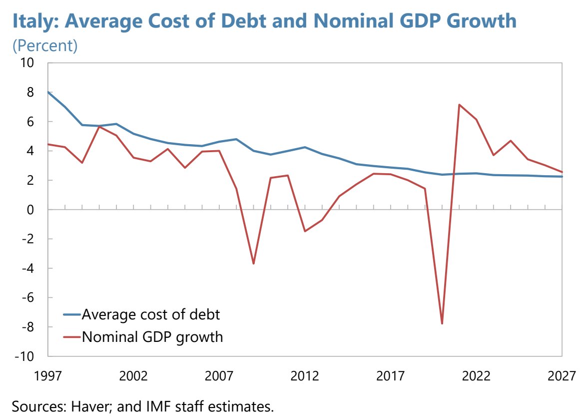
20. Favorable automatic dynamics are expected to support debt reduction in the next few years, but to sustain progress, faster growth and a larger primary surplus are needed. The recent rapid increase in government borrowing costs implies that the future decline in the effective cost of debt will now be shallower and shorter-lived than previously anticipated, including because of the limited extension of the maturity of public debt in recent years despite very favorable financing conditions. A brief window of favorable automatic debt dynamics—mainly due to a temporary acceleration in the GDP deflator—in the next few years would only return the public debt ratio to the already elevated pre-pandemic level. Population aging will add 1½–2½ percentage points of GDP to annual pension spending during 2035–45. Contingent fiscal liabilities from pandemic and NPL-related credit guarantees could also add to public debt. Even under current borrowing costs, keeping the debt ratio on a downward trajectory will require faster GDP growth and a much more ambitious path for the primary surplus than the government is currently targeting. If sovereign yields were to increase by more than assumed in the baseline, public debt could stabilize at the current high level over the forecast horizon (Annex II), and increase thereafter.

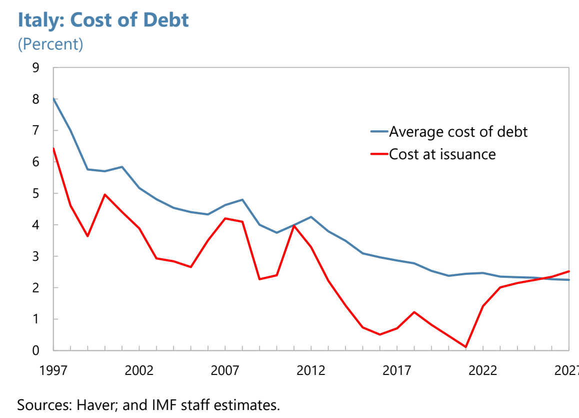
EA4: Average Residual Maturity of Government Debt Securities
(Years)



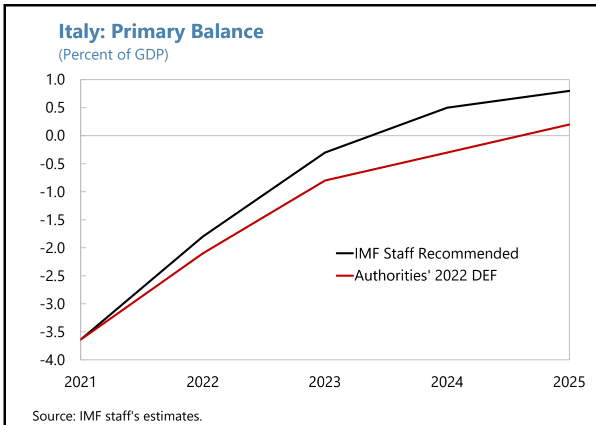
Sources: Eurostat; and IMF staff estimates.

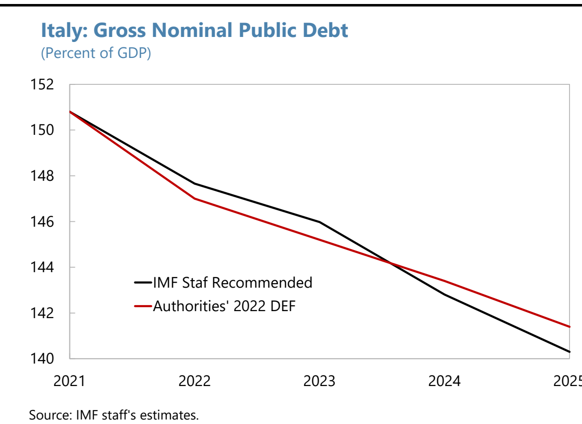
[16] Saving part of revenue from the inflation tax implies that the deficit and debt ratios would benefit from a smaller nominal deficit (numerator effect), while a higher GDP deflator would produce a larger denominator effect.





21. A credible two-pronged strategy is needed to significantly—albeit gradually—reduce high deficit and debt ratios over the medium-term. Comprehensive structural reforms, including a revenue-neutral broadening of the tax base to make the tax system more equitable, are needed to boost productivity and GDP growth. In addition, consistently growing non-interest current spending—inclusive of tax expenditures—by 1–2 percentage points below nominal GDP and further improving tax compliance would achieve an appropriately paced fiscal adjustment, which should commence in 2023 and deliver a primary surplus of 2 percent of GDP no later than 2030. A comprehensive review of the budget to find meaningful savings from existing spending and tax programs (Box 2) should underpin this spending-based strategy and measures could be incorporated in the 2023 draft budget. Over the longer term, maintaining the gap between growth in current spending and nominal GDP as well as keeping the primary surplus at 2 percent of GDP would create room for priority investments in education, digitalization and the energy transition while also reducing public debt to around 130 percent of GDP by 2030, with further sustained reduction thereafter. This recommended path is broadly consistent with fiscal targets for Italy from the IMF's Buffer Stock model (Box 3). The Buffer Stock model also clearly illustrates the benefits of higher sustained GDP growth, which delivers a similar decline in debt but with considerably less fiscal effort. The model also shows that higher government financing costs requires greater fiscal effort.





22. Continuing to improve the design of fiscal policies would reduce the risk of slippage and support debt reduction:

- The recent strengthening of job acceptance requirements and links to training in the Citizenship Income program are welcome. To make these conditions effective and avoid welfare dependence and disincentives to work, job openings and training opportunities must be offered, the rate of benefit withdrawal in response to earned income should be gradual, while benefit levels are high relative to the cost of living in some parts of the country.

- The early retirement scheme allowing retirement at the age of 64 with 38 years of contributions (Quota 102) is set to expire at end-2022, with a return to the statutory retirement age of 67. Any transitional arrangement or other early retirement options should be neutral in present value terms for the fiscal accounts and with lifetime benefits closely linked to lifetime contributions.

- Reinforcing existing controls on approvals of Superbonus tax credits would limit risks of spending overruns that may well occur because of very high demand in the context of the 110 percent subsidy on eligible spending. The subsidy rate should also be reduced (Annex VII).

- To avoid unintended distortions, the tax on windfall profits of energy companies should be based on the full range of items that determine profits.[17]

- Updating real estate values in the cadaster, which has not been comprehensively revised since the 1980s, is needed to improve equity. Taxable values of many properties are well below market values, and this gap increases significantly for higher market-value properties. With all housing property subject to a common tax rate (for a given property type), the effective tax rate is declining as market value (and household income) increases, rendering the property tax inequitable.

Authorities' Views

23. The authorities agreed that raising the primary surplus to 2 percent of GDP was appropriate and achievable within the next few years. For the current year, mitigating the social impact of the energy price surge while also retaining the original deficit ceiling was critical to signal the government's ongoing commitment to a declining deficit path. Simultaneously achieving these goals was made possible by higher structural and cyclical revenue and the tax on windfall profits. They concurred that ongoing fiscal support to activity was substantial, including from investment tax credits—which will be phased out gradually—but emphasized the need to support public and private investment to strengthen the recovery and hence public finances. They expected the debt ratio to remain firmly on a downward path in the coming years mainly due to an average cost of debt that will remain well below expected nominal growth at least for the next two years. However, successful implementation of the NRRP was seen as essential to raising potential growth in order to continue to lower the debt ratio over the longer term. Debt dynamics were also supported by the 30 percent of

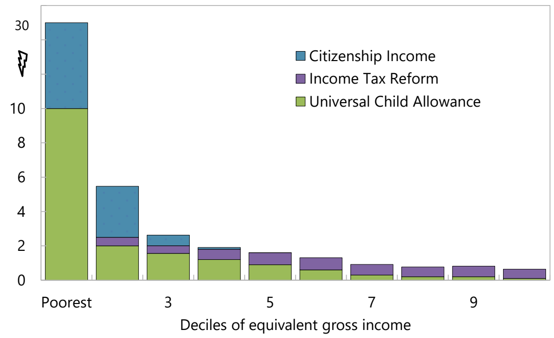
[17] The current formulation proxies profits by the difference between positive and negative VAT accountable items, which fails to capture important elements, including realized capital gains and losses and margin calls on energy price hedging contracts.

Italian public debt held by the Bank of Italy within the Eurosystem's asset purchase programs, which would be reinvested on maturity for the next few years, while interest payments on this debt are generally returned to the budget as dividends, thereby reducing the effective cost of debt. Nonetheless, returning to the pre-pandemic level of the primary surplus was viewed as appropriate to support debt reduction. The authorities stressed the importance of further combating tax evasion to deliver the needed structural adjustment.

Box 2. Policies to Achieve the Fiscal Targets

A comprehensive review of existing fiscal tax and spending programs is needed to find savings while ensuring the budget supports long-term growth and social inclusion. Despite public sector wage restraint, primary current spending has consistently grown faster than nominal GDP over the past decade, crowding out public investment in physical and human capital and room to lower the tax wedge on labor. Also, large pension spending favors older generations at the expense of young and working age generations, who comprise the bulk of the population at risk of poverty. Recently introduced social benefits, while mostly benefiting the most vulnerable, are too broad in their coverage. Numerous tax expenditures create distortions and reduce revenue. The recently approved income tax reform marginally reduces the tax wedge on labor, especially in the middle segment of the income distribution, but does not address the pressing need to broaden the tax base. Key areas where savings are feasible include:

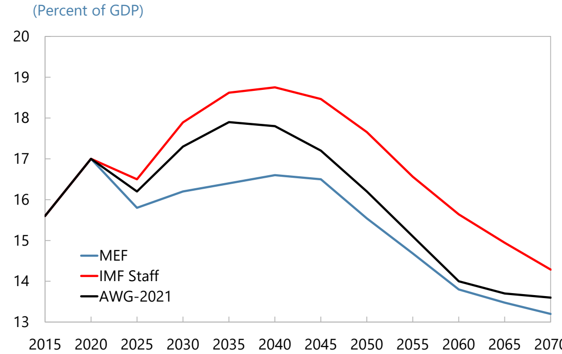
Italy: Impact of Selected Benefit and Tax Measures on Household Income (Percent)



Source: IMF staff estimates.

- *Pension spending*. Old age pensions cost the budget 15½ percent of GDP, against a euro-area average of 12 percent (European Commission, 2021 Aging Report), and will continue to rise over the next two decades as the population ages, despite earlier reforms to improve long-term system sustainability. Several factors contribute to the high cost: low productivity growth; a high old-age dependency ratio (about 57 percent against 46 percent in the EA) reflecting demographics and the low employment rate; and the generosity of the system. For instance, replacement rates under the former—but prorated—defined benefit scheme are high (about 67 percent compared to 50 percent in the EA); and the weighted average interest rate used to accrue notional pension rights (accrual rate) in the new defined contribution scheme is close to 2 percent (around 1.5 percent in the EA). In addition, the retirement age should be indexed to Italy's long life expectancy and benefits should be actuarially fair (i.e., closely linking lifetime benefits to lifetime contributions), including for early retirement options. These reforms could bring approximately 1¼ percent of GDP in annual fiscal savings (IMF working paper 18/59).

Italy: Pension Spending
(Percent of GDP)



Sources: Italian Ministry of Finance; and IMF staff estimates.

- *Social benefits*. In line with staff's past recommendations, the citizenship income program has been strengthened by introducing controls to reduce fraud and links to training.[1] The 2022 budget introduced a generous means-tested universal child allowance.[2] To avoid welfare dependence and disincentives to work, the rate of benefit withdrawal in response to earned income should be gradual, while the combined benefit level is high relative to the cost of living in some parts of the country.

Box 2. Policies to Achieve the Fiscal Targets (Continued)

- *Tax reforms.* The authorities' recently adopted income tax reform modestly reduces labor tax revenue by 0.4 percent of GDP in 2022–23. This is achieved by reducing the number of tax brackets and lowering statutory tax rates.[3] However, a comprehensive reform is needed to broaden the tax base, and promote efficiency and equity by addressing large compliance and policy gaps and rationalizing tax expenditures that cause revenue losses of nearly 10 percent of GDP (IMF working paper 20/37). Updating property values (last done in the 1980s) would help to increase tax equity and could also significantly lower statutory rates. To further support the authorities' efforts to address large tax compliance gaps, data analysis should be strengthened to improve risk-based compliance audit programs while also addressing staffing gaps.

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[1] In addition, refusal by the beneficiary to accept one of two (previously three) job offers made by employment centers results in interruption of the benefit.

[2] For each child aged 18 and under, a monthly benefit of €175 is paid to low-income households (with income-equivalent ISEE<€15,000). The benefit is gradually reduced to €50 for all households with an ISEE>€40,000 or who do not submit an ISEE declaration. The benefit is lower for dependents between 18 and 21 years of age. In addition, there are additional benefits for each child after the second one, children with disabilities, and single parents.

[3] The reform lowers the tax rate for incomes €15,000–€28,000 from 27 percent to 25 percent and €28,000–€50,000 from 38 percent to 35 percent; and cuts the number of income brackets by taxing all income above €50,000 at 43 percent.

Box 3. Fiscal Recommendations from the IMF's Buffer Stock Model

The IMF's Buffer Stock fiscal model is an optimizing framework that trades off the benefits of lower public debt—in terms of lower interest rates and greater scope for a countercyclical fiscal response—against the cost to output from undertaking fiscal consolidation.[1] The framework has the following features:

- *Two-way feedback between fiscal policy and output*. A tightening of the structural primary balance negatively affects output (fiscal multiplier), in which the multiplier is cycle dependent (larger during recessions). Output also impacts the fiscal outcome (automatic stabilizers).
- *Hysteresis*. Recessions create a persistent effect on potential output owing to lower investment in physical and human capital during economic downturns.
- *Macro stabilizing role of fiscal policy is constrained by high debt*. Countercyclical fiscal policy dampens recessions and limits overheating during upswings. However, the interest rate rises with debt, and at high levels, the government risks losing market access. As a result, the feasible fiscal response to a negative output shock will be much smaller than if access to credit markets is preserved. Therefore, building fiscal buffers by lowering debt is appropriate to reduce the risk of rising sovereign yields and market cutoff.

Calibrated to Italy and based on baseline growth forecasts for 2022–50, the model recommends achieving and then maintaining a structural primary surplus of close to 2 percent of GDP over the long term. Public debt would then decline to about 100 percent of GDP by 2050.[2] How quickly this structural fiscal target should be reached depends on the current level of debt and the cyclical position of the economy. With Italy's public debt very high and with a modest positive output gap, the model recommends a relatively frontloaded fiscal consolidation.

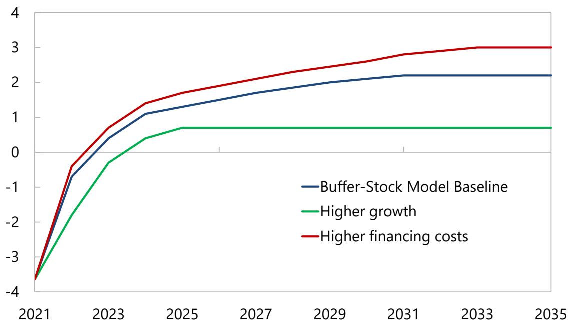
The model illustrates the sensitivity of the optimal fiscal path to potential growth and interest rates:

- If growth were permanently higher, the optimal fiscal stance would be looser as higher growth improves debt dynamics and provides additional tax revenue. Moreover, higher potential growth also increases the economy's debt-carrying capacity, permitting a larger anchor for public debt and a smaller permanent primary surplus. Specifically, if Italy's potential growth were to increase from the assumed 0.8 percent to 1½ percent, a structural primary surplus of only 0.7 percent of GDP would be sufficient to stabilize debt at the higher anchor of around 130 percent of GDP by 2050.

Box 3. Fiscal Recommendations from the IMF's Buffer Stock Model (Continued)

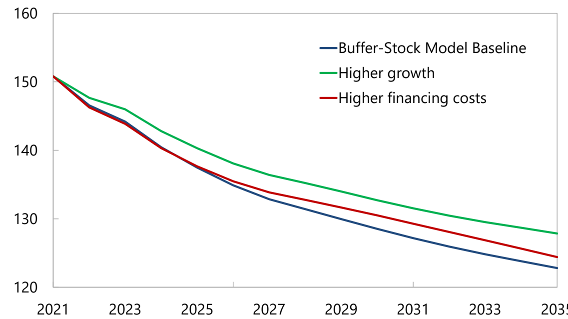
- If interest rates were higher (owing, for instance, to faster normalization of monetary policy rates or wider spreads), a larger fiscal adjustment than under the baseline would be advised to counter the risk of adverse debt snowball effects. For example, a further increase in the average nominal cost of debt by 100 bp over the medium term would require achieving and maintaining a structural primary balance of close to 3 percent of GDP in order to bring public debt to close to 100 percent of GDP by 2050.

Italy: Recommended Primary Balance
(Percent of GDP)



Source: IMF staff estimates.

Italy: Gross Nominal Public Debt with Recommended Primary Balance (Percent of GDP)



Source: IMF staff estimates.

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[1] For a more detailed discussion of the main features of the model, see October 2020 Fiscal Monitor.

[2] The model's recommended debt path is consistent with one obtained from an alternative probability-based approach to establishing a debt anchor using historical values of the primary balance, average cost of debt and growth. For Italy, this approach results in a debt anchor of 80–100 percent of GDP.

D. Preserving Financial Stability

Background

24. The banking sector's financial health has improved since the start of the pandemic, but is now facing new challenges. Return on equity rose in 2021, including on partial reversal of unused loan loss provisions accumulated during the pandemic. Banks made sizable carry-trade profits by borrowing from the ECB's concessional TLTRO facility and on-lending or purchasing securities. These concessional interest rates ended in June-2022 and repayments are due to commence next year. Bank capital has been largely insulated from rising yields on holdings of sovereign bonds owing to favorable COVID-era prudential treatment, but which expires at end year.[18] Gross non-performing loans (NPLs) have declined sharply in recent years, reaching 3.4 percent of loans at end-2021, primarily on securitized sales supported by government guarantees (GACS).[19] New NPL formation has been low, but edged up in early 2022 as growth

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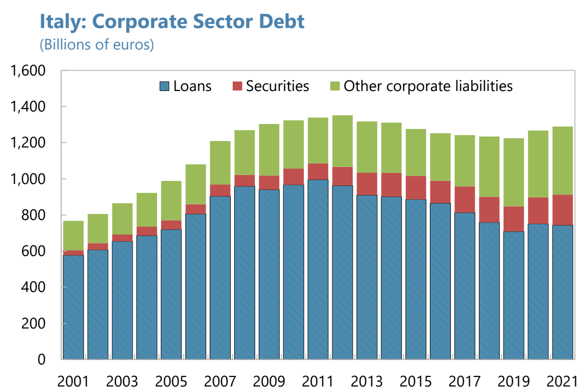
[18] According to the European Banking Authority (EBA), at end-2021 around 40 percent of banks' sovereign bonds were held at fair value at end-2021.

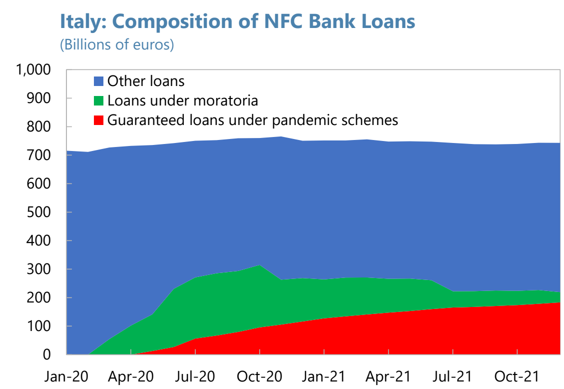
[19] Guarantee on Securitization of Non-Performing Loans (GACS) scheme, which applies to upper credit tranches. "Other corporate sector liabilities" (i.e., neither bank loans nor securities) have increased by around €100 billion during 2016–21 when the GACS scheme was in operation, similar to the amount of NPLs sold using the GACS scheme, suggesting limited reduction in borrowers' indebtedness.

weakened. Public guarantees (PG) cover one-third of the stock of loans to non-financial corporates (NFCs). Still-active grace periods on principal repayments of publicly guaranteed loans have kept stage 2 (doubtful) PG loans low. Pandemic-era loan moratoria and other supervisory relief have expired, while the PG scheme is set to transition back to the standard scheme—with somewhat lower, but still generous, coverage rates—starting in mid-2022.[20] To provide liquidity support to energy-intensive firms, a new targeted loan guarantee scheme was recently introduced. Banks' lending standards have tightened and banks anticipate further tightening on increased risk perceptions. New macroprudential policy instruments have been introduced to the toolkit and can be activated as needed to reduce the buildup of systemic risk.[21] The end-2021 deadline for selling the state-owned bank, Monte dei Paschi, was not met and the bank recently announced a new capital-raising plan.[22]

25. Italian banks and businesses had moderate exposures to Russia prior to the war in Ukraine. Claims of Italian banks—mainly the two largest lenders—on Russian residents stood at €23 billion (0.6 percent of banking assets) at end-2021, of which about €15 billion were cross border exposures.[23] Anticipating losses on these exposures, banks started to book loan loss provisions that reduced their capital buffers.[24] In addition, nonbank linkages to Russia include direct investment reported at €14 billion, but which could be larger owing to company registrations in third countries.



Sources: BIS; Haver Analytics, LLC; Bank of Italy; and IMF staff estimates.



Sources: Bank of Italy; and IMF staff estimates.

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[20] According to the Italian government, a guarantee scheme with lower coverage rates (80 percent for loans covering investment purposes and 60 percent for loans covering working capital) replaced the COVID-era scheme in July 2022. In January 2023, the guarantee scheme will revert to pre-COVID rules.

[21] The Bank of Italy recently introduced a systemic risk buffer and borrower-based measures.

[22] Monte dei Paschi di Siena (MPS), the fifth largest Italian bank, was bailed out by the Italian government in 2017. The end-2021 deadline for the government to sell its 64 percent stake in MPS was not met following unsuccessful negotiations on a sale to UniCredit. The government is reportedly in the process of extending the deadline and MPS now plans to raise €2.5 billion in capital (of which €1.6 billion from the state) by the end of 2022, together with cuts in staffing and the branch network.

[23] Italian banks also have exposure through derivative positions, with UniCredit disclosing a €1 billion derivative exposure, about €6 billion in guarantees extended, and €2.6 billion credit commitments as of end-2021.

[24] In Q1:2022, UniCredit absorbed 92 basis points of capital impact from Russia, including €1.3 billion loan loss provisions that were booked almost entirely against its Russia exposure. Intesa San Paolo set aside €800 million to cover its potential losses from Russia.

Staff's Views

26. Improved financial strength is expected to enable the Italian financial system to withstand aggregate shocks around the baseline scenario, but risks are rising. Further NPL reductions, recourse to the PGSs and fiscal support to borrowers have significantly de-risked banks' balance sheets. Banks' capital and liquidity positions have strengthened and households and firms maintain large liquidity cushions against higher prices and interest rates. Banks' direct and indirect exposures to Russia and Ukraine are concentrated, but limited, while energy-intensive companies comprise a relatively small share of loans for most banks.[25] While higher interest rates could boost banks' net interest margins, the effect on capital will likely be dominated by the tightening of financial conditions alongside slower growth, but with considerable variation across the sector. The phasing out of TLTROs will require banks, after exhausting their excess reserves, to seek alternative, costlier funding in order to avoid reducing loans and government bond holdings. The new PGS targeting energy-intensive firms should help to finance their higher expenses, but eligibility should be selective, with enhanced credit risk assessments at origination and guarantee coverage rates below those in pandemic schemes (Box 4). No generalized liquidity support measures are currently called for, although expiration of the COVID-era PGS could reduce banks' lending appetite. Banks should diligently apply loan classification standards and recovery procedures to their guarantee portfolios. The quality of the large stock of NPLs outside banks but within the financial system, including nearly €100 billion of sales facilitated by the GACS, should be monitored to ensure that risks to the government and banks (through their residual holdings) are contained and that borrowers' debt overhangs are manageable.

27. However, caution is advised given elevated uncertainty and the sequential nature of the current shock. Rising interest rates amid weaker growth and high public debt could give rise to adverse feedback channels between the sovereign, corporates and banks. Banks should prepare for severe downside events using scenario-based assessments of credit quality and other exposures. Based on the outcomes of these assessments, temporary conservation of capital may be advisable for specific banks pending greater clarity on the macroeconomic outlook and losses from their direct and indirect exposures. For these banks, reviewing the timing of dividend payouts and share buy-backs and postponing the drawdown of loan loss provisions may be appropriate.

28. Addressing weaker banks, whose profitability and business models could be further challenged by the sequential crises, is a priority. Slower economic growth increases the risk of stress in some small banks with already-low asset quality and capital. Progress has been made on numerous key recommendations from the 2020 Italy Financial Sector Assessment Program (FSAP), including on less-significant institutions' (LSIs) credit risk analysis, loan classification and NPL provisioning practices (Annex V). Robust supervisory assessments with targeted asset quality reviews should continue in order to pre-emptively identify vulnerable banks, including LSIs. Increasing digitalization, improving governance, and further consolidating the sector amid growing competition from fintechs and other banks remain priorities.

[25] According to Bank of Italy, as of end-2021, firms in energy-intensive sectors accounted for 8.5 percent of corporate loans in Italy, while around 20 banks have significantly higher shares.

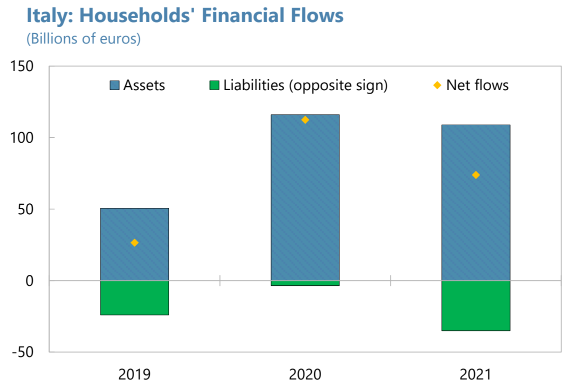
Authorities' Views

29. The authorities broadly agreed with staff's assessment and policy recommendations. Most Italian significant institutions weathered the pandemic much better than expected, allowing banks to reduce their expected cost of credit risk. Banks' operating expenses also fell last year. The PGSs were instrumental to maintaining credit flows during the pandemic. Performance of guaranteed loans is monitored closely, and fiscal resources set aside to cover any materialization of contingent liabilities are sufficient based on stress testing exercises. To avoid any future buildup in NPLs from remaining on banks' balance sheets for a prolonged period, consideration is being given to extending the GACS scheme while reducing the government's risk exposure by raising the minimum required rating and/or lowering the guarantee coverage ratio of senior tranches. While the war in Ukraine was expected to have limited direct effects on the banking sector, the new PGS for energy-intensive sectors and firms affected by sanctions—consistent with the EU's Temporary Crisis Framework for State Aid—was seen as necessary in the context of high uncertainty. Any adverse impact of rising interest rates on the banking sector is likely to be moderate but will ultimately depend on the size of the economic slowdown. In line with the SSM's stance on significant institutions, the authorities concurred that a cautious approach to bank capital was needed and, based on their assessments of individual banks' ability to withstand a severe and protracted economic downturn, pre-emptively restricting dividend distributions could be considered on a case-by-case basis. Supervision of LSIs continues to be enhanced and the activities of nonbanks that purchased securitized NPLs are monitored to ensure adequate risk management and debt servicing. Some LSIs have shown vulnerabilities in their business models, including excessive local risk exposure, and further bank mergers could help in reducing portfolio concentration risk and providing the economies of scale needed to support investments in digitalization and cybersecurity.

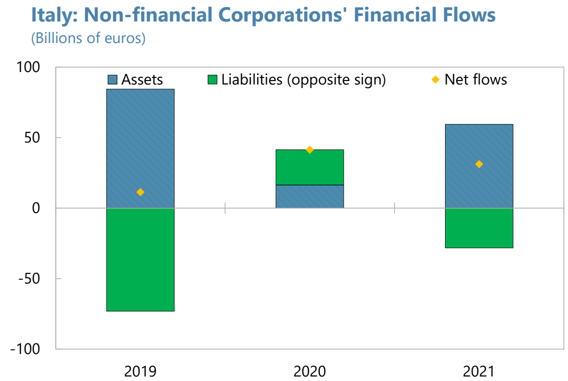
E. Managing Corporate Sector Risks

Background

30. Private sector balance sheets were relatively unscathed by the pandemic, but there are early signs of effects from rising energy and raw materials prices. Net financial positions of both households and firms improved in 2021, with financial assets increasing more than debt. Housing prices have inched up, but transaction volumes grew more than 30 percent, supported by fiscal refurbishment incentives. Aggregate NFC profit ratios turned positive, pandemic equity support schemes were largely unused, and bankruptcies have continued to decline. Corporate sector liquidity remains ample, but credit conditions have started to tighten, especially for smaller firms and in sectors most affected by the pandemic. Rising input costs are eroding profit margins.



Sources: Bank of Italy; and IMF staff estimates.



Sources: Bank of Italy; and IMF staff estimates.

Staff's Views

31. Italy's non-financial business sector remains resilient, but several evolving areas require careful monitoring. A large number of firms are still benefiting from active grace periods on repayment of guaranteed loans which clouds the true state of their financial health. While the direct incidence of the energy shock and fragmentation of supply chains will differ from that of the pandemic (manufacturing and energy intensive sub-sectors versus contact-intensive services), demand for non-essential services could weaken if consumers reduce discretionary spending in response to eroding real income, pointing to a potential increase in credit risk in those sectors. NPLs sold by banks appear to linger on borrowers' balance sheets, likely reflecting the inefficient debt restructuring framework.

32. Building up the efficiency of the debt restructuring toolkit and in-court procedures are key to reducing debt overhangs, releasing trapped capital and attracting new investment. A new Insolvency Code coming into force later this year (after a delay due to COVID) should integrate the newly introduced out-of-court restructuring procedure (i.e., Composizione Negoziata[26]), which provides a potentially straightforward out-of-court mechanism for debt restructuring. Furthermore, it will relax the design of the early warning mechanisms, in line with FSAP recommendations to remove mandatory insolvency triggers, by converting into a purely voluntary mechanism to alert firms of approaching financial distress and provide them access to expert financial counselling. Ongoing justice reform is appropriately aimed at streamlining in-court processes, shortening procedural deadlines, reducing the number of allowable appeals, as well as digitalizing judicial processes. Additional court resources, including hiring administrative staff, should alleviate magistrates' heavy workload, which is one of the structural factors preventing timely resolution of cases.

[26] The Law of October 21, 2021, No. 47.

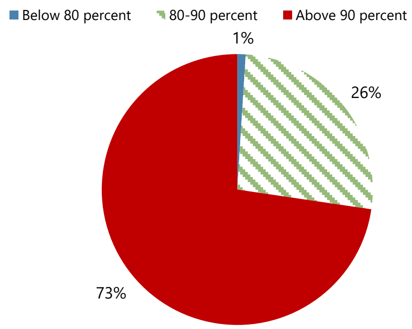
Box 4. COVID Public Guarantee Schemes

Italy's pandemic-era public guarantee schemes (PGSs) helped maintain corporates' access to credit during the pandemic.

The SME Guarantee Fund and the guarantee fund managed by SACE (the state-owned export credit guarantee agency) are the two main funds covering micro firms and SMEs, and large firms, respectively. For loans up to €30,000 (the limit was raised from the original €25,000), the guarantee ratio is 100 percent with a two-year grace period on repayment of principal. Guarantees of 80–90 percent are available for other loans to small firms. For guarantees granted by SACE, guarantee coverage ranges from 70 to 90 percent, with a grace period of up to three years. These guarantee schemes are set to transition to regular schemes with lower guarantee rates in mid-2022.

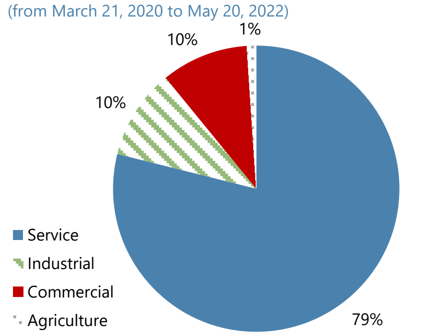
The SME Guarantee Fund facilitated the vast majority of guaranteed loans issued during the COVID pandemic. During March 21, 2020–June 9, 2022, the Guarantee Fund provided guarantees on €250 billion of loans, as well as on €27 billion of loans under moratorium (these guarantees have since expired).

Italy: Guarantee Ratio During COVID Period
(from March 21, 2020 to May 5, 2022)



Source: Guarantee Fund for SMEs, IMF Staff Calculation.

Italy: Sectors Receiving Guaranteed Loans
(from March 21, 2020 to May 20, 2022)



Sources: Guarantee Fund for SMEs, IMF Staff Calculation.
Note: This figure plots the distribution of loans by number.

Loan-level data are publicly available for loans covered by the guarantee fund for SMEs, indicating the borrowing company's name, region, sector, loan amount, guaranteed amount, and date of approval. Between March 21, 2020 and May 5, 2022, some 2.7 million guaranteed loans were recorded in the dataset with a median loan size of €25,000. Nearly 75 percent of these loans have a guarantee rate above 90 percent (likely 100 percent in practice), while another 20 percent have a guarantee ratio between 80 and 90 percent. The weighted average guarantee rate for guaranteed loans issued during this period is 85 percent,[1] higher than the near 70 percent during 2018–19.

Given that the pandemic shock hit the service sector hardest, about three quarters of the number of the guaranteed loans issued were to service sector firms, followed by the industrial and commercial sectors. Service sector firms tended to receive smaller-sized loans, with a median loan size of €25,000, compared to €93,000 for industrial firms and €50,000 for commercial firms. In terms of the geographic distribution of guaranteed loans, the northern regions—including Lombardia (18.1 percent), Veneto (10.1 percent), Emilia Romagna (9.3 percent) and Toscana (8.3 percent)—account for the highest share of guaranteed loans, followed by the central Lazio region (9.5 percent).

[1] Excluding guarantees for loans under moratorium (under Art. 56 DL Cura Italia).

Authorities' Views

33. The authorities noted the robust performance of the business sector and emphasized that private sector indebtedness in Italy remains lower than in peer countries. They viewed the new loan guarantee scheme targeting energy intensive firms as beneficial. However, SMEs were seen as more vulnerable to the energy shock given that they pay higher prices for energy than larger firms, which also have more sizable financial buffers. Demand for pandemic-era equity support schemes was seen as low because the implied dilution of control may not be appealing to Italy's mainly small, family-owned firms. Measures to speed up the pace of justice and reduce the backlog of trial cases are advancing, and will likely exert beneficial effects on the business environment.

F. Policies for a Severe Scenario

Staff's Views

34. In the event of a very sharp growth downgrade, a comprehensive policy response would be appropriate, but should reflect Italy's much more constrained policy space. Pandemic-era policy tools would be appropriate in this scenario to limit social hardship and excessive business insolvencies. However, with high public debt and tighter financing conditions, maintaining a credible commitment to fiscal sustainability is of the essence. As such, a smaller response (scaled by the size of the growth markdown) than during the pandemic would be warranted. Moreover, support should be targeted and temporary.

35. The policy toolkit will need to be enhanced in a severe scenario:

- Existing social safety nets should remain at the core of the fiscal policy response. The short-time work scheme and means-tested citizenship income program provide automatic income backstops to those facing job and income loss, but in the event of prolonged high inflation, eligibility thresholds may need to be adjusted. With the deficit expected to widen, fiscal consolidation should commence as soon as the intense phase of the emergency has passed to limit procyclical tightening.

- Enhanced liquidity support tools may be needed to avoid a potential large wave of corporate insolvencies. Publicly-guaranteed loans are preferable to moratoria, which obscure borrowers' true repayment capacity. New guarantees could be made available and the maturity of existing guarantees extended. However, banks should be required to retain a larger part of the credit risk on their own balance sheet for new and lengthened guarantees, and excessive issuance should be avoided. Extending the duration of the GACS would reduce the risk that any near-term increase in banks' NPLs turns structural. Italy's experience during the pandemic, where banks converted a large share of existing loans to publicly-guaranteed credits, suggests the merits of temporarily allowing banks greater flexibility to restructure their loans without triggering forborne thresholds that require holding additional provisions.[27]

[27] Any loan forbearance measure that reduces the net present value of the receivable by one percent or more triggers re-classification of the loan to "in default," requiring stricter regulatory treatment. This regulation encouraged banks to pre-emptively convert a large share of their existing loans to NFCs into publicly-guaranteed credits.

Authorities' Views

36. The authorities considered that pandemic-era measures should be employed only in a severe downside scenario. To reinforce domestic fiscal policy, an EU financing facility—modeled on the SURE scheme and/or the Recovery and Resilience Facility created during the pandemic—could provide funding to support an adequate response by all member states to a common energy shock but that affects countries to different degrees. The authorities agreed that loan moratoria had been an effective tool during the pandemic in order to avoid firms' liquidity shortages, but they do not appear the proper instrument to use at the current juncture. Instead, guarantees were seen as a preferable form of liquidity support, and a larger share of credit risk should remain with the issuing bank. They concurred that temporarily relaxing the quantitative threshold according to which a forborne exposure is classified as defaulted for prudential regulatory purposes could foster more effective restructuring by banks and thus reduce the need for publicly-guaranteed loans.

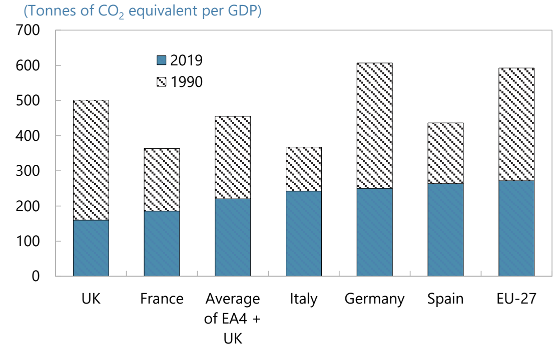
G. Decarbonizing the Future

Background

37. While CO2 emissions have fallen sharply since the early 2000s, and emissions intensity is below the EU average, Italy is not on track to meet its "Fit for 55" target. Energy efficiency subsidies for manufacturing and high domestic taxes on liquid fuels for transport has driven down emissions in those sectors faster than the EU average. Considerable decarbonization was also achieved in the electricity sector, supported by generous fiscal subsidies, but has since stalled once new subsidies were suspended in 2014 despite the fact that the cost of new renewables capacity has fallen sharply and fossil fuel prices have risen. A pipeline of new renewable electricity projects is awaiting authorization. Progress with greening the building sector remains limited. Maintaining the same rate of progress on curbing total emissions as during the past decade would deliver only half the targeted 55 percent emissions reduction (relative to 1990) by 2030 required under the EU's "Fit for 55" program.

Europe: GHG Emission Intensity of the Economy

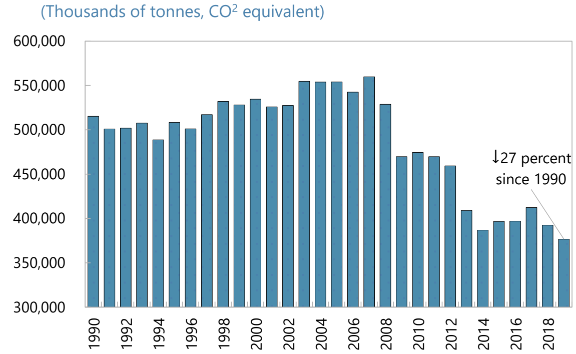
(Tonnes of CO_2 equivalent per GDP)



Sources: European Environment Agency; and IMF staff estimates.

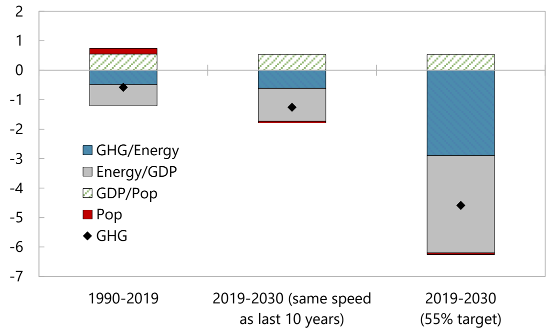
Italy: Total Green House Gas Emissions

(Thousands of tonnes, CO^2 equivalent)



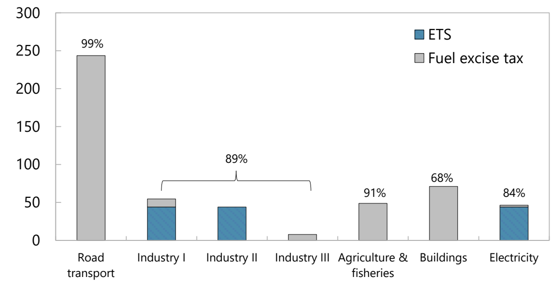
Sources: Eurostat; and IMF staff estimates.

Italy: GHG Emissions - Kaya Decomposition
(Annual percent change)



Sources: Istat; Haver Analytics; and IMF staff estimates.

Italy: Effective Carbon Rates, 2018
(Euros per tonnes of CO_2)



Note: Percentage above bars reflect percentage of sector covered by effective carbon taxes. Bars represent selected cases where emmission is above 5,000 KtCO2.
Source: OECD

Staff's Views

38. **Despite Italy's high taxes on energy, significant scope exists to improve the design of environmental taxation**. Taxes on energy should be based on their carbon content and carbon taxes should be equalized across fuels and sectors in order to equate marginal abatement costs. Similarly, the tax on electricity—which cannot differentiate between clean and polluting energy sources—should be eliminated. A gradually increasing national domestic carbon price floor could be considered to complement the price of carbon in the EU's Emissions Trading System (ETS) in order to protect recent price gains amid high ETS price volatility. A floor would also discourage new investment in fossil fuel-related capacity and reduce downside risks for green investment, making such investments more attractive. Model simulations indicate that a gradually rising carbon tax would achieve climate goals and that the negative impact on output from the carbon tax would be reduced by recycling the tax revenues into lower distortive taxes, such as the tax on labor income.[28] Environmentally damaging subsidies should be phased out.

39. **Green investment incentives should be made more cost effective**. The fiscal cost of green subsidies—including tax credits for building refurbishment (Superbonus) and subsidies for renewable electricity generation capacity—is estimated at more than 2 percent of GDP on average during 2021–22. Making carbon taxation more comprehensive and uniform would reduce the need for costly subsidies. Moreover, the steep decline in the cost of renewables generation capacity over the past decade, while fossil fuel prices (including carbon taxes) have risen sharply, provides room to scale back green investment incentives. Further streamlining approvals procedures for renewables capacity would lower the cost and riskiness of such investments. Improving the value for money of the Superbonus program is needed as energy efficiency improvements are poorly targeted and the subsidy rate is excessive (Annex VII). Nonetheless, some fiscal support to private investment will still be needed to address non-carbon market distortions. These include measures to mitigate credit constraints that can impede worthwhile green investments and support for investments where the private return is below the social return, e.g., due to network externalities.

[28] The simulations are based on the IMF-ENV model simulations and are discussed in the Selected Issues paper accompanying this report.

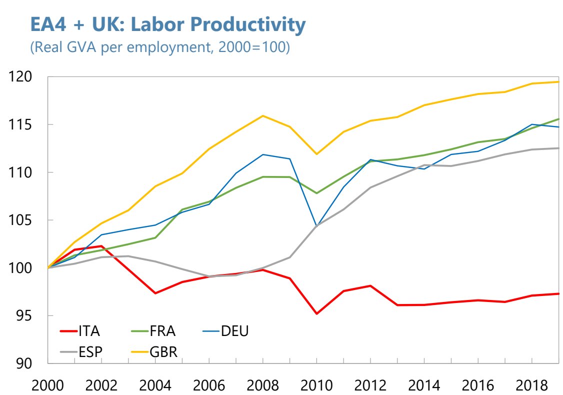
Authorities' Views

40. The authorities emphasized Italy's good performance with reducing greenhouse gas emissions relative to other countries, but agreed the policy framework should improve to meet the ambitious goals. They underscored that unilateral changes in carbon taxes would pose a risk for Italy's competitiveness and stressed the importance of a coordinated EU approach. Tax credits for refurbishments are being phased out although their deployment was primarily intended to support activity during the pandemic and its aftermath. Recently adopted and pending simplification measures for approving solar and wind generation capacity were expected to result in a significant increase in renewables investment by the private sector, thereby supporting Italy's energy security and green transition. Public investment needs beyond the NRRP were seen as quite limited as most infrastructure (e.g., transmission grids) should be implemented through concessions.

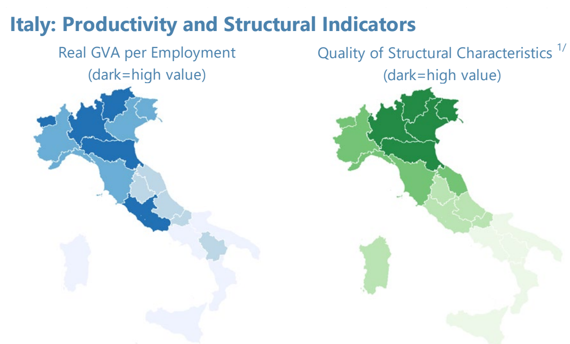
H. Structural Priorities

Background

41. Labor productivity has been declining since the turn of the century, and productivity gaps across sub-national regions and sectors have widened. Real value added per employed person has declined by nearly 5 percent during 2000–19, and total factor productivity has fallen by 13½ percent. While productivity declined in all regions, the decline has been faster in the south and the islands, where gaps in physical and social infrastructure are relatively large. Similarly, productivity has fallen in most sectors, and the decline is more pronounced in labor-intensive activities such as construction and arts and entertainment. Poor productivity performance in lagging regions reflects both across-the-board slower regional productivity growth, and a higher concentration in lower-productivity activities. Among other factors, weak human capital also poses challenges to raising labor productivity, particularly in the lagging regions where quality of education and educational outcomes are relatively low (OECD, 2019). Italy's NRRP entails more than 500 milestones and targets in total, which are expected to be met during 2021–26.



Source: Eurostat.



Note: 1/ First principal components of 56 structural indicators.
Sources: Eurostat; and IMF staff calculations.

Staff's Views

42. **Bringing to completion the reforms and investments set out in the NRRP (Annex IV) would reduce potential scarring from the energy crisis, support the green transition, and enhance the economy's ability to adjust to relative price changes**. Prior reforms and public investment programs have tended to stall and remain incomplete, and reforms were frequently diluted or reversed before the benefits were realized. Given these previous shortcomings and the complementarity of reforms, the proposed multi-faceted and front-loaded reform push detailed in the NRRP could be much more effective at raising productivity and encouraging private investment than in the past (see Selected Issues on Productivity in Italy). In particular, reforms to modernize public administration and the judiciary, simplify civil procedures, and strengthen competition will be key to improving the business environment, efficiently executing public investment (concentrated in the second half of the 2021–26 NRRP period), as well as building growth-enhancing infrastructure and institutions. These reforms will provide demand stimulus in the near term and support long-term growth potential. However, the planned increase in hiring to support the execution of the NRRP may prove challenging owing to the wage premia required to attract a highly skilled technical workforce.

43. **Recent efforts to strengthen the Anti-Corruption and AML/CFT frameworks could safeguard expected productivity gains from the NRRP, though enhancing transparency and availability of beneficial ownership information is still in progress** (Annex VI). New regulations and institutional processes are in place to enhance AML/CFT effectiveness, particularly for cooperation and exchange of information and financial intelligence. The 2019 Anti-Corruption Law strengthens prevention and enforcement against corruption, and a new National Anticorruption Plan (PNA) is being drafted by the National Anti-Corruption Authority (ANAC), incorporating lessons learnt during the pandemic. Important mitigation measures were taken towards the effective detection of potential evasion and ill-gotten proceeds related to Russia sanctions, which include a vast and complex network of economic interests. While concrete legal steps have been taken towards creating the Register of Beneficial Owners,[29] Italy has yet to implement the register in line with the 4th and 5th AML Directive since the publication of the corresponding decree and its entry into force is still pending. The timely availability of accurate beneficial ownership information is key to mitigate risks of misuse of legal entities for financial crimes.

Authorities' Views

44. **The authorities were firmly committed to full and timely implementation of NRRP reforms and investments and to fighting corruption and money laundering**. They viewed the NRRP as an opportunity to transform and modernize the Italian economy, significantly lift output in the near term and longer run and promote more equitable outcomes. They noted that while all targets and milestones for 2021 and the first half of 2022 had been successfully delivered, the positive effects on the Italian economy had yet to be felt as only a small part of the more than

[29] The MEF drafted a decree establishing the Register of Beneficial Owners, which received a positive opinion from the Council of State in 2021 and was subsequently signed by relevant Ministers. In March 2022, the draft decree was sent to the Ministry of Justice for review and eventual publication in the Official Gazette. The Italian Register of Beneficial Owners would be operational within 60 days of the decree coming into force, pending specific legislative measures to be adopted by the Ministry for Economic Development.

€200 billion envelope has been paid out by the budget as most projects are in the planning or start-up phase. Accelerating the plan was seen as promoting energy security and countering the current headwinds to economic growth. They noted however that implementation of the Plan would be complex and challenging. Italy will continue to make timely progress on the effectiveness of its AML/CFT framework.

STAFF APPRAISAL

45. Following an impressive recovery from the pandemic shock, Italy is now facing formidable new economic challenges. A successful vaccination campaign and policies to shelter incomes and profits helped to prevent significant economic scarring from the pandemic. More recently, high inflation and slower growth have materialized in response to escalating energy prices, global supply chain disruptions and rising interest rates. Italy's long-standing vulnerabilities of weak productivity and high public debt have again come to the fore. Nonetheless, while output has shown resilience so far, due in part to supportive fiscal measures, a period of subdued growth and elevated inflation is in the offing. More rapid tightening of financial conditions, a severe energy shortage and an extended period of high inflation are downside risks to the outlook. On the other hand, strong implementation of Recovery Plan reforms and investments would underpin demand in the next few years and support long-term growth, thereby creating a virtuous cycle for public debt sustainability.

46. Well-targeted and temporary measures to mitigate high energy prices should be accommodated within a below-target fiscal deficit this year. Compensation for higher energy bills, including benefits under recently-introduced social programs, have been adequate. With fiscal space at risk, measures should focus on the vulnerable and be phased out as energy prices moderate to their more-elevated "new normal" levels. Price signals should be preserved to encourage energy conservation. Extra revenue from higher energy prices and the tax on windfall profits of energy companies should be used to finance compensation, and additional structural and cyclical revenue should be saved.

47. High public debt and rising borrowing costs call for steady, decisive improvement in the primary balance, underpinned by structural reforms and rationalizing spending from 2023. Sustained higher GDP growth and a stronger fiscal balance are needed to reinforce the downward path of debt afforded by the brief window of favorable automatic debt dynamics, and to maintain debt reduction over the longer term. To this end, over-performing the 2022 budget target is warranted by saving a significant part of revenue overperformance. Growth-enhancing structural reforms, a revenue-neutral broadening of the tax base and further strengthening tax compliance should be complemented with restrained growth in current spending to achieve—and subsequently maintain—a primary surplus of 2 percent of GDP. This would create room for priority investments while also keeping the public debt ratio on a firmly downward path.

48. Improved financial health since the start of the pandemic should allow the banking sector to absorb ongoing shocks, but high uncertainty warrants a cautious approach to capital. Banks' direct and indirect exposure to Russia is concentrated but manageable. Tighter financial conditions and slower growth are likely to pressure bank capital in the aggregate. No across-the-board liquidity support facilities for the private sector are currently needed, and any guaranteed loans under the new scheme targeting energy-intensive firms should be selective and with banks retaining sizable residual credit risk. Extending the GACS scheme would continue to facilitate NPL disposal, but fiscal risks should be lowered. To prepare for potential severe downside events, results from scenario-based assessments of banks should inform decisions on whether temporary conservation of capital is advisable in specific cases, pending greater clarity on the outlook and losses. Moreover, some smaller banks with low asset quality and weak capital could be a drag on the sector and should be promptly addressed. The planned strengthening of the debt restructuring toolkit and streamlining of in-court procedures are welcome to help firms avoid financial distress and, where infeasible, to improve recovery rates on creditors' financial claims.

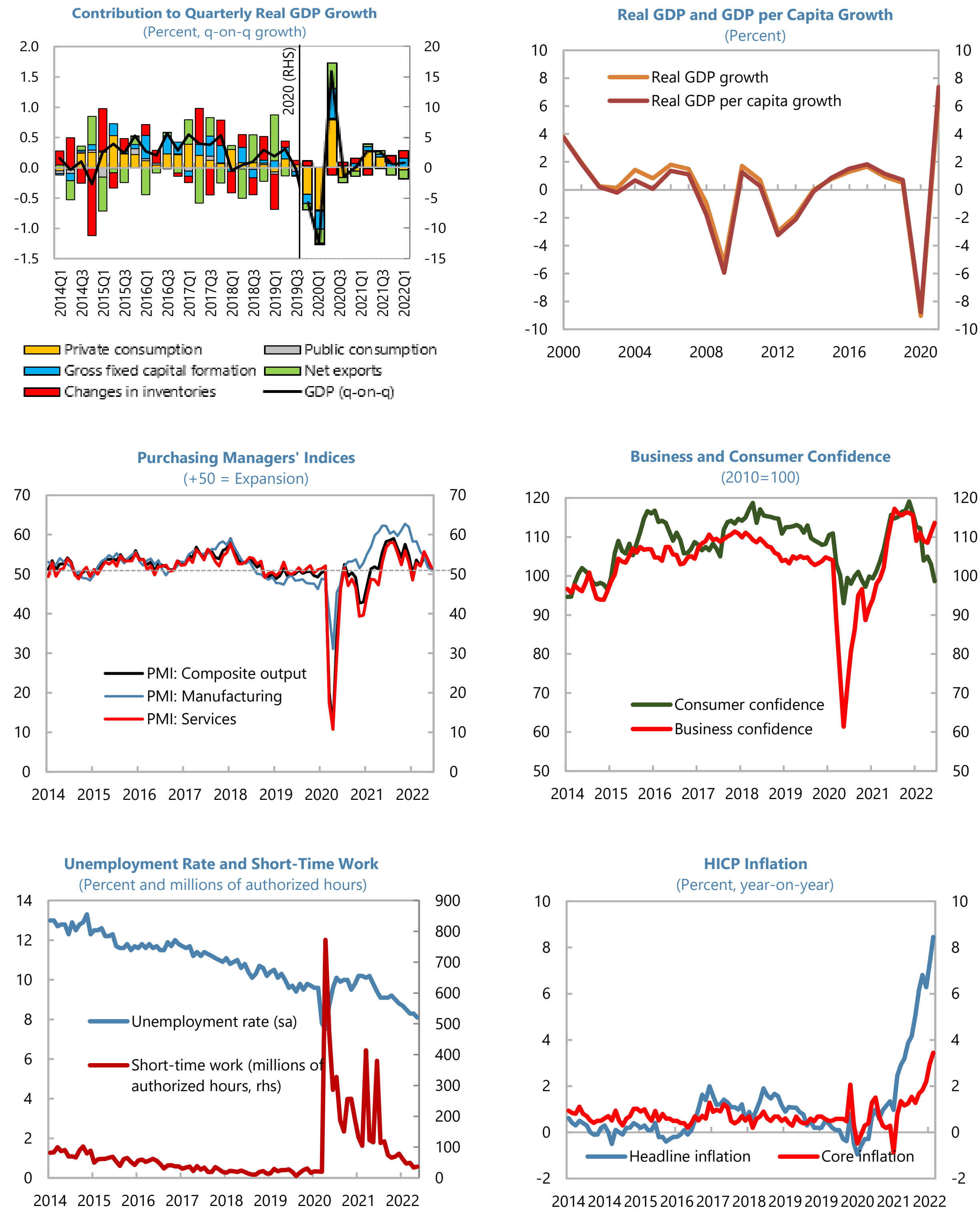
49. In the event of a severe downside scenario, comprehensive support measures will be needed, but spending restraint must be strictly exercised. With high public debt and rising borrowing costs, policy responses—both on-budget spending and contingent liabilities—will need to be considerably more contained, when scaled by the size of the growth downgrade, than during the pandemic. This implies better targeting and lower replacement rates for benefits and reducing coverage rates on guarantees so that banks retain a larger share of credit risk on their own balance sheets. Close oversight and strict spending controls should be adopted. A more accelerated fiscal consolidation path, commencing as soon as the intense phase of emergency is over, would be needed. Moratoria on servicing of loans obscures borrowers' repayment capacity and are not advised.

50. Italy has made considerable progress with decarbonizing its economy but a significant acceleration, underpinned by changes in policies, is required to meet its climate goals. To minimize carbon abatement costs, energy taxes should be formulated on the basis of their carbon content, and carbon taxes should be equated across different energy sources. Taxes on electricity should be replaced with a carbon tax on the energy source used to generate electricity, thereby giving a cost advantage to renewable electricity. Incentives for green investments by the private sector absorb considerable fiscal resources and should be made more cost effective. Streamlining procedures for approving investments in renewables and reducing the backlog of pending projects are critical to increasing energy security and reducing carbon emissions.

51. Full and timely implementation of the Recovery Plan would boost potential growth, support energy security and the green transition, and underpin activity through a period of weak growth. Synergies among the various reform areas would tend to amplify improvements in economic efficiency and labor productivity. The large program of public and private investments would help to rectify the shortfall in infrastructure spending over the past decade and expand capacity in renewable energy, while also providing well-timed support to domestic demand. Moreover, implementing the reform program should help to keep the external position broadly in line with the level implied by medium-term fundamentals and desirable policies—as was the case in 2021—by encouraging stronger private investment while the needed fiscal consolidation proceeds. Continuing to reinforce Italy's governance framework would help to strengthen the financial integrity of NRRP resources.

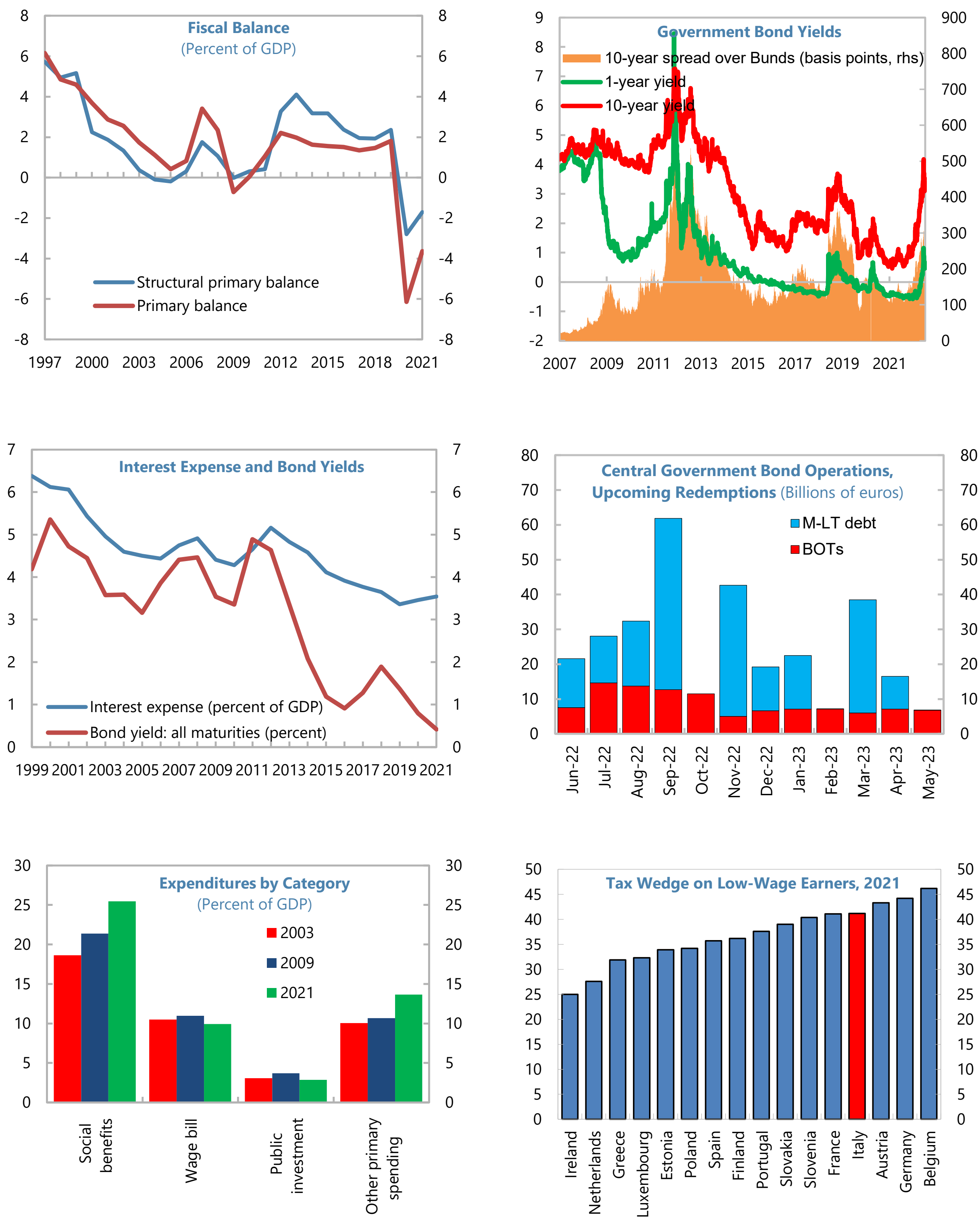
52. It is recommended that the next Article IV consultation take place on the standard 12-month cycle.

Figure 1. Italy: Real Sector Developments



Sources: ISTAT; Haver Analytics; IHS Markit; and INPS.

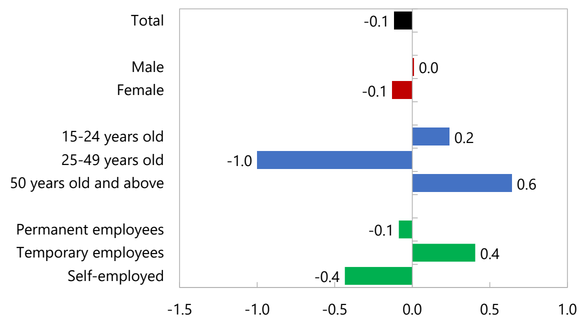
Figure 2. Italy: Fiscal Developments and Issues



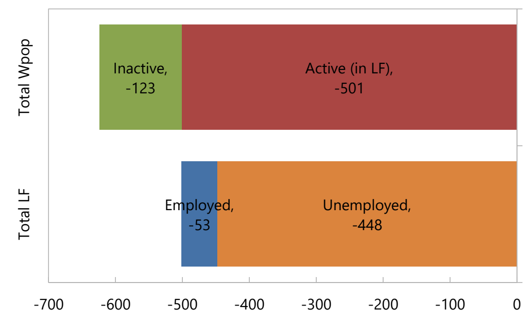
Sources: Eurostat; Bloomberg Finance L.P.; and Bank of Italy.

Figure 3. Italy: Labor Market Developments

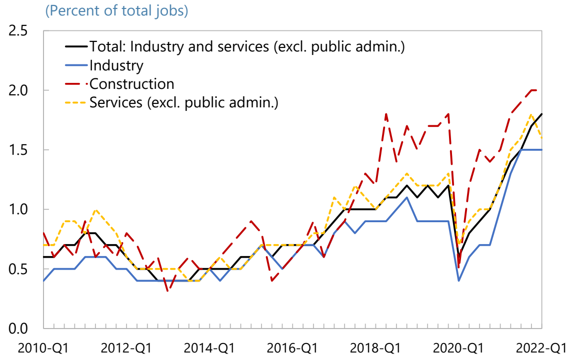
Changes in Employment by Group
(Percent of 2019 working age population: May 2022 relative to end-2019)



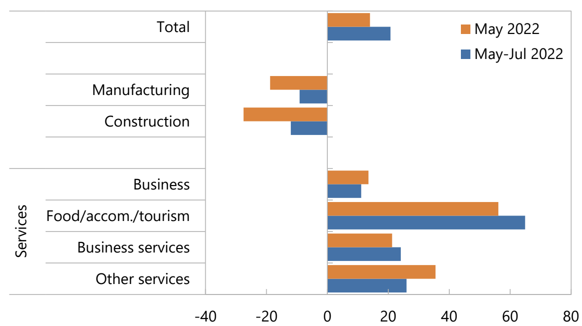
Changes in Working Age Population and Labor Force
(Thousands of people: May 2022, relative to end-2019)



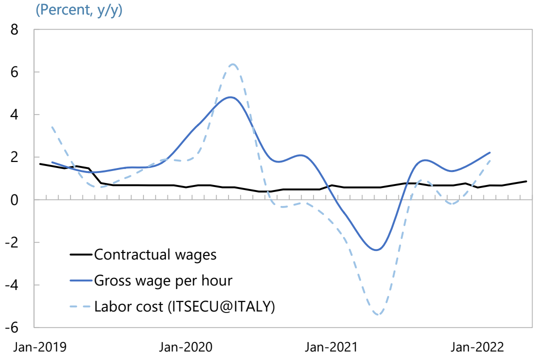
Job Vacancies
(Percent of total jobs)



Expected Hiring by Firms
(Percent, y/y)

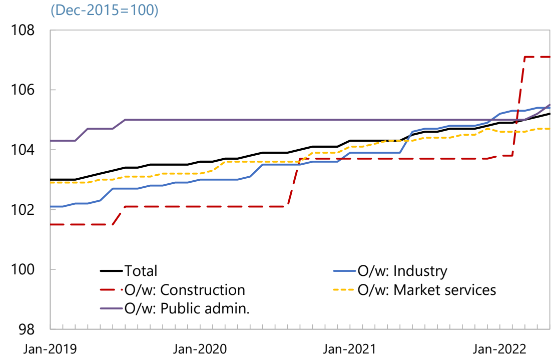


Growth of Contractual Wages and Labor Costs
(Percent, y/y)



Sources: Istat.

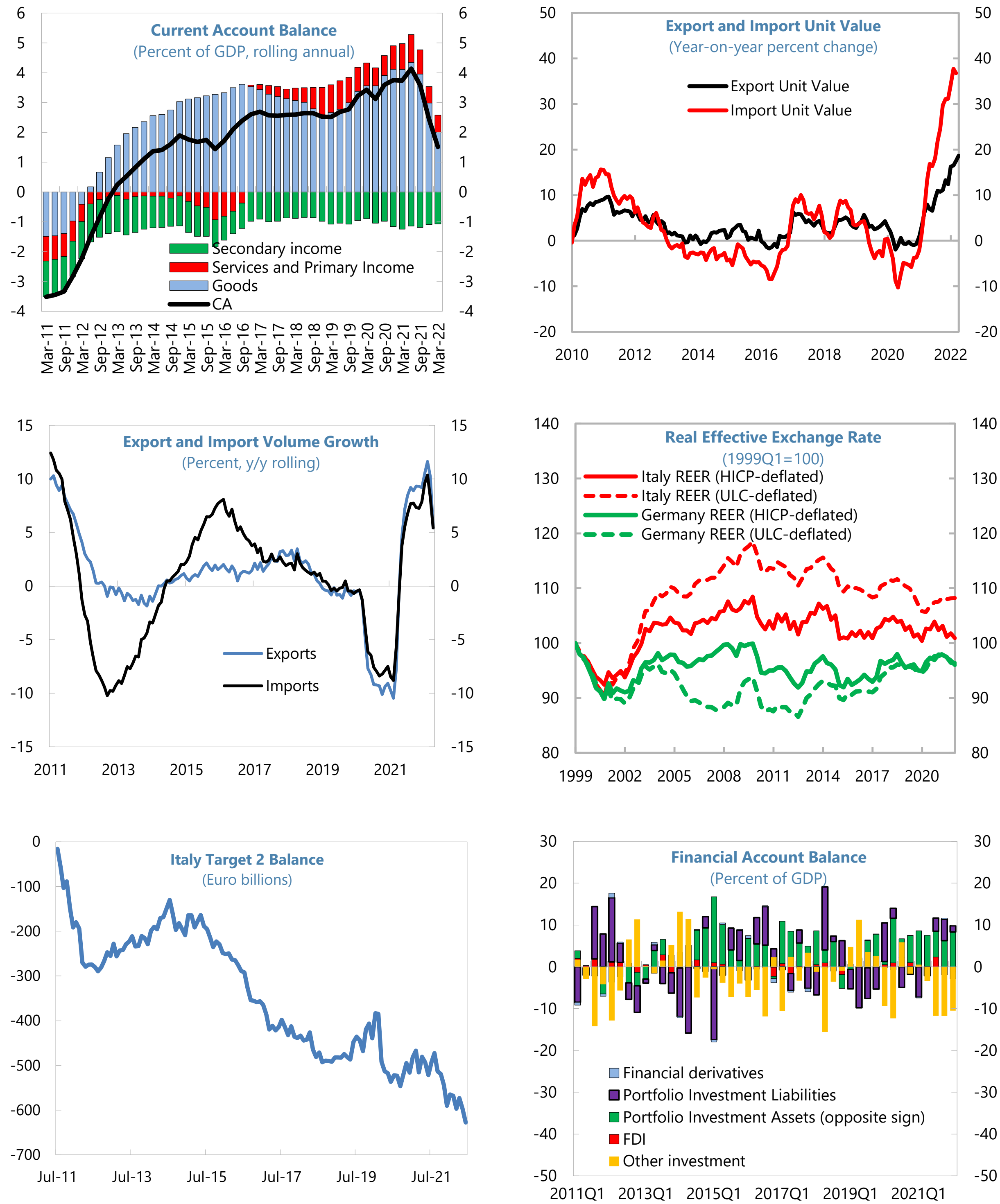
Wage Index According to Collective Labor Agreements
(Dec-2015=100)



Sources: Istat.

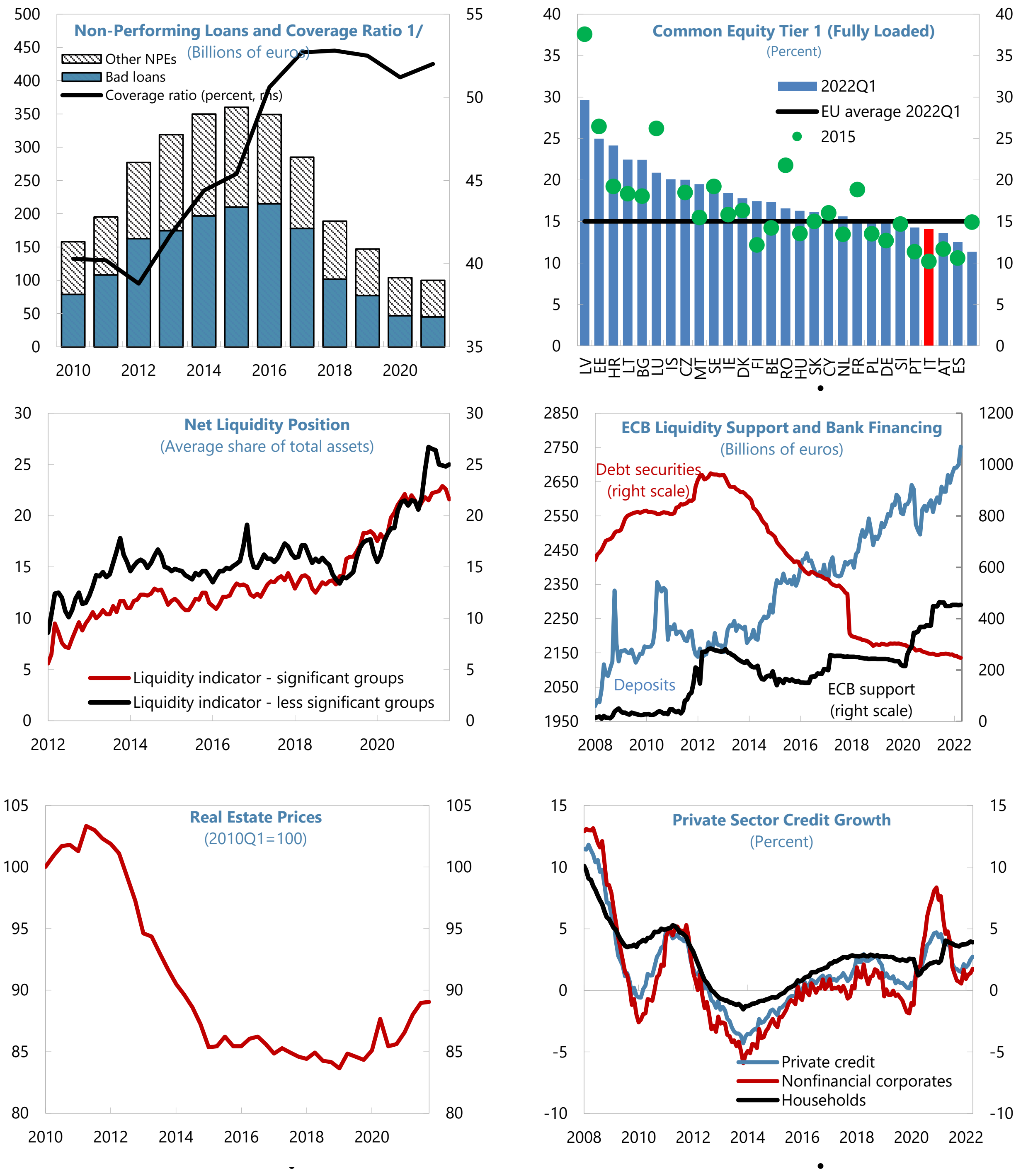
Sources: Istat; Unioncamere; and IMF staff calculations.

Figure 4. Italy: External Sector Developments



Sources: Haver; Eurostat; and IMF staff estimates.

Figure 5. Italy: Financial Sector Developments

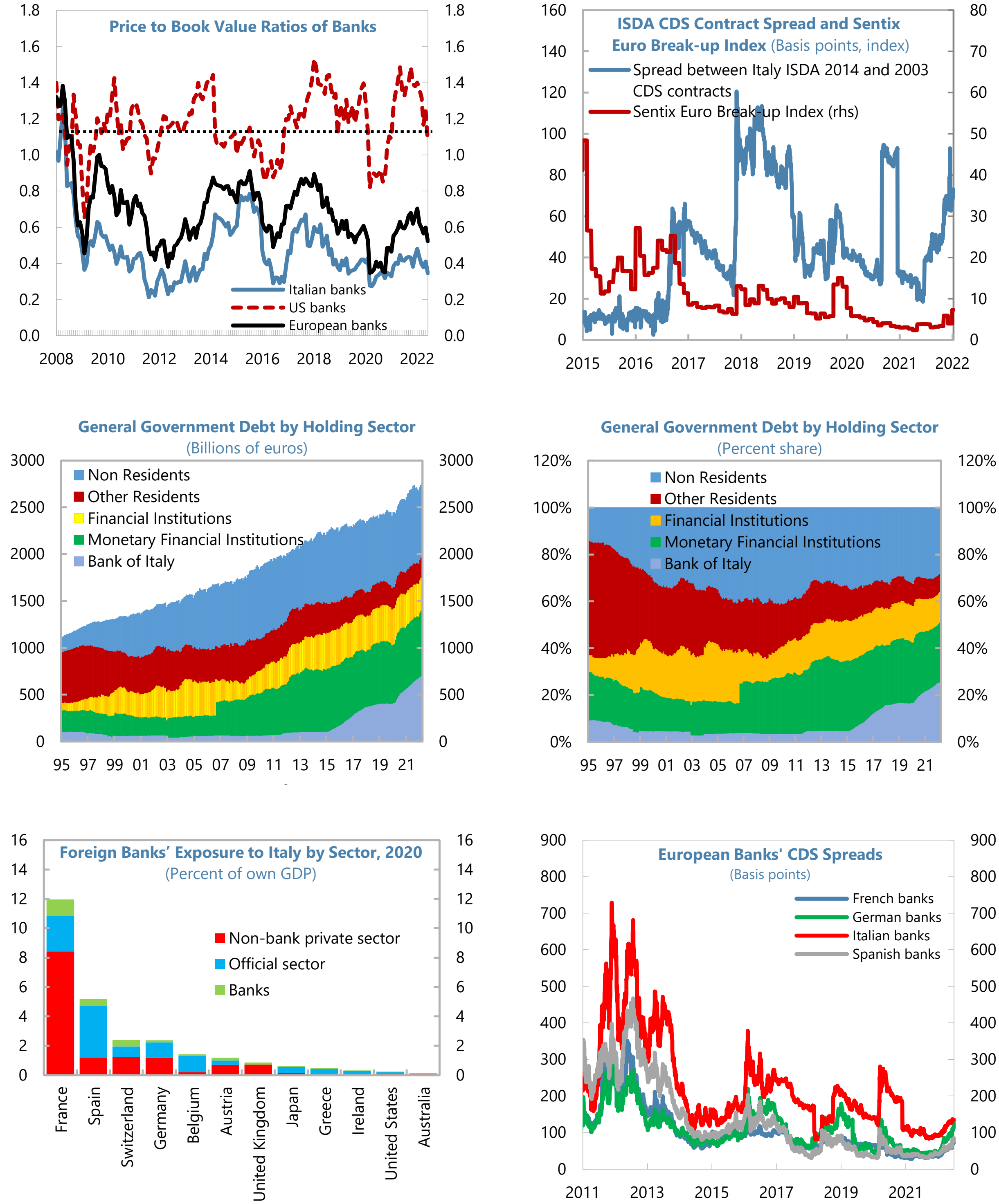


Sources: Bloomberg Finance L.P.; Bank of Italy; S&P Global Market Intelligence; ECB; European Banking Authority; and IMF staff estimates.

Notes: The net liquidity position is the difference between eligible assets for use as collateral for Eurosystem refinancing operations and cumulative expected net cash flows over the next 30 days.

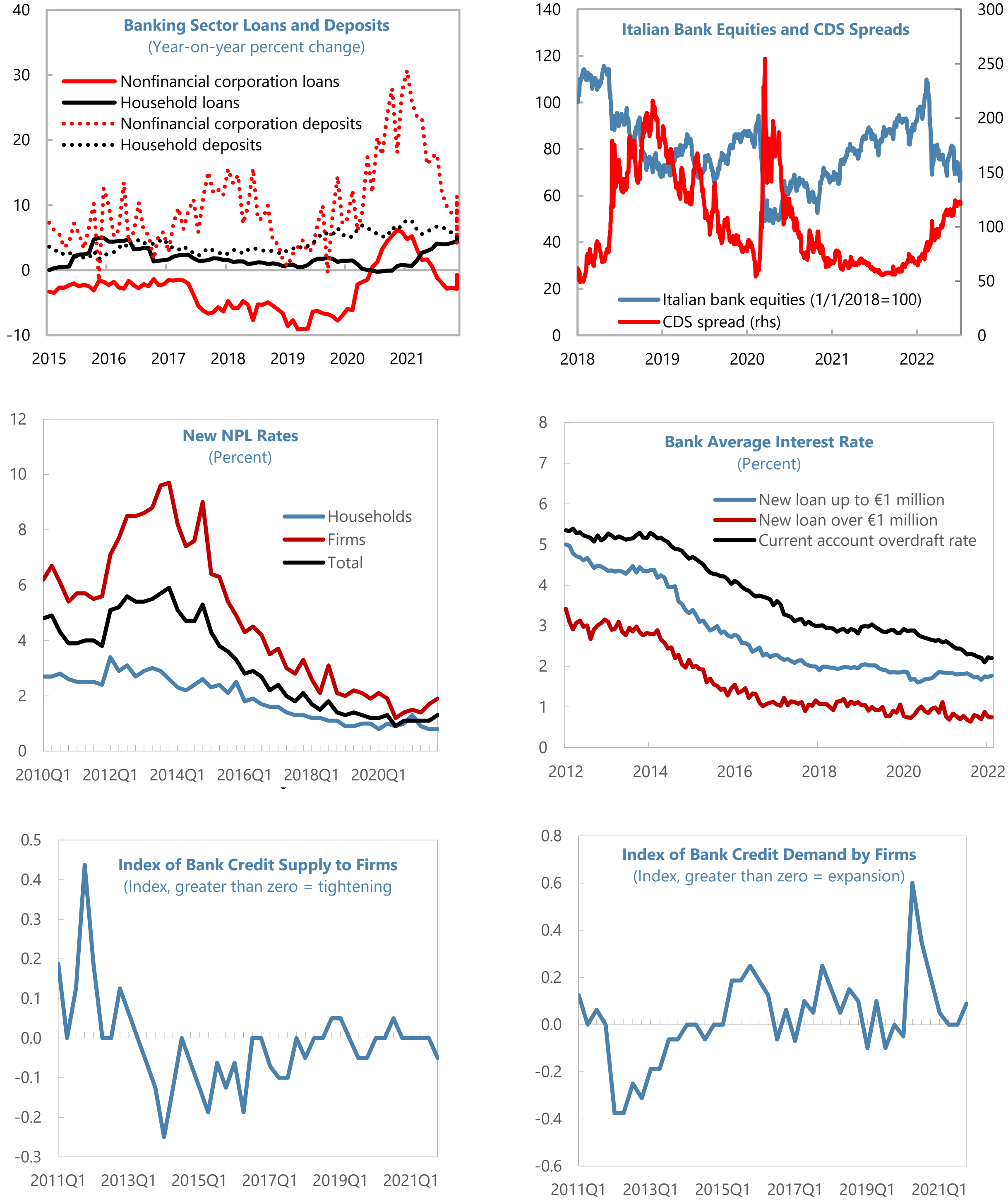
1/ Bank of Italy data starting from 2012.

Figure 6. Italy: Financial Sector Assets and Valuation



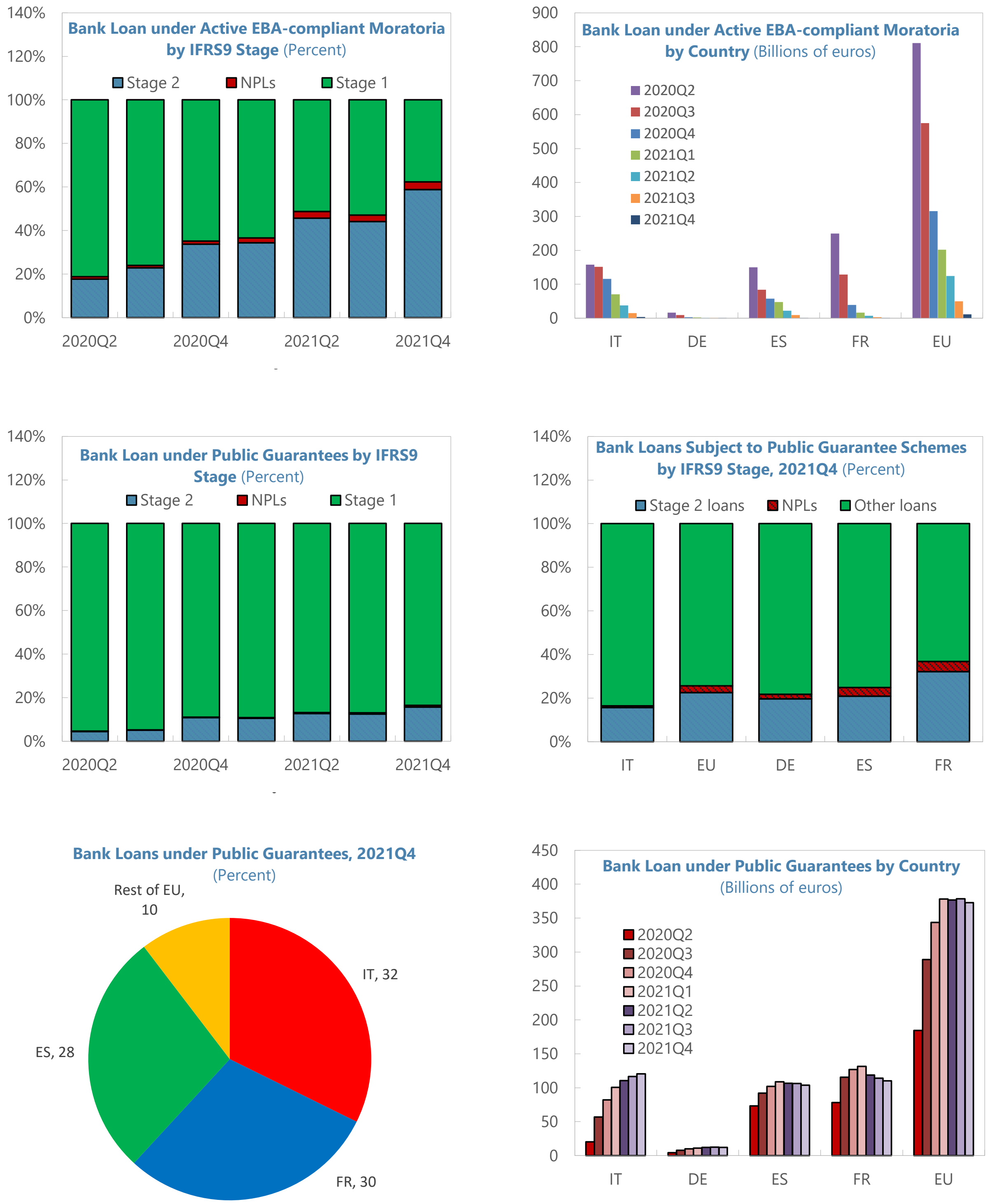
Sources: Bloomberg Finance L.P.; Bank of Italy; Bank of International Settlements; and IMF staff estimates.

Figure 7. Italy: Banking Sector Indicators



Sources: Bloomberg, Bank of Italy, Haver Analytics; and IMF staff estimates.

Figure 8. Italy: Bank Loans under Moratoria and Public Guarantees



Sources: European Banking Authority.

Table 1. Italy: Summary of Economic Indicators, 2018–27

	2018	2019	2020	2021	Projections 2022	2023	2024	2025	2026	2027
Real GDP	0.9	0.5	-9.0	6.6	3.0	0.7	1.7	1.1	1.0	0.5
Real domestic demand	1.3	-0.2	-8.5	6.8	3.3	1.1	2.0	1.2	1.1	0.6
Final domestic demand	1.2	0.3	-8.2	6.4	3.6	1.1	1.6	1.3	1.2	0.6
Private consumption	1.0	0.2	-10.6	5.2	2.0	0.5	1.3	1.0	0.9	0.7
Public consumption	0.1	-0.5	0.5	0.6	1.5	-1.9	0.4	0.9	0.9	0.5
Gross fixed capital formation	3.1	1.2	-9.1	17.0	10.6	5.5	3.2	2.3	2.0	0.5
Stock building 1/	0.1	-0.5	-0.3	0.3	-0.3	0.0	0.4	0.0	0.0	0.0
Net exports 1/	-0.3	0.7	-0.7	0.0	-0.3	-0.4	-0.3	-0.1	-0.1	-0.1
Exports of goods and services	2.1	1.6	-13.4	13.3	7.0	4.0	4.2	3.5	2.9	2.4
Imports of goods and services	3.4	-0.7	-12.1	14.2	8.6	5.5	5.2	4.0	3.2	2.6
Savings 2/	21.1	21.5	21.5	22.5	21.8	22.1	22.5	22.5	22.6	22.5
Investment 2/	18.5	18.2	17.7	20.0	21.3	20.8	20.5	20.1	19.8	19.6
Resource Utilization										
Potential GDP	0.5	0.4	-4.2	3.5	-0.7	1.3	0.7	0.7	0.8	0.8
Output gap (percent of potential)	-1.2	-1.2	-6.2	-3.3	0.2	-0.4	0.6	1.0	1.1	0.8
Employment	1.0	0.7	-3.1	0.8	2.4	-0.4	0.1	0.2	0.2	0.2
Unemployment rate (percent)	10.6	9.9	9.3	9.5	8.8	9.3	9.3	9.2	9.1	9.0
Prices										
GDP deflator	1.1	0.9	1.4	0.5	3.1	3.0	2.9	2.3	2.0	2.0
Consumer prices	1.2	0.6	-0.1	1.9	6.7	3.5	2.9	2.3	2.0	2.0
Consumer prices (core)	0.8	0.6	0.5	0.8	3.6	3.8	3.2	2.5	2.1	2.0
Hourly compensation 3/	1.7	2.9	3.3	-1.8	3.9	3.8	3.2	2.6	2.2	2.1
Productivity 3/	0.5	0.6	-0.5	0.7	0.6	1.1	1.6	1.0	1.0	1.0
Unit labor costs 3/	1.3	2.4	3.8	-2.5	3.3	2.8	1.5	1.7	1.2	1.1
Fiscal Indicators										
General government net lending/borrowing 2/	-2.2	-1.5	-9.6	-7.2	-5.6	-3.9	-3.6	-3.1	-3.0	-2.9
General government primary balance 2/ 4/	1.5	1.8	-6.1	-3.6	-2.1	-0.6	-0.3	0.1	0.1	0.2
Structural overall balance (percent of potential GDP)	-1.6	-0.9	-6.0	-5.1	-5.7	-3.8	-3.7	-3.7	-3.5	-3.4
Structural primary balance (percent of potential GDP) 4/	2.0	2.4	-2.8	-1.7	-2.2	-0.4	-0.4	-0.4	-0.4	-0.3
General government gross debt 2/	134.4	134.1	155.3	150.9	147.7	146.3	143.4	141.7	140.6	139.9
Exchange Rate Regime				Member of the EMU						
Exchange rate (national currency per U.S. dollar)	0.8	0.9	0.9	0.8	...	...	...	...	...	...
Nominal effective rate: CPI based (2000=100)	103.8	102.8	105.0	106.2	...	...	...	...	...	...
External Sector 2/										
Current account balance	2.5	3.2	3.7	2.4	0.5	1.2	2.0	2.5	2.8	3.0
Trade balance	2.4	3.4	3.7	2.3	0.3	1.0	1.8	2.3	2.6	2.8
Capital account balance	0.0	-0.1	0.0	-0.1	0.6	0.9	0.8	0.7	0.4	0.0

Sources: National Authorities; and IMF staff estimates.
1/ Contribution to growth.
2/ Percent of GDP.
3/ In industry (including construction).
4/ Primary revenue minus primary expenditure.

Table 2. Italy: Statement of Operations—General Government (GFSM 2001 Format), 2018–27

	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027
					Projections					
	(Billions of euros)									
Revenue	818.5	843.2	785.4	857.1	915.8	944.6	981.5	1011.6	1035.0	1053.3
Taxes	504.6	517.0	478.8	527.2	559.2	572.4	595.1	614.9	633.8	649.4
Social contributions	234.5	242.2	229.7	245.0	258.2	265.8	276.2	285.7	294.3	301.8
Grants	2.2	2.5	2.7	4.7	14.0	19.1	19.1	17.1	10.1	2.1
Other revenue	77.3	81.5	74.2	80.1	84.5	87.2	91.1	93.9	96.8	99.9
Expenditure	857.2	870.9	944.4	984.5	1021.1	1020.9	1054.6	1077.7	1101.3	1117.2
Expense	856.9	870.4	943.9	984.4	1021.0	1020.8	1054.5	1077.6	1101.2	1117.1
Compensation of employees	172.6	172.9	173.5	176.3	191.9	195.0	200.2	207.0	213.3	218.7
Use of goods and services	100.5	99.2	97.0	106.2	104.5	104.7	109.6	113.3	116.8	119.7
Consumption of fixed capital	49.0	49.1	49.3	58.4	68.6	76.9	80.5	80.9	78.8	68.2
Interest	64.6	60.4	57.3	62.9	66.1	65.4	66.7	67.9	68.0	69.0
Social benefits	394.5	408.9	451.9	452.0	462.8	468.7	490.7	507.5	522.8	536.7
Other expense	75.6	79.9	114.9	128.6	127.1	110.2	107.0	100.9	101.6	104.8
Net acquisition of nonfinancial assets	0.3	0.5	0.6	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Net Lending/Borrowing	-38.7	-27.7	-159.0	-127.4	-105.2	-76.4	-73.1	-66.1	-66.3	-64.0
	(Percent of GDP, unless otherwise indicated)									
Revenue	46.2	46.9	47.4	48.3	48.6	48.3	48.0	47.8	47.5	47.1
Taxes	28.5	28.8	28.9	29.7	29.7	29.3	29.1	29.1	29.1	29.0
Social contributions	13.2	13.5	13.9	13.8	13.7	13.6	13.5	13.5	13.5	13.5
Grants	0.1	0.1	0.2	0.3	0.7	1.0	0.9	0.8	0.5	0.1
Other revenue	4.4	4.5	4.5	4.5	4.5	4.5	4.5	4.4	4.4	4.5
Expenditure	48.4	48.5	57.0	55.4	54.2	52.2	51.5	50.9	50.5	50.0
Expense	48.4	48.4	57.0	55.4	54.2	52.2	51.5	50.9	50.5	50.0
Compensation of employees	9.7	9.6	10.5	9.9	10.2	10.0	9.8	9.8	9.8	9.8
Use of goods and services	5.7	5.5	5.9	6.0	5.5	5.4	5.4	5.4	5.4	5.4
Consumption of fixed capital	2.8	2.7	3.0	3.3	3.6	3.9	3.9	3.8	3.6	3.1
Interest	3.6	3.4	3.5	3.5	3.5	3.3	3.3	3.2	3.1	3.1
Social benefits	22.3	22.8	27.3	25.5	24.6	24.0	24.0	24.0	24.0	24.0
Other expense	4.3	4.4	6.9	7.2	6.7	5.6	5.2	4.8	4.7	4.7
Net acquisition of nonfinancial assets	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net Lending/Borrowing	-2.2	-1.5	-9.6	-7.2	-5.6	-3.9	-3.6	-3.1	-3.0	-2.9
Memorandum items:										
Primary balance 1/	1.5	1.8	-6.1	-3.6	-2.1	-0.6	-0.3	0.1	0.1	0.2
Structural primary balance 1/	2.0	2.4	-2.8	-1.7	-2.2	-0.4	-0.4	-0.4	-0.4	-0.3
Change in structural primary balance 2/	0.0	0.4	-5.2	1.1	-0.5	1.8	0.0	0.0	0.1	0.1
Structural balance 2/	-1.6	-0.9	-6.0	-5.1	-5.7	-3.8	-3.7	-3.7	-3.5	-3.4
Change in structural balance 2/	-0.1	0.7	-5.1	0.9	-0.6	2.0	0.0	0.0	0.1	0.2
General government gross debt	134.4	134.1	155.3	150.9	147.7	146.3	143.4	141.7	140.6	139.9

Sources: National Authorities; and IMF staff estimates.

1/ Primary revenue minus primary expenditure.

2/ Percent of potential GDP.

Table 3. Italy: Summary of Balance of Payments, 2018–27

	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027
					Projections					
	(Billions of euros)									
Current Account Balance	44.8	57.9	62.1	43.4	10.0	24.1	40.1	52.1	60.2	66.0
Balance of goods and services	43.0	60.3	60.8	41.6	5.3	19.6	35.9	48.1	56.4	62.3
Goods balance	45.9	60.7	68.2	53.0	6.6	19.3	37.9	50.2	58.5	64.5
Exports	451.3	459.0	414.5	494.6	577.6	613.1	651.7	687.7	719.2	739.5
Imports	405.4	398.2	346.3	441.6	571.0	593.7	613.8	637.5	660.6	675.0
Services balance	-2.9	-0.4	-7.4	-11.4	-1.3	0.3	-2.0	-2.1	-2.2	-2.2
Credit	104.5	109.4	74.9	86.7	97.1	107.3	114.6	118.5	122.1	125.2
Debit	107.4	109.8	82.4	98.1	98.4	106.9	116.6	120.6	124.3	127.4
Primary income balance	19.2	14.7	20.4	21.2	23.1	23.5	24.1	24.6	25.1	25.5
Credit	79.2	76.9	63.4	62.2	66.6	68.7	71.4	73.6	75.5	77.2
Debit	60.1	62.2	42.9	41.1	43.6	45.2	47.3	48.9	50.4	51.7
Secondary income balance	-17.4	-17.2	-19.1	-19.4	-18.4	-19.0	-19.9	-20.6	-21.2	-21.8
Capital Account Balance	-0.3	-1.8	-0.7	-2.3	11.7	16.8	16.8	14.8	8.9	0.5
Financial Account	32.8	54.3	62.7	25.7	21.7	40.9	56.9	67.0	69.1	66.5
Direct investment	-5.2	1.5	19.1	2.8	0.2	0.6	0.6	0.7	0.8	1.0
Portfolio investment	132.5	-51.8	108.5	123.9	-32.9	-16.3	-24.6	-18.0	-22.7	-19.1
Other investment	-94.4	98.8	-65.9	-121.7	54.1	56.3	80.5	83.9	90.6	84.2
Derivatives (net)	-2.8	2.6	-2.9	0.0	0.2	0.3	0.4	0.4	0.4	0.4
Reserve assets	2.6	3.2	4.0	20.7	0.0	0.0	0.0	0.0	0.0	0.0
Net Errors and Omissions	-11.6	-1.8	1.3	-15.4	0.0	0.0	0.0	0.0	0.0	0.0
	(Percent of GDP)									
Current Account Balance	2.5	3.2	3.7	2.4	0.5	1.2	2.0	2.5	2.8	3.0
Balance on goods and services	2.4	3.4	3.7	2.3	0.3	1.0	1.8	2.3	2.6	2.8
Goods balance	2.6	3.4	4.1	3.0	0.4	1.0	1.9	2.4	2.7	2.9
Services balance	-0.2	0.0	-0.4	-0.6	-0.1	0.0	-0.1	-0.1	-0.1	-0.1
Primary income balance	1.1	0.8	1.2	1.2	1.2	1.2	1.2	1.2	1.2	1.1
Secondary income balance	-1.0	-1.0	-1.2	-1.1	-1.0	-1.0	-1.0	-1.0	-1.0	-1.0
Capital Account Balance	0.0	-0.1	0.0	-0.1	0.6	0.9	0.8	0.7	0.4	0.0
Financial Account	1.9	3.0	3.8	1.4	1.2	2.1	2.8	3.2	3.2	3.0
Direct investment	-0.3	0.1	1.2	0.2	0.0	0.0	0.0	0.0	0.0	0.0
Portfolio investment	7.5	-2.9	6.5	7.0	-1.7	-0.8	-1.2	-0.9	-1.0	-0.9
Other investment	-5.3	5.5	-4.0	-6.9	2.9	2.9	3.9	4.0	4.2	3.8
Derivatives (net)	-0.2	0.1	-0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Reserve assets	0.1	0.2	0.2	1.2	0.0	0.0	0.0	0.0	0.0	0.0
Net Errors and Omissions	-0.7	-0.1	0.1	-0.9	0.0	0.0	0.0	0.0	0.0	0.0
Gross External Debt	120.5	124.2	139.9	137.6	137.2	137.1	135.1	134.0	133.3	132.9
Public sector	68.7	72.9	84.6	83.3	84.0	84.5	83.9	83.7	83.8	84.1
Private sector	51.8	51.3	55.2	54.3	53.2	52.6	51.2	50.3	49.5	48.8

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

Table 4. Italy: Financial Soundness Indicators, 2014–21[1]

	2014	2015	2016	2017	2018	2019	2020	2021
	Core FSIs for Deposit-taking institutions							
Regulatory capital to risk-weighted assets	14.3	14.8	13.8	16.7	16.1	17.2	19.3	18.8
Regulatory tier 1 capital to risk-weighted assets	11.9	12.3	11.3	14.3	13.9	14.9	16.9	16.5
Nonperforming loans net of provisions to capital	93.4	89.0	85.2	58.0	40.1	29.6	20.2	16.5
Nonperforming loans to total gross loans	18.0	18.1	17.1	14.4	8.4	6.7	4.4	3.3
Sectoral distribution of loans to total loans:								
Loans to Residents	75.3	74.3	76.9	75.5	75.5	74.0	74.9	75.3
Loans to Deposit takers	2.5	2.5	2.3	2.5	2.9	1.8	1.5	1.5
Loans to Central Bank	0.6	0.8	2.8	4.3	3.6	3.9	11.7	14.7
Loans to Other financial corporations	6.6	7.4	7.7	7.6	8.1	8.6	5.8	4.9
Loans to General government	2.4	2.0	1.9	1.5	1.5	1.4	1.1	1.2
Loans to Nonfinancial corporations	36.8	35.4	34.6	32.3	31.3	29.6	28.4	26.8
Loans to Other domestic sectors	26.5	26.2	27.6	27.3	28.0	28.6	26.3	26.3
Loans to Nonresidents	24.7	25.7	23.1	24.5	24.5	26.0	25.1	24.7
Growth of bank loans to private non-MFI 2/	-1.6	-0.4	1.1	1.8	2.1	0.2	4.7	2.1
Nonfinancial corporations	-2.3	-0.6	0.3	0.2	1.4	-1.9	8.4	1.7
Households	-0.6	0.7	1.9	2.8	2.8	2.6	2.3	3.7
Return on assets	-0.2	0.3	-0.5	0.6	0.5	0.4	0.1	0.4
Return on equity	-2.8	3.4	-7.7	7.5	6.1	5.1	0.9	6.0
Interest margin to gross income	50.4	47.7	48.4	48.2	49.6	48.2	49.5	46.4
Net open position in foreign exchange to capital	0.0	0.3	1.6	1.3	0.7	0.4	0.8	0.0
	Encouraged FSIs for Deposit-taking institutions							
Capital to assets	5.9	6.2	5.5	6.6	6.3	6.7	6.6	6.1
Gross asset position in financial derivatives to capital	70.4	85.8	84.3	45.8	51.1	40.1	38.4	34.3
Gross liability position in financial derivatives to capital	71.2	87.2	88.1	43.2	55.7	43.2	40.2	36.1
Personnel expenses to noninterest expenses	55.0	52.8	53.0	54.3	52.1	53.2	54.2	53.1
Customer deposits to total (noninterbank) loans	56.3	60.6	64.9	69.1	67.9	75.1	68.5	90.6
Foreign-currency-denominated loans to total loans	9.5	10.0	9.7	8.6	8.1	7.8	6.3	7.1
Foreign-currency-denominated liabilities to total liabilities	7.1	7.9	7.9	7.3	7.5	7.3	6.0	6.0

Sources: IMF, Financial Soundness Indicators

1/ Data from the IMF Financial Soundness Indicators database have been updated, when possible, with Bank of Italy's or ECB's data. 2021Q2 data are latest available.

2/ Data are from Bank of Italy. 2020Q4 data are latest available.

Annex I. Risk Assessment Matrix

Sources of Risk	Relative Likelihood	Impact If Realized	Policy Responses
Global Risks			
Russia's invasion of Ukraine leads to escalation of sanctions and other disruptions. Sanctions on Russia are broadened to include oil, gas, and food sectors. Russia is disconnected almost completely from the global financial system and large parts of the trading system. This, combined with Russian countersanctions and secondary sanctions on countries and companies that continue business with Russia, leads to higher commodity prices, refugee migration, tighter financial conditions, and other adverse spillovers, which particularly affect LICs and commodity-importing EMs.	**High**	**High.** It could cause a severe output contraction that intensifies sovereign-bank-corporate feedback channels. If extended, could cause a significant drop in GDP unless sufficient replacements are secured. The resulting deterioration in loan quality—including publicly-guaranteed loans—would raise funding costs for banks and the sovereign, causing credit to retrench and forcing a procyclical tightening of fiscal policy. These factors could cause a flare up of banks-corporate-sovereign linkages	• The existing means-tested citizenship income program and the short-time work scheme can provide an automatic income backstop for those facing job and income loss. Targeted energy-price compensation to poorer households and viable firms should continue alongside incentives for conservation. • Liquidity support to the most affected firms should be provided, consistent with the recently approved EU temporary crisis framework, to prevent temporary liquidity shortfalls from a large wave of corporate insolvencies.
Outbreaks of lethal and highly contagious COVID-19 variants. Rapidly increasing hospitalizations and deaths due to low vaccine protection or vaccine-resistant variants force more social distancing and/or new lockdowns. This results in extended supply chain disruptions and a reassessment of growth prospects, triggering capital outflows, financial tightening, currency depreciations, and debt distress in some EMDEs.	**Medium**	**High.** Demand in contact-intensive sectors remain low for longer. Long-run scarring will be larger, due to large scale impaired corporate balance sheets and a persistent increase in unemployment, with rising inter-generational and regional disparities.	• Maintain and intensify if needed public health measures, in particular large-scale testing and contact tracing. • Use available fiscal resources to support households, workers, and business to overcome liquidity needs; and gradually encourage necessary reallocation of resources once the recovery is well established.
De-anchoring of inflation expectations in the U.S. and/or advanced European economies. Worsening supply-demand imbalances, higher commodity prices, and higher nominal wage growth lead to persistently higher inflation and inflation expectations, prompting central banks to tighten policies faster than currently anticipated. The resulting sharp tightening of global financial conditions and spiking risk premia lead to currency depreciations, asset market selloffs, bankruptcies, sovereign defaults, and contagion across EMDEs.	**Medium/ Low**	**High.** Financial markets may reassess real economy risks, leading to a repricing of risk assets, unmasking of debt-related vulnerabilities, and weakening banks' balance sheets. Calls on government contingent liabilities could increase refinancing risks and raise concerns over fiscal sustainability.	• Reduce the risk of a vicious cycle between the sovereign, corporates and banks through: (i) A credible medium-term strategy to anchor public debt reduction; (ii) Streamlining debt resolution and insolvency procedures; and (iii) Promptly repairing banks' balance sheets.

Sources of Risk	Relative Likelihood	Impact If Realized	Policy Responses
Abrupt growth slowdown in China. A combination of extended COVID-19 lockdowns, rising geopolitical tensions, a sharper-than-expected slowdown in the property sector, and/or inadequate policy responses result in a sharp slowdown of economic activity, with spillovers affecting other countries through supply chain disruptions, trade, commodity-price, and financial channels.	Medium	**High.** Disruptions will adversely affect the profitability of firms by preventing firms from capitalizing on strong market demand due to unavailability of products, and increased costs, leading to loss of market share. Raising capital could become more expensive. Disruptions can also negatively impact the productivity and utilization of assets.	• Build inventory of critical supplies for production and to protect safety and health. • Promote high-quality public investment in infrastructure that facilitates global trade, such as ports, and information technology.
Rising and volatile food and energy prices. Commodity prices are volatile and trend up amid pent-up demand and supply disruptions, wars, export restrictions, and currency depreciations. This disrupts the green transition and leads to bouts of price and real sector volatility, food insecurity, social unrest, and acute food and energy crises (especially in countries with lack of fiscal space for policy response).	High	**High.** Could lead to second-round inflationary effects through wage contract negotiations; negatively impact business confidence, leading to lower investment and damage productivity growth. They can increase public discontent and loss in social cohesion, jeopardizing political stability.	• Provide well-targeted support to avoid excessive volatility in energy prices. • Promote investment in innovative energy systems.
Geopolitical tensions and de-globalization. Intensified geopolitical tensions, security risks, conflicts and wars cause economic and political disruptions, disorderly migration, production reshoring, a decline in global trade, and lower investor confidence.	High	**Medium/high.** In the near term, escalating geopolitical tensions could undermine growth both directly and through adverse confidence effects and financial market volatility. The growth impact could be severe if imports of Russian energy were shut off. In the medium term, deglobalization can give rise to reshoring and less trade, reducing potential growth.	• Continue support for the multilateral rules-based trading system, and advocate trade liberalization. • Safeguard energy security by accelerating the green transition and obtaining alternative supplies.
Domestic Risks			
Sharp tightening of global financial conditions could transmit to Italian bonds via contagion following sovereign restructurings in emerging markets, or because of increased uncertainty about the war	Medium	**High**. Sharply higher sovereign borrowing costs could slow public debt reduction and decelerate growth, raising concerns over fiscal sustainability.	• A credible medium-term strategy to anchor public debt reduction
Inefficient or only partial absorption of Next Generation EU (NGEU) resources for investment in green and digital infrastructure**,** coupled with **incomplete adoption of growth-enhancing structural reform** to raise productivity.	Medium	**High.** High quality public investment together with comprehensive structural reforms in the NRRP to raise productivity would boost medium-term output and potential growth by enhancing the productive capacity of the economy.	• Promote high-quality public investment in digitization, green infrastructure, and education and innovation. • Adopt comprehensive structural reforms to raise productivity.
Lack of policy continuity Impasse over policies stalls parliamentary approval of reforms, with the potential for snap elections.	Medium	**High.** Italy-specific risk perceptions would jump, sharply raising funding costs for the public and private sectors, which would slow growth and renew public debt sustainability concerns. Lack of timely progress on the NRRP would delay NGEU funding.	• Ensure full compliance with milestones and targets in the NRRP; as well as timely approval by parliament of reforms that require changes in legislation.

Annex II. Debt Sustainability Analysis

A. Public Debt Sustainability Analysis

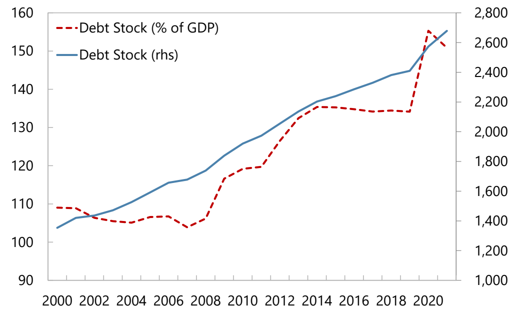
After increasing by 20 percentage points of GDP in 2020, Italy's public debt declined somewhat in 2021 to nearly 150 percent of GDP. Over the forecast horizon (2022–27), debt is projected to decline steadily to about 140 percent of GDP, benefiting from still favorable automatic debt dynamics. In the longer term, and under unchanged policies, the public debt ratio is projected to turn up because of higher aging-related pension spending. Further sustained and significant reduction in the public debt ratio is needed to safeguard debt sustainability. Key risks stem from a disappointing growth trajectory, a sharper increase in financing costs and materialization of large contingent liabilities.

1. Italy's public debt is very high and financing needs are large:

- Debt increased from about 100 percent of GDP in 2007 to 135.7 percent of GDP in 2019. While Italy's primary surpluses averaged 1¼ percent of GDP during 2001–19, they were insufficient to offset the effect of very weak growth. As a result of the COVID crisis, the debt increased by 20 percentage points of GDP in 2020 and then declined by 5 percentage points in 2021 as a result of the strong recovery.

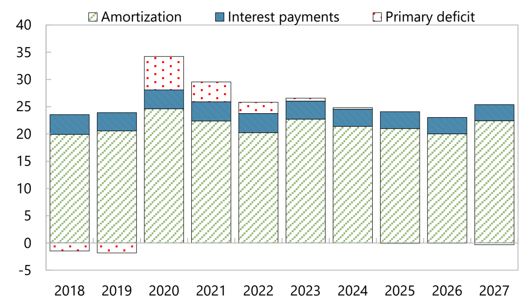
- Gross financing needs are sizable, mainly on account of large rollover requirements. After increasing to about 35 percent of GDP in 2020 (from about 23 percent in 2019), gross financing needs are projected to moderate over the forecast horizon on the projected decline in the primary deficit. While the structure of debt holdings partially mitigates refinancing risk—with about two-thirds held by domestic investors, of which nearly half is held by the BdI—holdings of government securities by nonresidents have declined by about €70 billion over the past 6 months. Average residual maturity is around seven years and about 90 percent of debt is at fixed rates, reducing sensitivity to changes in market interest rate.[1] However, interest payments on

Debt Stock
(€ Billion and in percent of GDP)



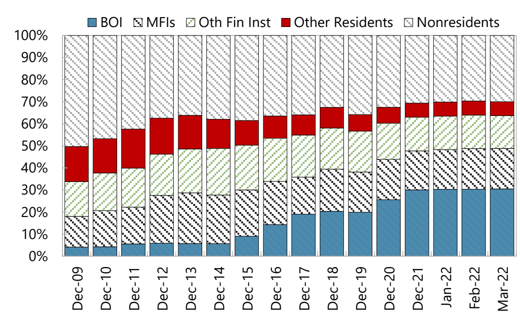
Source: Haver

Gross Financing Needs
(Percent of GDP)



Sources: Bloomberg and IMF staff

General Government Debt Holders
(Percent of total securities)



Source: Haver

[1] From a consolidated public sector perspective, liabilities of around 90 percent of GDP are either at variable rates (e.g., Target 2 balances and banks' overnight deposits at the Bank of Italy) or have residual maturity of up to 1 year (including part of government debt).

inflation-linked bonds have risen by about ½ percentage point of GDP relative to 2021. Since the beginning of 2022, credit default swap (CDS) spreads on Italian sovereign bonds have risen, but remain much below their past peaks, with redenomination risk also ticking up.

- The ECB's accommodative response to the pandemic, including its bond purchasing program, has helped to lower yields and mitigate refinancing risks. At about €680 billion (net-of-reinvestments of maturing securities), the Eurosystem's holdings of Italian debt are about 25 percent of the total, and are assumed to remain around this level through 2022.

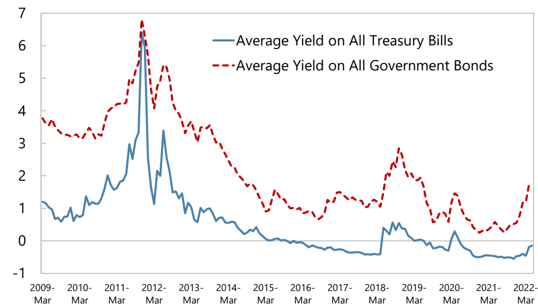
2. **Public debt is projected to moderate somewhat over the medium term, before turning up over the longer term**. In the baseline, debt is projected within the 150–140 percent of GDP range during 2022–27, supported by favorable automatic debt dynamics. Debt is expected to increase in the longer term due to higher pension spending and rising interest rates. The assumptions underpinning the baseline are as follows:

- Real GDP growth is projected to average 1 percent during 2022–27. Thereafter, growth is maintained at just above ¾ percent, which is higher than the average for the past two decades. The GDP deflator is projected to rise from 0.7 percent in 2019 to 2½, on average over 2022–27.

- Under current policies, the government is assumed to maintain an average structural primary deficit of about ¾ percent of GDP (against a debt-stabilizing primary deficit of ½ percent of GDP) over the 2022–27 period. Thereafter, the primary balance deteriorates by about 1½ percentage points of GDP due to higher pension spending over the period 2027–35 under unchanged policies.

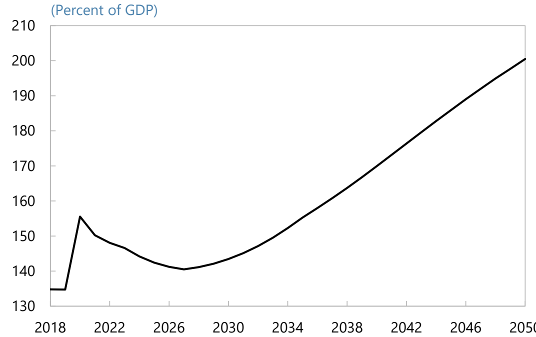
- Over the medium term, staff projects an effective nominal interest rate of about 2½ percent, or an average interest bill of about 3½ percent of GDP. The marginal cost of borrowing, i.e., at issuance, declined to 0.1 percent in 2021 from 1.1 percent in 2018, but is projected to rise steadily over the medium-term

Treasury Bills and Government Bond Yields
(percent)



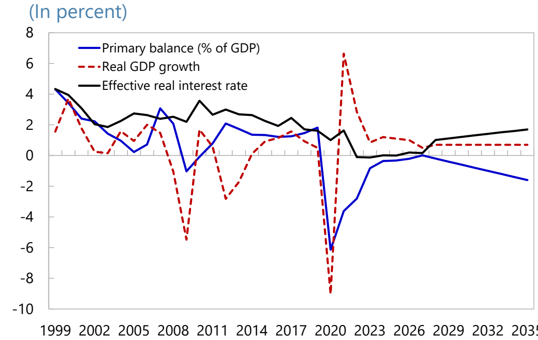
Source: Haver Analytics

Gross Nominal Public Debt
(Percent of GDP)



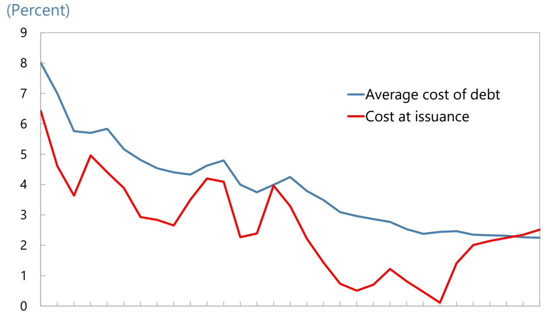
Souce: IMF staff projections.

Debt Dynamics Parameters
(In percent)



Sources: Haver and IMF staff calculations

Cost of Debt
(Percent)



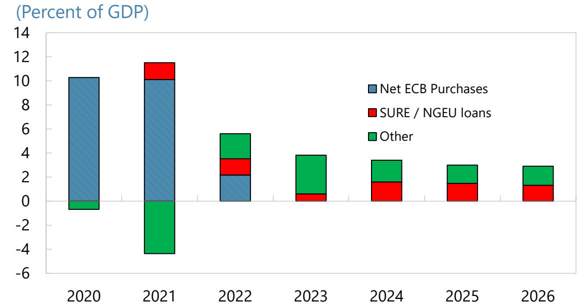
Sources: Haver; and IMF staff estimates.

toward 3 percent. In the longer term, the average cost of debt is assumed to rise further as monetary policy normalizes, with the effective nominal interest rate increasing to around 3 percent by 2035 (1 percent in real terms). However, borrowing costs could rise further if debt reduction were to stall.

- The baseline scenario assumes the government uses its envelope of about 8 percent of GDP in loans from the Next Generation EU (NGEU) Fund through 2026 to finance higher public investment. However, if spending efficiency were to remain low, possibly due to eroding political support for reforms, growth could disappoint, causing public debt to rise even over the medium term.

Net Financing Sources, 2020-26

(Percent of GDP)



Sources: IMF staff estimates.
Note: Assumes €40 bn in ECB net purchases in 2022. Excludes ECB reinvestments of maturing assets from 2022.

- Contingent liabilities: According to the latest available report from the European Commission, public guarantees amounted to 13 percent of GDP at end-2020, including the guarantee scheme on distressed bank loan portfolios (GACS). Government intervention in SOEs has been limited in the past 15 years (below 1 percent of GDP). As part of the emergency response to the COVID crisis, public guarantees on bank loans amounted to 10 percent of GDP at end-2021.

3. **Important risks are embedded in the baseline assumptions**. Staff's forecast track record for Italy in recent years is comparable to that of other surveillance countries, with the forecast errors for real GDP growth and inflation close to the median across surveillance countries. However, the projected fiscal position for Italy is subject to significant downside risks. This reflects conservative budgeting of expenditure and revenue, and hence a tendency for somewhat better outcomes.

4. **Materialization of moderate shocks would result in debt rising earlier and faster.** These include rollover risk compounded by the phasing out of the ECB's bond purchasing programs, as well as political shocks or further negative spillovers from geopolitical events that could result in higher debt spreads. These risks are, however, partially offset by the European Union's response to the crisis, which made available 8 percent of GDP in loans from the Next Generation EU (NGEU) Fund through 2026 at low yields and longer maturities. Large holdings by domestic banks creates the risk of a vicious cycle between the sovereign and banks. In particular:

- *Standard growth shock.* Real output growth rates are assumed to be lower by one standard deviation for two years starting in 2023, resulting in average growth of -2 percent in 2023–24. Furthermore, for every 1 percentage point decline in growth, inflation is assumed to decline by 25 basis points. The primary balance would decline further, reaching -4 percent of GDP by 2024. Debt increases to about 160 percent of GDP in 2024 and declines only gradually afterwards.

- *Interest rate shock.* Sovereign yields could increase further than assumed in the baseline, for instance, prompted by political uncertainty, a re-emergence of concerns about debt sustainability, or policy surprises. A further increase in borrowing costs by 200 basis points to

5 percent is assumed. Higher borrowing costs are passed on to the real economy, depressing growth by 0.4 percentage points for every 100 basis points increase in spreads. The implicit average interest rate on debt would reach a minimum of 3¼ percent by 2024 and rise thereafter. Debt would remain close to its current elevated level over the forecast horizon and increase thereafter.

- *Contingent liability shock.* Negative surprises, such as from the financial system, could lead to a one-time increase in non-interest expenditure that is standardized to 10 percent of GDP. This is assumed to be accompanied by lower growth for two consecutive years by -1½ percentage points, and lower inflation by ½ percent. The primary balance is assumed to worsen by 14 percentage points of GDP in 2023, i.e., from costs to recapitalize the banking system or materialization of other contingent fiscal liabilities. Debt rises to over 170 percent of GDP by 2024. Gross financing needs would be significantly higher.

B. External Debt Sustainability Analysis

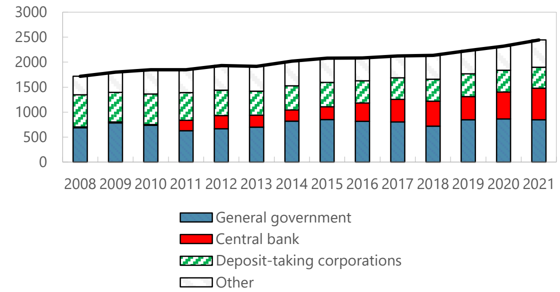
This external debt sustainability analysis complements the External Sector Assessment (Annex III). External debt declined sharply from 149 percent of GDP in 2020 to 131 percent of GDP in 2021. Under the baseline scenario, external debt is projected to increase in 2022 and 2023 but decline gradually to 133 percent of GDP in 2027. While the nominal gross external debt in 2021 increased in euro terms, a robust economic recovery is the main driver for the large reduction in the external debt to GDP ratio. Under standard shock scenarios, further increases in external debt would be limited. However, external debt dynamics is closely linked to public external debt and TARGET 2 liabilities. Further strengthening of public and financial sector balance sheets and sustaining strong domestic growth are necessary to lower external vulnerabilities.

5. **External debt to GDP ratio grew by 66 percentage points between euro adoption and 2020, plateauing in 2017 at around 128 percent of GDP**. Over the past 5 years, Italy's Net International Investment Position (NIIP) turned from negative to positive. The improvement in Italy's NIIP is due to outflows in portfolio investments by the nonfinancial private sector and net valuation gains on external positions, leading to faster increases in IIP assets than liabilities. Both IIP assets and liabilities reached record levels in 2021, reflecting Italy's increased financial integration with the rest of the world.

6. **Under the baseline scenario, external debt is projected to increase from 131 percent of GDP in 2021 to 136 percent of GDP in 2022.** The increase in gross external debt in 2021 is €126 billion (5 percent y/y change). About 50 percent of this increase is due an increase in the Bank of Italy's external debt (mainly TARGET2 liabilities). The robust economic recovery due to pandemic-related support measures is the major contributing factor to the large reduction in the external debt to GDP ratio in 2021. The current account surplus in the near term is projected to temporarily decline because of the commodity price increases and geopolitical tensions, whereas large portfolio outflows of debt liabilities (reduction of foreign holdings of Italian sovereign bonds) will be mostly offset by accumulation of TARGET 2 liabilities (recorded in "other investment" in the financial

account). Over the medium term, the post-COVID recovery would bring the ratio gradually lower to 133 percent of GDP in 2027. Standardized shocks are calibrated to one-half standard deviations for growth, interest rate, and the current account. Under these scenarios, external debt would worsen by a few percentage points at the end of the forecast horizon, but with a 17 percentage points increase under the growth shock. The historical scenario is much less favorable, however, with debt climbing to 169 percent of GDP, because the result is based on averages of macroeconomic variables for the past 10 years, which include the Eurozone Crisis and the COVID-19 pandemic. Although standard macroeconomic shocks would not significantly influence external debt over the medium term, ensuring that it remains on a downward path is ultimately tied to public debt dynamics and the strength of the domestic growth path, underscoring the need for comprehensive structural and fiscal reforms.

Gross External Debt and Its Composition
(Billions of Euros)



Source: Bank of Italy.

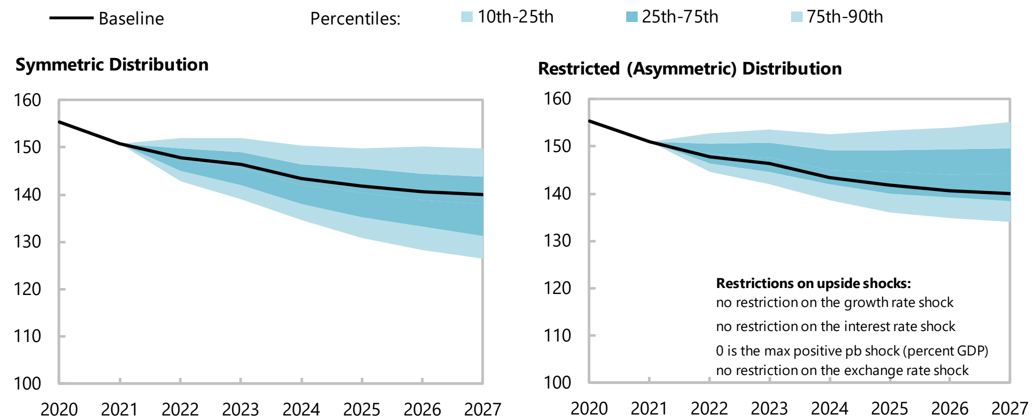
Figure AII.1. Italy: Public DSA Risk Assessment

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

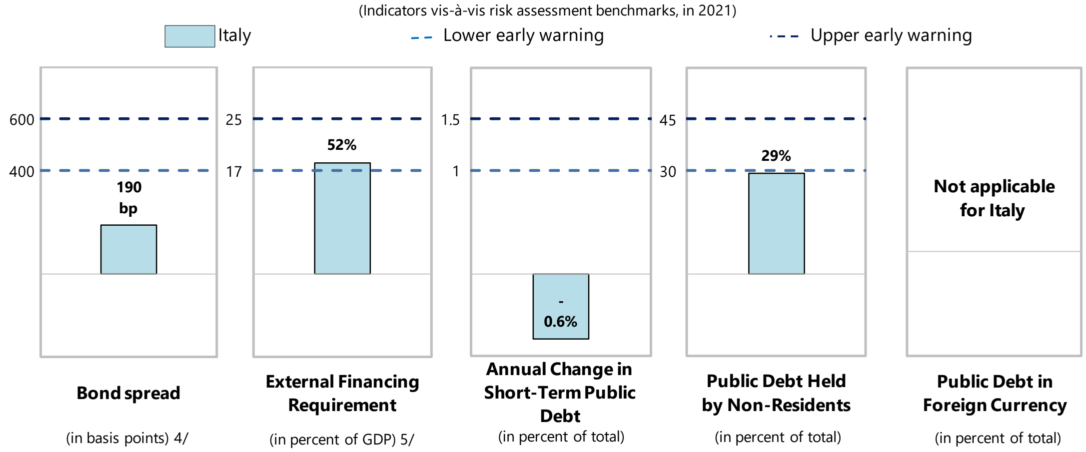
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2021)



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.

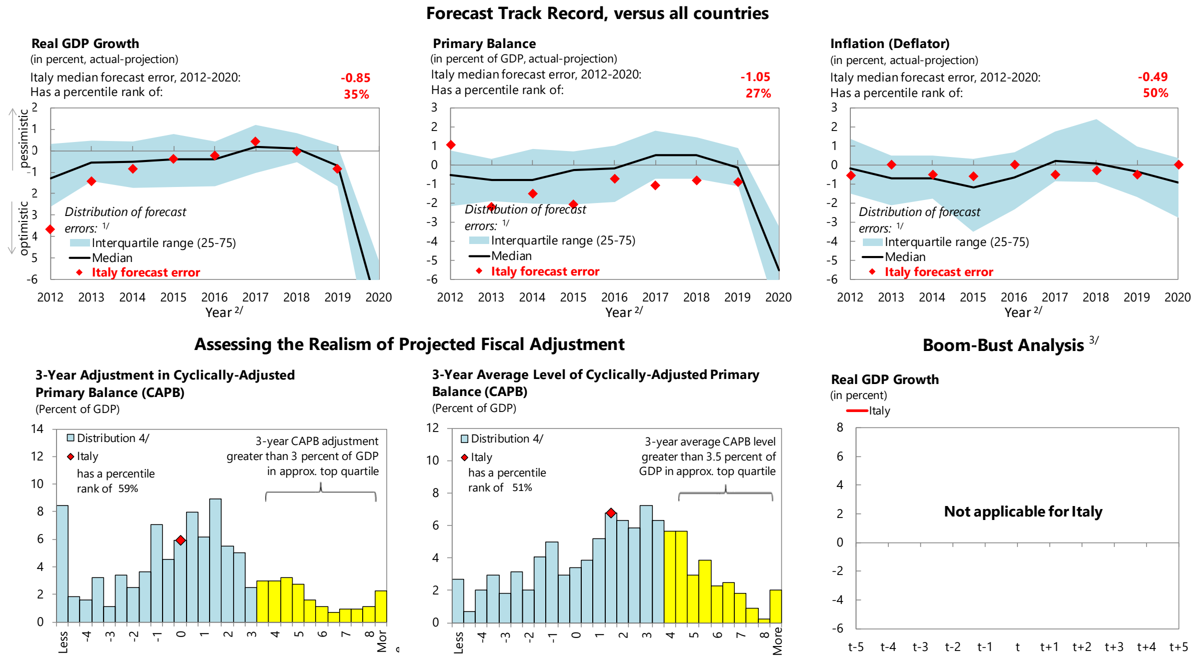
3/ The cell is highlighted in green if country value is less than the lower risk-assessment benchmark, red if country value exceeds the upper risk-assessment benchmark, yellow if country value is between the lower and upper risk-assessment benchmarks. If data are unavailable or indicator is not relevant, 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; 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/ Long-term bond spread over German bonds, an average over the last 3 months, 02-Apr-22 through 01-Jul-22.

5/ External financing requirement is defined as the sum of current account deficit, amortization of medium and long-term total external debt, and short-term total external debt at the end of previous period.

Figure AII.2. Italy: Public Debt Sustainability Analysis—Realism of Baseline Assumptions



Source : IMF Staff.

1/ Plotted distribution includes all countries, percentile rank refers to all countries.

2/ Projections made in the spring WEO vintage of the preceding year.

3/ Not applicable for Italy, as it meets neither the positive output gap criterion nor the private credit growth criterion.

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 AII.3. Italy: Public Sector Debt Sustainability Analysis—Baseline Scenario

(In percent of GDP unless otherwise indicated)

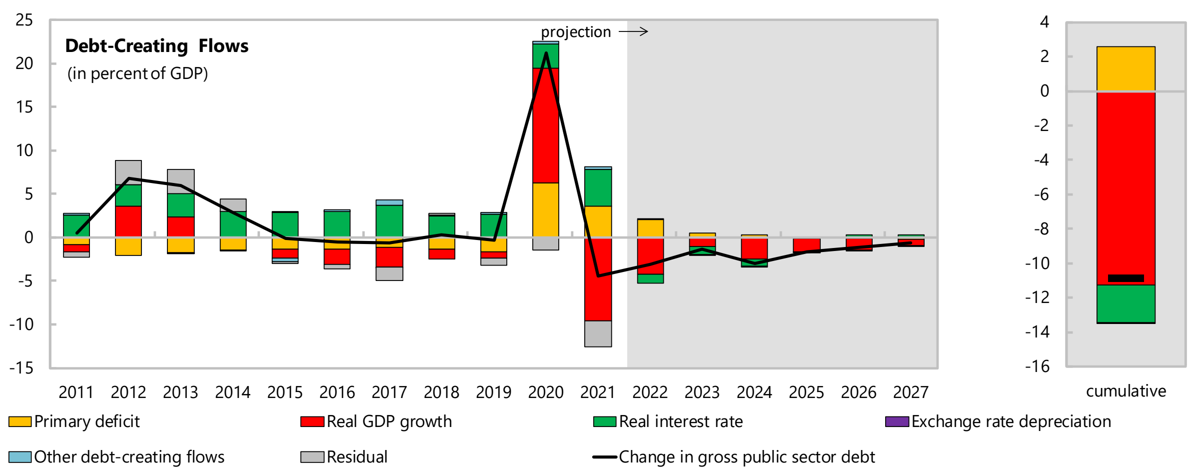
Debt, Economic and Market Indicators [1/]

	Actual			Projections					
	2011-2019 [2/]	2020	2021	2022	2023	2024	2025	2026	2027
Nominal gross public debt	131.9	155.3	150.9	147.7	146.3	143.4	141.7	140.6	139.9
Public gross financing needs	25.6	34.2	29.5	25.9	25.8	24.8	24.3	24.2	23.8
Net public debt	128.6	151.7	147.4	144.4	143.1	140.2	138.7	137.6	137.0
Real GDP growth (in percent)	0.1	-9.0	6.6	3.0	0.7	1.7	1.1	1.0	0.5
Inflation (GDP deflator, in percent)	1.1	1.4	0.5	3.1	3.0	2.9	2.3	2.0	2.0
Nominal GDP growth (in percent)	1.2	-7.8	7.2	6.1	3.7	4.7	3.4	3.0	2.6
Effective interest rate (in percent) [4/]	3.3	2.4	2.4	2.5	2.3	2.3	2.3	2.3	2.3

As of July 01, 2022		
Sovereign Spreads		
EMBIG (bp) 3/		183
5Y CDS (bp)		149
Ratings	Foreign	Local
Moody's	Baa2	Baa2
S&Ps	BBB	BBB
Fitch	BBB+	BBB+

Contribution to Changes in Public Debt

	Actual			Projections							
	2011-2019	2020	2021	2022	2023	2024	2025	2026	2027	cumulative	debt-stabilizing
Change in gross public sector debt	1.7	21.2	-4.5	-3.1	-1.4	-3.0	-1.6	-1.1	-0.6	-10.9	primary
Identified debt-creating flows	1.3	22.6	-1.5	-3.1	-1.4	-3.0	-1.6	-1.1	-0.6	-10.9	balance [9/]
Primary deficit	-1.4	6.3	3.6	2.1	0.6	0.3	-0.1	-0.1	-0.2	2.6	-0.4
Primary (noninterest) revenue and grants	46.8	47.2	48.3	48.6	48.3	48.0	47.8	47.5	47.1	287.3	
Primary (noninterest) expenditure	45.4	53.5	51.9	50.7	48.9	48.3	47.7	47.4	46.9	289.9	
Automatic debt dynamics [5/]	2.6	15.9	-5.5	-5.2	-1.9	-3.3	-1.5	-1.0	-0.4	-13.4	
Interest rate/growth differential [6/]	2.6	15.9	-5.5	-5.2	-1.9	-3.3	-1.5	-1.0	-0.4	-13.4	
Of which: real interest rate	2.8	2.8	4.2	-1.0	-0.9	-0.9	0.0	0.3	0.3	-2.2	
Of which: real GDP growth	-0.2	13.1	-9.6	-4.2	-1.0	-2.4	-1.5	-1.4	-0.7	-11.2	
Exchange rate depreciation [7/]	0.0	0.0	0.0	…	…	…	…	…	…	…	
Other identified debt-creating flows	0.1	0.4	0.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
0 (negative)	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Please specify (2) (e.g., ESM and Euroarea loans)	0.2	0.4	0.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes [8/]	0.4	-1.4	-3.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	



Source: IMF staff.

1/ Public sector is defined as general government.

2/ Based on available data.

3/ Long-term bond spread over German bonds.

4/ Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.

5/ Derived as [(r - π(1+g) - g + ae(1+r)]/(1+g+π+gπ)) times previous period debt ratio, with r = interest rate; π = 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 numerator in footnote 5 as r - π (1+g) and the real growth contribution as -g.

7/ The exchange rate contribution is derived from the numerator in footnote 5 as ae(1+r).

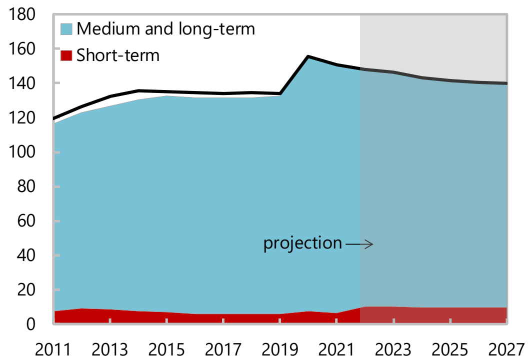
8/ Includes asset changes and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

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.

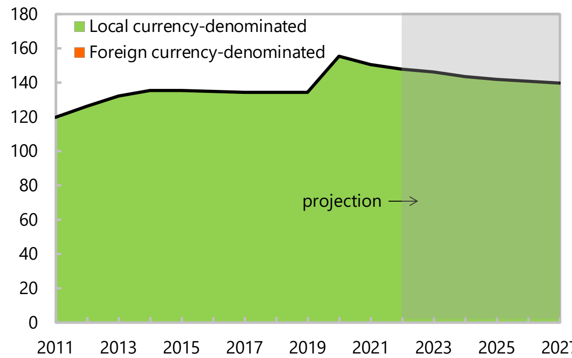
Figure AII.4. Italy: Public Debt Sustainability Analysis—Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

By Maturity
(in percent of GDP)



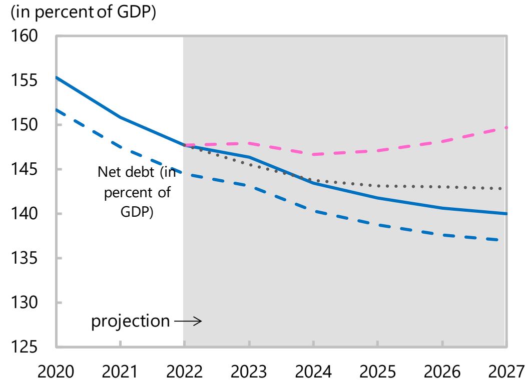
By Currency
(in percent of GDP)



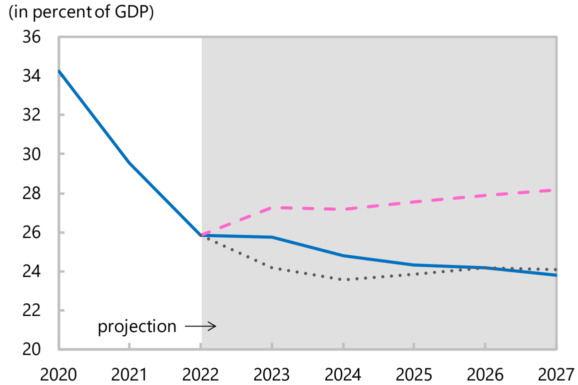
Alternative Scenarios

Baseline   Historical   Constant Primary Balance

Gross Nominal Public Debt
(in percent of GDP)



Public Gross Financing Needs
(in percent of GDP)



Underlying Assumptions
(in percent)

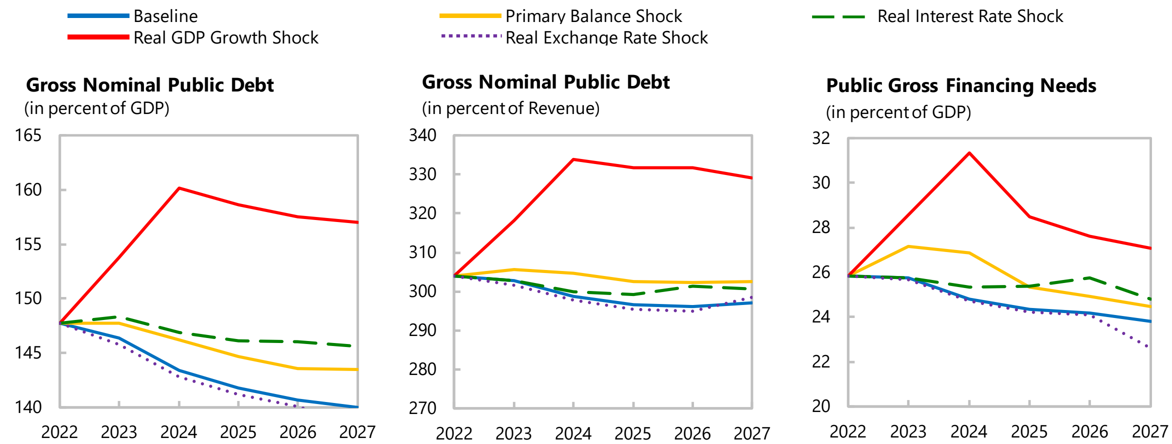
Baseline Scenario	2022	2023	2024	2025	2026	2027
Real GDP growth	3.0	0.7	1.7	1.1	1.0	0.5
Inflation	3.1	3.0	2.9	2.3	2.0	2.0
Primary Balance	-2.1	-0.6	-0.3	0.1	0.1	0.2
Effective interest rate	2.5	2.3	2.3	2.3	2.3	2.3
Constant Primary Balance Scenario						
Real GDP growth	3.0	0.7	1.7	1.1	1.0	0.5
Inflation	3.1	3.0	2.9	2.3	2.0	2.0
Primary Balance	-2.1	-2.1	-2.1	-2.1	-2.1	-2.1
Effective interest rate	2.5	2.3	2.3	2.3	2.2	2.3

Historical Scenario	2022	2023	2024	2025	2026	2027
Real GDP growth	3.0	0.1	0.1	0.1	0.1	0.1
Inflation	3.1	3.0	2.9	2.3	2.0	2.0
Primary Balance	-2.1	1.2	1.2	1.2	1.2	1.2
Effective interest rate	2.5	2.3	2.6	2.8	2.9	2.7

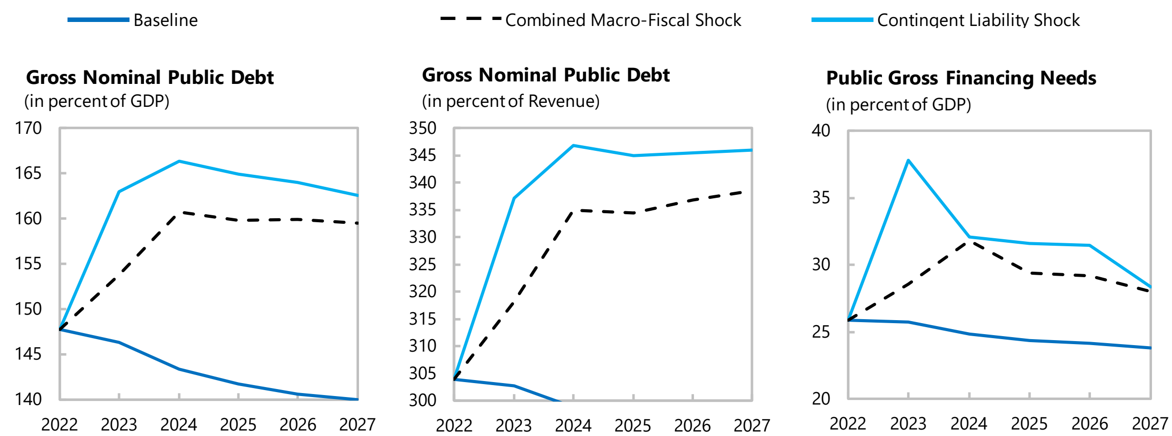
Source: IMF staff.

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

Macro-Fiscal Stress Tests



Additional Stress Tests



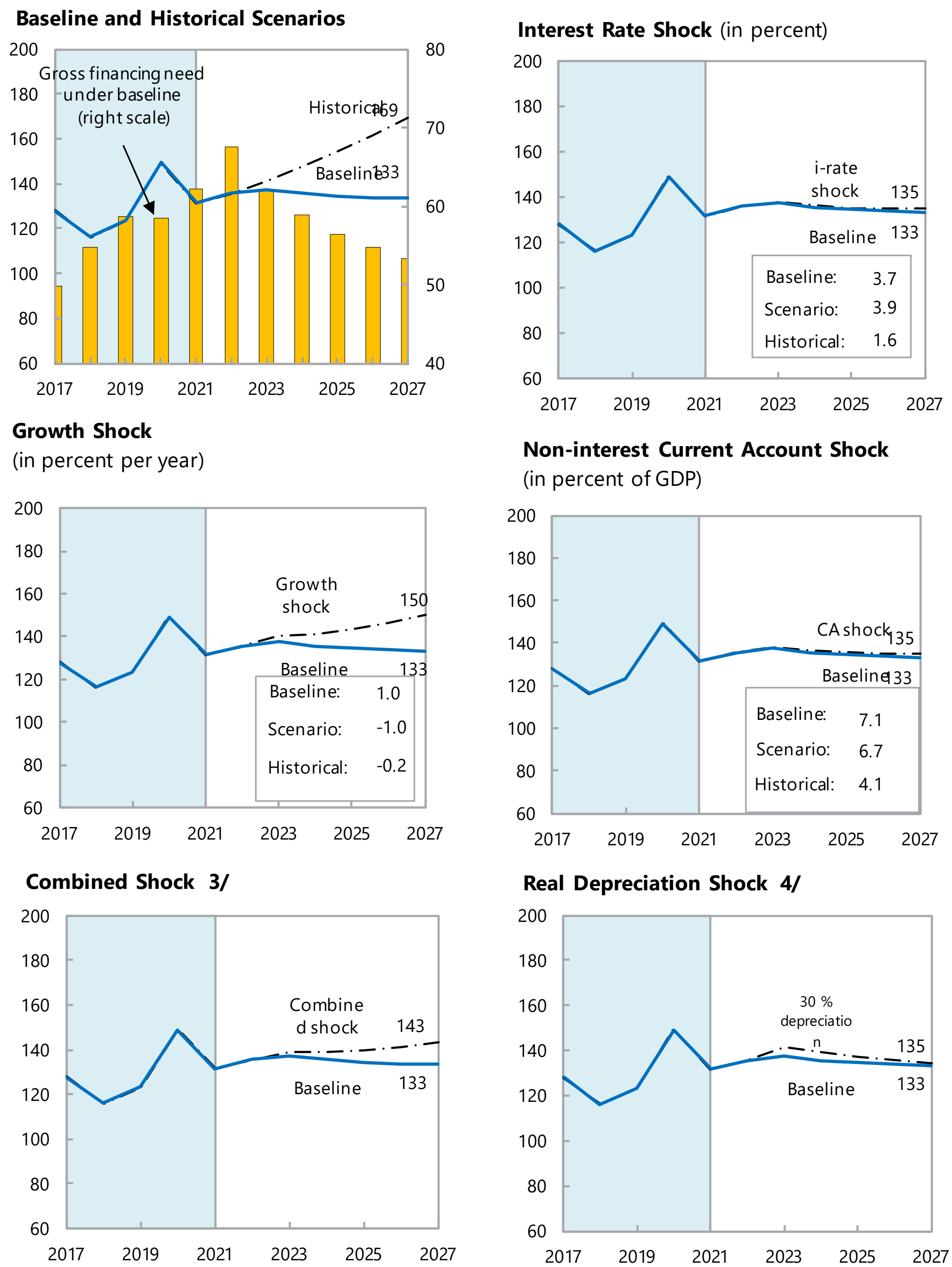
Underlying Assumptions
(in percent)

Primary Balance Shock	2022	2023	2024	2025	2026	2027
Real GDP growth	3.0	0.7	1.7	1.1	1.0	0.5
Inflation	3.1	3.0	2.9	2.3	2.0	2.0
Primary balance	-2.1	-2.0	-1.7	0.1	0.1	0.2
Effective interest rate	2.5	2.3	2.4	2.4	2.3	2.3
Real Interest Rate Shock						
Real GDP growth	3.0	0.6	1.5	0.9	0.8	0.5
Inflation	3.1	3.0	2.9	2.3	2.0	2.0
Primary balance	-2.1	-0.6	-0.3	0.1	0.1	0.2
Effective interest rate	2.5	2.9	3.4	3.6	3.8	4.1
Combined Shock						
Real GDP growth	3.0	-2.3	-1.3	1.1	1.0	0.5
Inflation	3.1	2.2	2.2	2.3	2.0	2.0
Primary balance	-2.1	-2.4	-4.1	0.1	0.1	0.2
Effective interest rate	2.5	2.3	2.7	2.9	3.1	2.9

Real GDP Growth Shock	2022	2023	2024	2025	2026	2027
Real GDP growth	3.0	-2.3	-1.3	1.1	1.0	0.5
Inflation	3.1	2.2	2.2	2.3	2.0	2.0
Primary balance	-2.1	-2.4	-4.1	0.1	0.1	0.2
Effective interest rate	2.5	2.3	2.4	2.5	2.4	2.3
Real Exchange Rate Shock						
Real GDP growth	3.0	0.7	1.7	1.1	1.0	0.5
Inflation	3.1	3.4	2.9	2.3	2.0	2.0
Primary balance	-2.1	-0.6	-0.3	0.1	0.1	0.2
Effective interest rate	2.5	2.3	2.3	2.3	2.3	1.9
Contingent Liability Shock						
Real GDP growth	3.0	-2.3	-1.3	1.1	1.0	-2.5
Inflation	3.1	2.2	2.2	2.3	2.0	1.3
Primary balance	-2.1	-11.5	-0.3	0.1	0.1	0.2
Effective interest rate	2.5	2.4	2.8	2.6	2.5	2.2

Source: IMF staff.

Figure AII.6. Italy: External Debt Sustainability: Bound Tests 1/ 2/
(External debt in percent of GDP)



Sources: International Monetary Fund, Country desk data, and staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.
3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.
4/ One-time real depreciation of 30 percent occurs in 2023.

Table AII.1. Italy: External Debt Sustainability Framework, 2017–27

(In percent of GDP unless otherwise indicated)

	Actual							Projections						
	2017	2018	2019	2020	2021	10-Year Historical Average	10-Year Standard Deviation	2022	2023	2024	2025	2026	2027	Debt-stabilizing non-interest current account 7/
Baseline: External debt 1/	128.0	116.1	123.3	149.1	131.4			**135.6**	**137.3**	**135.5**	**134.4**	**133.7**	**133.3**	**1.6**
Change in external debt	11.0	-11.9	7.1	25.9	-17.7			4.2	1.7	-1.8	-1.1	-0.7	-0.4	
Identified external debt-creating flows (4+8+9)	-6.4	-5.2	-5.4	7.9	-12.6			-4.7	-2.3	-4.4	-4.1	-4.2	-3.7	
Current account deficit, excluding interest payments	-4.3	-4.0	-4.8	-5.4	-3.7			-2.9	-5.9	-6.7	-7.2	-7.8	-8.1	
Deficit in balance of goods and services	-2.9	-2.4	-3.4	-3.7	-2.3			-0.3	-1.0	-1.8	-2.3	-2.6	-2.8	
Exports	30.8	31.4	31.6	29.5	32.7			35.8	36.9	37.5	38.1	38.6	38.7	
Imports	27.8	29.0	28.3	25.9	30.4			35.5	35.9	35.7	35.8	36.0	35.9	
Net non-debt creating capital inflows (negative)	-1.0	0.0	-0.8	1.4	0.0			-0.2	-0.2	-0.2	-0.2	-0.2	-0.1	
Automatic debt dynamics 2/	-1.1	-1.2	0.2	12.0	-8.8			-1.7	3.7	2.5	3.3	3.7	4.5	
Contribution from nominal interest rate	1.8	1.5	1.6	1.7	1.3			2.3	4.6	4.7	4.8	5.0	5.1	
Contribution from real GDP growth	-1.9	-1.1	-0.6	11.8	-8.9			-4.0	-0.9	-2.3	-1.4	-1.3	-0.6	
Contribution from price and exchange rate changes 3/	-1.0	-1.6	-0.8	-1.5	-1.2			...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 4/	17.4	-6.7	12.6	17.9	-5.1			8.9	4.1	2.6	3.0	3.6	3.3	
External debt-to-exports ratio (in percent)	416.3	370.1	389.7	504.9	401.4			378.7	372.6	361.8	352.8	346.6	344.7	
Gross External Financing Need (in billions of US dollars) 5/	976.8	1147.5	1179.8	1105.2	1304.9			1370.4	1297.7	1293.4	1292.3	1297.5	1306.8	
in percent of GDP	49.8	54.8	58.7	58.4	62.1			67.5	62.0	58.8	56.5	54.7	53.3	
Scenario with Key Variables at their Historical Averages 6/								**135.6**	**141.4**	**147.7**	**154.2**	**161.6**	**169.2**	**4.5**
Key Macroeconomic Assumptions Underlying Baseline														
Real GDP growth (in percent)	1.7	0.9	0.5	-9.0	6.6	-0.2	4.0	3.0	0.7	1.7	1.1	1.0	0.5	
GDP deflator in US dollars (change in percent)	2.8	5.7	-4.4	3.3	4.2	-0.4	6.6	-6.1	2.3	3.3	2.9	2.7	2.8	
Nominal external interest rate (in percent)	1.6	1.2	1.3	1.3	1.0	1.6	0.4	1.7	3.5	3.6	3.7	3.9	3.9	
Growth of exports (US dollar terms, in percent)	9.5	8.9	-3.1	-12.2	23.2	1.6	10.8	5.7	6.0	6.8	5.8	5.1	3.5	
Growth of imports (US dollar terms, in percent)	11.7	11.0	-6.1	-14.0	30.6	0.7	14.0	13.0	4.0	4.7	4.4	4.3	3.0	
Current account balance, excluding interest payments	4.3	4.0	4.8	5.4	3.7	4.1	0.8	2.9	5.9	6.7	7.2	7.8	8.1	
Net non-debt creating capital inflows	1.0	0.0	0.8	-1.4	0.0	0.4	0.7	0.2	0.2	0.2	0.2	0.2	0.1	

1/ The gross external debt ratio reported in the external DSA is different than the external debt data in Table 3. The discrepancy is caused by different exchange rates used to convert the numerator and denominator.

2/ Derived as [r - g - r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

3/ The contribution from price and exchange rate changes is defined as [-r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock. r increases with an appreciating domestic currency (e > 0) and rising inflation (based on GDP deflator).

4/ For projection, line includes the impact of price and exchange rate changes.

5/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

6/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

7/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

Annex III. External Sector Assessment

<table>
<tr><td colspan="8">Overall Assessment: The external position in 2021 was broadly in line with the level implied by medium-term fundamentals and desirable policies. The combined current and capital account surplus declined as private sector saving net of investment declined by more than the increase in government saving net of investment as pandemic-related income support was wound down. Generous tax credits and other fiscal programs under the National Recovery and Resilience Plan, mainly funded by the European Union, lifted private and public investment in 2021. Nonetheless, chronic weak productivity and uncertain medium-term growth prospects could dampen private investment once these programs expire. How the current account balance evolves over the medium term will depend on progress with the green transition, ability to adapt to fragmentation of global value chains, and how successfully structural reforms are implemented. Under the baseline scenario, the CA surplus is expected to moderate over the next few years due to the adverse commodity terms-of-trade shock and higher imports of capital goods to support the green transition and digitalization, after which the CA balance would gradually improve.

Potential Policy Responses: Raising productivity and improving the business climate through structural reforms would sustain the higher private investment while the fiscal primary balance returns to surplus and household saving moderates. In particular, upskilling the workforce and increasing the quality of infrastructure and the effectiveness of the judiciary and public administration would boost productivity, reduce high unemployment, and raise output and domestic absorption. Vulnerabilities associated with rollover of public debt would be reduced by improving budget efficiency and fully implementing the National Recovery and Resilience Plan.</td></tr>
<tr><td>Foreign Asset and Liability Position and Trajectory</td><td colspan="7">Background. Italy’s NIIP further increased to 7.4 percent of GDP at the end of 2021, continuing its gradual upward trend owing to sustained CA surpluses and net valuation gains on external positions. Gross foreign assets and liabilities increased during 2021 to 188 and 181 percent of GDP, respectively. This includes an increase in TARGET2 liabilities to a record high of 33 percent of GDP. About half of gross external liabilities is attributed to the general government and the Bank of Italy. A steady accumulation of direct and portfolio investments in foreign equities and a net long US dollar external position contributed to the net valuation gains on Italy’s NIIP over the past decade.

Assessment. Further strengthening public balance sheets and undertaking structural reforms would reduce vulnerabilities associated with the high public debt, reinvigorate economic growth, and reduce the potential for negative feedback loops between the debt stock and debt servicing costs.</td></tr>
<tr><td>2021 (% GDP)</td><td>NIIP: 7.4</td><td>Gross Assets: 188.1</td><td>Debt Assets: 45.4</td><td>Gross Liab.: 180.6</td><td colspan="3">Debt Liab.: 103.0</td></tr>
<tr><td>Current Account</td><td colspan="7">Background. Italy’s CA has continued to gradually increase, averaging 2.9 percent of GDP during 2016–20. This increase was underpinned by rising private sector gross national saving and lower public and private sector gross domestic investment. More than half of the increase in the CA balance is due to the trade surplus, with the rest reflecting strong dividend and interest income on the rising foreign asset holdings of the nonfinancial private sector as well as declining interest payments on external liabilities owing to the ECB’s accommodative monetary stance. Due to the pandemic, the CA balance reached a high of 3.7 percent of GDP in 2020 as private saving surged and private investment declined. In 2021, the CA moderated to 2.4 percent of GDP, mainly due to a 1.1 percent of GDP increase in the energy trade deficit on much higher energy import prices in the latter part of the year, despite a recovery in exports of services and a strong rebound in goods exports. This moderation was underpinned by a larger increase in investment than the increase in total saving, with declines in private saving more than offset by higher government saving. Italy’s overall trade and financial linkages with Russia and Ukraine are limited (3 percent of imports and 2 percent of exports). However, Italy is heavily reliant on energy imports from Russia (including 40 percent of Italy's natural gas consumption). The war in Ukraine has pushed up international commodity prices, widening Italy's energy trade deficit, and reduced export demand from regional trade partners, with the impact on the current account felt mostly beginning in 2022.

Assessment. The cyclically adjusted CA is estimated at 2.2 percent of GDP in 2021, 1.2 percentage points below the EBA-estimated CA norm of 3.4 percent of GDP. An Italy-specific COVID-19 adjustor of 0.3 percent of GDP is applied to account for a temporary decline in travel (0.4 percent) and transport (0.1 percent) net receipts, medical trade (0.1 percent), and the household shift in consumption (–0.2 percent) caused by the pandemic. Therefore, and taking into account uncertainty around the estimate, the IMF staff assesses the CA gap to be in the range of –1.6 to –0.2 percent of GDP.</td></tr>
<tr><td>2021 (% GDP)</td><td>CA: 2.4</td><td>Cycl. Adj. CA: 2.2</td><td>EBA Norm: 3.4</td><td>EBA Gap: –1.2</td><td>COVID-19 Adj.: 0.3</td><td>Other Adj.: 0</td><td>Staff Gap: –0.9</td></tr>
<tr><td>Real Exchange Rate</td><td colspan="7">Background. During 2016–20, the CPI-based REER appreciated by 2.2 percent while the ULC-based REER was unchanged. During 2021, the CPI-based REER was broadly stable, with a 0.3 percent depreciation relative to the 2020 average, mainly on account of a weakening euro. However, during this pandemic period, official statistics may not fully capture actual price and wage dynamics. As of May 2022 the REER was 4.1 percent below the 2021 average.

Assessment. The IMF staff CA gap implies a REER gap of 3.3 percent in 2021 (applying an estimated elasticity of 0.26). The level and index CPI-based REER models suggest an overvaluation in 2021 of 10.8 percent and 8.6 percent, respectively, with an average of 9.7 percent. Taking into account the staff CA gap, the IMF staff assesses a REER gap range of 0.7 to 6 percent, with a midpoint of 3.3 percent.</td></tr>
<tr><td>Capital and Financial Accounts: Flows and Policy Measures</td><td colspan="7">Background. The capital account balance remained unchanged at –0.1 percent of GDP in 2021. The financial account posted net outflows of 1.5 percent of GDP in 2021, reflecting residents’ net purchases of foreign assets. Large portfolio investment outflows were mostly offset by inflows of other investment, including a €74 billion increase in Italy’s TARGET2 liabilities.

Assessment. The low global interest rate environment has been conducive to the smooth functioning of the sovereign debt market. However, rising inflation and geopolitical tensions, large refinancing needs of the sovereign and the banking sector, and exposures to the current geopolitical situation and energy shocks suggest Italy remains vulnerable to market volatility.</td></tr>
<tr><td>FX Intervention and Reserves Level</td><td colspan="7">Background. The euro has the status of a global reserve currency. Italy's reserves increased by €21 billion in 2021 mostly on account of the IMF’s SDR allocation.

Assessment. Reserves held by the euro area are typically low relative to standard metrics, but the currency is free floating.</td></tr>
</table>

Annex IV. Select Reforms and Investments in the NRRP[1]

Digitalization of the Public Administration

- *Digital infrastructure*. Create a cloud-based hybrid infrastructure (Polo Strategico Nazionale); certification of secure and scalable public cloud alternatives; migrate datasets and applications to a cloud environment.
- *Data and interoperability*. Develop a national digital data platform (Piattaforma Digitale Nazionale Dati) to guarantee the interoperability of datasets across central and local administrations. Develop a "Single Digital Gateway" to help prioritize procedures and processes.
- *Cybersecurity*. Develop a state-of-the-art, integrated system, tightly interconnecting different entities across the country and internationally with partners and trusted technology providers.
- *Basic digital skills*. Launch the 'Digital civic service' initiative, a network of young volunteers to provide training to individuals at risk of digital exclusion.
- *ICT Procurement*. Set up a single database of economic operators authorized to provide goods and services to public administrations. Introduce a dedicated technological infrastructure to allow the certification of suppliers. Adopt a simplified approach to streamline ICT purchases for PNRR projects. Introduce a digital procurement service.
- *Cloud First and interoperability*. Introduce a set of incentives and obligations to facilitate the migration to cloud and removing procedural constraints to the broad adoption of digital services.

Justice

- *Reduce the number of incoming cases in civil justice courts*. Strengthen mediation; introduce alternative dispute resolution and arbitration; review the current system of legal fees.
- *Simplification*. In civil justice, strengthen 'filtering procedures' at the appeal level, extend the cases where a single judge is competent to adjudicate, secure the actual implementation of binding timeframes for procedures. In criminal justice, extend the application of simplified procedures, broaden the use of digital technology, define time limits for the duration of preliminary investigation, and review the notification system to make it more effective.
- *Enhancing of Insolvency Proceedings*. Introduce early warning mechanisms prior to insolvency; support the specialization of courts and pre-court institutions to manage all phases of insolvency proceedings more effectively including through training.
- *Digitalization*. Introduce mandatory electronic filing of all documents and full electronic workflow for civil proceedings. Introduce fully accessible and searchable database of civil law decisions.
- *Recruitment*. Establish (or strengthen) support teams for the magistrates through temporary hiring, with the aim of reducing the backlog and the disposition time in Italy. Provide training to support the digital transition in the justice system.

Public Administration

- *Public employment reform*. Update job profiles; reform hiring procedures to be more targeted and effective; homogenize appointment procedures across the public administration; strengthen the link between life-long learning and rewarding mechanisms or specific career paths; strengthen the commitment to gender balance; and review options for horizontal and vertical mobility of staff.
- *Technical assistance and capacity building for the implementation of the Italian NRRP*. Recruit a pool of experts (on a temporary basis), notably at local level. Provide training.

[1] Compiled by Fund staff, based on the Revised Annex to the Council Implementing Decision on the Approval of the Assessment of the Recovery and Resilience Plan for Italy.

Public Procurement and Payments by Public Administrations • *Reform of public procurement*. Simplify and digitalize procedures of central purchasing bodies; register contracts in the anti-corruption database of the national anti-corruption authority; set up dedicated offices for public procurement procedures; set a target to reduce the timing between the publication and contract award and between the award of the contract and the completion of the infrastructure; incentivize alternative dispute resolution mechanisms in the execution phase of the contracts. • *Reduction of late payments*. Enhance procedures to ensure that by 2023 public administrations pay within 30 days, and regional health authorities pay within 60 days.
Fiscal-Structural Reforms • *Tax administration*. Adopt dedicated IT infrastructure for the release of pre-populated VAT tax returns; strengthen communication with taxpayers; adopt legislation to ensure effective administrative sanctions in case of refusal of electronic payments; strengthen data analysis to improve risk analysis for tax audits; improve operational capacity with new hiring. • *Spending review framework*. Undertake yearly spending reviews over 2023–25, to achieve fiscal savings to support sustainable public finances and/or finance growth-enhancing fiscal reforms. • *Subnational fiscal framework*. Improve transparency of fiscal relations across the different levels of government; assign resources to subnational governments based on objective criteria; encourage spending efficiency at the subnational level. • *Public accounting rules*. Implement a single accrual accounting system for the public sector. Complete the conceptual framework as reference for the accrual accounting system according to the qualitative features defined by Eurostat, the set of accrual accounting standards and the multidimensional chart of accounts.
Innovation, Competitiveness, Business Environment and Competition • *Tax Credits in the context of the Transition 4.0*. For expenses on technologically advanced tangible and intangible capital goods, research, development and innovation activities, and training, carried out to acquire or consolidate the knowledge of relevant technologies. • *Strengthen Competition Legislation*. Increase competitive procedures to award local public service contracts (notably in waste and public transport); avoid prolongation of concessions in ports, highways, electric charging stations and hydropower to incumbent operators; strengthen regulation of public service contracts; increase incentives for regions to tender their public services contracts for regional rail services. • *Reform of the Industrial Property Code*. Review the regulatory framework to strengthen the protection of industrial property rights and simplify procedures; strengthen the support to companies and research institutions; enhance skills and the development of competences; facilitate knowledge transfer; strengthen the promotion of innovative services. • *Digital approach for the relaunch of tourism and culture*. Provide support for capacity building and financing for a new digital infrastructure, artificial intelligence models for data analytics, and basic digital services for culture operations and in the Tourism industry.

Green Revolution and Ecological Transition

- *Adoption of a National Strategy for Circular Economy and Waste Recycling Enhancement*. Introduce a new digital waste traceability system; provide tax incentives to support recycling activities; incentivize the use of secondary raw materials; review environmental taxation.
- *Sustainable management of drinking water*. Reform the legal framework to reduce the number of operators and encourage economies of scale; provide incentives to reduce water leakages and the excessive consumption of water by the agricultural sector; establish adequate pricing policies for a more sustainable consumption of water.
- *More efficient private and public buildings*. Strengthen the Ecobonus tax deduction for housing renovations entailing an improvement of at least two energy classes (corresponding on average to primary energy saving of 40 percent). Invest in the construction, requalification, and strengthening of public buildings to reduce energy consumption, increase seismic safety, and development of green areas.
- *Investments in Green rural communities*. Investment in the integrated and certified management of the agro-forestry heritage; water resources; the production of energy from local renewable sources; support the development of sustainable tourism; energy efficiency and intelligent integration of plants and networks; the sustainable development of production activities (zero waste production).

Energy Transition

- *Regulatory framework for renewable energy*. Define criteria to identify suitable/non suitable areas for the installation of renewable energy plants; adopt a support mechanism for additional non-mature technologies or those with high operating costs.
- *Adopt legislation to promote renewable gas production and consumption*. To increase the scope of bio-methane projects eligible for support and extend the period for the availability of grants.
- *Hydrogen in industry and transport*. Update the regulatory framework for hydrogen deployment. Adopt tax incentives for production and/or utilization of hydrogen. Support the creation of at least 40 hydrogen-based refueling stations located at motorway service areas, logistic warehouses and ports; and at least ten refueling stations for railway based on hydrogen along six railway lines. Support R&D activities in Green and Clean Hydrogen production.
- *Promotion of innovative energy systems*. Investment in at least 100 MW of floating wind and floating photovoltaic power plants, together with energy storage systems, and 100 MW of power plants integrated by the combination of several technologies, together with the necessary infrastructure for grid connection and possible electrification of local areas and infrastructures (such as port docks).
- *Development of bio-methane*. Support the construction of new plants. Reconvert and improve the efficiency of existing biogas plants for production of biomethane in transport, industry and heating.
- *Strengthen the resilience of the power grid*. Against extreme weather events, particularly on the distribution grid, and to reduce the probability of prolonged interruptions of electricity supplies.
- *Charging infrastructures*. Support the development of 7,500 fast public charging infrastructure points on freeways and 13,755 in urban centers; 100 experimental charging stations connected to storage. Reform electric charging price structure and concessions.
- *Development of renewables and batteries*. Support the development of technological skills to put into operation manufacturing facilities.
- *Start-ups and venture capital for the ecological transition*. Establish a €250 million dedicated "Green Transition Fund" with an investment strategy focused on renewables, circular economy, mobility, energy efficiency, waste management and energy storage. Over a five-year period (and a subsequent five-year portfolio management), the Fund would invest in venture capital funds, start-ups and incubation/acceleration programs, alongside top venture capital managers and system actors.

Territorial Planning

- *Interventions against hydrogeological instability. I*ncrease the administrative capacity of the entities responsible for the implementation of these projects; reinforce the coordination between the various levels of government involved.

- *Flood and hydrogeological risk reduction*. Secure landslides; reduce the risk of flooding in metropolitan areas with others focused on requalification, monitoring and prevention of emerging risks. The objective is reducing by 1.5 million the number of people that are presently at risk.

- *Protection and enhancement of urban and peri-urban forests; recovery of the biodiversity, and restoration and protection of seabed and marine habitats.*

Infrastructure for Sustainable Mobility

- *Expand high-speed railway infrastructure for passengers and freight. C*onstruct 274 km of high-speed railway infrastructure in the lines Napoli-Bari, Salerno-Reggio and Palermo-Catania; 180 km in the lines Brescia-Verona-Vicenza-Padova, Liguria-Alpi and Verona-Brennero; 87 km in the lines Roma-Pescara, Orte-Falconara e Taranto-Metaponto-Potenza-Battipaglia; equip 3,400 km of rail lines with the European Rail Transport Management System; upgrade 1,280 km of railway line sections built on 12 metropolitan cities nodes and the key national links; upgrade 680 km of regional lines; upgrade 38 railway stations.

- *Green ports*. Ensure competitive award of concessions; support digitalization of passenger and freight services; adopt a Single Customs Window; invest in the purchase of zero-emission vehicles or the transformation of fossil fuel vehicles into zero-emission ones.

- *Development of Rapid Mass Transport systems* (metro, streetcar, BRT). Build 11 km of metro lanes, 85 km of tramway lanes, 120 km for trolleybus lanes and 15 km of funicular lanes. Renew the regional public transport bus fleet with at least 3,000 Zero Emission vehicles. Renew the regional public transport railway fleet with 150 Zero Emission trains to replace old diesel and electric trains.

Education and Research

- *Enhance School infrastructure. C*onstruct or renovate nurseries, preschools, and early childhood education centers to create 228,000 new nursery slots for children aged 0–6; upgrade sports facilities and school gyms to ensure an increase in the educational offer and increase school hours.

- *Improve teachers' recruitment processes*. Introduce higher requirements for access to the teaching professions, a more effective mobility framework for teachers, limiting excessive mobility, and a clear link between career progression and performance evaluation and continuous professional development.

- *Integrated digital teaching and training on the digital transformation for school staff*. Create a system of continuous training for teachers and school staff for the digital transition; and adopt a national reference framework for integrated digital teaching.

- *Reform of student housing regulation and investment in student housing*. To triple available places for out-of-school students from 40 thousand to over 100 thousand by 2026.

- *Funding for research projects and partnerships with universities and research centers*. To support research activities of up to 2,100 young researchers, along the lines of the European Research Council; and 5,350 research projects of significant national interest.

Inclusion and Cohesion

- *A national program to ensure worker employability*. Enable the provision of services to the unemployed, thus strengthening their activation paths.
- *Strengthening Public Employment Services*. Develop regional labor market Observatories; develop interoperability between regional and national information systems; provide training to update the skills of job counsellors.
- *National Plan against undeclared work*. Strengthen the inspection capacity of the National Labor Inspectorate; improve data systems; support the adoption of deterrence measures and incentives for regular work; carry out communication campaigns, information and awareness-raising activities.
- *Creation of women's enterprises*. Improve the design of current measures to support female entrepreneurship to increase their effectiveness; support the implementation of innovative business projects already established and operating; provide mentoring, technical-managerial support, and measures for work-life balance; create a favorable cultural climate for women's entrepreneurship.
- *Support for people who are vulnerable, non-self-sufficient, or live with disabilities*. Promote a framework Law for Disability to strengthen social services (including social housing); provide simplified access to social and health services; promote independent living projects.
- *Innovative Plan for Housing Quality*. Invest in new public housing accommodations and redevelop degraded areas, mainly focusing on green innovation and sustainability.
- *Sport and Social Inclusion*. Invest in the construction and regeneration of sports facilities, located in disadvantaged areas of the country including metropolitan suburbs; provide sports equipment for the disadvantaged areas.

Healthcare

- *Revise and update the current legal framework of the Scientific Institutes for Hospitalization and Care*. Enhancing its strategic management and competence areas; comprehensively define the rules on the status of the Scientific Director and of research staff.
- *Hospitals' technological equipment*. Invest in the modernization of large healthcare equipment; informatization of processes; increase the number of beds in intensive and semi-intensive care units.
- *Development of technical, digital, and managerial skills*. Provide scholarships for specialized courses in general medicine; activate a training path for personnel with top roles within NHS bodies in managerial and digital skills.
- *Improve territorial health assistance*. Establish and operationalize at least 1,350 Community Health Houses, through the activation, development and aggregation of primary care services and implementing (energy efficient) assistance delivery centers for an integrated response to care needs.

Annex V. Implementation of Key 2020 FSAP Recommendations

Recommendations	Authorities' Self-Assessment of Implementation[1]	Agency	Time[2]
Bank Supervision and Regulation and NPL Resolution			
Enhance banks' capital levels, as appropriate, to ensure all banks maintain adequate capital ratios under stress scenarios.	Following recent developments at the regulatory and supervisory levels, Banca d'Italia (BdI) introduced a new approach for the determination of the Pillar 2 Guidance (P2G) for LSI banks that represents the main tool for ensuring adequate capital ratios based on a stressed scenario analysis. Such approach, which allocates banks into different buckets of P2G, envisages a strong correlation between the results of the stress test (i.e., supervisory stress test complemented by internal stress test stemming from ICAAP) and the P2G capital demand. It is compliant with the new regulatory package CRR/CRD as well as the EBA Guidelines on SREP and implements the methodology defined at SSM level. The combined effect produced by this new approach and the severity/features of the stress test methodology determined a significant increase of the average P2G for LSI banks that have received a new capital decision in 2021. The same approach will be applied in the SREP of 2022. Moreover, in line with the decision made by other Competent Authorities and in line with the policy stance adopted at the international level, the authorities' requested a prudent approach for dividend distributions from 2019 to 2021, as a response to the challenges posed by the COVID pandemic. This approach determined a strengthening of banks' capital ratios.	Bank of Italy (BdI), SSM	ST
Consider more timely escalation of corrective measures for weak banks to effect improvement (e.g., in capital levels, operational efficiency, governance) or achieve consolidation or orderly winddowns when needed.	In recent years, the actions by BdI on weak banks promoted turnaround processes achieved through capital strengthening initiatives and combinations with other banking/financial partners. In this context, the BdI increasingly adopted early intervention measures. After the outbreak of the pandemic, in-depth horizontal analyses were performed in order to assess banks' resilience against possible effects of the negative economic situation. Specially, the BdI launched a project consisting of a horizontal analysis aimed at individuating the potential weaknesses of LSIs on a threefold level, focusing on: (i) business model sustainability; (ii) credit risk; (iii) turnaround costs. With reference to the first point, the initiative leveraged on the outcomes of a specific business model analysis carried out in 2020 (please also refer to the answer relating to next recommendation "Perform more periodic deep dives and thematic and targeted inspections on key LSI weaknesses such as bank governance, credit risk, and business models"). This activity was carried out using specific horizontal analysis tools, which made possible to identify the level of "business model risk" for each bank.	BdI	I

Recommendations	Authorities' Self-Assessment of Implementation[1]	Agency	Time[2]
Bank Supervision and Regulation and NPL Resolution (Continued)			
	The second layer of the analysis (credit risk), performed by integrating off site and on site criteria, aimed to estimate the risk of misclassification and under-provisioning. In particular, the analysis was based on the cross comparison between the NPL classification of the exposures referring to each LSI with those of the system based on data from the central credit register and, for a sample of LSIs, on the analysis of the main positions benefiting from a moratorium. This approach led to the determination of an "adjusted NPL" stock, to which we applied the benchmark coverage ratios used in the BdI stress test. Finally, the estimated potential under-provisioning was translated into capital impacts. The third part of the analysis concerned the estimation of the restructuring costs that banks would have to incur (in terms of the reduction in extra staff) in order to achieve efficiency levels equal to those of the most virtuous banks. The findings of each strand of analysis were subsequently aggregated, by virtue of a holistic approach, to identify those banks that could suffer most from the effect of the higher risks in 2022 as a way to better target the supervisory intervention strategies. In this context, the riskiest banks were clustered according to the severity of the potential impacts. A limited number of small banks were identified as characterized by serious weaknesses. For these banks, specific turnaround projects with the involvement of third party investors are currently under assessment. Were these projects to fail, a further escalation of the supervisory action may become necessary, including early intervention measures. In the case of a crisis, initiatives consistent with the crisis management policy adopted (see below "Reinforcing crisis management and safety nets") will be taken. Where the conditions are met, support by the Italian DGS or of the public scheme for the liquidation of small banks could help in minimizing negative effects on depositors and on the local economy. For a few banks included in a second cluster that still have margins to autonomously carry out turnaround processes, supervisory interventions will focus on initiatives aimed at increasing business model sustainability and reducing legacy assets. If deemed necessary, reaching specific targets related to operating efficiency (i.e., cost-income ratio target) or credit quality (i.e., NPL reduction target) could be asked within specific action plans. Up to now, the management of problem in small weak Italian banks has been effective, following the objective of minimizing negative effects on depositors and on the local economy. Nonetheless, it is important to underline, as already represented to the IMF in previous discussions, the shortcomings of the EU crisis management framework and the constraints that it imposes on national authorities, particularly in countries with a large number of LSIs (see "Reinforcing crisis management and safety nets" below). The BdI has promoted a debate in the EU on the lack of a suitable framework for dealing with the crises of small and medium sized banks that is now		

Recommendations	Authorities' Self-Assessment of Implementation[1]	Agency	Time[2]
Bank Supervision and Regulation and NPL Resolution (Continued)			
	at the center of the review of the Crisis Management and Deposit Insurance (CMDI) framework. More details on this issue are provided in: (https://www.bancaditalia.it/pubblicazioni/note-stabilita/2019-0015/Note-stabilita-finanziaria-n15.pdf) In addition, starting from 2018 the BdI has implemented an Early Intervention framework supported by an IT tool aimed at automatically detecting potential financial deteriorations of LSIs under its jurisdiction. The tool is back-tested periodically and the relevant thresholds for the alarms annually calibrated; in the aftermath of the pandemic, the thresholds have been adjusted in order to further reduce the risk tolerance of the framework. The framework has been recently refined in order to provide a more holistic picture of the potential weaknesses of the LSI under scrutiny (inter alia, credit risk and business model sustainability). In order to improve banks' governance arrangements and to enhance the timely implementation of corrective measures (including early intervention measures), in February 2022 the BdI achieved compliance with the new EBA guidelines on recovery indicators (EBA GL 2021/11) with the issuance of new provisions on recovery plans. These provisions offer additional guidance to institutions on the general principles to be followed in setting the thresholds of recovery plan indicators in order to: i) shorten the time for the bank's autonomous decision to activate their recovery plan; ii) ensure the timely notification of recovery plan indicator breaches to the competent authority; iii) engage in a more frequent monitoring of indicators in a situation of crisis for the institution and the competent authority.		
Perform more periodic deep dives and thematic and targeted inspections on key LSI weaknesses such as bank governance, credit risk, and business models.	In the last two years, the BdI performed deep dives and thematic analyses on both off-site and on-site level. With regard to off-site analyses, an "inspection-oriented" approach was followed in several cases. In particular, the BdI has been increasingly intrusive on governance issues. In this regard, a thematic review on the governance systems of LSI's was recently concluded, focusing on the composition (in terms of size, expertise and formal independence) and functioning) of the Management Board in its supervisory functions (MBSF) (e.g., committee structure, reporting, role of the MBSF chairman, level of discussion within the Board). The assessment was performed through an innovative methodology that leveraged both off-site and on-site tools and approaches, guided by the analysis of information and documents requested from a sample of LSIs (e.g., selected minutes of board meetings and accompanying documentation), as well as direct interviews with board members (chair, executive and nonexecutive members). Upon completion of the interviews, a benchmarking analysis has been carried out to identify good and worst practices and make recommendations to the LSIs. The task force shared the results of the analysis with the structures in charge of off-site	BdI	ST

Recommendations	Authorities' Self-Assessment of Implementation[1]	Agency	Time[2]
Bank Supervision and Regulation and NPL Resolution (Continued)			
	supervision, which could take appropriate action against individual LSIs where necessary. With reference to credit risk, particular attention was reserved to the ways banks have supported households and firms by providing government measures introduced in response of the outbreak of the pandemic (i.e. credit moratoria). In this context, a sample of LSIs was subject to a specific in-depth assessment regarding the main exposures interested by moratoria, in order to investigate the risk of potential cliff effects related to the phase out of the public measures. The analysis was embedded in the scope of a wider horizontal exercise aimed at assessing the sustainability of the LSIs' business model in relation to the potential impacts of the pandemic. In this regard, in 2020 the Banca d'Italia requested a sample of LSIs—mainly "traditional banks"—to carry out a comprehensive business model self-assessment in a time horizon of two years, representing possible vulnerabilities and planned remedial actions. In 2021, the BdI reviewed the feedbacks and followed-up by requesting the banks to provide further information and by launching a supervisory dialogue on the matter. The results of the analysis helped to categorize banks into different business model risk profiles which, in conjunction with further drill down on the banks' loan portfolio quality and the investments needed to raise profitability, supported a better focus of the intervention strategies on the weakest banks (see above). With reference to the on-site activities, the BdI has continued to carry out on-site inspections on LSI, driven by risk exposure, size and complexity identified via SREP. In 2020 and part of 2021, on-site inspections were significantly impacted by the pandemic restrictions, although a hybrid approach (mixing on-site presence at the banks' premises and remote analyses) was adopted. Against this background, the missions performed were focused mainly on credit risk, internal control and risk management, as well as business model and profitability. For smaller banks, full-scope inspections continue to be the most suitable approach to investigate local banks. On larger LSIs, targeted missions were carried out more frequently—with an increase in the number of targeted and thematic missions. Those investigations have been recognized as more suitable to investigate banks with higher complexity and diversified business and organization. In this regard, targeted missions were performed both in 2019 and 2020 with a focus on business model and profitability, internal governance and risk management. Moreover, in 2020 a thematic review was carried out for the first time on two IT outsourcer providers, with the aim of assessing governance and control of IT services support to the client banks. In 2021, an on-site thematic campaign was launched in order to assess the adequacy of the procedures, governance, risk management and AML control of the Government support pandemic finance.		

Recommendations	Authorities' Self-Assessment of Implementation[1]	Agency	Time[2]
Bank Supervision and Regulation and NPL Resolution (Continued)			
Continue scrutinizing banks' credit risk and loan classification and provisioning practices, particularly of UTP portfolios, and challenging progress and ambition of banks' NPL reduction plans.	The BdI has continued its action of scrutiny of loan classification and provisioning practices in the regular context of the supervisory review and evaluation cycle and through the on-site activities. The NPL reduction plans (submitted annually by a subset of directly supervised less significant banks) are subject to both horizontal and individual analyses aimed at assessing the results concretely achieved in the NPL management related activities, the expected evolution of the NPL portfolio and the actions (contents and ambition) identified by the banks within the NPL strategies. A horizontal analysis has been also performed with reference to the management of the unlikely to pay exposures. It allowed us to figure out a set of best practices which were also disclosed on the BdI Website (https://www.bancaditalia.it/media/notizia/note-di-stabilit-finanziaria-e-vigilanza-n-28-indagine-sulla-gestione-delle-inadempienze-probabili/?dotcache=refresh). Given the current and expected development of the credit securitization market, the BdI also intensified its supervisory action towards supervised entities active in servicing activities in credit securitization transactions, with a cycle of supervisory meetings and the planning of on-site inspections. In this context, last November the BdI sent a communication to the banking and financial servicers that aimed to highlight the sector's risks and formulate recommendations on the appropriate controls to be adopted in the servicing business. In addition, steps were taken to collect more information. At the same time, analyses were conducted to investigate the operations of funds investing in loans, given the growing interest of asset managers in these asset categories. In this context, interviews were carried out with some of the most active managers in this market segment, also through a specific questionnaire, and a cycle of targeted inspections was launched. As a result of these initiatives, it will be possible to improve the supervision methodologies on the servicers, on the specialized asset management companies and on the funds managed and give policy indications to the industry.	BdI, SSM	C
Consider extending the SSM approach that sets bank-specific expectations for the gradual path to full provisioning on existing NPL stocks to LSIs with high NPLs with an adequate phase-in period; and update the LSIs' NPL management guidance.	Regarding the NPL management guidance, the full compliance with the EBA Guidelines (GL) on NPE management (EBA/GL/2018/06) has been recently attained, by replacing the previous national GL issued in 2018. Thanks to the high similarity between the two GLs in terms of additional obligations for high NPLs LSIs, achieving full compliance with the EBA GL has only slightly increased the number of banks subject to a stricter monitoring on the NPE management strategy. (https://www.bancaditalia.it/compiti/vigilanza/normativa/orientamenti-vigilanza/elenco-esa/note/Nota-n-26-del-5-aprile-2022.pdf). Considering the whole population of LSIs and regardless of the level of the NPL ratio, the assessment of coverage adequacy and the	BdI	I

Recommendations	Authorities' Self-Assessment of Implementation[1]	Agency	Time[2]
Bank Supervision and Regulation and NPL Resolution (Continued)			
	increase of provision levels, both for performing and non-performing exposures, have always represented a priority for the national banking supervisor. In particular, the current SREP methodology defines a specific supervisory proxy to calculate a P2R and a P2G add-on to cover the risk of under-provisioning, respectively in normal and stressed conditions (taking into account the severity and the vintage of the non-performing status, the IFRS staging for the performing portfolio and the status of secured/unsecured). In this context, the updated methodology for the calculation of P2G and P2R capital requirements (for additional details on the new methodology and related impacts see answer provided for recommendation 1) and the subsequent supervisory action, allowed us to reach significant results, in terms of both coverage levels and the workout of NPL legacies (see also answer provided for recommendation number 4), even though the ECB calendar approach has not been extended to the existing NPL stock in the LSIs' portfolio.		
Amend relevant laws to confer BdI and IVASS authority on removal of authorization and winding-up of banks and insurers, respectively.	The Ministry's involvement in the decision-making process for the initiation of resolution or liquidation does not affect the BdI's operational independence and timely intervention, since: • the initiation by the Ministry may occur only based on a BdI proposal; • does not affect the BdI's operational independence: while the Minister might either refuse or accept the BdI's proposal, as a matter of fact, it may only accept it, as a refusal would inevitably further exacerbate the bank's conditions, leading eventually to the commencement of resolution/liquidation; • the Minister's involvement provides the BdI a shield from social/political pressures and establishes a form of responsibility-sharing that is very effective in ensuring that a resolution/liquidation decision is effective and timely taken; • is necessary in light of the potential impacts of these decisions on creditors' property rights and on the financial, economic and social context potentially affected by these decisions. As for the insurance sector, the matter falls within the competence of the Italian Parliament. As far as we know, there are no legislative initiatives in progress, aimed at modifying the current legislative framework. According to the current legislative framework (Art. 240 of the Italian Insurance Code—Withdrawal of the authorization issued to an insurance undertaking) the insurance undertaking authorization shall be withdrawn by decree of the Minister of Economic Development, upon IVASS' proposal. If the authorization is withdrawn for all the insurance classes pursued, the undertaking immediately goes into compulsory winding up.	MEF, MISE	ST

Recommendations	Authorities' Self-Assessment of Implementation[1]	Agency	Time[2]
Bank Supervision and Regulation and NPL Resolution (Concluded)			
Address gaps in governance regulations of banks and insurance companies by issuing the draft MEF and MISE decrees.	With regards to banks, the decree setting the suitability requirements for banks' board members and key function holders entered into force on January 30, 2020 (i.e., ministerial decree no. 169/2020) and is in line with the relevant framework provided by the CRD and the Joint ESMA and EBA Guidelines on the assessment of the suitability of members of the management body and key function holders. The suitability assessment procedure is provided in the Consolidated Law on Banking as complemented by an ad hoc Regulation of the Banca d' Italia adopted on May 4, 2021. With regard to the insurance sector, Ivass has provided its technical contribution to MISE for defining the regulation concerning the fit and proper requirements applicable to corporate officers and persons who carry out key functions, implementing art. 76 of the Italian Insurance Code. Ivass has also proposed to MISE to set up with a coordinated table with MEF in order to draft the regulation applicable to qualifying shareholders in insurance companies, implementing art. 77 of the Italian Insurance Code. Such proposal is aimed at providing a coordinated regulation for the financial sector, considering also the ESA's Joint Guidelines issued in the European context and the need to ensure a level playing field.	MEF, MISE	I
Macroprudential Policies and Framework			
Establish a national macroprudential policy authority with a leading role for BdI.	The Italian government is planning to promote a legislative initiative establishing the national macroprudential policy authority in the form of a Committee with a leading role for BdI. The legislative proposal is included in the "DDL Delegazione Europea" (DDL 2481) and it is currently under evaluation of the relevant Parliament Commissions.	MEF, IVASS, BdI, CONSOB	ST
Incorporate the Systemic Risk Buffer (SyRB) and borrower-based tools into the macroprudential toolkit.	In February 2022 the Systemic Risk Buffer and borrower-based measures have been incorporated into the BdI's macroprudential toolkit via a revision of the Circular n. 285. (https://www.bancaditalia.it/compiti/vigilanza/normativa/archivio-norme/circolari/c285/aggiornamenti/Atto-emanazione-38agg.pdf)	MEF, BdI	ST
Consider implementing prudential policies to moderate the sovereign-bank nexus with an appropriate phase-in period to avoid possible market disruptions.	At the moment, no actions are planned beyond regular/continued monitoring. In any case, our view is that in the euro area/EU any such action at the national level is not advisable. As it is known, political discussions at the EU level on completing the banking union continue.	BdI	MT

Recommendations	Authorities' Self-Assessment of Implementation[1]	Agency	Time[2]
Insolvency Framework			
Enhance the enforcement and insolvency framework and ensure that courts have sufficient resources and specialization to timely handle insolvency cases.	In August 2021, decree law 118/2021 introduced a novel framework to enhance out-of-court workouts (negotiated workout for resolving a firm's crisis). In July 2022, the novel bankruptcy code (legislative decree 14/2019) will enter into force, as amended in order to implement the EU preventative restructuring directive. Since January 2022, art. 35-ter of the law 233/2021 provides that judges dealing with bankruptcy proceedings shall undertake professional courses in order to enhance technical specialization, particularly in smaller courts. The new code strengthens bankruptcy professionals appointment and training requirements.	MoJ, NJC	ST
Reinforcing Crisis Management and Safety Nets			
Establish additional loss absorbing capacity to enable greater loss allocation to unsecured and uninsured creditors in resolution and liquidation, notably for LSIs for which a resolution strategy is foreseen; and strictly limit the use of public funds to exceptional events that could undermine system-wide financial stability.	The LSIs resolution planning activity is fully in force, with a periodical update of the plans by the Resolution Authority (RA). In this context, MREL binding target are set according to BRRD2/SRMR2, envisaging an adequate buffer to recapitalize the entity and sustain sufficient market confidence in case of resolution as preferred resolution strategy (PRS). Some further in depth analyses are currently ongoing in order to better support the public interest assessment for the determination of the preferred resolution strategy, also in case of systemic wide events. In terms of operational capabilities, a comprehensive Manual for crisis management and resolution has been finalised in November 2020, covering all the different aspects of the resolution activity, and is periodically updated in order to take into account the evolution of the regulatory framework and of the related policies. Moreover, in 2021 the Banca d' Italia (BdI) took part in an EU level dry-run, aimed at enhancing crisis preparedness and testing the functioning of the procedures in a Resolution College. As for the recommendation related to public funds, the use of public funds limited to exceptional events that could undermine financial stability is a policy line agreed and followed by the Italian authorities. Indeed, the European Commission (DG-COMP) strictly monitors this issue, allowing the use of national public funds for managing bank crises only in the specific circumstances envisaged by EU regulations. BdI's view is that those events should not be necessarily limited to cases with an impact on system-wide financial stability, as stated by the IMF but, based on specific market conditions, they could comprise also those events having effect only at regional or multi-regional level that could unpredictably cause a deep impact on financial stability and real economy.	BdI, MEF	ST
Reinforce the DGS by removing active bankers from their boards; assessing the adequacy of funding targets; strengthening backstops; and avoiding the use of	With reference to DGSs and safety nets, the national DGS (FITD) has recently taken measures that move in the direction indicated by the IMF recommendations. Indeed, the DGS has promoted and the Banca d' Italia has approved a by-law amendment in which the independence of the Chair of the Board is streamlined and strengthened. Further increases of the degree of independence of the FITD Board could be discussed in the future.	DGS, BdI, MEF	ST

Recommendations	Authorities' Self-Assessment of Implementation[1]	Agency	Time[2]
Reinforcing Crisis Management and Safety Nets			
DGS resources for failure prevention outside of resolution or liquidation as much as possible, only using it in exceptional cases with strong prospects for successful rehabilitation and restoring long-term viability.	Finally, BdI disagrees on avoiding the use of DGS resources for failure prevention outside of resolution or liquidation as much as possible. Indeed, in Italy the so-called "preventive interventions" have been successful over the last 20 years. These interventions, explicitly envisaged by the European legislation and by the IADI Core Principles, can be a helpful instrument to prevent or face bank crises at an initial stage, before they evolve in resolution or liquidation. BdI agrees on using preventive intervention only in presence of strong prospects for ensuring successful rehabilitation and long-term viability.		

[1] Prepared by the Italian authorities.

[2] C = Continuous; I = Immediate (within one year); ST = Short Term (within 1–2 years); MT = Medium Term (within 3–5 years)

Annex VI. Italy's Anti Money Laundering and Anti-Corruption Frameworks

1. **Italy continues to take important steps to strengthen the effectiveness of the AML/CFT framework, though enhancing transparency and availability of beneficial ownership information is still in progress**. New regulations were recently adopted to enhance the cooperation and exchange of information and financial intelligence of the Italian financial intelligence unit (UIF), which will strengthen the prevention and enforcement against financial crimes[1]. The UIF implemented an internal reorganization for efficiency of processes and enhanced the dissemination of financial intelligence to the National Prosecutor's Office (DNA). Following FSAP recommendations, the Bank of Italy (BoI) continue enhancing its supervisory practices in relation to money laundering and terrorism financing (ML/TF) risks and is planning to define a new internal set-up for AML/CFT supervision of financial institutions. While concrete legal steps have been taken towards the creation of the Register of Beneficial Owners[2], Italy has yet to implement the register in line with the 4th and 5th AML Directive since the publication of the corresponding decree and its entry into force are still pending.

2. **Domestic and transnational corruption risks, including those related to the COVID-19 pandemic, prompted concerted efforts and transparency safeguards**. The 2019 Anti-Corruption Law set-up a two-pronged approach focused on prevention and enforcement against corruption. Relevant measures include debarment of public officials and private/individuals convicted for corruption; permanent inability to contract with public administrations and permanent disqualification from public office; strengthening of individual and economic sanctions; and freezing of the statute of limitation. The COVID-19 pandemic increased risk of corruption prompting additional safeguards including guidelines and inspections to prevent the misuse of public resources. Most notably, all procurement activities are transparent and available to auditors and citizens in real time. In addition, joint efforts of the Guardia di Finanza (GdF) and the National Anti-Corruption Authority (ANAC) enabled automated risk indices, crossing of relevant databases, and specific situational analyses. ANAC is currently drafting the new National Anticorruption Plan (PNA), incorporating lessons learnt from the pandemic scheduled to be issued for stakeholder consultation in June 2022. The PNA will focus on Anti-Corruption measures targeted to protect the National Recovery and Resilience funds with particular attention to public contracts. The GdF and the State General Accounting Office enhanced their cooperation to prevent procurement fraud related to the Next Generation EU program for investments in goods and service. The authorities are also engaged in the fourth phase of the evaluation of Italy in implementation of the OECD Anti-Bribery Convention, which should provide additional input upon its publication. Italy is also actively involved

[1] Legislative Decree n. 186 of 8 November 2021 has transposed into the domestic law the EU Directive 2019/1153.

[2] The MEF drafted a decree establishing the Register of Beneficial Owners, which received a positive opinion from the Council of State in 2021 and was subsequently signed by relevant Ministers. In March 2022, the draft decree was sent to the Ministry of Justice for review and eventual publication in the Official Gazette. The Italian Register of Beneficial Owners would be operational within 60 days of the decree coming into force, pending specific legislative measures to be adopted by the Ministry for Economic Development (MiSE).

in the G7, G20 and OECD anticorruption efforts, promoting a holistic view of corruption, including its nexus to organized crime and ML/TF crimes.

3. Important mitigation measures were taken towards the effective detection of potential evasion and ill-gotten proceeds related to Russia sanctions. The authorities note that Russian related sanctions address vast and complex networks of economic interests, often articulated through multiple companies that employ significant personnel, creating a significant spillover effect on non-designated individuals and companies, and that significant resources are needed for the managing and maintenance of the frozen properties. Italy has a centralized system for the management of counter-terrorism financing and the implementation of UN and EU sanctions, and BoI called on all reporting entities for prompt compliance. In order to mitigate the possible risks of evasion of the freezing measures imposed on Russia, at an operational level, the GdF uses intelligence and targeted investigations aimed at reconstructing the financial position of listed subjects and for the identification of Russia-related assets or suspected of having an illegal origin or destination.

Annex VII. Italy's Superbonus Tax Credits

1. Introduced in mid-2020, Italy's Superbonus 110 is a government program to mitigate the economic impact of the pandemic through tax incentives for green investments by households.

2. *Main features:* Tax credits of up to 110 percent are available on eligible expenses for retrofitting existing properties to make them more energy efficient and/or more resilient to seismic events. Each qualifying expense is subject to a specific maximum cap, which also varies by type and size of the property. The interventions must improve building efficiency by at least two energy classes (or to the highest class) or by one seismic risk class.

- *Energy efficiency (primary) interventions* cover installation of thermal insulation and replacement of an existing heating system with a class-A heating/cooling system. Installation of electric car charging stations, solar panels, or new windows may also qualify if undertaken in conjunction with one of the primary qualifying interventions.
- *Interventions to reduce seismic risks* may qualify only in high seismic-risk municipalities.
- *Other eligible interventions* include renovating building facades, improving building accessibility for people with disabilities and purchasing furniture and appliances.

3. *Eligibility*: Private individuals, including foreigners, are eligible on a maximum of two properties per individual, provided they own the property and it is not used for business purposes. Condominiums, apartment blocks, housing cooperatives, social housing, non-profit and voluntary organizations, and amateur sport associations and societies are also eligible.

4. *Program duration*: Expenses incurred between mid-2020 and end-2023 in the case of single-family homes, and end-2025 for condominiums and social housing, are eligible.

5. *Fiscal cost:* From its introduction an envelope of €33.3 billion of on-budget resources has been allocated for the financing of the scheme. An additional envelope of about €14 billion is funded by the NRRP. Through June 2022, €38.7 billion (2 percent of GDP) have been committed.

6. *Receiving the tax credit:* Up to 110 percent of total qualifying primary investment expenditure can be used as a credit against taxes due by the homeowner. The tax credit can be divided into five equal portions to offset income tax payable over five consecutive years. Alternatively, homeowners may transfer the tax credit partly or in full to a bank or other financial institution or to contractors, typically at a sizable discount on the face value. Transferability allows the homeowner to undertake the green investment without incurring any out-of-pocket expenses by using the credit to pay the contractor or to repay a loan taken out to finance the investment.

7. *Assessment*: The Superbonus scheme has been highly successful at ensuring a strong post-pandemic recovery in construction, and in GDP more generally. Moreover, with housing one of the largest sources of carbon emissions, increasing the energy efficiency of housing is essential for meeting climate targets. However, the scheme has several design challenges:

- *Value for money is low* as energy efficiency is poorly targeted and the subsidy rate is excessive. In 2021, some 57,000 buildings (out of 12.4 million buildings in Italy—less than 0.5 percent of the total) were renovated under the scheme, delivering only 0.6 Mtoe in *lifetime* energy savings against *annual* final residential energy consumption of 30 Mtoe, notwithstanding the large fiscal cost. Moreover, the very high rate of tax credit (more than the cost of the investment) subsidizes part of spending that would have occurred anyway and encourages moral hazard as households have no incentive to prevent over-invoicing.

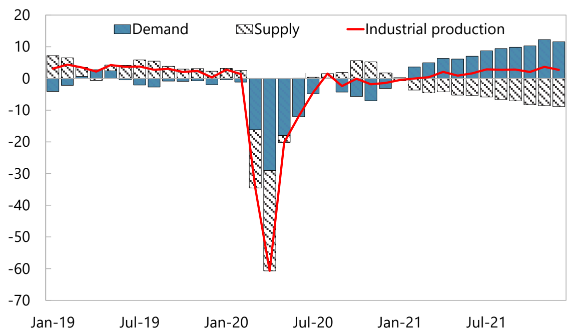
- The scheme is *regressive* as spending on improvements is likely higher by wealthier households, and associated spending caps are set at relatively high levels.

- The scheme remains *vulnerable to excessive markups*, although a measure to reduce fraudulent claims for tax credits (by allowing credits to be transferred at most three times among regulated financial institutions but only once for other entities) has been introduced.

Annex VIII. Supply Disruptions and the Role of Foreign Value Added

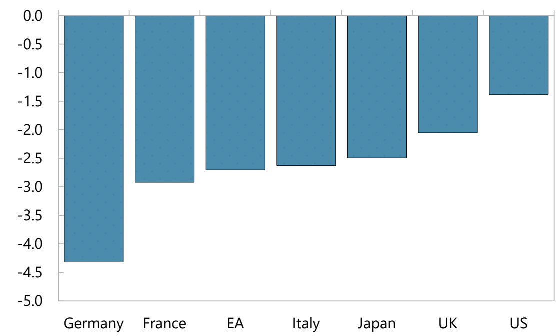
1. **Supply constraints likely held back Italy's GDP growth in 2021.** Using a structural VAR, Celasun and others (2022) estimate that supply bottlenecks significantly impeded Italy's industrial production growth in 2021, reducing GDP by 2½ percentage points relative to a counterfactual without supply constraints.

Italy: Contributions to Industrial Production Fluctuations
(Percent)



Source: Celasun et al. (2022)

Advanced Economies: Impact of Supply Shocks on GDP, 2021
(Percent deviations compared to the counterfactual without shocks)



Source: Celasun et al. (2022)

2. **Surveys of firms by the Bank of Italy confirm the presence of widespread sourcing problems.** Of surveyed manufacturing companies, 60 percent experienced difficulties procuring raw materials or intermediate goods in 2021. Firms that were more reliant on imported inputs were more likely to face sourcing problems. A related survey found that companies expected shortages to remain unchanged or to worsen in 2022. Nonetheless, turnover of companies facing input shortages grew faster than for those without input constraints, suggesting that shortages were a function of the strength of demand. Moreover, exports of companies that use imported intermediates more intensively grew faster than those of less import-intensive firms. To limit their future exposure to supply bottlenecks, 65 percent of firms with supply problems planned to diversify their suppliers, 25 percent intended to replace foreign suppliers with domestic ones or ones located closer to Italy (near shoring), while 10 percent planned to replace domestic with foreign suppliers (offshoring).

3. **In sum, supply constraints appear to have been a material drag on Italy's GDP growth in 2021, though by less than in some other EU countries, and conditions may have worsened in 2022.** However, in Italy—as in a number of other large economies—concerns about input shortages may have fueled a precautionary accumulation of inventories, suggesting that the presence of supply constraints may itself have contributed to the strength of demand. To increase resilience to future supply disruptions, a majority of Italian exporters preferred further diversification and internationalization of suppliers, rather than deglobalization. However, geopolitical tensions could limit their ability to implement this response.

4. **Italy has become more globally integrated over the past two decades.** The share of foreign value added in Italy's exports has risen from 19 percent to 23 percent during 2000–18, with

the EU contribution rising from 9 percent to 11 percent. Similarly, the value added in Italy's final domestic demand contains about 11 percent from the rest of the EU, about 12 percent from non-EU countries (the largest partners being the US and China), with the residual reflecting Italian value added. For both exports and domestic demand, the EU27 as a whole is more dependent on inputs from non-EU countries than is Italy.

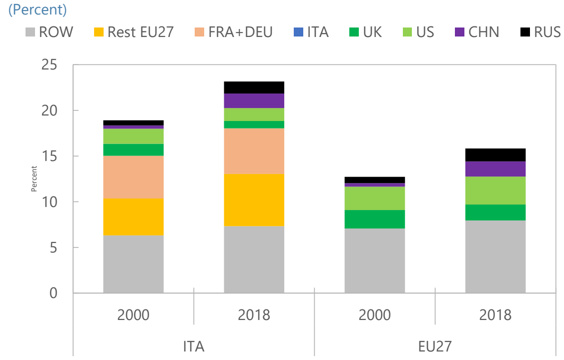
5. **Much of Italy's dependence on non-EU regions reflects demand for basic materials, including mining, petroleum and metals.** For manufacturing, the EU is the dominant supplier of foreign value added, although a sizable part also comes from China for the computer, electronics and electrical sector and for textiles.

6. **Fragmentation of global supply chains and greater recourse to near-shoring from EU countries would still allow Italy access to the majority of its production inputs.** However, this ignores that some inputs from other regions may not be readily available closer to home.

Text Figure. Italy: Trade in Value Added

The non-EU VA in Italy's exports has risen since 2000, mainly due to greater contribution from China and Russia,...

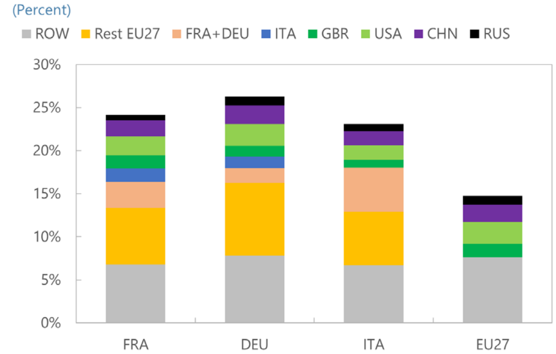
Foreign VA share of Gross Exports, 2000 & 2018
(Percent)



Sources: OECD; and IMF staff estimates.

The share of foreign non-EU VA in the total final demand remains limited.

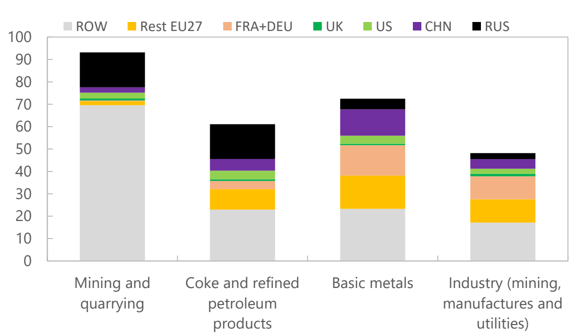
Foreign Value Added in Total Final Demand, 2018
(Percent)



Sources: OECD; and IMF staff estimates.

However, it is significant for some industries, including mining, petroleum products, and metals,...

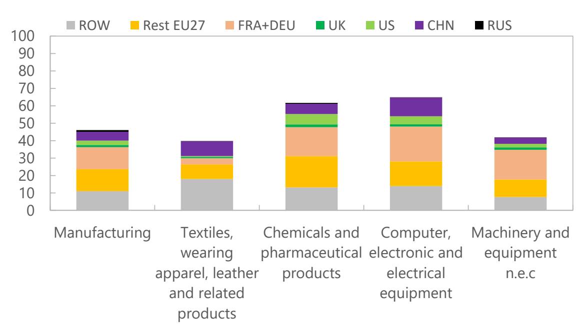
Origin of Value Aded in Italy's Total Final Demand, 2018
(By source country, percent)



Sources: OECD; and IMF staff estimates.

...as well as computer electronics, textiles, and chemicals.

Origin of Value Aded in Italy's Total Final Demand, 2018
(By source country, percent)

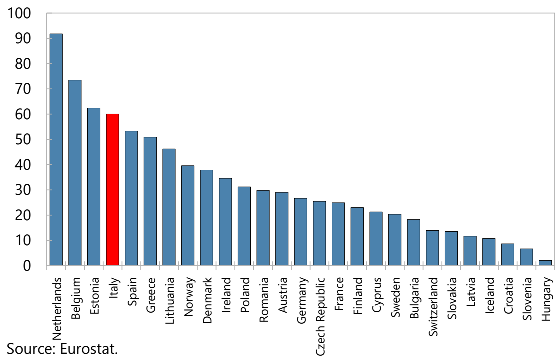


Sources: OECD; and IMF staff estimates.

Annex IX. Energy Shock: Transmission and Policy Response

1. A very large jump in European gas prices has been partly passed through to domestic energy prices. Since late 2021, a 500 percent increase in regional wholesale gas prices caused a significant domestic impact. Wholesale gas prices are transmitted to wholesale electricity prices in the context of the marginal cost pricing (MCP) framework, which balances electricity supply and demand in the spot market. The last unit of electricity sold at any point in time is priced at its marginal cost. With gas being recently the most expensive to generate, wholesale electricity prices increased by a similar magnitude. The transmission to retail prices (both electricity and gas) was more gradual and partial, yet substantial. Benefiting from significant non-tradable components like distribution fees and taxes (which accounted for 30–50 percent of the bill, depending on energy price) and policy interventions, retail prices gradually reached only around 70 percent above pre-pandemic levels, still the fourth highest in the EU (see chart).

Europe: Electricity Price Increase
(Percent, Jan-Apr 2022 vs 2019 average)



Source: Eurostat.

2. Differences in institutional arrangements affected the magnitude and timing of the impact on end-users. A large number of producers, wholesalers and retailers of energy operate in the free market where daily spot and futures prices of electricity and gas are set. Given free trade in energy at the EU level, these wholesale prices are closely aligned with developments in other EU markets. However, at the retail level, around 40 percent of end-users operate in the protected market (scheduled to expire in 2024) in which their tariff is reset every three months by the Italian energy regulator, ARERA, based on developments with wholesale prices. Remaining end-users operate in the open market and are free to choose their utility providers, which can draw on the possibility of buying energy at futures prices and selling to end-users under fixed-price contracts of one year or sometimes longer. Around half of electricity consumers choose such fixed-term contracts in the open market. Staggered resetting of these contracts causes prices in the free market to gradually increase.

3. For some sectors, price developments generated windfall benefits. MCP implies that inframarginal units of electricity are sold at that same marginal price, independent of their production cost. Generation from renewables—which comprises a third of electricity sold—is much less costly to produce than generation from fossil fuels, making it possible for those generators to earn significant windfall profits. Also, import prices, generally governed by longer-term contracts, have seen a smaller price increase than those observed in wholesale spot markets, making it possible for importers to resell and reap large gains (see chart). As a result, end-users' prices would increase significantly more than import prices, thereby amplifying the negative terms of trade shock. To the extent that some renewables producers or gas importers had already sold their energy in the futures markets when prices were still low, in practice these windfall gains could have accrued to other intermediaries in the energy sector.[1] Also, the government generated exceptional revenue as energy bills are subject to ad-valorem taxes (see table below summarizing impact by sector).

Italy: Sectoral Gains and Losses from Higher Imported Gas Prices (Without Redistributive Policies)

Foreign primary energy exporters	++
Domestic energy sector	+
Government	+
End-users (households and non-energy corporate users)	- - - -

Note: "+" ('-") indicates gain (loss). The number of + and – indicates the relative size of sectoral gains and losses.

4. The government took measures to mitigate the impact on end-users. Measures include: (i) discounts on energy bills for poorer households (expanded to cover nearly 3 million families); (ii) partially suspending some taxes and fees on end users' gas and electricity bills (which previously accounted to 25–30 percent of total bills); (iii) granting tax credits to large corporates on 15–25 percent of their energy bill if bills rose by more than 30 percent; (iv) a one-off cash transfer of €200 for households with an annual income below €35,000; and (v) allowing customers to pay their energy bills in instalments.

5. These relief measures were funded in part by redistributing the windfall gains accruing to other sectors. The government is tapping these extraordinary rents by: (i) giving back its own windfall tax revenue; (ii) establishing a "contract for difference" pricing mechanism for renewable electricity suppliers that claws back that part of revenue that arises when spot market prices exceed the contract price;[2] and (iii) imposing a 25 percent surtax on additional profits of all energy sector firms compared with their 2019 profits (as proxied by the difference of VAT accountable items).

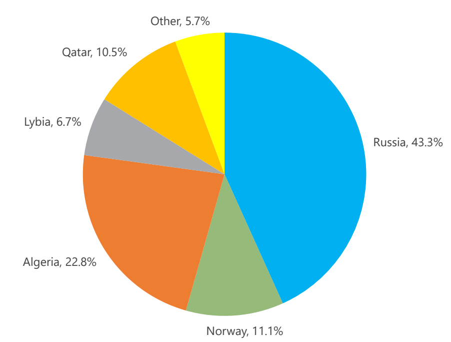
[1] Volatile electricity prices could also create financial stress for intermediaries that purchase in spot markets but sell at fixed prices, with any failures disrupting supplies to some customers.

[2] The CfD scheme is symmetric—the government compensates RE companies when spot market prices are below the contract price. The guaranteed price is set at a level to ensure adequate return on investment so as to encourage new investment in renewables capacity.

Annex X. Output Loss Estimates from Interruption of Russian Gas

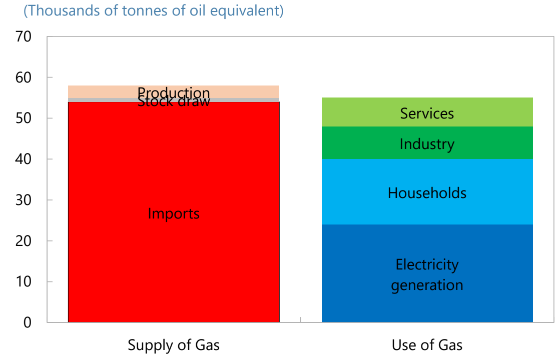
1. **Russian gas constituted 40 percent of Italy's gas supplies in 2021 (about 13 percent of total energy needs), but has since fallen sharply.** Most Russian gas is piped in, but a small part arrives as LNG. Other major gas suppliers are Algeria, Norway, Qatar, Libya and the US. In late 2021–early 2022, the US sharply increased LNG exports to Italy. Natural gas provides about half of Italy's primary energy needs. The share and absolute amount of energy from gas has risen over time as Italy reduced its consumption of oil—and to a lesser extent—coal. Italy uses gas for electricity generation, industrial purposes and consumption by households (mainly for heating) and the service sector. Nearly half of Italy's electricity is generated from gas. The share of gas from Russia has declined significantly in early 2022, falling to around half of previous year's supplies in June. However, alternative supplies from other countries have fully covered the shortfall from Russia.

Italy: Natural Gas Imports by Country, 2020



Sources: Eurostat; and IMF staff estimates.

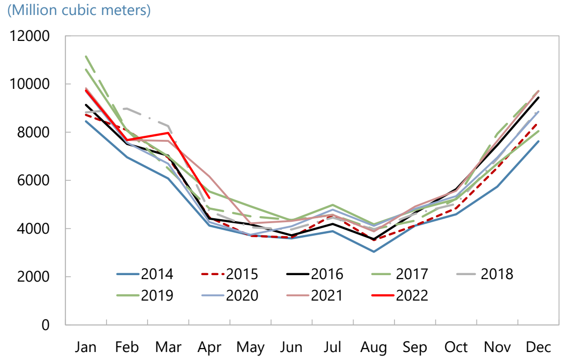
Italy: Natural Gas Sources and Uses, 2020
(Thousands of tonnes of oil equivalent)



Sources: Eurostat; and IMF staff estimates.

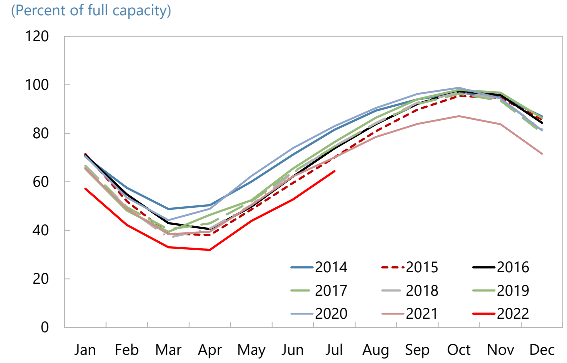
2. **Gas consumption has high seasonality and is also very sensitive to cold weather conditions.** With around 15 percent of gas on average used for home heating, gas consumption is heavily concentrated in the colder months of the year. As a result, during the colder months of September–February, Italy typically consumes about 62 percent of its total annual gas usage. However, a cold winter can increase in annual gas consumption by 5–10 percent. The seasonality of gas prices allows Italy to import heavily in the summer months when prices are typically low in order

Italy: Natural Gas Consumption
(Million cubic meters)



Sources: ESTAT; and IMF staff estimates.

Italy: Natural Gas Storage
(Percent of full capacity)



Sources: ESTAT; and IMF staff estimates.

to build up storage ahead of winter, and then to economize on imports when prices are at their highest at the end of winter. The stock of stored gas therefore peaks in late autumn at around 95 percent of storage capacity and reaches a minimum of around 40 percent in early spring. Storage levels during 2022 have been below levels of previous years.

3. **In a scenario with full interruption of Russian gas flows into Italy from July 2022, staff estimates a net gas shortfall of 15 percent of total gas supplies over the subsequent 12 months.**[1] The gross shortfall of Russian gas could be partially met by: (i) additional inflows resulting from recent agreements with other gas suppliers replacing 40 percent of total Russian flows; (ii) delaying the retirement of coal power plants, thereby freeing up gas for other uses, and (iii) allowing a larger seasonal drawdown of gas inventories to 10 percent of storage capacity by next spring (compared with the 32 percent minimum achieved this year). However, with existing LNG handling capacity close to full utilization, and an additional 5 bcm in new LNG capacity expected to come online only in spring 2023 (with a further 5 bcm in 2024), there is limited scope to further increase LNG imports to alleviate gas shortages during the upcoming winter.[2] As the situation is continuing to evolve, the net gas shortfall could deviate from the current estimates, in both upside and downside directions.

Table AX.1. Italy: Estimated Gas Shortfall Under Full Russia Shut Off, 2022–24

		Jul-2022/ Jun-2023	Jul-2023/ Jun-2024	Jul-2024/ Jun-2025
Total gas supply under the baseline	bcm	76	76	76
Imports from Russia (gross shortfall)	bcm	29	29	29
Extra use of gas inventories 1/	bcm	3.5	0	0
Alternative supplies	Percent of Russian gas	40	75	85
	bcm	11.6	21.8	24.7
Other additional energy sources		13	15	16
coal for electricity generation	Twh	13	15	16
	bcm 2/	2	3	3
Residual gap (net shortfall)	bcm	11.6	4.6	1.5
	Percent gas supply	15.2	6.0	2.0

1/ Reducing minimum storage to 10 percent by Spring 2023 instead of normal 30 percent.
2/ Natural gas equivalent after accounting for transformation losses in gas power plants.

4. **The GDP loss from a gas shortfall depends, inter alia, on how the scarce gas is allocated across sectors.** Price is typically the method used to allocate goods and services. However, in the context of limited supply, the price increase needed to clear the market may be very large and preclude some priority users from accessing gas. Consistent with EU policy and Italy's emergency

[1] A study by Bruegel estimates the needed reduction in demand for gas in order to get through next winter in the absence of Russian gas is 9 percent for Italy, compared with zero for France and Spain and 29 percent for Germany.

[2] The coming onstream of new LNG capacity next spring allows the minimum gas storage level to be drawn down below normal levels over the coming winter. With the new LNG capacity, the gas shortfall during mid-2023 and mid 2024 is expected to decline to around 6 percent of total gas needs.

plan, we assume households have preferential access to gas and electricity, thereby further reducing the amount of energy available to "productive" sectors. We also assume that the service sector, which has a high value added per unit of energy consumed, is partially protected.

5. Considering only production-side effects, the output loss from the gas shortfall could be on the order of 3½ percent relative to a no shutoff counterfactual during mid-2022 and mid-2023.[3] This estimate assumes only limited near-term scope for replacing gas with other energy sources in production, approximating a fixed-proportion, Leontief production function. However, substitution of part of gas with coal in the generation of electricity is assumed, introducing some overall elasticity of substitution in production.[4] The scenario further assumes full protection of the strategic food and agriculture sectors and partial protection of households. In addition, more energy-intensive sectors (e.g., non-metallic minerals and iron and steel) are assumed to face a larger percentage reduction in their consumption of gas and electricity. Downstream supply chain impacts and aggregate demand effects could increase the output loss.[5,6] Table AX.2 summarizes the assumed reductions in gas supplied to each sector. The implied increase in shadow prices needed to achieve the imposed quantity reductions, based on sector-specific demand elasticities obtained from the literature, are shown in Table AX.3. The shadow price of gas for households increases the least owing to the relatively small supply reduction and the highest demand elasticity, while the largest shadow price increase is for industry.

Table AX.2. Italy: Natural Gas and Electricity Reduction by Sector 1/

Natural gas (final consumption)	Rationing 2/	Residual consumption	Electricity use (final consumption)	Rationing 2/	Residual consumption
	percent	*TWh*		*percent*	*TWh*
			Gas inputs in electricity production		229
		386	Total electricity		338
Industry	-7.5	98	Industry	-7.5	116
Services	-4.0	82	Services	-4.0	77
Households	-3.0	166	Households	-3.0	67
Transport, agriculture	0.0	14	Transport, agriculture	0.0	17
Other	-5.0	27	Other	-5.0	62
Gas usage before shutoff		405	Gas inputs in electricity before shutoff	321	
Natural gas total demand, including for electricity					
With full shutoff		616			
Counterfactual without shutoff		726			
Change, percent		-15			

1/ Under a scenario with full shutoff of Russian gas.
2/ Reduction relative to the counterfactual with historical level of Russian gas flow

[3] The no shutoff counterfactual assumes Russian gas imports continue at their historical level. This differs from the current situation where Italy's imports of Russian gas have been halved since mid-June and which underpins the baseline macroeconomic forecasts. Italy has been able to replace these reduced flows from Russia. However, this has resulted in much higher European gas prices, which will have an adverse impact on GDP.

[4] An average transformational loss of around 50 percent when using gas to generate electricity is assumed.

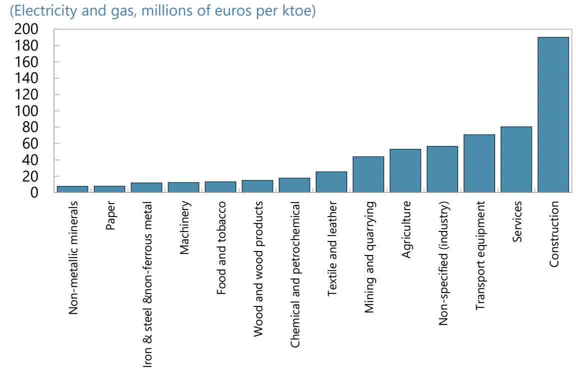
[5] Resulting downstream shortages of intermediate inputs could be partially relieved with higher imports.

[6] Specifically, a reduction in available gas shifts the aggregate GDP supply curve leftward. Aggregate demand could also shift inward due to adverse confidence effects or higher interest rates, but these are excluded here. As a result, the new equilibrium corresponds to a movement along the largely-unchanged demand curve, and results in a smaller level of aggregate output and a higher price level.

6. The rate at which GDP declines in response to a rising shortfall of Russian gas is likely to be nonlinear. This reflects three factors. First, for relatively modest reductions in Russian gas, these can be fully offset by alternative gas supplies. Second, with households' access to gas partially protected, the effect of a reduction in gas supplies will be borne disproportionately by sectors that directly generate GDP. And third, within the productive sector, there is a very wide cross-sectoral range of value added per unit of energy consumed. Starting with the sector with the lowest value-added per unit of energy consumed and sequentially shutting off access to gas for more value-added generating sectors (i.e., moving rightward across the sectors in the text chart) as the need for rationing increases, implies that GDP losses will increase more than in proportion to shortage of gas. Such an outcome could be approximated through a reverse action whereby industrial users bid for compensation in exchange for not consuming gas.

Italy: Value Added per Energy Input

(Electricity and gas, millions of euros per ktoe)



Sources: Eurostat; and IMF staff estimates.

Table AX.3. Italy: Price Elasticities of Demand for Gas and Increases in Shadow Prices

	Price elasticity	Gas supply rationing	Implied price increase
	ΔQ/ΔP	ΔQ, percent	ΔP, percent
Industry	-0.08	-7.5	89.3
Services	-0.10	-4.0	40.0
Households	-0.24	-3.0	12.5

7. Several other studies estimate the GDP loss for Italy from a full suspension of Russian gas, with the findings highly-sensitive to specific assumptions and the modeling approach (Table AX.4):

- The Bank of Italy estimates that in the event of a total interruption of gas from Russia, recourse to other suppliers and increased domestic extraction could offset during a 12-month period around two fifths of the shortfall.[7] Production of the electricity, gas, steam and air conditioning sectors would decline by around 10 percent, reducing output in energy-intensive manufacturing. Including effects of input shortages in downstream sectors, together with falling employment and income, is seen as lowering aggregate domestic and external demand and reducing GDP by approximately 4.5 percentage points over a 12-month period with respect to a scenario of no interruption of gas.
- The Ministry of Finance assumes a gas shortage equal to 18 percent of imports by volume in 2022 and 15 percent of imports in 2023[8] as well as higher gas and electricity prices.[9] The impact

[7] Bank of Italy "Macroeconomic projections for the Italian economy - June 2022".

[8] Based on evaluations carried out with the contributions of experts in the sector.

[9] Italy's Stability Program 2022.

on GDP is estimated through a two-stage simulation: 1) the impact of the rise in gas, electricity and oil prices on the activity of the economic sectors, GDP and gas consumption is estimated; 2) once the new demand is calculated, the share of gas consumption to be rationed needs to match the overall decrease in imports. The further decline in GDP needed to obtain the required decrease in gas consumption is accordingly calculated. The overall GDP losses amount to 2.3 percentage points in 2022 and 1.9 percentage points in 2023. The simulation, which was carried out at the end of March, and assumed that gas imports from Russia would fall to zero from May 1, 2022, whereas they are still ongoing, albeit at reduced volumes.

- Confindustria finds that a full shutoff of Russian gas from June 2022 onwards, together with the assumption of a gradual monthly increase in alternative gas sources, would impact GDP through two channels:[10] 1) the direct impact on sectoral value added, assuming a complete shut-off of gas-intensive manufacturing industries and, partially, of some service activities (i.e., accommodation, restaurants and trade), excluding indirect effects via shortages of inputs to down-stream industries; and 2) through the impact on households and firms' balance sheets due to additional commodity price increases. The overall impact on GDP is estimated at a cumulative reduction of 3.9 percent in 2022–23 (1.2 percent in 2022 and 2.7 percent in 2023).

- A forthcoming IMF Working Paper analyzes the implications of a full disruption of Russian gas on European countries using two different approaches:[11]

  - A multi-sector general equilibrium model with a globally-integrated market for LNG allows gas flows to adjust to equate supply with demand in each country at the common world market-clearing price.[12] Implicitly, therefore, it is assumed that there are no bottlenecks—such the absence of spare LNG handling capacity—to impede trade in gas between countries. As a result, increased demand for gas in one region raises the world price and diverts supplies from other regions of the world. In addition, some limited substitutability between energy and other factors of production is assumed, such that higher energy prices increase demand for other factors. The estimated GDP loss for Italy is between 0.6 to 2.1 percent over 12 months.

  - A multisector production-side model assumes energy is used in fixed proportions with capital in production. Prices play no role in allocating scarce gas, which is rationed across sectors through a common proportional across-the-board cut to supply. The estimated GDP loss is between 3.6 and 5.7 percent, depending on the degree to which households are insulated from gas cuts.

[10] https://www.confindustria.it/home/centro-studi/temi-di-ricerca/congiuntura-e-previsioni/tutti/dettaglio/congiuntura-flash-maggio-2022

[11] Di Bella G. and others (2022), "Natural Gas in Europe: The Potential Impact of Disruption to Supply," IMF Working Paper 22/145.

[12] See also Albrizio and others (2022), "Market size and supply disruptions: Sharing the pain of a potential Russian gas shut-off to the European Union," IMF Working Paper 22/143.

Table AX.4. Italy: Estimates of Output Loss from Full Termination of Russian Gas

Study	Shut-off date	Gas inventories usage	Alternative gas supplies	Gas shortage (percent of baseline)	GDP impact next 12 months 1/	GDP loss per 1ppt of gas shortfall	Energy substitution	Rationing	Households protected	Other parameters/ assumptions
BdI 2/	Jul-22		Y	24	-4.5	-0.19	Y	N	N	Incorporates further increases in energy prices, indirect effects from fall in employment, income and aggregate demand, as well as external demand and a deterioration in domestic confidence
MoF 3/	Apr-22		Y	17 on average	-2.8	-0.16	partial	Y		Extra external demand impact
Confindustria 4/	Jun-22		Y	18.5	-2.0	-0.11	N	Y	Y	All gas-intensive manufacturing industries and some service activities are shut off
IMF Multisector Model with demand spillovers 5/	end-Jun-22	reduce to minimum in 1st winter	Y	15	-3.7	-0.25	partial	Y	N	
			Y	15	-5.7	-0.38	partial	Y	Y	
IMF Multisector General Equilibrium Model 5/	end-Jun-22		...	...	-0.6	...	Y	N	N	EU fully integrated in global LNG market
			...	...	-2.1	...	Y	N	N	EU not fully integrated in global LNG market
IMF Italy team estimates	Jul-22	reduce min storage to 10 percent in Spring 2023 (instead of usual 30 percent)	Y	15	-3.6	-0.24	partial	Y	partial	Industry is rationed with the exception of food and construction, which are protected

Notes:
1/ 12 months from the shutoff date.
2/ Bank of Italy "Macroeconomic projections for the Italian economy - June 2022".
3/ Italy's Ministry of Finance "Stability Program 2022", second (most severe) downside scenario.
4/ Confindustria Economic Outlook May 2022.
5/ Di Bella G. and others (2022), "Natural Gas in Europe: The Potential Impact of Disruption to Supply," IMF Working Paper 22/145.

Annex XI. Progress on Past IMF Recommendations

2021 Article IV Policy Advice	Actions Since 2021 Article IV
I. Structural Reforms[1]	
Labor Markets	
Enhance social safety nets to provide reliable protection for those transitioning between jobs or remaining unemployed, or during downturns, while avoiding disincentives to work. Comprehensive reskilling and upskilling programs to raise productivity and facilitate necessary job transition.	Job acceptance requirements and links to training in the Citizenship Income program have recently been strengthened, and a means-tested universal child allowance was introduced in 2022. The National Strategic Plan for New Skills and the provision of support for women's entrepreneurship were introduced.
Product Markets/Competition	
Lower regulatory barriers to competition. Avoid delays in implementing legislated pro-competition measures.	In the NRRP, the authorities have committed to lowering product market regulation and to review the Competition Law annually.
Public Administration	
Modernize the public administration (PA) and streamline public administrative rules and procedures (including by expanding the use of digital services).	Legislation and implementation frameworks to support the execution of PA reforms under the NRRP (with a focus on strengthening recruitment, simplifying procedures, and increasing digital services) were adopted. A new recruitment portal for PA hiring is operational. It also establishes rules and requirements for the recruitment of personnel to implement NRRP-related measures.
Insolvency and Judicial Reforms	
Boost court resources and streamline insolvency and debt restructuring procedures. Reform civil procedures to simplify processes/reduce the length of trials.	The reform of the Italian civil justice system was approved by Parliament in late 2021. It aims at reducing the overall duration of civil proceeding (by 40 percent over the next five years) with a series of measures, including setting strict time limits for appeals, allowing for remote hearings for first instance proceedings, and increasing staffing.
II. Fiscal Policy	
Fiscal Consolidation	
Implement a credible medium-term structural consolidation to put debt on a firmly declining path. Legislate upfront pro-growth and inclusive measures to establish credibility.	The April 2022 Document on Economy and Finance envisages a gradual path of fiscal consolidation toward achieving a small primary surplus in 2025.

2021 Article IV Policy Advice	Actions Since 2021 Article IV
Improve the Quality of Fiscal Policy	
Curtail wasteful spending, rationalize social benefits, including pensions, and improve the design of the citizenship income program Raise capital spending and improve the quality of projects.	The citizenship income program has been strengthened by introducing controls to reduce fraud and links to training. The 2022 budget introduced a generous means-tested universal child allowance. Capital spending will be raised significantly during 2022–26 under the NRRP.
Undertake a comprehensive reform of the tax system, to broaden the tax base, lower statutory tax rates, and help fight evasion.	Guidelines for a comprehensive reform of the tax system were approved by Parliament in October 2021. The principles of the reform include: (1) reducing the tax burden; (2) rationalizing tax expenditures; (3) promoting equity; and (4) reducing tax evasion. As part of this reform proposal, the 2022 budget adopted an income tax reform that modestly reduces labor tax revenue by 0.4 percent of GDP in 2022–23. Tax compliance has been further strengthened with the introduction of electronic invoicing and reporting.
III. Financial Stability	
Maintain Bank Lending and Liquidity Support to the Real Economy	
Maintain bank lending to avoid renewed liquidity pressure as the economy reopens. Banks' risk retention on guaranteg89ged loans should increase and updated borrower credit checks should be required to extend loan moratoria.	The COVID-era public guarantee schemes are expected to be phased out, and guarantees will revert back to pre-COVID schemes; legislative loan moratoria for firms have expired. A new targeted public guarantee scheme was introduced to facilitate liquidity support to energy-intensive firms.
Enhance Banks' Asset Quality, Credit Risk Management, and Business Models	
Banks and the authorities should intensify efforts to improve their understanding of underlying loan quality, with timely classification, provisioning and restructuring of problem loans. Banks need to modify their business models, increase efficiency and reduce costs, as well as catch up in digital infrastructure and fintech capacity.	The authorities have enhanced credit risk analysis, loan classification and provisioning practices as well as business model sustainability analysis for LSIs. Banks' operating expenses decreased in 2021.
Address Distressed Banks	
The authorities should plan to take prompt, targeted action to deal with any individual distressed banks	The authorities have enhanced the analytical tools used to monitor and assess individual distressed banks.

[1] See https://italiadomani.gov.it/en/Interventi/milestone-e-target.html for more details on milestones and targets of the NRRP to be achieved by 2026.

INTERNATIONAL MONETARY FUND

ITALY

July 12, 2022

STAFF REPORT FOR THE 2022 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

Prepared By

European Department
(In consultation with other departments)

CONTENTS

FUND RELATIONS

(As of June 30, 2022)

Membership Status: Joined March 27, 1947; Article VIII.

General Resources Account:	SDR Million	Percent Quota
Quota	15,070.00	100.00
Fund holdings of currency	11,159.67	74.05
Reserve Tranche Position	3,910.41	25.95
Lending to the Fund		
New arrangements to borrow	92.06	
SDR Department:	SDR Million	Percent Allocation
Net cumulative allocation	21,020.03	100.00
Holdings	20,562.92	97.83

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				
	2022	2023	2024	2025	2026
Principal					
Charges/Interest	1.90	4.35	4.35	4.35	4.35
Total	1.90	4.35	4.35	4.35	4.35

Exchange Arrangements: The currency of Italy is the euro. The exchange rate arrangement of the euro area is free floating. Italy participates in a currency union (EMU) with 18 other members of the EU and has no separate legal tender. The euro, the common currency, floats freely and independently against other currencies.

Italy accepted the obligations under Article VIII and maintains an exchange system free of multiple currency practices and 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 December 2–10, 2020, January 25–February 8, 2021 and March 16, 18, 22 and 29, 2021; the staff report (IMF Country Report No. 21/101) was discussed by the Executive Board on May 26, 2021.

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
FSAP	March 2020	No. 20/81

Technical Assistance:

Year	**Department/Purpose**
2007	FAD: Public Expenditure Management
2012	FAD: Tax Policy
2015	FAD: Tax Administration

Data: Italy subscribes to the Fund's Special Data Dissemination Standard plus, and comprehensive economic data are available on a timely basis (Table 1).

STATISTICAL ISSUES

(As of July 11, 2022)

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.	
Government Finance Statistics: Annual and quarterly consolidated general government operations and financial balance sheet data are reported, with extensive time series. Component details on Expense (Interest, Grants, etc.) and transactions and stock positions in assets and liabilities by counterparty sector are not available.	
Monetary and Financial Statistics: The ECB reporting framework is used for monetary statistics and data are reported to the IMF through a "gateway" arrangement with the ECB for publication in the IFS. Monetary statistics for Italy are published in the IFS cover data on central banks and other depository corporations (ODCs) using Euro Area wide residency criterion. Italy reports data on key series and indicators of the Financial Access Survey (FAS), including the two indicators (commercial bank branches per 100,000 adults and ATMs per 100,000 adults) adopted by the UN to monitor Target 8.10 of the Sustainable Development Goals (SDGs).	
Financial Sector Surveillance: Italy participates in the IMF's financial soundness indicators (FSIs). The Italian authorities report all of the 12 core FSIs and 11 of the 13 encouraged FSIs for deposit takers semi-annually to the IMF and quarterly on their National Summary Data Page. In addition, 12 FSIs for other sectors are compiled and reported. FSI reporting is timely.	
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. In addition, Italy reports the International Reserves and Foreign Currency Liquidity Template (IRFCL) data and participates in the IMF's Coordinated Direct Investment Survey (CDIS) and Coordinated Portfolio Investment Survey (CPIS).	
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 adhered to SDDS Plus, together with the first group of adherents. **Implementing G-20 DGI recommendations:** Italy has achieved compliance with the core requirements in relation to many DGI recommendations for which data templates have been already defined. Further progress in the 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 July 11, 2022)

	Date of latest observation	Date received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of Publication[7]
Exchange Rates	Jul 11, 2022	Jul 11, 2022	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	Apr 2022	Jun 2022	M	M	M
Reserve/Base Money	Apr 2022	Jun 2022	M	M	M
Broad Money	Apr 2022	Jun 2022	M	M	M
Central Bank Balance Sheet	Apr 2022	Jun 2022	M	M	M
Consolidated Balance Sheet of the Banking System	Mar 2022	May 2022	M	M	M
Interest Rates[2]	Jul 11, 2022	Jul 11, 2022	D	D	D
Consumer Price Index	Jun 2022	Jul 2022	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3]—General Government[4]	Apr 2022	Jun 2022	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3]— Central Government	Apr 2022	Jun 2022	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Apr 2022	Jun 2022	M	M	M
External Current Account Balance	Mar 2022	May 2022	M	M	M
Exports and Imports of Goods and Services	Apr 2022	Jun 2022	M	M	M
GDP/GNP	Q1:2022	May 2022	Q	Q	Q
Gross External Debt	Q4:2021	Mar 2022	Q	Q	Q
International Investment position[6]	Q4:2021	Mar 2022	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-à-vis nonresidents.

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

Statement by Domenico Fanizza, Executive Director for Italy
July 27, 2022

We thank staff for the insightful and well-written papers that are rightly focused on Italy's current main policy challenges: (a) minimizing the economic impact of Russia's aggression against Ukraine; and (b) maximizing the impact of the National Recovery and Resilience Plan (NRRP) on potential growth. My authorities' comprehensive policy response has helped the economy rebound from the pandemic-induced slump. The authorities have also started to address long-standing structural challenges in the context of the NRRP. No doubt much work is still needed, but they are off to a good start. The country's recent economic resilience suggests that continuing these efforts will yield substantial payoffs.

1. The Post-pandemic Recovery and the Outlook

The pandemic hit Italy early and hard. In response, the authorities took strict measures to limit mobility and, as a result, economic activity came to a halt. **The rebound has so far been way stronger than expected**. The country's economic resilience has, indeed, been remarkable; the policy response has proved quite effective. The war has made for a gloomier outlook for the rest of this year and the next one, but economic activity in Italy has continued to move at a brisk clip, despite the surge in inflation and the slowdown in global growth. In fact, the latest WEO Update has just revised upward its growth projection for 2022—the only upward revision among G7 countries. Nevertheless, we do agree that the outlook for the next year has worsened because of: (a) the increasing likelihood of a gas shut-off by Russia; and (b) the tightening of global financial conditions, as a result of the central banks' efforts to bring inflation back to targets. The authorities have already reduced Italy's dependence on Russian gas by diversifying supply sources and simplifying procedures for investments in renewable energies. **A much-strengthened financial sector should withstand the adverse impact of tighter financial conditions**, and even possibly benefit from higher interest rates. Similarly, still declining average debt costs and a long average debt maturity would contain the impact on public finances. Thus, the authorities are more sanguine than staff on the growth outlook for 2023, also because of the favorable demand impact from the implementation of the NRRP.

2. Public Finances

Like elsewhere, the pandemic caused a step increase in the public debt-to-GDP ratio (21 percentage points) that reached 155 percent in 2020, no doubt a high level. However, staff project that 36 percent of this increase will be reverted by the end of this year, much sooner than expected only a few months ago. **This performance compares favorably with those of the other G7 countries** that experienced even larger percentage step increases. We believe these dynamics augur well for further reducing Italy's public debt burden. Indeed, under the baseline scenario, staff project further sizable reductions over the medium-term horizon. **The public finance position has indeed strengthened**. Buoyant revenue performance and strict expenditure control have improved the primary balance, despite additional temporary spending to shelter households and firms from the spike in energy prices. These efforts will continue over the medium term, with the objective of bringing the debt-to-GDP ratio, gradually, to its pre-pandemic level by 2030. Over the longer term, we believe raising trend-output growth will be essential to lower the debt burden.

It is reassuring that staff acknowledge that the authorities' budgetary projections have a conservative bias with, **often, better-than-budgeted outcomes**. Thus, we believe there are good chances that the 2022 fiscal outcome could be in line with staff's recommendation to save part of the revenue overperformance. Looking forward, the fiscal adjustment path will have to comply with the EU fiscal rules, when they resume. We believe that suspension of the existing fiscal rules should continue until new rules are agreed upon.

Public-sector financing requirements have remained substantial, but **are declining and projected to reach pre-pandemic levels in 2023**. The average debt cost is projected to decline at least until 2025, even under pessimistic assumptions on borrowing costs, as new issues replace maturing high interest-bearing securities. Moreover, the ECB has committed to roll over its holdings that come to maturity. Overall, financial conditions for placing Italian debt appear favorable. Increases in secondary market spreads appear to have reflected more domestic political noises than fundamentals.

3. Financial Sector

The Italian banking sector has strengthened since the start of the pandemic. Capital and liquidity buffers have significantly risen, despite banks resumed dividends' distribution: (a**) the stock of outstanding gross NPLs has continued to decline to reach about 3 percent** of total loans; and (b) the flows of new NPLs have dropped to only 1 percent of loans. Both households and corporations maintain large liquidity buffers against rising prices and interest rates that should cushion the impact of tighter financial conditions on both consumption and investment.

Banks' profitability has improved with higher returns on equity, reflecting mainly reductions in fixed costs. The impact on banks' profitability from the expected rise in interest rates should be favorable overall. The expected increase in net interest income should more than offset the amount of additional loan-loss provisions necessary to deal with a possible rise in NPLs over the medium term. Bank of Italy estimates a quite limited reduction in capital buffers as a result of the impact of higher interest rates on the market value of banks' holdings of fixed-income securities. There is no evidence suggesting a deterioration of the quality of loans previously subject to moratoria or under public guarantees.

Nevertheless, we agree with staff that a cautious approach to bank capital is needed; pre-emptively restricting dividends distributions could be considered on a case-by-case basis, depending on individual banks' capacity to withstand a severe and protracted economic downturn.

Progress has been made on numerous key recommendations from Italy's 2020 Financial Sector Assessment Program (FSAP), including on credit risk analysis for less-significant banks, loan classification and NPL provisioning practices, and the macro prudential framework.

Small- and medium-sized banks that fall under the supervision of the Bank of Italy have reduced risks and improved their capitalization, as a result of a pro-active and preemptive supervision approach, which identified remedial measures to improve the position of the most fragile intermediaries.

4. Structural Priorities

The authorities reiterate their commitment to a steadfast implementation of the NRRP that will provide a significant boost to Italy's economic performance, by supporting domestic demand in the short-term, and more importantly, lifting supply constraints over the medium-term to boost potential growth. Moreover, making the best use of the EU Recovery and Resilience Facility (RRF) funds will help close the public investment gap, which will lift potential output and crowd in private investment. **So far, all the NRRP-envisaged targets have been met.**

We wish to point out that projects that support the ecological transition absorb most of the NRRP's resources. **Staff rightly note Italy has made substantial progress in reducing Green House Gas (GHG) emissions**, but less in lowering GHG intensity of production in comparison with other European countries. However, all the countries included in the comparison still rely on nuclear power generation that has been banned in Italy since 1987.

We agree that a carbon tax would help achieve Italy's "Fit for 55" target, as suggested by staff. However, **to be effective, carbon taxation should be implemented only in the context of an EU coordinated approach that includes a Carbon Border Adjustment Mechanism**, building on the successful experience of the European Emissions Trading System (ETS). We would have welcomed staff's input on "second-best" policies that could be followed in the absence of an EU coordinated approach, particularly considering the already quite high level of energy taxation in Italy.

5. Conclusions

During the last year, policies have managed to successfully balance, on the one hand, the need to reduce the public-debt burden with, on the other hand, supporting the pandemic recovery and containing the adverse impact of high energy prices and inflation on the weakest population. **The financial sector has worked well to sustain the recovery and is now in a much stronger condition, which should help withstand adverse shocks**.

Moreover, the authorities have laid down the groundwork to implement the NRRP that should help improve productivity growth and address long-term vulnerabilities.

No doubt, a gas shut-off by Russia would trigger a downside scenario. The authorities have already started implementing their risk-mitigation strategy that aims at severing the country dependence on Russian gas by 2024; they believe a coordinated European response would be warranted in the event this scenario materializes.